HEDGE FUNDS

The problem with writing a chapter about hedge funds is the vast number of completely different strategies followed by hedge fund managers. This has caused some investors to describe them as a "talent class" rather than an "asset class", meaning that the returns are generated at least as much by the individual manager as by the type of securities owned by the fund.

Hedge Funds are perhaps best seen as a style of investment rather than an asset class and, as the industry grows and matures, distinct sub-groups are evolving. On close inspection, some hedge funds look and increasingly behave remarkably like conventionally managed unit trusts, many conventional managers have started to use techniques and instruments that until five years ago were the preserve of the hedge fund manager.

At the time of writing, the clear distinction that used to exist between conventional management and hedge fund management has become blurred. With the recent changes to UCITS legislation (the rules that govern the management of pooled funds), the legal distinctions between hedge funds and mainstream funds has shrunk to such a degree that many recent hedge fund launches have actually been within the regulated space that had previously been the sole preserve of the "plain vanilla" unit trust.

While bringing the regulation and scrutiny of hedge fund practices into the mainstream is probably a good thing, investors will need to be aware of the potentially very wide scope this may give previously simple long-only single asset-class funds should their managers chose to use them.

That said, there are still some generalisations that can be made about hedge funds before exploring the different strategies and deciding whether an allocation might be appropriate for your portfolio.

In terms of structure, even the most extreme hedge funds have many of the characteristics of unit trusts: the majority are pooled funds in which investors hold units that can be bought and sold at set times and at a price which is determined with reference to the underlying value of the funds portfolio portfolio. A minority are structured as investments trusts, are traded on equity markets and can be priced at premiums or discounts to their net asset values. Some investors, generally for tax reasons, gain exposure through bonds or structured products.

However, the similarities with conventional "long only" funds generally end there.

Hedge funds still tend to be located offshore in unregulated jurisdictions (even if the day-to-day investment management company is located onshore and is regulated), have a very high level of minimum subscription, can usually only be bought and sold quarterly or monthly, are empowered to borrow in order to "gear up" their performance and, finally, invariably charge a performance-related fee.

From an investment point of view, the major difference with the conventional manager is the focus on making positive absolute returns at all times against any wider market backdrop. While this is in part a "mindset", one of the major tools required to achieve positive returns in all market conditions is the ability to "short" securities.

In the vocabulary of the hedge fund manager, conventional investment managers are "long only" investors. In other words, they buy and hold investments, aiming to make money as prices rise, limiting their trading activity to switching between individual securities and asset classes from time to time as conditions change. While they might hold more in cash or defensive assets if the short-term outlook seems poor, they will generally be "long" of securities. Their aim will be to make attractive absolute returns over the medium to longer term, but to be judged over shorter time frames on a relative basis.

If markets go down, conventionally managed portfolios generally fall in value. The investment manager tries to make sure that the portfolio falls by (substantially) less than the market through good stock selection or asset allocation but is generally content to remain largely invested in the conviction that prices will recover before long. Since the long-term trend in the market is upwards, the conventional manager sees much more risk in being out of the market than in it.

This is easily recognisable as the standard approach followed by most investors, whether it be for an individual asset class or indeed for a portfolio investing across a range of asset classes.

The hedge fund manager takes a different view. A key investment characteristic of hedge fund managers is that they seek to make money whatever the market environment.

A hedge fund manager is only content to be "long" if markets are rising: if markets are falling, then it will be necessary to go "short". Specifically, by selling investments that the fund doesn't own, the manager can profit at a later date by buying them back at lower levels once they have fallen in value.

This process usually involves borrowing stock. Nowadays, in return for a small premium, one can borrow a huge range of stocks, including individual equities, baskets of equities, bonds, currencies, commodities – effectively, if you can buy / own something, there is probably an investment bank that will find stock for you to borrow, or perhaps structure a bespoke instrument for you such that you can make a profit if the price falls.

Once you have borrowed your stock (generally for an agreed period of time at a set price) you can sell it in the market in just the same way you would if you had owned the stock in the first place. Technically, although this is how short positions were initially achieved, it should be noted that derivatives and CFDs (Contracts for Difference) are probably used at least as much to create "synthetic shorts" today than the traditional approach of actually borrowing stock.

Crucially therefore, the hedge fund manager can actively manage the "net" market exposure of the fund, by balancing the value of long positions and short positions, thus making money whether markets go up or down.

A fund that is "net long" will not only make money through good stock selection but will also benefit from rising markets. A fund that is "net short" will make money from stock selection and also if the market falls.

The value of a fund that has a "neutral" net market position made up of both long and short positions of equal value should in theory only go up and down due to stock selection. This is the purest form of hedge fund where the aim is to have no market risk with the only influence on the value of the fund being the quality of the stock selection.

For the sake of clarity, a neutral market exposure could simply be achieved by a two stock portfolio whereby the fund manager takes a stock he likes, say Barclays Bank and buys £1m worth of stock. He then sells short £1m of a similar stock whose share price he feels is likely to fall, say Lloyds TSB. The net effect of these two transactions is to cancel out the impact of the wider market (or indeed the banks sector) going up and down. The profit or loss will simply be the relative performance between the two stocks – a very specific relative judgement call.

8.1
The XYZ UK Equity Fund

Subscribed Capital	35,000,000

Long Positions	£	% Net Assets	Short Positions	£	% Net Assets
Pearson	7,500,000	21	BT	-4,000,000	-11
Anglo American	5,000,000	14	Bae Systems	-2,500,000	-7
Lloyds Bank	5,000,000	14	Kingfisher	-2,500,000	-7
Schroders	5,000,000	14	Land Securities	-2,000,000	-6
Fenner	5,000,000	14	RBS	-2,000,000	-6
AstraZeneca	4,500,000	13	Citigroup	-3,500,000	-10
BSkyB	4,000,000	11	FTSE 100 Future	-13,500,000	-39
Ceres Power	3,000,000	9			
	39,000,000			**-30,000,000**	
%	**111**			**-86**	

	%
Net Exposure	**26**
Gross Exposure	**197**

A theoretical UK equity long-short equity fund is set out in Table 8.1.

It can be seen that this is a fairly concentrated portfolio, with the long positions set at between 9% and 21% of the subscribed capital (or net assets.) The manager would appear to be expecting the market to rise as the fund has positive net exposure of 26% of its net assets, while he is clearly bullish about his own stock picking ability as gross exposure is running at 197% (i.e. the total value of longs plus shorts divided by the net assets)

In this imaginary hedge fund, the manager has chosen to use a FTSE future to increase the value of the short positions, and he has also sneaked in one overseas stock he obviously has strong feeling about.

The sort of absolute and relative judgements seen in this theoretical example can be made between any number of tradable securities and most hedge funds will have many different positions in a wide range of different securities depending on the background and skills of the fund manager.

Over the years, a number of key styles and types of hedge fund have emerged and industry sources now identify up to thirty different investment strategies employed by hedge fund managers. Some of the most common are set out in Table 8.2.

8.2

TYPES OF HEDGE FUNDS

Equity Market Neutral: funds will typically be invested in equities and are designed to maintain a neutral exposure to one or more variables including equity market indices in absolute or beta terms. Leverage is frequently employed to enhance returns. The main characteristic is that net equity market exposure will be no greater than 10% long or short.

Equity Directional: funds will typically employ quantitative and qualitative techniques to ascertain information about future stock and index movements with the aim of timing markets and positions in individual shares. Significantly different levels of net long or short equity market exposure will be held at different points in the market cycle.

Equity Short-Biased: funds will typically employ analytical techniques in which the investment thesis is predicated on identifying overvalued companies. The fund would be expected to maintain a net short equity position at all times.

Event Driven Merger Arbitrage: funds will typically employ an investment process primarily focused on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction. Merger arbitrage strategies typically have over 75% of positions in announced transactions over a given market cycle.

Credit Arbitrage Strategies: funds can either be event driven (with analysis based around the likelihood of specific known corporate events occurring) or based on a much wider range of anticipated idiosyncratic developments within bond markets. Managers will look to isolate attractive opportunities in corporate credits relative to bonds issued by other companies and governments or indeed between different bonds issued by the same company. High levels of leverage are often employed. Net exposure to corporate and government bond markets and indeed to bonds of different maturity and credit quality will vary appreciably depending on the particular strategy of the manager.

Macro: strategies will typically focus on the evaluation of macroeconomic variables in which the portfolio positioning is predicated on a move up or down in a particular index or type of asset. Positions could be in equities, bonds (government and corporate), currencies or commodities. Managers will employ a variety of techniques, both qualitative and quantitative and through both top down and bottom up analysis. Macro strategies are distinct from relative value strategies in that the primary investment thesis is predicated on absolute movements in the underlying instruments, rather than realisation of a relative valuation discrepancies between securities.

Macro, Systematic Diversified: will usually have an investment process that is based on mathematical, algorithmic or technical models where people then have little or no influence over portfolio positioning. Strategies will look to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. They will generally focus on highly-liquid instruments and maintain shorter holding periods than either discretionary or mean-reverting strategies.

Relative Value, Volatility: strategies trade volatility as an asset class, employing arbitrage, directional, market neutral or a mix of types of strategies, and include exposures which can be long, short, neutral or variable to the direction of implied volatility, and can include both listed and unlisted instruments. Volatility arbitrage positions typically maintain characteristic sensitivities to levels of implied and realised volatility, levels of interest rates and the valuation of the issuer's equity, among other more general market and idiosyncratic sensitivities.

So, the term “hedge fund” is a generic one that describes a multitude of very different strategies. While many multi asset class investors will chose to treat the industry as an asset class in its own right and invest across the whole array of hedge fund strategies in a very diversified and strategic “Fund of Funds”, as the industry becomes more mature, we expect an increasing number will choose to target specific categories of hedge funds that particularly complement their strategy and mix of investments.

The key to understanding the performance of different styles of hedge funds and the likely returns of an individual manager will relate not only to the type of assets they are buying and selling, but more importantly to their natural degree and direction of market exposure, the extent to which they will deviate from their normal position and the degree to which they will use their powers to borrow in order to magnify their underlying returns.

Borrowing is usually measured in terms of a fund’s “gross” exposure, with figures above 100% indicating that the fund has investment positions worth more than the assets of the fund. So, a fund with net neutral market exposure could have gross exposure of 200%. This could have been achieved by, say, initially selling short positions to the value of 100% of capital and then buying long positions to the same value. So, if a fund raised £100m, it might have £200m worth of fund management “judgements” influencing its performance but technically no market exposure. Note that theoretically it would also still have £100m on deposit earning a cash return.

Given that some funds borrow up to ten times their actual capital/assets, leverage is clearly a crucial element of performance. With such high gearing, a favourable 1% move in the value of their positions could become a 10% gain in unit price, whilst conversely an unfavourable 10% move could eliminate the whole fund.

Hedge funds that employ gearing on this scale must make rigorous use of “stop loss” systems and other portfolio insurance measures in order to protect themselves. However, as has been witnessed on numerous occasions, hedge funds can and do sometimes lose nearly all of their investors’ money.

Perhaps the best known case was that of Long-Term Capital Management, whose near failure and subsequent rescue by a consortium of banks was one of the causes of the crisis in world markets in the autumn of 1998.

Long-Term Capital Management had borrowings of as much as one hundred times its net assets at the time of the crisis. In 2007, Amaranth (a hedge fund trading in oil and gas prices) made for some equally disturbing headlines, while 2008 witnessed the demise of funds managed by Bear Stearns, Bernard Madoff, Citadel and Galleon.

That said, the vast majority of hedge funds do not “blow up” or prove hugely value destructive: this just makes good headlines. Most funds shut down because they simply don’t make enough money. While industry sources suggest that around a quarter of new funds fail and are wound up within two years of their launch, the vast majority of these do so because they have failed commercially rather than in investment terms. The returns have simply not been enough to justify the risk and fees associated with their management and, as a result, investors move elsewhere. These funds shrink to the extent that it is not worth while for their managers to manage them any more.

So, why has there been such significant growth in hedge funds in the past 15 years? From an investors point of view, it is probably aspirational – the hope that there is a "better" way forward than the rollercoaster ride provided by conventional long term investment management. From a fund managers' point of view, it is probably as much about the fees that can be earned as by the desire to satisfy the markets demand for absolute returns.

Although hedge funds have existed since the 1950s, there has been particularly rapid growth in the hedge fund movement over the last ten to fifteen years, with a proliferation of new funds appearing in the last five years. Some of the best investment talent has been recruited to manage these new hedge funds. Managers are attracted by the highly focused nature of the job and the high rewards on offer: in addition to the usual fixed percentage of the assets being managed, they are normally rewarded by a second fee linked to performance.

It is not unusual for managers to earn 25% of any gain made by a fund after the annual management fee has been earned. The overall charges on hedge funds therefore tend to be much higher than on conventional funds. Direct charges on a hedge fund that manages to produce a return of 14-16% may be in the order of 4-5%, compared to 1.5% on a conventional unit trust.

If hedge funds exposure is achieved through the medium of "Funds of Funds", additional layers of fees need to be factored in. A Fund of Hedge Funds that provides investors with a return of 9% could easily have paid away nearly 7% in fees. Looked at another way, the underlying securities ultimately owned need to have risen by nearly 16% to provide the investor with a return of 9%.

George Soros and others brought hedge funds to public attention when their "macro" hedge funds mounted speculative attacks on weak currencies, such as sterling in 1992 and the far eastern currencies in 1997. However, it was probably the turn of the century bear market that resulted in an explosion of interest in hedge funds, reflecting a growing appetite amongst investors for strategies that hold out the prospect of making money whatever happens to the wider market.

By the end of 2009, hedge funds were held in a wide range of private, charity and pension fund portfolios. Some mainstream and well-known managers of long-term private and institutional wealth were recommending allocations of 25-30% in hedge funds and other newer market participants were advocating much higher figures. Exposure to hedge funds had clearly helped some investors during the 2000 to 2003 collapse in equity markets – would they prove beneficial during the next market collapse?

With another significant sell-off having taken place over the past two years, making two significant asset price corrections in just ten years, now is a good moment to consider their long-term record and whether the "absolute return" mantra and claim to protect investors whatever general market conditions are prevailing has worked.

Table 8.3 looks at a range of hedge fund indices. We have also shown the comparative returns from world equity and bond markets and also from US equities. All the figures are expressed in US dollars, being the reference currency for most hedge funds and where we can find the longest runs of data. Investors using other currencies should be able to find a wide range of equivalent funds designed to produce absolute returns in their accounting currency of choice.

It can be seen that the CS/Tremont Hedge Fund Index has outperformed the world equity index substantially over the period, despite displaying a lower level of volatility. It has also outperformed the US equity index whilst displaying significantly less volatility. It has outperformed the world bond index with similar levels of volatility.

In other words, there is evidence here to support the proposition that hedge funds can achieve above-average returns for below-average risk.

To test the claim that hedge funds achieve absolute returns regardless of market conditions, it is instructive to examine the record in a number of difficult years for investment markets. Table 8.4 shows the performance of the same index in a number of recent "down" years, defined as any year in which one or more of the quoted market indices has given a negative return.

It can be seen that the HFRI Fund Index was up in five of the "down" years that have occurred since 1988, albeit only very modestly in two of these years. 2002 and 2003 were less good.

However, these indices of individual hedge funds are generally recognised as showing an overly positive interpretation of how actual hedge fund investors would have faired. When using any historic index to analyse and consider future investment experience, three factors need to be taken into consideration: the quality of data, the dispersion of returns and the costs and problems associated with trying to replicate the index return in practice. In each of these, hedge fund indices are at the lower end of what would usually be tolerated.

8.3

Global Hedge Fund Performance in US Dollars (to Dec 2009)

Hedge Fund Strategy	3 Years % p.a.	5 Years % p.a.	10 Years % p.a.	Standard Deviation % p.a.
Convertible Arbitrage	-10.9	-4.8	3.4	13.1
Short Bias	-1.1	-1.0	-2.7	17.8
Emerging Markets	-2.3	7.7	12.6	12.4
Market Neutral	-14.1	-6.6	-0.4	16.0
Event Driven	0.7	4.5	7.2	7.2
Fixed Income Arbitrage	-6.5	-3.6	1.6	11.9
Global Macro	6.1	3.7	7.0	8.3
Long/Short Equity	-6.2	-1.2	0.8	10.5
Multi Strategy	-6.7	-0.5	4.1	8.0
Managed Future	6.9	5.3	8.2	12.3
CS/Tremont Blue Chip Hedge Fund Index	-2.6	1.0	4.6	6.2
MSCI World Equity Index	-5.6	2.0	-0.2	16.6
S&P 500 US Equity Index	-5.6	0.4	-1.0	16.1
Lehman Brothers Aggregate Bond Index	7.0	4.6	6.5	6.3

Source: Credit Suisse/Tremont

8.4

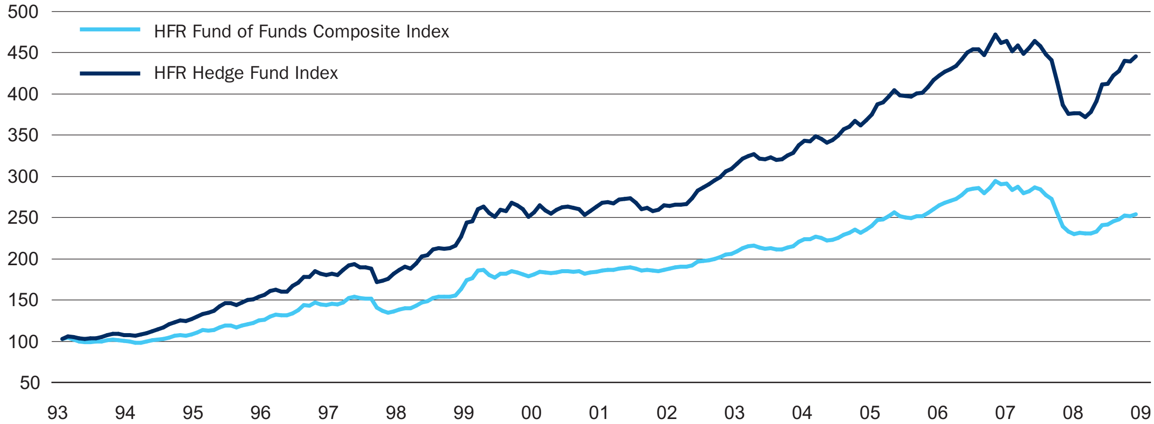
Global Hedge Fund Performance In "Down" Years

Fund Type	1990 %	1992 %	1994 %	2000 %	2001 %	2002 %	2008 %
Equity Market Neutral	15.5	8.7	2.7	14.6	6.7	1.0	-5.9
Equity Quantitative Directional	-7.2	22.8	5.1	-9.0	1.4	-8.5	-22.9
Equity Short Bias	36.2	10.1	18.5	34.6	9.0	29.2	28.4
Merger Arbitrage	0.4	7.9	8.9	18.0	2.8	-0.9	-5.4
Macro	12.6	27.2	-4.3	2.0	6.9	7.4	4.8
Fixed Income Asset Backed	-	-	11.6	-1.4	21.2	8.6	-3.4
Fixed Income Convertible Arbitrage	2.2	16.4	-3.7	14.5	13.4	9.1	-33.7
Fixed Income Corporate	-12.1	18.5	1.5	-3.0	5.4	5.8	-24.2
Emerging Markets	-3.4	24.4	3.4	-10.7	10.4	3.7	-37.3
Fund of Funds - Diversified	17.0	10.3	-3.1	2.5	2.8	1.2	-20.9
HFRI Weighted Composite	5.8	21.2	4.1	5.0	4.6	-1.5	-19.0
MSCI World Equity Index	-18.7	-7.1	3.4	-14.0	-17.8	-21.1	-40.8
S&P 500 US Equity Index	-3.0	7.6	1.3	-9.1	-11.9	-22.1	-37.0
Lehman Bros Aggregate Bond Index	10.3	7.4	-2.9	11.6	8.4	10.3	10.9

Source: Hedge Fund Research, Inc., © 2010, www.hedgefundresearch.com and Sarasin & Partners LLP

As far as the first point is concerned, the data has been collected over a relatively short period of time. The indices also tend to show the more mature and successful funds and not the raft of smaller funds, many of which fail and are never get reflected in the mainstream indices. Furthermore, those funds that become very successful and close to new investors remain in the indices despite an inability for people

8.5
Hedge Funds versus Funds of Hedge Funds (1993-2009)



Source: Hedge Fund Research, Inc., © 2010, www.hedgefundresearch.com and Sarasin & Partners LLP

to gain exposure to them. Consequently, hedge fund indices are deemed to show a high degree of "survivorship bias".

As regards the second factor, trying to achieve an average return is likely to be difficult in practice: the "dispersion" or range of returns around the median fund in each sub-category is typically very large. As with private equity, it is more important to decide in which fund to invest, than the decision to invest in the asset class itself

As a result, many investors choose to invest in hedge funds through a "fund of funds". This strategy reduces concerns about the specific risk of individual hedge funds and having to understand the technical nature of the various hedge fund strategies, the difficulty of finding information and advice on them and the high minimum subscriptions. They provide diversified exposure to a range of managers and strategies, which are researched thoroughly and monitored by experts in the sector.

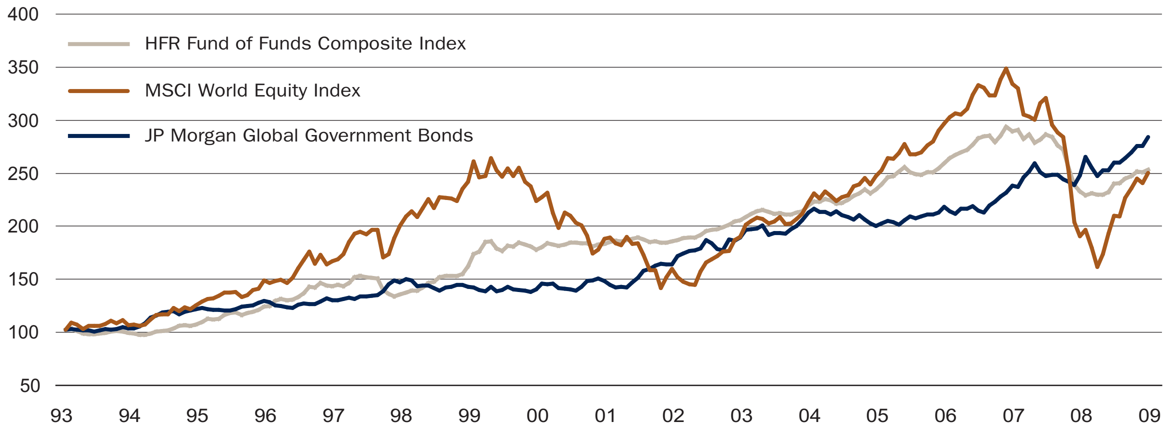
However, this does add a further layer of cost and does not allow the "cherry picking" of specific strategies that might be less correlated (and thus more appropriate) with your other investments or in keeping with your current tactical policy.

However, by analysing the historic returns of funds of hedge funds, we should get a much more realistic view of how hedge funds have behaved in the hands of investors. Actively managed Funds of Funds will have suffered losses: they will have invested in bad funds as well as successful ones and, in choosing between the myriad of offerings, they will have suffered the additional costs that investors will have to pay.

Table 8.5 shows one of the main providers of hedge fund data. It can be seen that, hedge funds of funds have significantly lagged the indices of individual hedge fund strategies. However, they still show a good combination of risk and return characteristics when compared to the conventional asset classes.

8.6

Funds of Hedge Funds versus Global Equities and Bonds (US$) (1993-2009)



Source: Hedge Fund Research, Inc., © 2010, www.hedgefundresearch.com and Sarasin & Partners LLP

Table 8.6 charts the progress of the HFR Fund of Funds index graphically since inception.

The "absolute returns in all market conditions" claims made by the proponents of hedge funds clearly rings hollow when considered in the context of in the last two years. However, while failing badly in this regard, there is further evidence that while not achieving the positive returns produced by government bonds and cash, they did perform much better than most real and risk assets.

If one made a strategic allocation to hedge funds out of cash and bonds one is likely to have been disappointed. If one allocated monies out of equities, then the lower volatility probably made up for the losses even if the end result was much the same.

Whether hedge funds will be seen as a mainstream asset class is still open to debate, and it remains unusually difficult to find unbiased opinion. There is no doubt that there is significant talent within the hedge fund industry and it would be inadvisable to disregard and to avoid hedge funds altogether. However, there is no doubt that they are expensive and in most cases opaque and illiquid. They also provide no income stream.

Many conventional managers use much of the toolkit of hedge funds in terms of derivative protection strategies, cash benchmarks and medium term absolute return.

To the extent that they seek to provide returns irrespective of general market conditions, hedge funds provide an additional tier of diversification for portfolios. If they continue to demonstrate that they really can reduce risk, whilst also boosting returns, they will become an increasingly plausible investment, even if only on a peripheral rather than a core basis.

In terms of gaining exposure to hedge funds, the market in listed vehicles has taken something of a body blow over the last 18 months, suffering from widely fluctuating discounts, illiquidity and unexciting performance. Several funds have been wound up and while new funds have been launched, the share price volatility will cause many investors to question whether this is the right way to gain exposure to managers.

On the other hand, we expect the increased use of regulated UCITS funds (as opposed to tax inefficient offshore vehicles) to increase the appeal of hedge funds and we foresee a number of fund launches over the next two years.