

Hedge Fund Strategies: The Outlook for 2007

We are no better off letting the weatherman predict the economy and the economist predict the weather... having said that, let us press on.

Stock selection:

Stock selection strategies and strategies that profit from an increase in specific risk will find more opportunities this year. The withdrawal of liquidity by central banks of US, UK, the Eurozone and the Japan over the past three years is beginning to take effect. Liquidity will diminish as a driver of financial market returns relative to fundamentals, increasing the share of idiosyncratic risk as a proportion of total risk in asset prices. This favours equity long short, event driven, credit long short strategies which are based on fundamental security selection.

Macro:

Global macro has always profited from trending markets. Trending equity markets, surging ones in some areas did not help macro in 2006. The changing face of macro is responsible. Discretionary and directional macro is out of fashion and in some cases out of businesses. Whereas in the mid 1990s discretionary macro was able to profit despite considerable uncertainty over policy by punting equity markets, today's macro is more fixed income driven, more systematic, less discretionary. Fixed income markets have behaved erratically and counter intuitively. Whether they settle into a pattern this year is crucial to macro. As always, macro is difficult to call. Macro managers who can and do actively participate across all asset classes will find ample opportunity. Macro managers trading in fixed income land will likely continue to

generate sub par results.

Event Driven:

Over the years the event driven space has grown in variety and richness. Once dominated by merger arbitrage and distressed investing there is now a growing supply of multi strategy event driven funds. Activists are a resurgent breed within the space. Merger deal flow will continue until corporate balance sheets are once again stretched. For the moment they are still relatively fat. When equity swap deals begin to proliferate will mark the time for caution. Until then, bet long on this strategy. At the distressed end, value is slowly being squeezed out of the market as default rates struggle to keep up with demand from ever sprouting hedge funds. In the convertible space, distressed investing has all but dried up from the dearth of low delta issues. The hostile activist which was in the limelight in 2005 and 2006 has lost some of its shine. High profile retractions show chinks in the armour. In emerging markets, a friendly activist still finds ample opportunities as corporates look to them for assistance.

Convertible Arbitrage:

Convertible arbitrage managers have returned to profit despite volatility remaining low. While implied vols have fallen back from the elevated levels of last summer realized volatility has risen. This has created opportunities particularly outside the US. In the US, the VIX continues to track realized volatility closely. Convertible arbitrage is more than being short implied and long realized vols. With the protracted shakeout of 2004, convertibles are showing good value. Rising deltas on the back of strong equity markets have improved the returns of synthetic puts. The trading of convertibles from a credit or equity directional view has also gained ground during gamma's troubled years. Increasingly capital structure arbitrage, directional views on a particular stock, are expressed in the convertible market. These strategies are more

exposed to event and execution risk than global trends in implied or realized volatilities.

As credit spreads have compressed across ratings, convertible bond issuance has slowed. This has implications on the competitive environment in the convertible arbitrage space. As corporate balance sheets re-lever and equity valuations become stretched, convertible bonds become a more attractive source of funding for corporate treasurers.

Credit:

In the tranching credit markets, correlations have been rising. This has provided the long equity versus senior trade some tailwind. The liquidity scenario painted above, of rising inflation and more hawkish central banks threaten this scenario as it encourages dispersion.

Credit spreads continue to decline, particular in HY where spreads are near historical lows. IG spreads remain barely wide to 10 year lows. Private equity investors continue to be active creating LBO risk and higher volatility in spreads. This is expected to continue into 2007 providing the event driven credit strategy healthy deal flow. For fundamental long shorts, LBO activity is a risk they have to manage carefully as private equity investors become less demanding and hence more unpredictable.

Asia:

Asia represents considerable threats and opportunities. Just as 2005 witnessed hedge fund assets growing in Japan on the back of high returns generated by levered long bets on the direction of the Japanese equity market, so too Asian hedge funds have printed remarkable results, also on the back of levered long bets on Hong Kong, China and India. In early 2006, the Japanese equity market wobbled and Japanese hedge funds recorded large losses. A similar risk plagues Asia ex-Japan.

Just as Japanese managers who have weathered the storm are now emerging with more reasonable and stable returns, well risk managed hedge funds in Asia will find the region a rich and rewarding space. Activists will find particularly interesting situations if they are happy to be constructive critics. Credit funds are finding improved market depth and range. Stock borrow improves daily in Asian markets while derivative technology opens up shorting opportunities in India and China. The attraction of Asia is clear: India and China as the new engines of world growth. The complex relationships within Asia mean that obvious trends often result in counter intuitive outcomes. For the astute investor, the less efficient markets of Asia present rich pickings.

Commodities:

A four year bull market in commodities, following nearly 20 years of dead money, has led to strong interest in the asset class. This despite a very volatile and negative 2006. Interest has rotated first from precious metals in 2002 as a store of value, USD short, to industrial commodities such as base metals and energy on the China growth story, to softs and ags almost by default. A secular growth story supporting a long only exposure based investment strategy no longer works. Investors seek more intelligent trade expression which they hope to find in hedge funds. Whether they will find it is another matter. Commodities are factors of production with very peculiar supply dynamics. Too many financial traders participate in a market which should be driven by marginal cost. The result is ample alpha for the skilled trader and a high attrition rate among managers.