

Christopher Miller, November 2008

## The Current Market for Hedge Funds

### Key Points

- Hedge funds are not all the same, but deleveraging and redemptions are very common issues at the moment.
- Remember the three Ds - Diversification, Due diligence and Darwinism.
- The overhang of potential redemptions towards the end of 2008 could stress popular hedge fund strategies.
- For crowded strategies, subscriptions or the end of deleveraging could be very positive, but more redemptions, further deleveraging or shutdowns could cause further losses.
- Change brings opportunity. Seek out the less crowded trades and more innovative strategies.

### The Rationale for Hedge Funds is bruised but still valid

- Hedge funds usually produce returns which are uncorrelated to conventional investments.
- Diversified Hedge Funds tend to produce better risk adjusted returns over time.
- Providing your due diligence screens out the pitfalls of hedge funds, they can provide a very useful profit stream.
- The saying that hedge funds can produce profits whether the underlying market is up or down is still true, but we now know what can happen when externalities happen, like removal of ability to short, exercise leverage or mass redemptions.

### But What Happened?

- Many hedge funds may have lost money recently, but a diversified portfolio of hedge funds will still have outperformed equities during the crisis and over a longer horizon.
- Longer redemption periods protected hedge funds from worse forced liquidations, but now funds are exiting strategies to make cash for the redemptions, and to offset hedging losses.
- Correlated hedge fund losses started from enforced deleveraging, and then accelerated with redemptions.
- Other losses have arisen from the fall in equity markets and curbs on short selling. Some consider the curbs to be market manipulation.
- Funds have started to impose "gates" or create "side pockets" for illiquid holdings. We consider the latter option is fairer, providing that it is not a surprise to investors.

### What Should happen?

- Tighter regulation is regarded as inevitable. We consider that the biggest obstacle to genuine risk management is the lack of coordination between regulators and prime brokers.
- We need a global risk management agency to monitor exposures of funds, investment banks, countries or other entities, aggregating data across countries and prime brokers, to find concentrations of risks that may not be apparent to investors or an individual prime broker, when the fund has multiple prime brokers.
- Hedge funds will have to adapt to much less availability of leverage. Some strategies will continue to prosper, and others will wither.
- Picking the right hedge funds will be even more important in the future.

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## The Hedge Fund Story

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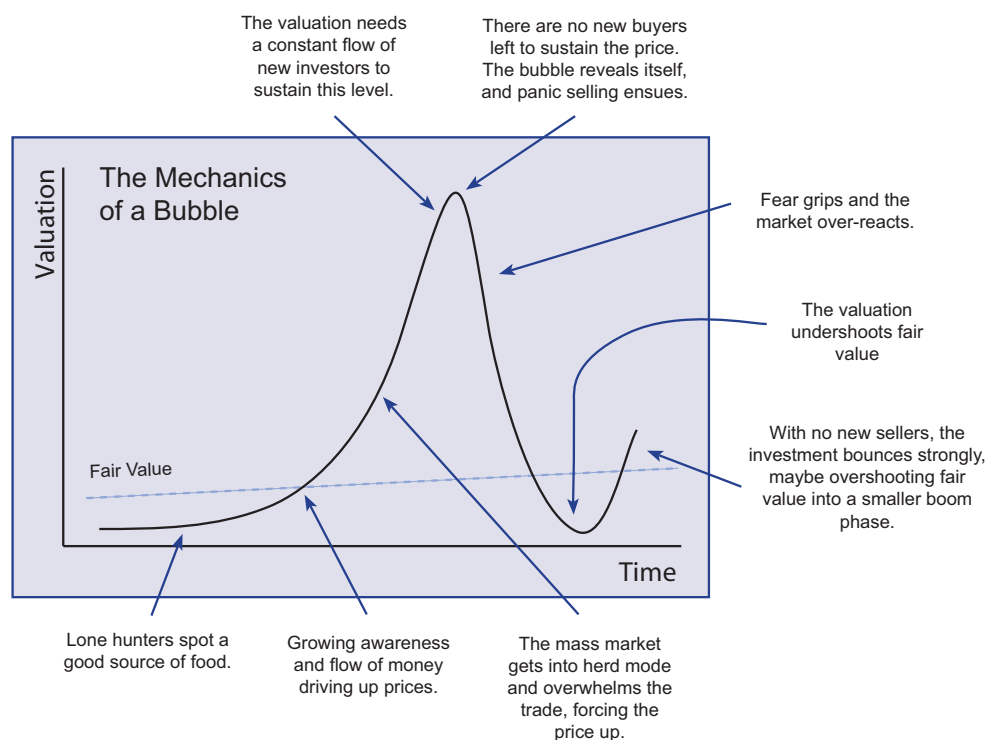
The arguments for investing in hedge funds are severely bruised, and many investors are very disappointed at the :

- Negative performance when they expected absolute returns
- Greater correlation with mainstream investments
- Changing goal posts and inability to redeem in a crisis.

We contend that the hedge fund story is bruised but still alive. Certainly many clients have been so badly hit that they never intend to invest with [*insert name of just about any manager*] again and will take a while before they trust the asset class at all.

### The Mechanics of a Bubble

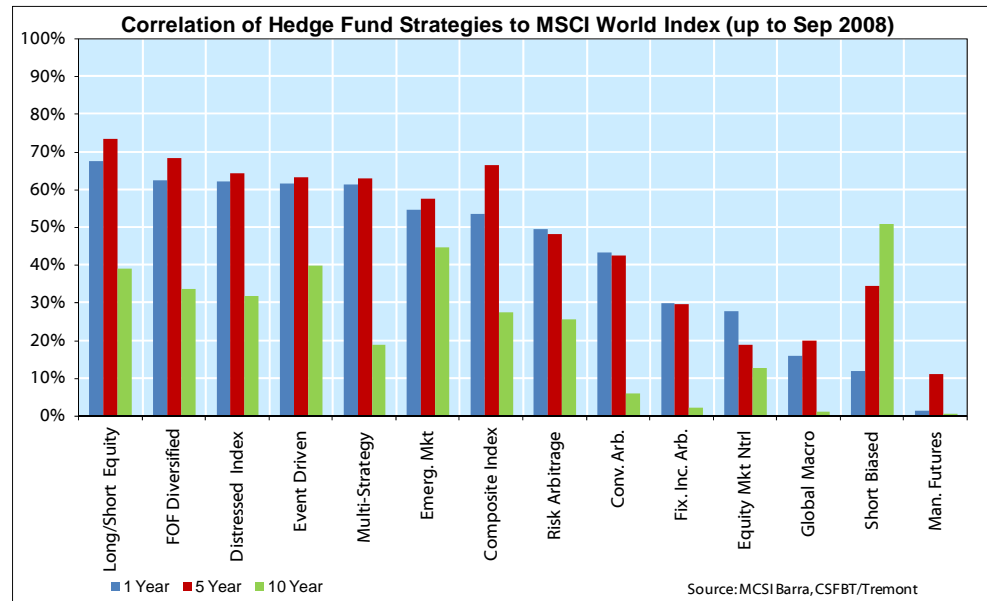
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Correlated negative performance has happened due to synchronous extraction of money from all asset classes at the same time. The diagram above illustrates that pricing can be highly dependent on flow of money. And at a time when banks are forcibly removing leverage and clients are demanding their money back en masse, it is not surprising that valuations and strategy spreads suffer.

## Hedge fund correlation

In the chart below, we can see that hedge fund correlation is generally increasing. We believe that is a function of hedge funds entering the mainstream. As new money is attracted to hedge funds, it supports many of the strategies they follow, and the reverse happens when investors take their money away. Because everyone is deleveraging across the board, increased correlation is an unwelcome consequence.

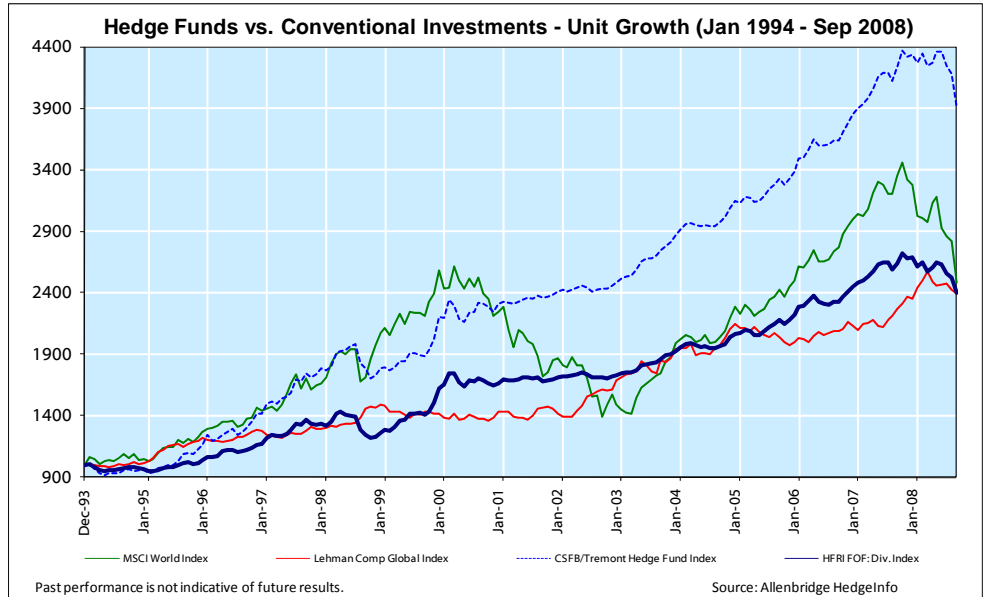


Correlations are simple in theory. Everyone knows that +1 is perfect correlation, 0 is no correlation and -1 is perfect inverse correlation. But many people don't realise that correlation is not linear. In other words, a 0.5 correlation coefficient is not half matched. It's actually more like a quarter matched.

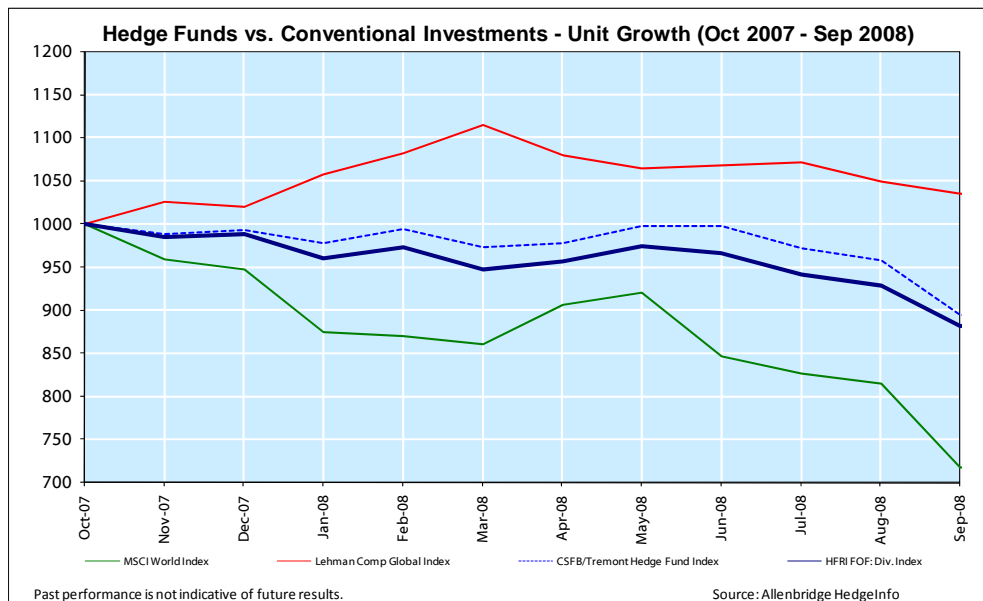
This is because the square of the coefficient (or r square) equals the variation in percent of one variable versus the other. An r of .5 means 25% of the variation is related (.5 squared = .25).

Because of this, we have used r square to illustrate correlation, rather than the raw correlation, as we think it makes the true relationship clearer in a graphical format.

**Hedge funds vs. conventional investments LT**

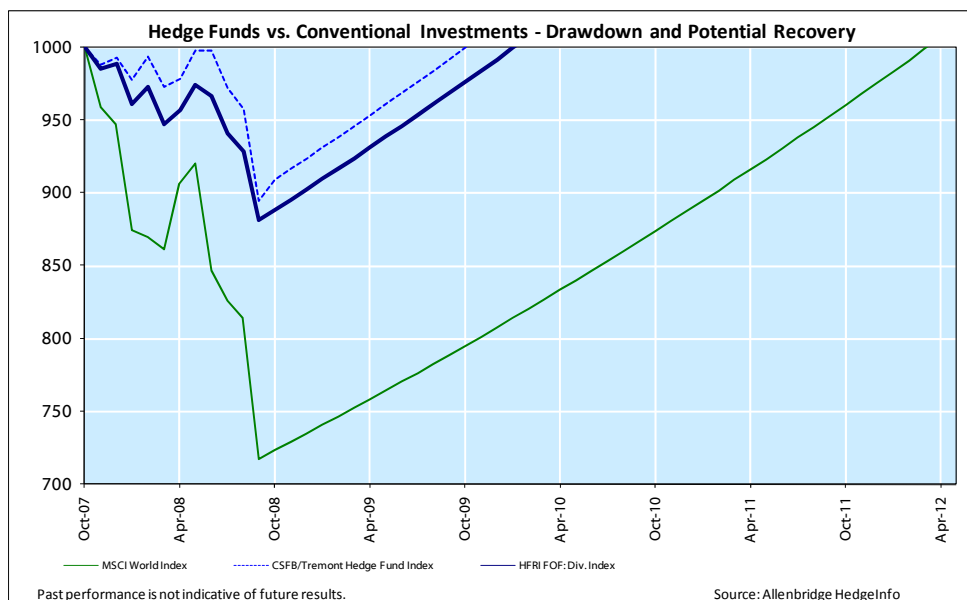


**Hedge funds vs. conventional investments ST**



The above charts show that over long time periods or even the recent past, hedge funds have outperformed equities, and had lower volatility. It is true that in the recent past, there have been absolute losses in most hedge fund strategies, as hedge funds - being a strategy class rather than an asset class - behave more like an asset.

**Hedge funds vs. conventional investments potential recovery**



The above chart shows the losses rebased from a common date, October 2007, which was roughly the high point for most of the indices. The hypothetical recovery period is calculated using the average annualised return since January 1994.

**Recovery rates and dates**

	Av. Annualised Return	Recovery Date
MSCI World Index	6.35%	April 2012
CSFB/Tremont Hedge Fund Index	9.69%	November 2009
HFRI FoF Diversified Index	6.1%	February 2010

**Funds of hedge funds liquidity squeeze**

As most readers will be aware, the financial world is still experiencing major challenges. While the meltdown of the banking system seems to have been avoided for now, the fallout is wide-ranging. Hedge funds have been hit hard, and this is most notable because hedge funds often claim to be able to make money whether the markets are going up or down, and this has not been the case for the majority of hedge funds, despite outperforming the wider equity market. After several seismic crises, such as the collapse of sub-prime credit values, deleveraging, and stand-alone events, such as Volkswagen and the Petters fraud, the current issue is hedge fund redemptions.

As global investors are moving to cash, they are putting in redemption notes with hedge funds and funds of funds. And the underlying investments are liquid enough for redemptions in normal markets, but the industry is not able to unwind quickly enough when mass redemptions (think 10-20% of the industry) are requested. And to cap that, the rise in the dollar versus European currencies has caused huge currency hedging losses, which would normally be covered by matching gains in the portfolio... but they can't all be realised easily at the moment.

The reaction by funds to an impairment in liquidity could involve:

- activating a gate (which is a limit on the percentage of a fund that may be redeemed in one redemption period)
- imposition of side pockets (which is where the illiquid portions of a portfolio get parked, while the liquid portions are redeemed and cash paid out, and when the side pocket becomes realisable, it gets paid out later)
- suspension of redemptions (allegedly some solvent managers put up the barrier to avoid being the cashpoint, when investors want out, but if the portfolio is genuinely too illiquid for redemptions, sometimes this is the only option)

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- suspension of NAV calculation (because the models or markets aren't functioning well enough to make a fair and tradable value; or
  - just simply a wind down.

A finger in the air estimate is that 25%+ of the industry is or will shortly be experiencing problems of the type described above (different strategies vary as Convertible arbitrage is in meltdown, L/S Equity is not so badly affected). The issues are currently mainly to do with the mass redemptions from clients who are scared, or putting speculative redemption requests in, and will decide later whether or not to crystallise the investment. This is why so many strategies are correlating so closely. In our opinion, hedge funds can be blamed for not anticipating sub-prime, VW etc. (there were enough warning signs for VW), but they can't be blamed for not anticipating mass withdrawal of equity by investors. They are paid to do their particular strategy on the assumption of functioning markets and continuing patronage. Obviously they keep some liquidity for reasonable redemptions at all times, but like banks, who borrow short term and lend long term, funds of funds usually have a liquidity mismatch in that they could not redeem all clients at the same time. The majority of the time that mismatch is a useful service, as it provides a greater choice of financing and investment terms.

### **Regulation**

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Few people in the industry do not accept that increased regulation is inevitable. But it must come from the top because fiscal revenues could lose significantly from tighter regulation - and arguably that is one of the reasons why leverage was allowed to rise to such dizzy heights. Another is political desire to enable poor voters to buy houses. But realistically, we consider that very few participants were blameless. In addition to the banks, regulators, politicians and yes, hedge funds, you can add buy-to-let speculators, and homeowners over-extending themselves.

We were amazed that after LTCM, there was not greater co-ordination between regulators and banks. And now we are convinced that data sharing between regulators, prime brokers and banks is vital so that the risks of the financial system are transparent on an aggregate scale.

### **Under pressure**

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The hedge fund industry is still under pressure, but it has qualities which will ensure that it survives one way or another. However, no one is in any doubt that there will be a contraction of the business at least over the rest of the year.

The question is: how soon is it safe to invest again? At risk of being glib, the answer is: as soon as investors stop putting in redemptions. Because then the selling pressure will be over, and hedge fund managers can stop scraping around for liquidity, and get on with finding anomalies to arbitrage and other inefficiencies to profit from.

If it is true to say that hedge fund managers are at the innovative end of investing, then they will surely respond to changing rules and markets with innovation. So the soothsayers of hedge fund doom are probably right that there will be pain and closures. But closures have always been a part of the darwinian hedge fund life-cycle, it is just that closures have been getting more column inches lately, and there have been fewer openings for the time being.

In the future, greater due diligence will definitely be required at all levels, and we are sure that some investors will be shy of hedge funds for a long time. That is probably not a bad thing, as hedge funds remain a specialist investment product.

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## Myths and Misconceptions

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The press is often full of anti-hedge fund rhetoric. We sometimes wonder why the same misleading or untrue allegations are repeated over and over again. We suspect that newspapers are trying to stimulate debate with controversial views, but the big picture is that:

- There are many more conventional long-only fund managers than hedge fund managers.
- Hedge fund managers are sometimes envied for their reputed riches.
- Conventional fund managers are much more likely to have a PR department than hedge fund managers.
- Hedge funds are prevented by law from promoting themselves to the public.

### **Hedge Funds are too risky, aren't they?**

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There is a grain of truth that some hedge funds are highly leveraged or have wild performance profiles. But in general, the exact opposite is true. Diversified hedge fund indices consistently show lower volatility than indices of blue chip stocks.

### **Hedge Funds have too much leverage**

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Some hedge funds work on high levels of leverage; but different instruments and markets behave differently. So 2x leverage in long/short equities is much more volatile than 2x leverage in convertible arbitrage. Average is probably about 1.4x (down from a high of about 1.8x in 2007). But we agree that some hedge funds have taken things to extremes, and up until recently no one felt strongly enough to stop them: clients could have walked away, prime brokers could have lent them less and regulators could have limited them.

### **Hedge Fund Indices are rubbish because of survivorship bias**

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Studies have shown that hedge fund indices are affected by funds which stop reporting, but it is wrong to suggest that only bad funds stop reporting. Good funds sometimes also stop marketing and reporting to databases when they reach capacity. But the allegation is particularly hypocritical because indices like the FTSE100 are founded on survivorship bias. At least hedge fund indices carry funds until they stop reporting, whereas the FTSE100 drops stocks because of poor performance.

### **Hedge Funds blow up all the time**

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Hundreds of hedge funds open and close every year, but the ones closing are more newsworthy. A tiny minority blow up, and this compares favourably with blue chip equities like Enron, Marconi, WorldCom, Parmalat etc. In the world at large, there will always be mistakes and frauds. We usually see hedge fund failures as being a symptom of inadequate due diligence, and possibly regulation.

### **Hedge Funds caused the credit crisis**

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Because hedge funds are usually prevented by legislation from answering back, many people actually believe that this credit crisis is caused by hedge funds. The reality is of course that bank salesmen discovered that no one was stopping them from giving loans to Americans with no jobs and no money. The salesmen bank the commission. The bank sees property prices rising, and keeps some for its own book and then makes a profit from repackaging it for hedge funds or any schmuck who will buy it. When the value of the hedge fund's assets or the bank's capital adequacy goes down, they give the hedge funds margin calls, and the hedge funds sell whatever they can at the rapidly diminishing price. Some hedge funds actually alerted the world to the sub-prime problem, by betting against it and thus stopping it from building up further.

### **Hedge Funds shorting the banks caused the run on banks**

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There's a fundamental difference between share price and balance sheet that some people fail to understand. A low share price does not cause a bank to become insolvent. Share price falls are a symptom, not a cause, but they certainly don't help, as they make capital raising much harder, especially if hedge fund managers are shorting. But that is a moot point. Certainly there were sales of shares in banks, but were hedge funds putting new shorts on, or were long investors getting out? Ironically, in the rights issue of HBOS, the underwriting banks could have influenced the price when they hedged their underwriting exposure by short selling in a jittery market.

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**Hedge funds make the markets more volatile**

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In the recent bans on shorting, the markets became more volatile. The truth is that hedge fund activity decreases volatility through providing greater liquidity to the market; and by providing more nimble price discovery, shares can reach their fair value more easily. No one could argue that arbitrage strategies (which involve shorting) do not make markets more efficient. Other strategies also have benefits, but they are not as immediately obvious.

**Hedge Funds are too opaque**

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A good start would be to allow hedge funds to publish their data more openly or comment to the press without fear of regulatory discipline. We obtain a great deal of transparency from the managers we look at, and we suspect that the less transparent ones survive because customers accept the opacity. But normal commercial confidentiality is reasonable and expected to protect the uniqueness of the strategy. That happens in all types of business, and especially in listed companies, which are not allowed to disclose information selectively, and as a result sometimes disclose the bare minimum.

**Hedge Funds are unregulated**

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The FSA and many other regulators round the world regulate hedge fund managers to a greater or lesser extent. We believe that the FSA's approach is one of the better ones, as managers are required to follow principles whether the specific fund vehicle is regulated or not. Investors can choose for themselves how much regulatory footprint they require, and invest accordingly.

**Hedge Fund managers fake alpha**

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Because some investors don't do due diligence or are seduced by high returns, there are opportunities for alpha fakers. But there are other hedge funds to choose from. And this is a good example of why single manager strategies should be left to professional investors.

**Selling out-of-the-money options is a con**

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Short out-of-the-money option strategies are sometimes described as "picking up pennies in front of a steamroller" because you get a stream of small profits and the occasional large loss. Certainly, you shouldn't gamble money you can't afford to lose in this sort of strategy, or pay excessive fees. But perceptive investors will realise that the strategy is exactly the same as underwriting insurance. It fulfils a vital role in the financial markets, and the returns and fees should ideally reflect the underlying risk.

**Returns are all due to leverage**

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Leverage can be used to fake alpha if it is constant, but when used tactically it creates alpha. Many hedge fund strategies require leverage to operate effectively, and these strategies will underperform if they can not get the leverage. Current problems are more to do with the enforced process of deleveraging than running in normal markets on low leverage.

**Hedge Funds are all...**

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Usually the biggest mistake is to generalise about hedge funds as they are very diverse. But if you withdraw money from all of them at the same time, then they will have to close their positions at the same time, and thus they will correlate with each other. Many people don't realise that hedge fund managers mainly come from big banks. Many of the strategies are straight off banks' prop desks.

**Hedge fund managers are all rich**

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The ones that hit the papers tend to be, but with a universe of 10,000 funds, the vast majority are very small indeed, and often struggle to make ends meet. And they may well make less than the average remuneration in an investment bank.

**Hedge fund managers are all arrogant**

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There is an element of truth to this. Many good investment managers are quite dysfunctional, and need a strong sense of self-belief to be successful. Not everyone is cut out for that or the sheer pressure. In addition, a level of aloofness and a "loner" mentality can be helpful for original thought and avoiding crowded trades.

**Hedge Funds should educate investors about them**

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Some hedge fund salesmen are knowledgeable and even handed, but most are trying to sell you something. If you want impartial education, go to someone independent. Allenbridge HedgeInfo exists because we are fans of the hedge fund concept, but we know there are pitfalls to avoid.

**Hedge Fund fees are too high**

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Too high for what? The net return is more important than the fees, and performance fees mean that managers only get big rewards when investors get really big returns - that helps

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to align interests. Investors are welcome to vote with their feet. But predictions of lower hedge fund fees often turn out to be wishful thinking. Unless the investor is particularly big or has some other hold over the manager, like big losses, and a credible threat to redeem, reduced fees are a fantasy. In addition, managers prefer to keep a headline fee level higher, and then discount from that. It means that the track record is kept consistent.

**Funds of funds are not worth the extra layer of fees**

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Due diligence is more time and cost intensive than many people think. Funds of funds provide a due diligence and diversification service, as well as making it possible to invest small amounts in hedge funds with high minimum investments. For the very large institutional investors who could afford to set up their own due diligence, manager selection and macro strategy department, then the fund of funds will usually be flexible on fees, particularly if the marginal cost of managing the extra money is low.

**Profiting from price falls is immoral**

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If two investors both believe they are right and want to take opposite sides of a bet, then we think that is up to them. There are many benefits from the presence of hedge funds, and without shorting, it would be harder for stocks to reach fair price. Although "hedge fund" is often a misnomer, it is true that there is a lot of hedging going on, and this means that shorts are not always naked; they may be part of an arbitrage trade, with an obvious benefit for market efficiency.

**Hedge funds manipulate the market**

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Most investors - conventional and alternative - have sheep-like moments, when they all do the same thing in unison. That doesn't mean it is organised, and it is a very human behaviour. We suspect that in general, hedge fund managers are no better or worse at passing on rumours or acting on news than long investors, bank prop desks or brokers. But some hedge fund managers, especially those with "black box" models, really do work in isolation from the market, so it is very unlikely that they would have the human contacts or need to manipulate the market.

Short selling has been described as "abusive" but market manipulation can be done by abusive price ramping just as easily as short selling. The principle that you should always blame whoever is least likely to answer back is unlikely to go away.

**Hedge funds are illiquid**

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Hedge fund liquidity varies, and there are many financial products which have become very popular notwithstanding their liquidity. In general, professional investors respect that some strategies only work over longer timeframes. Private equity and structured products are good examples of products that can't operate without extended lock-ins. Hedge funds sit somewhere between private equity and individual listed equities. Our due diligence looks at whether the liquidity is reasonable, given the individual hedge fund strategy.

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- An investor could lose all or a substantial amount of his or her investment
- There may be no secondary market for the investments
- There may be restrictions on transferring investments
- The investment may be leveraged
- The Investment performance may be volatile
- The Investment has fees and expenses that will reduce returns
- Investors should refer to the Fund Prospectus or the Investment Manager for a more complete set of factors

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**Allenbridge Hedgeinfo**

17 Hill Street  
Mayfair, London  
W1J 5NZ United Kingdom  
Tel: +44 20 7409 1111  
Email: [info@hedgeinfo.com](mailto:info@hedgeinfo.com)  
Web: [www.hedgeinfo.com](http://www.hedgeinfo.com)

**Contact:**

Christopher Miller  
Chief Executive Officer,  
Allenbridge Hedgeinfo  
Direct: +44 20 7318 6303  
Email: [christopher.miller@hedgeinfo.com](mailto:christopher.miller@hedgeinfo.com)