HEDGE FUND RETURNS

Portfolio management lessons after the storm

Portfolio managers must ensure that they are fully aware of the exposures they have at any given time and the ability of the portfolio to react independently in the eye of a storm, writes John Godden

The alternative investment world can never be accused of not providing interest, but during the days of high summer 2007 many investors would have longed for boring, risk-free deposit-type interest instead of the constant flow of interesting news that bombarded almost every alternative asset class along with the mainstream asset sector.

Funds suspending redemption due to 'unacceptable market prices' followed by cash crunches at levered collateralised debt obligation (CDO) vehicles were hot on the heels of accusations levied at the private equity sector of 'cheating' on tax and destroying company value. Meanwhile, commercial property stagnates and residential property funds look precarious.

So has all of this negative news driven investors away? Apparently not. Reports of continued strong inflows into hedge funds have been seen recently from several data providers and private equity groups are still very well capitalised. So were the reported problems merely minor events on the edges, is there no long term damage to any part of the alternatives world?

An examination of the return patterns in the hedge fund of fund world provides us with an insight into the real impact on investors during the third quarter of 2007 and provides an indication of how investors felt their experiences matched up against their expectations. Hedge fund return data is, perhaps surprisingly given their reputation for opacity, some of the fastest reported performance indicators in the alternative space.

"FOLLOWING A STRONG SEPTEMBER A BRUISING THIRD QUARTER WAS CLOSED OUT WITH MOST FUND OF HEDGE FUNDS IN POSITIVE TERRITORY"

The first two quarters this year had proven to be fairly good for most hedge fund strategies with an average fund of hedge funds achieve a year-to-date return of around 10 per cent by the end of Q2. Not a bad number given that volatility levels were down at around 3 per cent.

The portfolio allocators task had been made a little easier than in previous years with greater differentials opening up between the different strategies and between different managers. All this accompanied by a material increase in market volatility saw things set fair for a strong 2007.

WINDS OF CHANGE

Then along came July – credit crunch, CDO-storm, liquidity desert, valuation whirlwind – the whole bag of issues. The headlines were clear – some funds were all but destroyed, many others suffered heavy losses and all were going to face a new world of service provision from the banks that had been throwing credit lines at them all year.

In among all of the horror stories of funds set up by banks to invest in uber-levered baskets of low-quality loans there were more than a handful of winners, hedge funds who did just that – hedge – or at least provide a Hedge against the predominant market direction.

The super-smart (lucky?) managers who took a leveraged bet against credit and went heavily short. Such funds are sitting on returns in triple digits year-to-date. An examination of the exposure to credit generally, and sub-prime in particular, within the fund of hedge funds community shows that few were highly exposed and many were net short in the sector.

The fund of hedge funds community did suffer losses in July (less than 1 per cent on average) and August, where the better performers held losses to less than 1 per cent, but too many suffered what are regarded as 'substantial' losses of near 3 per cent.

However, following a strong September with even the most conservative fund of hedge funds returning more than 2 per cent a bruising third quarter was closed out with most fund of hedge funds in positive territory for the quarter. Year-to-date numbers of 6 per cent, for the relative underperformers, and more than 13 per cent for the over-achievers still look reasonable relative to previous years and, most importantly, relative to investor expectation.

The marketers for such funds

Performance of hedge fund indexes

HFRX Index	DTD	MTD	YTD	Value	Sep ROR	2006 TOTAL	2005 TOTAL	2004 TOTAL	2003 TOTAL
	Daily - 10/12/2007								
HFRX Global Hedge Fund Index	0.1721	1.6672	5.7576	1349.23	1.28	9.26	2.72	2.69	13.39
HFRX Equal Weighted Strategies Index	0.1253	1.3109	5.2378	1293.59	1.12	8.83	1.28	2.72	11.32
HFRX Absolute Return Index	0.0557	0.7462	5.8460	1165.35	-0.03	7.43	-0.03	3.20	11.95
HFRX Market Directional Index	0.2994	2.5638	7.5816	1294.57	2.10	10.45	4.20	4.85	25.22
HFRX Convertible Arbitrage Index	-0.1553	0.7850	3.4212	1093.99	2.56	9.57	-5.69	-0.14	8.85
HFRX Distressed Securities Index	0.1016	0.7991	4.1651	1450.08	-0.33	9.56	1.21	8.95	20.90
HFRX Equity Hedge Index	0.2355	1.9696	6.6371	1390.39	0.56	9.23	4.19	2.18	14.47
HFRX Equity Market Neutral Index	0.0994	0.3789	2.4894	1048.85	-1.73	4.76	0.21	0.32	-2.38
HFRX Event Driven Index	0.3211	1.8993	9.2872	1546.81	1.08	10.32	2.81	6.93	18.74
HFRX Macro Index	-0.0636	1.7571	-0.8104	1244.63	4.79	5.61	6.67	-0.32	14.61
HFRX Merger Arbitrage Index	0.2426	1.2271	6.8384	1311.80	0.89	10.73	3.72	2.80	4.26
HFRX Relative Value Arbitrage Index	0.1996	1.6376	6.3260	1269.97	1.00	10.65	-0.97	1.98	9.15

Source: Hedge Fund Research, Inc

will, quite rightly, insist on these numbers being seen in conjunction with the low volatility levels being used to produce them.

So what does the landscape look like from here? How does an allocator deal with the revised parameters that the market now presents?

The good news is that the differentials between the various strategies and exposures is showing signs of offering a truly diverse selection of returns with which to utilise your portfolio construction tools. There is a significant difference observed in the two primary strategy groupings – market directional on one hand, including strategies such as equity long/short and macro, and absolute return on the other, covering market neutral and relative value plays.

Market directional strategies have show growth of more than 5 per cent over the past six weeks compared with just 1 per cent for absolute return. This is fuelled, in part, by the continuing bullish behaviour of equity markets driving performance still further upward at this time.

Whether your view is of continuing positive performance from equities or, more likely that there is some doubt about this, the continued reliance on equity market beta for hedge fund returns is at best questionable in the light of market expectation or, at worst, not of much use alongside long-only equity holdings and even the new of populist product the 130/30 fund.

The bad news is that credit is not only becoming scarce but is already more costly than pre-third quarter. This will have a dragging effect on many strategies and will reduce the impact of leverage right across the board.

We have already seen the dangerous, short-term impact on funds that employ heavy usage of margin trading of not having sufficient liquidity to meet margin calls and we will see this same effect played out across other strategies as banks reduce, remove or price-out leverage for trading.

Indeed, just when the institutional investor community was getting comfortable playing with the sensible application of leverage to boost alpha generation on a low volatility portfolio, the source of the leverage will be taking their ball home with them.

STRATEGIC THINKING

So what does a portfolio manager do? Are commodity trading advisers (CTAs) going to deliver on their eternal promise of providing the best formula of portfolio risk reduction with anti-correlated returns or will the whip-saw markets be just too disrupted for them to deploy their quant models?

Evidence from the third quarter is rather similar in quantum to the fund of hedge funds as a whole – up, just, on the quarter following losses in July and August. But were these returns a different shape to other asset classes? Probably not, but there is a 'feeling' that CTAs will benefit from the more organised dislocation that is predicted for global markets in the fourth quarter of 2007.

Having worked out that the directional hedge fund strategies need positive equity beta to thrive, the default hedge fund portfolio position of being 35-45 per cent exposed to equity long/short is only reasonable in isolation, away from the long equity or the 130/30 brigade.

So, absolute return, arguably the 'real' hedge fund strategies, could be kings over the next part of the cycle despite the new limitations and challenges brought on by the banks risk paranoia and credit line reduction. The difficulty then arises that whilst such conservatism panders to the increased focus on capital preservation it is not going to provide any thrills.

Enter 'alternative alternatives'.

"WHAT HAS BECOME APPARENT DURING THE THIRD QUARTER IS THAT A TOP-DOWN, MACRO-ECONOMIC DRIVEN INVESTMENT STRATEGY IS CRUCIAL DURING PERIODS OF UNCERTAINTY AND DISLOCATION"

John Godden, IGS

Energy trading, carbon trading, timber, land reclamation are all being explored, brought inside fund structures and being used as satellite holdings around a core of 'traditional' alternatives including private equity and hedge fund strategies.

The search for truly differential return streams that remain relatively unaffected by the global credit crunch and therefore non-correlated is driving significant sums into the space and, as a result, product development is moving fast.

To give an example of what is working in the alternative alternative arena, current offerings have included a 'reserve asset' fund and a distressed US residential property fund. The former provides investment into physical assets, instead of the usual futures contracts, which removes completely any sensitivity to credit degrading by the financial institutions.

Such a strategy provides a strong hedge against serious credit meltdown and also against high levels of inflation. A distressed US residential fund is a little more obvious and very cyclical in nature. It offers the classic 'buy-low, sell-high' routine but with massive discounting for those with current liquidity and excellent returns over a six to 10-year period for those not requiring that liquidity, or indeed valuation marks, during that period. Both offer a strong portfolio risk-reducing factor.

LOSS OF CREDIBILITY

What has become apparent during the third quarter of this year is that a top-down, macro-economic driven investment strategy is crucial during periods of uncertainty and dislocation. Many bottom-up manager-pickers have lost credibility, if not money, over the period by being caught with the wrong exposures.

Hedge funds are defined by their ability to be non-conformist and fleet of foot but they all are ultimately constrained by the practicalities of their market/strategy. Private equity is also limited in its ability to offer true diversification in times of trouble. Any portfolio manager must therefore ensure that they are fully aware of the exposures they have at any given time and the ability for the portfolio to react independently in the eye of a storm.

The new paradigm in utilising alternatives in portfolio management is to get fund of hedge funds, and to a lesser extent fund of private equity fund managers and property fund managers, to become more proficient at deploying macro-economic overlays thus bringing a greater discipline to allocation patterns. Additionally, institutional investors in particular are taking a more granular approach to their engagement with the multi-manager community by placing funds with 'restricted mandate' fund of funds such as relative value portfolios, market neutral portfolios, geographically restricted portfolios, CTA baskets or, yet more narrowly defined, ABL multi-manager baskets.

The shift in responsibility for overall allocation, and therefore ultimate risk and downside control is shifting toward the investor.

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IGS Group (www.igsgroup.co.uk) is a full-service provider to both the Alternative Assets product community and the Investing community offering expert services for all aspects of product design, strategic market positioning, infrastructure design and distribution. IGS combines the resources of highly experienced professionals from across the Alternative Investments world to engineer strong connections between investors and opportunities in the hedge fund, private equity and multi-asset space.