

What Do Hedge Fund Investors Want? June 2009

Although I have never been a marketer, and am firmly on the buy side, being part of **First Avenue Partners**, effectively a marketing firm active in hedge funds, private equity and real estate, as well as a hedge fund seeder, gives me a very interesting view on what investors want. Being responsible for due diligence and manager selection for the hedge fund practice, I spend most of my time looking at the hedge fund industry, but I also keep track on the private equity and real estate fund management industry as there are often interesting overlaps.

It was very clear that in **4Q 2008, investors simply wanted out**, they wanted to redeem from their managers and they often wished they had never been invested with the funds they were invested with, that they had never got involved in the dreadful investment game, and that they should all have been dentists instead. You get paid for pulling teeth, patching teeth, straightening teeth, and poking around in teeth. But the more teeth you pull, patch, poke or straighten, the more you get paid. In those times, investing was like having your teeth pulled and paying for the pleasure, a bit like being on the other side of the drill. It was not material which investment strategy you were in whether it was equity long short, merger arbitrage, relative value, event driven, credit, fixed income or macro. The pain was less in macro and risk arb, although so widespread was the pain and so punchdrunk were investors by the end of 2008 that many did not even realize that risk arb actually turned in a relatively strong performance, losing some money but mostly protecting capital for the year. Global macro made money, but even macro as a group saw investors making net withdrawals from the strategy. Investors wanted out. They just wanted to sell sell sell. Put or Call? Doesn't matter. Sell sell sell. The redemption terms of hedge funds made it possible to forecast the degree of outflows since there is usually a long notice period of anywhere from 15 days to 180 days, although its more usually clustered around 30 to 45 days. Also, in the industry, people talk. And misery likes company. The anticipated and realized redemptions for September 2008 was high, but December saw a crescendo. Sentiment was terrible. And then some managers started **suspending redemptions and applying gates** and side pocketing illiquid investments. For the most part, if you were in 'traditional' hedge fund strategies such as equity long short, merger arbitrage, statistical arbitrage, relative value, convertibles, global macro and CTA's, you would have lost money but you would have got your money back. If you were in the less liquid end of credit, levered loans, LCDS, private convertibles, PIPEs, quasi private equity (PE without control, lovely), asset based lending, chances are your manager would not be able to get you your money back even if they wanted to. And to be fair some of them wanted to.

Human beings are predisposed to extrapolation. Estimates for the March 2009 redemption volumes ran to the fanciful. In the end, **over a 6 to 9 month period ending March 2009, a 2 trillion USD industry had been halved**. Hedge fund managers who once were Masters of the Universe were humbled. Funds that were closed to new investment were open again and their managers had to suffer the ignominy of presenting at capital introduction events.

We have seen evidence of interest in distressed credit, global macro, equity long short and convertible arbitrage.

Distressed credit is a strategy which according to investor survey's conducted earlier in the year continue to see a lot of investor interest. In fact, distressed credit was a strategy offered in volume in late 2007 and which in 2008 burned a lot of investors. One factor in the disappointment was the lack of corporate defaults in 2008. Distressed investing worked only if you were ultra selective and if you went where the defaults were underway and not where they were waiting to occur. The place to be was arguably in the ABS market where RMBS and their CDO's were already defaulting. In corporate credit, default rates are only now accelerating. The market expects default rates in double digits by the end of the year, arguing that investors were too early in 2008 but are likely to be right this time.

Global Macro in 2009. Think again where I argue that the easy trades are done, that the opportunities are still there, but the way one captures them, and the subspecies of manager required for the job, are different. But who am I to argue with the legions of investors who want to invest in Global Macro?

Equity long short is a perennial strategy. In the turmoil of the last 12 months, the strategy has had mixed success. The traders have done well as equity markets abandoned fundamentals and traded almost purely on psychology. There are signs that **idiosyncratic risk is beginning to rise** and that the day for the stockpicker

is not far away. Of course the holy grail is finding the investment manager who both understands fundamentals and has the ability to trade, who has a full arsenal and can deploy the right weapon for the right battle for the winning of the war. As investors restore their risk, equity long short is one of the strategies that ranks high.