Hedge Funds: Looking Back – Moving Forward

Investment markets are like roller coasters but this last cycle has been so different to previous experience that investors are questioning strongly held beliefs in respect to alternative assets and particularly hedge funds.

While we are still a long way from being able to look back and draw conclusions with a high level of confidence, we do have enough distance from the most extreme events of 2007 to 2009 to draw a considered assessment of the behavior of the hedge fund sector over this period.

As the title of this newsletter implies, Sovereign believes that there are valuable investment lessons that can be drawn from looking back at the recent past. **The hedge fund investment model has many flaws and these must be addressed. However the asset class is not fundamentally flawed**.

As a result, hedge funds, when correctly implemented <u>should</u> continue to provide valuable investment options for investors going forward.

Bearing this in mind, we can consider some of the lessons that can be drawn from the events of the last few years.

<u>Some Lessons</u>

1. **Hedge funds have actually performed in line with reasonable expectations**

   "What!!?? you say – but we have all been told that hedge funds caused the Global Financial Crisis, and besides, hedge fund managers lost money in 2008 which meant that they did not deliver an 'absolute return' as promised!!!"

   It's a popular assertion that hedge funds caused the Global Financial Crisis in 2008 and more particularly from the investors perspective lost value which meant that they did not deliver an "absolute return" as promised and at a time it was needed most.

   Well, no and yes actually. Hedge funds did <u>not</u> cause the GFC, just as margin lending did <u>not</u> cause the Great Depression of the 1930's and Dynamic Portfolio Hedging did <u>not</u> cause the Crash of '87 – no matter what the pundits said at the time. On the other hand, hedge funds were <u>involved</u> in the GFC, along with Superannuation Funds, sub-prime mortgage brokers, central banks, Chinese steel mills, university endowments, regulators, credit rating agencies, criminals (e.g. Bernie Madoff), the criminally negligent (who invested with Bernie without doing basic due diligence), and you and I doing our best in difficult circumstances.

   In reality hedge funds lost, on average, between 10% and 20% in 2008 which, given the two major drivers of return – market index declines of up to 50% and huge increases in market irrationality – was a reasonable result. Moreover, as at mid-2010, we can see that hedge funds have largely returned to pre-2008 levels (HFRI Composite Index flat (actually +0.3%) for the 3 years to June 2010), while US equity markets remain more than 20% below their June 2007 levels.

So one can conclude that hedge fund managers have performed as expected over the last few years. In particular, the high quality institutional quality managers that we have traditionally found to be attractive, have added considerable value – more so in relative terms than the 'absolute return' targets that never contemplated the GFC.

A strong qualification to this is the use of a Fund of Hedge Funds. Traditional widely diversified Fund of Hedge Funds have quite significantly underperformed relative expectations and are likely to do so going forward given their excessive number of managers, high cost structures, lack of strategy diversification and poor alignment of interest.

2. Leverage is unrewarded risk

Looking at the hedge funds that did suffer considerable loss of capital value, a common factor seems to be the use of high levels of leverage, particularly when associated with assets whose liquidity deteriorated (which ended up including most listed investments and non-government bonds). Essentially only strategies based on exchange traded futures and currencies maintained the levels of underlying liquidity required to sustain even moderate levels of leverage.

Leverage reduces the margin for error in an investment portfolio by magnifying the effects of changes in underlying investments. An 'acceptable' 10% decline in values quickly becomes an unbearable 20% or 30% loss when significant leverage is employed.

We saw, particularly in late 2008, that even supposedly 'risk free' arbitrage strategies (such as fixed interest arbitrage) suffered significant losses as a result of leverage magnifying relatively small underlying losses into large losses of capital. On the other hand, strategies using less leverage (such as long/short equity, credit and multi-strategy funds), or where the level of underlying liquidity was maintained (such as futures trading funds and global macro managers) generally avoided large capital losses.

The magnified gains provided by leverage, across all types of investments prior to 2008, contributed to a false sense of security for many investors. However this complacency was rudely shattered when excessive leverage and illiquidity combined in 2008.

Even so, leverage remains a valid tool when used appropriately.

3. Writing put options is <u>not</u> a sustainable investment strategy

A number of strategies used by hedge funds also failed (suffered large loss of capital) because they had effectively evolved into 'put option' writing strategies. In essence, put writing involves receiving a regular small income, which hopefully will offset the occasional large losses that occurs when markets move against you. (It's a bit like writing insurance, except that you don't have the advantage of diversifying your risk across many insurance buyers.) Another dynamic is that if the losses occur only very occasionally, then the premiums tend to drop well below fair value because the risks are perceived as being very low.

When you write put options you will occasionally suffer large (and typically unanticipated) losses. This occurrence seems to surprise many writers of put options and this leads to investors exiting 'at the bottom' of the market – thereby locking in their losses. It is for this reason that these investment strategies are unsustainable on a long term basis. Behavioural finance warns us of this.

These investment strategies include a number of 'arbitrage' strategies that typically promise a relatively low, but stable, rate of return derived from the realignment of distortions in market prices between various investments. Such strategies include convertible and fixed interest arbitrage and statistical arbitrage (which relies on a large number of small offsetting investments to generate stable returns).

Unfortunately, as the return expectations of investors rose in the late 2000's in response to years of historically high investment returns, and the weight of capital invested reduced the returns available, the amount of leverage applied to these strategies was increased. As a result, when the inevitable occurred in 2008, losses were exacerbated by the higher levels of leverage.

4. Investors continue to be insufficiently aware of market irrationality

John Maynard Keynes is famously and frequently quoted as having said that "the market can stay irrational longer than you can stay solvent". On the other hand, most of us were brought up to have (even in the back of our minds) some concept that markets are 'Rational' (a.k.a. Rational Expectations and the Efficient Markets Hypothesis).

Investors and market participants in general, seems to live constantly in a world that adheres to the second of these beliefs. (When was the last time you saw a measure of market irrationality printed on the front page of the financial section of the paper?)

The simple reality is that **markets suffer from some degree of irrationality all of the time** – i.e., they do not seamlessly glide from one point of 'equilibrium' to another as theory would have us believe.

To use a not-so-extreme analogy, many investors seem to act as though investment markets are the equivalent of a golf course, made of very smooth glass on a declining slope shaped as a cone with the hole at the bottom. Imagine that you are standing on tee. All that you have to do is set the ball in motion and gravity will unerringly pull the ball down towards and into the hole. Everyone would complete the course with a score of 18 strokes, and there would be no need for player skill. (We could say that golf is an 'efficient' game as skill would not make any difference to your score.)

Of course this works because gravity is doing the work of constantly adjusting the path of the ball. In other words, gravity is acting as the rational influence guiding the ball inexorably towards the hole (i.e., its position of equilibrium). In markets, it is the process of research and rational decision making that drives the prices of securities and markets towards their equilibrium price (or fair value). The role of good investment managers is to identify when the price of a security is away from fair value and take a position that will drive the price towards equilibrium.

The big difference between our imaginary golf course and real investment markets is that while gravity is a constant, market rationality is not. Indeed, what we saw in the 4th quarter of 2008 was the equivalent of gravity going into reverse, causing our imaginary golf ball to accelerate up the hill away from the hole as markets became more and more irrational.

What this means for investors is that **in times of increasing irrationality good managers will underperform**, as cheap securities become cheaper, and expensive securities become more expensive.

So looking back at 2008 we see that what occurred was exactly what we would expect. Most good fund managers – in every investment strategy from long only equities to bonds to hedge funds – underperformed as markets became more and more irrational. And then in 2009, as markets became less irrational, they added significant value for their investors.

So, were the losses experienced by hedge fund in 2008 a sign of a failure of the process? No! Hedge funds performed largely as expected. Where there was a failure was in investors naively believing in rational markets in a world “which can stay irrational longer than they can stay solvent”.

5. **Investors continue to undervalue the importance of quality due diligence**

The other losses that occurred in financial markets over the last few years, related to simple, basic criminal activity (think Bernie Madoff, et. al.). It is said by wiser souls that ‘those who fail to learn from the past are destined to repeat the mistakes of the past’, and this particularly applies to the issue of financial malfeasance.

The simple reality is that quality due diligence was required to avoid losses from malfeasance over the last few years – whether in hedge funds or other financial investments. If investors, or their agents, had gone through the basic checklist of only dealing with funds with recognised counterparties (custodian’s, prime brokers, administrators and auditors), had required audited accounts and had carried out effective background checks of managers’ key staff, then the losses through criminal activity could have been avoided.

We think that the problem is that quality due diligence is not interesting or special, so it tends to get overlooked. In many ways it is like basic community services such as clearing away the garbage and putting in proper sewerage systems. We forget that these activities were developed for good reason, and the reality is that of if you don't do the basics then the rats and the plague will return.

Looking back at the last few years, we can conclude that the hedge fund model did not fail – although the approach to hedge funds by some was not well considered, and the subsequent failures tarnished the whole industry.

Moving Forward

Our conclusions are as follows

If the hedge fund model is not broken, then we need to ask ourselves whether hedge fund investments make sense. The key to answering this question is to determine whether managers **can create or access sustainable investment opportunities at an acceptable cost** going forward.

Recall what a hedge fund is: "A fund that obtains the majority of its investment return from manager skill rather than exposures to market risks." The question is whether there are investment strategies and market conditions that are favourable to the generation of returns from manager skill, and importantly whether those conditions are more favourable today than in the past.

Our experience tells us that these sustainable investment opportunities do exist and can be exploited by quality hedge fund managers. Moreover, conditions are more favourable for hedge funds today than has been the case for a number of years due to:

1. **The restoration of reasonable risk adjusted pricing for capital**

   We are now in an investment environment in which capital – both debt and equity – is in more restricted supply than in the past. As a result, the price at which capital can be obtained has altered to favour providers of capital rather than consumers. This is being reflected in hedge funds widely reporting and demonstrating that they are seeing, and expect to continue to see, attractive risk/reward opportunities across the investment spectrum.

2. **The reduction in competition in financial markets**

   The years up to 2008 witnessed an explosion in competition in the provision of capital. For hedge funds this competition came from many sources, most significantly from securitisation vehicles of various sorts, investment banks and from other hedge funds. For those quality hedge funds left standing after 2008, the level of competition for investment opportunities from each of these sources has diminished markedly.

3. **Forced deleveraging and liquidations of assets**

   While this paper has not discussed the outlook for specific hedge fund strategies, the broad balance sheet deleveraging that has, and continues, to occur as a result of the drying up of credit and the increase in bankruptcies has meant that many attractive investments have been available at cheap prices. As a result the risk adjusted returns available to hedge funds have become very attractive.

These, and other forces currently playing out, are creating attractive risk return opportunities in some, but not all, hedge fund strategies.

Against this we do offer two qualifications. Firstly, the alpha produced by hedge funds need to be carefully scrutinised. Not all managers will generate real levels of net alpha over and above their fees. Secondly, excessive numbers of managers in a portfolio cannot be justified as this leads to over-diversification of exposures. We would note that Funds-of-Hedge-Funds fail on both of these issues.

The hedge fund model, while severely tested, did not fail over the last few years. Overall, risk adjusted returns have been as expected, particularly in those strategies that focussed primarily on manager skill rather than leveraging up diminishing returns from unsustainable investment approaches.

When combined with solid manager research and due diligence by investors, the opportunities available for quality hedge fund managers to generate attractive risk adjusted returns on an ongoing basis are significantly more attractive today than at any time in the last decade.

As a result, hedge funds should, where employed intelligently as part of an overall diversified investment strategy, continue to provide valuable investment options for investors going forward.

John Peterson
Principal