Hedge Funds: The State of the Craft: June 2009

The fundamental picture:

The second quarter of 2009 witnessed a continuation of the rally in all risky assets from equities to credit to commodities and energy to illiquid Asian physical real estate. On the back of this reversal of the acute risk aversion that plagued the fourth quarter of 2008 and the first quarter of 2009, economists began to detect 'green shoots' of economic recovery. However, economic growth forecasts in the developed world continue to be depressed. The US for example is expected to show -2.8% growth in 2009 with a weak recovery in 2010 of 1.6%; the Euro zone is expected to shrink by 2.3% in 2009 and grow by an insipid 1.7% in 2010 with dire numbers from Germany (-5.5% 2009, +0.55% 2010), and Italy (-4.4% 2009, +0.4 2010). Emerging markets were widely expected to decouple, but thus far the incipient recovery is only evident in BRIC, with China growing +6.5% in 2009 and +7.3% in 2010, India growing +5.5% in 2009 and +6.4% in 2010, Brazil shrinking 1.5% in 2009 before growing 2.7% in 2010 and Russia shrinking 5% in 2009 and growing 2% in 2010. Outside of the BRIC, emerging markets' highly export driven economies are severely impacted by the slowdown in the developed world, the dearth of demand and the unavailability of trade finance.

Developed markets have been hobbled with historically high debt levels, distressed real estate prices, rising unemployment, weakening retail sales, shrinking industrial production and declining consumer and business confidence. Coupled with impaired sovereign balance sheets, the result of financial rescue packages, Keynesian fiscal reflationary policies, an ageing population's impact on state pensions and healthcare, the outlook for developed market growth is not optimistic. The one area of potential respite is the external sector, which as a matter of mathematics has to and will adjust to reduce the scale of current account imbalances.

Emerging markets have somewhat healthier financial systems, sovereign balance sheets and private savings levels and are thus in a better position to implement fiscal reflationary policies and centrally influenced if not planned extension and allocation of credit. This, however, remains concentrated in the larger emerging markets such as BRIC where domestic diversification reduces the dependence on the external sector.

The expansion of the government in the economy is therefore more feasible in the BRIC. It has been moderately successful. China is a case in point where fixed capital formation in the form of infrastructure build has more than made up for the gap from a collapse of external trade and a moribund consumer sector.

These efforts provide a stay of execution. Time, however, is a healer, under the assumption of free markets. Protectionism and outright central planning has historically proven counter productive. It is interesting to note that while developed markets flirt with market interventionist policies, bend Chapter 11, and increasingly embrace quantitative easing, further emergency interest rate policy, flirting with protectionism, interfering with the banking system; emerging markets have by and large embraced free markets.

While policy makers continue to hold interest rates at low levels, the inflation deflation debate continues. Central banks with formal inflation targets may be more likely to tighten prematurely than central banks with a softer target or a more holistic mandate. Given the rate at which capacity utilization has fallen and the current levels at which it rests, it is unlikely that inflation will take hold. On the other hand, given the reflationary capacity of BRIC and competition for natural resources, deflation is unlikely to take hold either. Central banks are likely to be afforded the latitude to hold short rates lower for longer in their anti-recessionary campaigns. Long bond yields are likely to display news driven and data driven volatility as signs of inflation wax and wane.

Hedge Fund Performance:

Performance to June 2009:

Hedge Fund Outlook:

Generally, the outlook for hedge fund strategies is very positive. There are a number of reasons for this. The period 2005 to 2007 saw a surge in equity capital employed in hedge fund strategies. With increasing volumes of arbitrage capital, return on gross capital employed compressed, as one would naturally expect. Hedge funds adaptively increased their leverage in order to maintain return on equity, a strategy feasible because interest rates were low and credit spreads were tight and thus leverage was cheap. The bankruptcy of Bear Stearns and then Lehman Brothers in 2008, triggered a massive deleveraging of the entire arbitrage industry from hedge funds to bank proprietary trading desks. Mark to market losses triggered large scale redemptions from hedge funds which left what in 2007 was a 2 trillion USD industry with an estimated paltry 1.2 trillion USD of assets under management. This together with the wholesale withdrawal of leverage from an average of 3.5 to 4 X to 1.5 to 2X, implies a 70% to 75% shrinkage in capital employed in arbitrage. The indiscriminate withdrawal of risk has created ubiquitous arbitrage and relative value opportunities.

Equities: Market sentiment went from monotonic risk aversion from the second half of 2009 into the first quarter of 2009. During this time, equity dispersion was explained not by earnings prospects but by news flow and macro implications on balance sheet integrity. And a great deal of simple panic. The very sharp rebound from mid March 2009 has similarly been driven not by earnings fundamentals but by a reversal of risk aversion and other dynamic factors. As market volatility settles, equity dispersion is expected to be increasingly driven by fundamentals once again. The opportunity set for equity long short managers is improved.

Event driven: In every distressed cycle, private equity buyouts dwindle and deal break risk is escalated due to buyers remorse. When coupled with a credit crisis, jurisdictions where committed financing is not a prerequisite to an approach and banks themselves in jeopardy also increase deal risk. Following this initial round of panic and disorder, the following period of calm usually witnesses deal flow on the basis of strategic alliance, self preservation, consolidation, asset disposals, and capital raising. This is the landscape facing the event driven merger arbitrageur today. The dearth of arbitrage capital has also resulted in slower convergence, more volatility of spread and a profitable environment for the strategy.

Macro and Fixed Income: Macro strategies did relatively well in 2008 as large and trivial trades presented themselves with the ebb and flow of capital driven by acute risk aversion and government reactionary policy. These trades have now receded into history. Going forward macro is likely to continue to perform well on the back of persistent volatility in fixed income markets driven by the cycles of central bank policy and investor prevarication between inflation and deflation. These same themes create interesting arbitrage opportunities in fixed income arbitrage as well as short rates react to policy and long rates to inflation expectations and sovereign credit risk. The reduction of capital in fixed income arbitrage also presents interesting arbitrage opportunities between cash, synthetic, futures, forwards, swap and repo markets.

Asset based investing / lending / Trade Finance: The global credit crisis and associated global economic recession has resulted in a dearth of credit. Providers of credit are therefore well rewarded. In trade finance, for example, a sharp fall in world trade of over a third in the final quarter of 2008 was only surpassed by the contraction of available trade finance. Banking consolidations also constrain credit further as obligor limits are exceeded in merged financial institutions. The result is wider spreads and tighter collateral terms. Hedge funds involved in lending are able to use non-traditional deal structures to secure their collateral while exacting competitive spreads.

Credit: A situation in credit markets exists akin to the one in equities. Systemic risk was high in 2008 and credit was systematically sold despite differentiated idiosyncratic issuer risk. The credit space is richer than equities, however, due to the richness of the capital structure, particularly in more mature developed markets like the US, representing excellent raw material for which to express capital structure dislocation trades. Differing natural investors or traders at different parts of the capital structure create arbitrage opportunities which barring unilateral regulatory or government intervention, represent true arbitrage.

Convertible arbitrage: Convertible arbitrage was one of the worst performing strategies in 2008 and one of the best performing strategies in 2009 to June. The losses came from a confluence of general risk aversion, deleveraging by banks and institutions, hedge fund redemptions and failures from over-levered portfolios, and a collapse in the funding mechanism of which the prime brokers were integral. With a normalization of market conditions convertible bond markets have recovered sharply. The crucial question is, to what extent is the current recovery in convert arbitrage funds purely a directional one, profiting from the rising tide lifting all boats. Convertible arbitrage, however, is a catch all for a suite of sub strategies of varying sophistication, direction and use. The current market is replete with less-directional opportunities. These arise from the diversity of pricing and valuation across the convertible space, as well as a revival in primary issuance. The credit elements of convertible arbitrage were highlighted in 2008 and will continue to be a key consideration in assessing convertible bonds. Directional expressions of fundamental views on companies can be very efficiently captured using convertibles as well. A fundamental view on a company need not be restricted to first order (levels) pricing but can extend to views about the pricing of the volatility of the company. Capital structure trades can also be expressed with convertibles for example in theoretical replications with bounded jump to default values for a range of recoveries.

Distressed Credit: When the credit crisis first broke in mid 2007 in the US sub prime real estate mortgage market, investors had already begun to seek opportunities in distressed debt. The distress has been concentrated mostly to the real estate backed securities market and latterly to consumer loan backed securities. Among corporate rated issuers default rates remained low. High yield default rates while accelerating sharply in 2008 had only reached 5.42% by 1Q 2009 according to S&P. S&P expects the default rate to climb to a peak of 14.3% in 2010. Distressed debt managers returns tend lag default rates and accelerate when default rates have peaked. A three to four year period of outperformance is usually measured from the peak of the distressed cycle. This is consistent with the bankruptcy processes of the developed markets such as Chapter 11 in the US. The risk remains that the economic recovery will be an insipid one and or that the economy may sink back into recession before it finds a stable trend path. Distressed debt managers also tend to be weakly correlated at the peak of the default cycle and maintain low correlation for about 3 years after which correlation creeps into their returns.

The events of 2008 have resulted in a peculiar situation where almost every hedge fund strategy is likely to perform well going forward. This is not to say that there is little or no risk. The choice before the investor remains the magnitude and the type of risk they are happy to assume. In liquid strategies such as equity long short, the risk is non-convergence, for there is often no functional relationship to bring relative value trades in line. For strong convergence, such as capital structure arbitrage strategies, convergence is less uncertain, at maturity or in default. However, under going concern assumptions, spreads can be volatile and can widen significantly and sometimes unpredictably. There is a trade off between market risk and liquidity risk.

At various times, the opportunity has shifted from asset class to asset class, from strategy to strategy, requiring a careful portfolio construction to capture the appropriate risk reward characteristics of each strategy, while achieving efficient portfolio diversification. Under current conditions, when risk reward properties of almost every strategy are favourable, the portfolio construction problem is significantly simplified.

Investor Risk Appetite:

In the first half of 2008 investors were content to be worried about their hedge fund allocations while remaining invested. Recall that for the year up till June 2008, hedge funds had turned in a moderately poor (-2.43%) performance. It was only when the losses accumulated and large regulated insurance companies and banks either went bankrupt or threatened to do so, did hedge fund investors decide to redeem in any size. The Madoff fraud further destroyed the trust between investors and their fund managers leading to the demonizing of the entire hedge fund industry not only within the industry but in the general medial as well. Redemptions crescendoed in March 2009 while hedge fund managers, some with liquidity mismatches or funding issues, began to restrict or suspend redemptions in an attempt to avoid disposing of assets at firesale prices.

Hedge fund investors' reaction, quite understandable began with complacency in early 2008, to fear and panic in 3Q 2008 to despondency in 4Q 2008 and 1Q 2009. The rebound in markets and hedge fund performance took most investors by surprise.

As recently as April / May 2009, investors' risk aversion remained acutely high. From early June 2009 this has changed somewhat as investors have begun to scout for opportunities in the hedge fund space. A number of things have changed since 2008. For one, investors will no longer tolerate liquidity mismatches, and while the immediate reaction has been to demand liquidity and favour liquid funds, a more discerning investor base is now analysing portfolio and strategy liquidity and requiring fund terms to better reflect the underlying liquidity.

The area of hedge fund fees has also come under scrutiny. While a number of funds have discounted their fees, it is unclear if there is any price elasticity. Price elasticity appears to be a weak factor compared with other factors such as manager quality, rational liquidity terms, transparency and operational integrity. In the area of fees, more sophisticated fees seem to be emerging which seek to better align investor and fund manager interests over a rolling investment horizon instead of the current annual fee crystallization which creates cyclicality in manager behaviour.

Transparency has become the most important issue for investors. Without transparency, due diligence and ongoing monitoring is blunted, style drift and frauds go undetected. Transparency goes beyond, and sometimes around, position level disclosure. More constructive forms of transparency include risk aggregation reports, sometimes sent by the fund administrator, periodic calls with the portfolio manager, periodic portfolio detail. The periodic preference for managed accounts has once again re-emerged. Quite whether it is sustained remains to be seen, but managed accounts while useful in some respects is no panacea.

As hedge funds react to investor needs, a stronger industry will arise, albeit initially a smaller one. It is hard to see growth rates regain their heights in 2007. However, given the relative outperformance of hedge funds versus long only equity, credit fixed income, commodities and real estate both in 2008 and over a 10 year period it is easy to underestimate the growth of the industry.