INTRODUCTION

MANAGING CLIENT EXPECTATIONS

Hedge funds have received a bad press of late as investors hoping for absolute returns were disappointed with their performance. But these vehicles can still offer uncorrelated alpha and the industry is responding to calls for greater openness, writes Elisa Trovato

The increased correlation between hedge funds and the main markets casts a doubt on the role that these instruments play in investors' portfolios. Hedge funds have not been immune to the financial crisis: the average global multi-strategy funds of hedge funds lost 18 per cent in 2008, their worst year on record. The fact that mainstream funds and indices registered much higher drawdowns - the S&P global 1200 fell 40.1 per cent last year - has not been of great consolation to those investors who were expecting these financial instruments to deliver the absolute returns they promise.

While large redemptions in the hedge fund industry underline investors' fear and disappointment, fund selectors and wealth managers remain relatively upbeat.

"Performance should not really alter the definition of what an alternative investment is," says Paul Marson, chief investment officer at Swiss private bank Lombard Odier. "The role of a hedge fund in a portfolio today should be the same as the desired role of a hedge fund in a portfolio a year or two ago. The reason you own hedge funds is because they are a source of non-correlated alpha," he says, adding that what investors have found to their cost is that many hedge funds contained a great deal more of "disguised beta", or equity market returns.

Mr Marson admits that investors now "are less comfortable" with a generic hedge fund. "But part of our job is really to reassure clients that the due diligence that we do is consistent and we are sourcing alpha."

The strategic recommended allocation to hedge funds has not changed, says Mr Marson, disclosing that alternatives, including private equity and real estate, represent around 20 per cent of an investor's portfolio at the Swiss private bank.

The robust due diligence process that allowed the bank to avoid the latest hedge fund fraud, in which financier Bernard Madoff has admitted that his seemingly successful hedge fund was in fact a Ponzi scheme, was not able to fully detect the illiquidity issues in the hedge fund universe and the correlation between hedge funds, concedes Mr Marson. "Perhaps, on reflection, what everyone in the industry could have done is to demand a greater transparency, but in a sense the market was not such that would have delivered it."

GREATER TRANSPARENCY

Screening hedge funds today is probably getting easier, says Mr Marson. "We are asking for greater transparency and greater visibility and hedge funds are generally responding to those industry pressures. At the moment, the overriding objectives of hedge funds is to retain assets, and part of the effort to retain assets is responding to demand of greater openness," he says.

The increasing convergence between the alternative and long only industry allowed by Ucits III is also going in the direction of providing higher standards of investor protection, liquidity and transparency.

"WE ARE ASKING FOR GREATER TRANSPARENCY AND GREATER VISIBILITY AND HEDGE FUNDS ARE GENERALLY RESPONDING TO THOSE INDUSTRY PRESSURES"
PAUL MARSON, LOMBARD ODIER

If hedge fund firms like GLG Partners and Odey Asset management have been active in the regulated fund arena for some time and their Ucits ranges have attracted strong inflows recently, Brevan Howard, Europe's largest hedge fund manager with $25bn (€19.5bn), has just launched its first Ucits III absolute return bond fund.

However, while some strategies like long-short, low leveraged macros and long-only convertible can be successfully replicated in Ucits III funds, strategies that involve a significant amount of leverage or a considerable degree of illiquidity face big constraints.

A senior figure at a leading hedge fund group says: "Ucits III is a very big opportunity but it cannot substitute hedge funds. You have a continuum of products that go from long-only to slightly leverage funds, like Ucits III, to hedge funds and they all have different risk returns and characteristics."

DANGER OF GENERALISATION

Graham Wainer, group head of private clients and portfolio management at Gam, the asset management arm of Julius Baer, emphasises that there has been a tremendous generalisation about the hedge fund industry as a whole. "Broad generalisations are really not doing justice to the richness of the hedge fund industry."

General views on hedge funds on performance, correlation, or fees cannot be applied to the entire industry indiscriminately. For example, while long-short equities have been strongly correlated with the equity market, other strategies like discretionary macro or trading funds showed no correlation and have performed well. There are some really talented managers that produced between 8 and 12 per cent last year, says Mr Wainer.

At Gam, which is one of the largest funds of hedge funds players, the allocation to alternative investments that Mr Wainer recommends to private clients and private banks has stayed unchanged.

Gam's absolute return strategy retains its significant exposure of 48 per cent to alternative investments, over two third of which now sit in discretionary macro and trading strategies. "The size of allocation (to alternatives) itself is not a factor that provides comfort, because you could have much less and know very little about it," says Mr Wainer. "At Gam, we are very comfortable with this level, because we know the strategies and the managers so well, as we have been in this business since 1983."

Mr Wainer stresses that, in the fund management business, managing money is as important as managing clients' expectations. "You can never do a good job of running money well if the actual characteristics of the fund, in terms not only of performance, but also structure of the fund, redemptions terms and pricing are mismatched with clients' expectations."

What also needs to be re-emphasised with clients is that an investment and economic cycle is a rolling five-year period, says Mr Wainer. This has a huge impact on clients' expectations on short term performance.

Hedge funds were seen by many investors as a form of investment which offered a low correlation to the equity market, says Giles Keating, head of private banking research and chair of the global economics and strategy group at Credit Suisse.

That ought to mean that if the equity market tends to fluctuate between large positives and large negatives from one year to the next, uncorrelated investments ought to have at the very least a much lower fluctuation in returns, he says.

"BROAD GENERALISATIONS ARE REALLY NOT DOING JUSTICE TO THE RICHNESS OF THE HEDGE FUND INDUSTRY"
GRAHAM WAINER, GAM

"But people took it to the next extreme and were hoping they would outright deliver positive returns, which in most years until last year they had done. But there was never any reason why hedge funds would be able to deliver a positive return every year," he says.

"If you assign a more model role to hedge funds, as one of the alternative assets that are hoping to diversify your overall portfolio, that they can play a very sensible role, if you choose well." Hedge funds, which are employed in clients' portfolios mainly in the form of funds of hedge funds for diversification purposes, tend to represent a "not particularly high single digit" percentage of clients' portfolios at Credit Suisse, says Mr Keating.

Introducing the German perspective, Christoph Hott, head of alternatives at Sal Oppenheim private bank, says that, while for private investors "real estate is the name of the game right now" – because prices have come down and real estate is perceived as a protection against inflation and as a conservative investment providing a steady income – the firm is about to implement a new strategy for all its clients with regards to hedge funds. In the liquid part of a balanced investor' portfolio, exposure to hedge funds has decreased from 15 to 10 per cent.

Hedge funds are erroneously generally perceived as alpha generators, says Dr Hott, but extensive in-house regression analysis shows that 80 per cent of hedge fund returns are alternative or exotic beta. This can relate to

interest rate movements, to spreads on the credit markets or volatility and so on, while traditional beta is related to the equity market returns. In addition to exotic beta, hedge funds' returns are also due to illiquidity premium, which has little or nothing to do with alpha. Consequently, only 10 to 20 per cent of hedge funds' performance is a real alpha premium.

"It would be wrong to conclude that hedge funds are not an attractive asset class, because their alternative beta is diversifying," says Dr Hott. "In contrast to alpha it is, however, essential to manage beta actively." Hence it is paramount that hedge funds are managed and employed in investors' portfolios on a top down basis, says Dr Hott.

"Classical asset allocation views are coming now into the hedge fund segment," he says. Liquidity is another key characteristic that hedge funds increasingly need to provide going forward. "We are planning to have the bulk of our hedge fund business in really liquid strategies."

Another important lesson to learn is the importance of diversification on the bottom up side. "Our hedge fund portfolio consists of about 20 different single fund managers managing different strategies." Not more than 5 per cent is allocated to one single hedge fund manager, although, if the strategy is really liquid that can go up to 10 per cent. "No matter how good your due diligence process, it is quite difficult to avoid disasters in the hedge fund space," says Dr Hott.

David Miller, head of alternative investments at Cheviot Asset Management, a UK based firm operating in the wealth management space, believes that one of the factors not to underestimate when selecting hedge funds is the stability of the client base. "We want to know who is investing, if the fund has substantial capital from the partners, if it has a solid base of private individuals and long-term investors like pension funds," says Mr Miller.

WINNERS AND LOSERS

According to Hedge Fund Research data, around 4 per cent of hedge fund houses manage over 56 per cent of the global $1,400bn assets as at year-end 2008, and the analyst consensus is that the industry is marching towards a greater concentration.

It is therefore imperative for distributors to be able to distinguish between those managers who have robust investment platforms, good risk management practices and are able to generate alpha, who will thrive and prosper, and those who are destined to fail.

A very solid infrastructure, ability to have access to big teams of talented people and the ability not to be married to one given strategy, is the recipe for success given by the CEO of a large hedge fund house. "The pressure is going to be much higher, there will be higher barrier to entry, more regulation and it is will be much harder to set up a smaller hedge fund," he predicts.

The industry is undoubtedly going through a Darwinian process and a further depolarisation within the alternative investment space in general, and long short in particular is taking place, says Mr Wainer at Gam.

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CHRISTOPH HOTT, SAL OPPENHEIM

"The really talented people are coming to the fore and they continue to attract money and charge premium fees," he says. "On the other side hedge fund firms are now either leaving the industry entirely or reducing fees."

Mr Miller at Cheviot Asset Management believes that there will be much more focus on understanding how hedge fund managers add value. The credit crunch has exposed those funds that simply seemed to be using high leverage and were investing in illiquid markets, where the growth potential was superior but the risks were higher, in order to generate a superior return while taking little account of the risk.

Dislocation and high volatility in the market are offering new opportunities to hedge fund managers, who have the chance to making good returns as there is less competition. Strategies that specialise in the credit area, global macro strategies that are trading the volatility in fixed income markets, interest rate expectations or foreign exchange are less correlated to the equity market and have become attractive, says Mr Miller. The long-short space is also presenting opportunities as the differential in performance between good and bad companies has started to open up and hedge fund managers can take advantage of this.

The greater availability of niche funds of hedge funds - which can be more selective in the managers they use, unlike the very large funds which have struggled in the past to allocate their capital to managers they really want to invest in - now makes it possible to combine them in a portfolio in a more tailored approach. "It is getting more complicated but also you have more control over the end results," says Mr Miller.