State of the Craft First Quarter 2011

Three years after the financial crisis of 2008 and one bull market later, the world looks like a highly risky and uncertain place again with troubles in the Middle East, disaster in Japan, sovereign debt concerns in Europe and dare we say it, the US, food inflation in emerging markets and surging energy prices.

During this quarter, equities (MSCI World) gained 3.93%, global bonds (Barcap Global Bonds) gained 0.80%, commodities (CRB Index) gained 8.00% and hedge funds (HFRI Index) gained 1.60%. Go back 12 months and hedge funds have gained 9.42% while the MSCI gained 11.79%, Global Bonds have gained 6.60% and commodities a robust 31.50%.

On a 5 year annualized basis, however, hedge funds have returned 4.98%, MSCI a paltry 0.83%, Bonds 6.79% and commodities a mere 0.17%.

On a 10 year annualized basis, hedge funds returned 7.15%, MSCI 3.10%, Bonds 6.33% and commodities 6.97%. The volatility of hedge funds has averaged 6.9%, equities 16.8%, bonds 4.1% and commodities 20.2%.

Clearly hedge funds provide a superior return profile compared to the other asset classes once the risks are factored into the equation. Whereas passive exposure to equities or bonds or commodities may provide periods of significant outperformance, these periods are unpredictable and difficult for the non-professional investor to take advantage of.

During this quarter, Event Driven funds returned 3.5% according to the HFRI strategy indices, outperforming other strategies. A surge of activity in mergers, spin offs, carve outs, tender offers, exchange offers helped drive returns in this strategy. Distressed debt investing returned 3.20% as the recovery took hold. Convertible arbitrage turned in a very consistent 2.7% as credit continued to tighten and implied vols to richen. Mortgage backed security strategies continued their outperformance with a 3.45% quarter as the dynamics between servicers, borrowers, GSEs and regulators continued to present relative value opportunities.

It is tempting to invest based on one’s outlook for a strategy. The reality in hedge fund investing is that a good manager can and does outperform his peers to an extent as to confound the strategy outlook. Nevertheless, calling the strategy right is a useful exercise in the talent scouting process and is helpful in portfolio construction if the investor (such as a fund of funds) is sufficiently large that a concentrated portfolio is not possible.

The available tools in convertible arbitrage continue to recommend it as a strategy. The ability to rotate between delta, gamma, vega and credit provides the arbitrageur with an arsenal with which to attack a range of market environments. The enemy of convertible arbitrage is convertible arbitrage itself. Once too much capital is deployed in this area, not only do returns become more moderate, but risks rise as well as arbitrageurs apply more leverage to maintain returns on equity just as returns on gross assets become compressed. Currently convertible arbitrage is still an attractive strategy.

In the last 12 months the merger arbitrageur has found plenty of deal flow, but tighter spreads and most have struggled to make decent returns. There are exceptions to the rule of course, especially those who approach risk arb from a more creative angle calling not only deal closure or failure, but the path of the transaction. I expect that spreads will widen to reflect deal break risk as the macro environment continues to become more risky. Acquirers are being rewarded at the same time as targets and it is likely that more hostile and competitive bids will surface. Event driven strategies are likely to profit handsomely in this environment.

Fixed income (we lump arbitrage, relative value and macro in this segment) should have generated higher returns that it did in the last 12 months. The environment for fixed income has become more risky and unclear. The obvious trades of front running the world’s central banks was an easy trade which was surprisingly not as widely exploited as one would have expected. The opportunity has largely passed. Some of these ‘central bank’ front running trades were well played by the mortgage arbitrageurs as the Fed bought mortgage assets. The same opportunities in treasuries under so-called QE2 were not exploited.

Equity hedge funds maintain their net long bias and thus introduce correlation. The prospects for equity funds remains difficult as the proportion of stock price variation due to macro factors still dominates that due to idiosyncratic factors. Equities can therefore remain mispriced for protracted periods of time.

Credit hedge funds based on fundamental stock picking have an advantage over their equity counterparts in that credit trade expressions have a day of reckoning whereas equities can be mispriced indefinitely. For stockpicking hedge funds, credit is by far the better trade expression. Capital structure strategies like convertible arbitrage present a wide array of trade expressions which present no shortage of opportunities in any environment.

Global macro managers are too heterogeneous a group to speak about as a group. As noted before, the world has become a more risky and uncertain place and the opportunity for macro to make and lose money are equally heightened.

2011 promises to be a fascinating year. In the developed markets, economic policy (inflation, employment and growth policies) confronts sovereign balance sheet integrity. In emerging markets, rampant economic growth confronts income and wealth inequality. The ad hoc and desperate measures in addressing the financial crisis of 2008 have persisted and evolved into a prolonged yet unsustainable tactic of asset and liability transfers and liquidity and credit infusions. The economist worries about these real problems. The trader or investor deals in nominal terms and realizes that they are merely redistributing wealth, hopefully in their own direction. Theirs is not to reason why…