Hedge Fund Performance Aug 2011 And A Look Back at 2008

Hedge funds have had a tough time, but not quite as tough as equities or commodities. Bonds have continued to outperform, much to the bewilderment of investors.

On a risk adjusted basis, hedge funds trounce equities and commodities but still lag bonds.

Year to date hedge funds have been nearly flat whereas equities have lost some 6%. This masks some very poor performance in emerging markets and European equities. US equities have proven more resilient than expected but then 75% of the S&P500’s profits originate outside the USA.

It is interesting to note that in 2008, until July, the HFRI had dropped -3.6% while the MSCI had dropped 16.3%. From July to December 2008, the HFRI fell a further -16% while the MSCI world fell -34%. What happened from August to December? A liquidity crisis exacerbated and related to risk of a major counterparty default. In those days, investors waited sleepless weekends to see if the likes of Morgan Stanley, Goldman Sachs and Lehman would open for business on Monday. Eventually Lehman fell.

Hedge funds traded not only against each other. They traded with their prime brokers and it was the prime brokers who faced each other as counterparties. When the market cast doubts over the solvency of prime brokers, lines were pulled and redemptions poured in.

What about today? While markets trade continuously and in liquid fashion hedge funds will continue to outperform and more than that, limit losses substantially. To assess the risk of a drastic drawdown in hedge fund investments, one has to assess the risk of counterparty default among the prime brokers.

There is an irony when investors fret about hedge funds that are levered 2X and have independent administrators performing valuations that borrow from institutions which tend to be levered 20X and where nobody seems to be able to value their assets.