

# **The Future of Hedge Funds**

**Melbourne Centre for Financial Studies  
MCFS Finance Forum Series 2009  
Melbourne, Victoria, Australia  
Tuesday, 31<sup>st</sup> March 2009**

**Jeremy Connor  
Director, Portfolio Manager  
Attalus Capital**

## **THE FUTURE OF HEDGE FUNDS**

- ✓ Hedge Fund Overview
- ✓ 2008 Hedge Fund Review
- ✓ Historical Perspective
- ✓ Current Opportunities
- ✓ Operational Research and Risk Management
- ✓ Goals and Expectations
- ✓ Conclusion

# HEDGE FUND OVERVIEW: INTRODUCTION

## What is a Hedge Fund?

- First hedge fund started by Alfred Jones in 1949. His goal was to reduce market risk and focus on security selection
- Hedge funds derived their name from being long and short, thus “hedged” or protected to some degree against market uncertainties
- The term hedge fund, like mutual fund, refers to an investment structure, not an investment approach
- Hedge funds are diverse and complex - there are many different strategies used by hedge funds
- There are now more hedge funds than mutual funds or US stocks

# **HEDGE FUND OVERVIEW: INTRODUCTION**

## **Common Attributes**

- Focus on generating absolute versus relative returns
- Returns not strongly correlated with general market movements
- Private funds, usually limited partnerships or limited liability companies
- Hedge fund managers generally make a substantial personal investment in their own funds

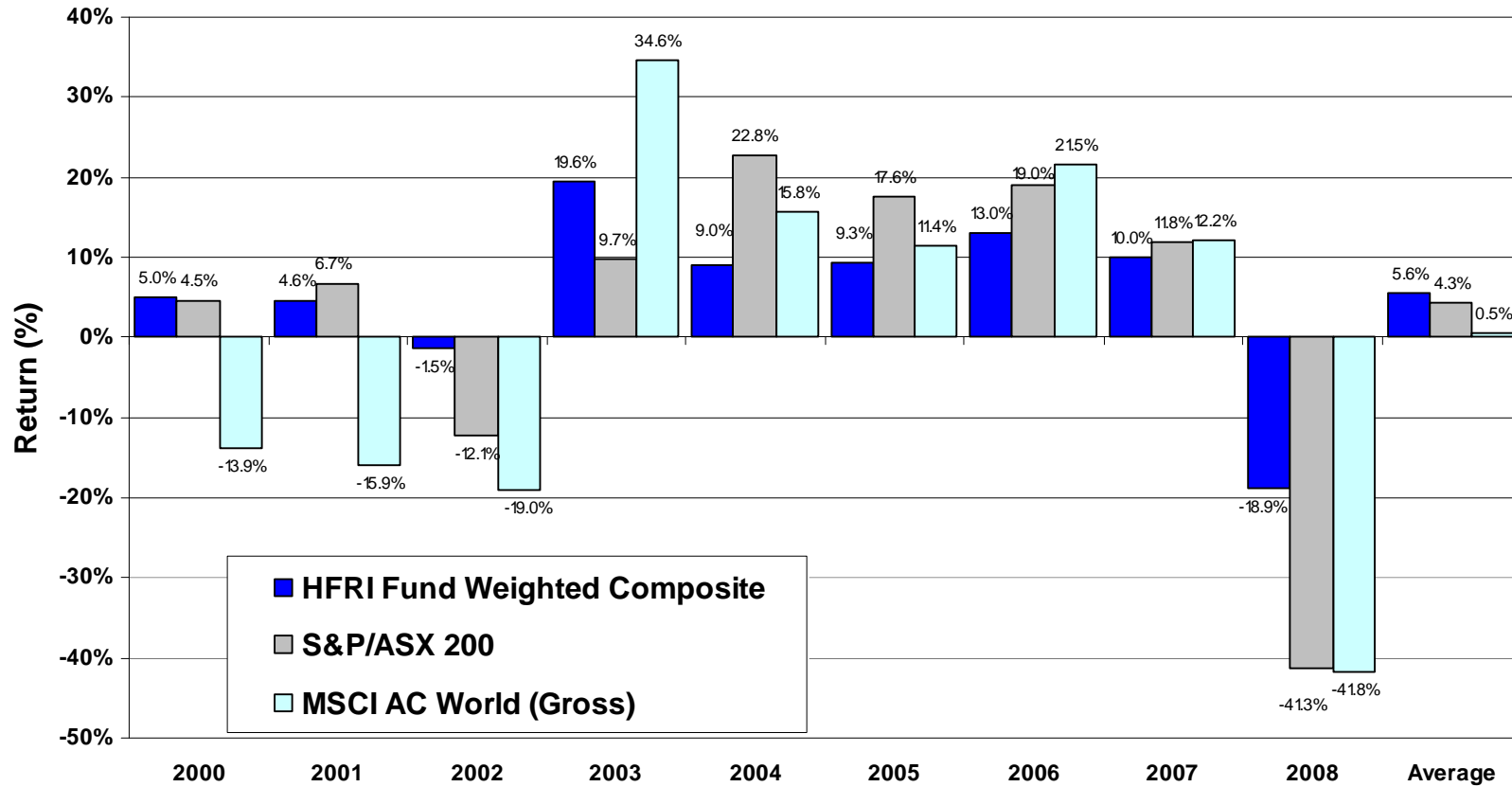
# **HEDGE FUND OVERVIEW: INTRODUCTION**

## **Why Investors Use Hedge Funds?**

- Diversification Benefit
- Non-Correlated Return Streams
- Lower Volatility
- Increased Opportunities

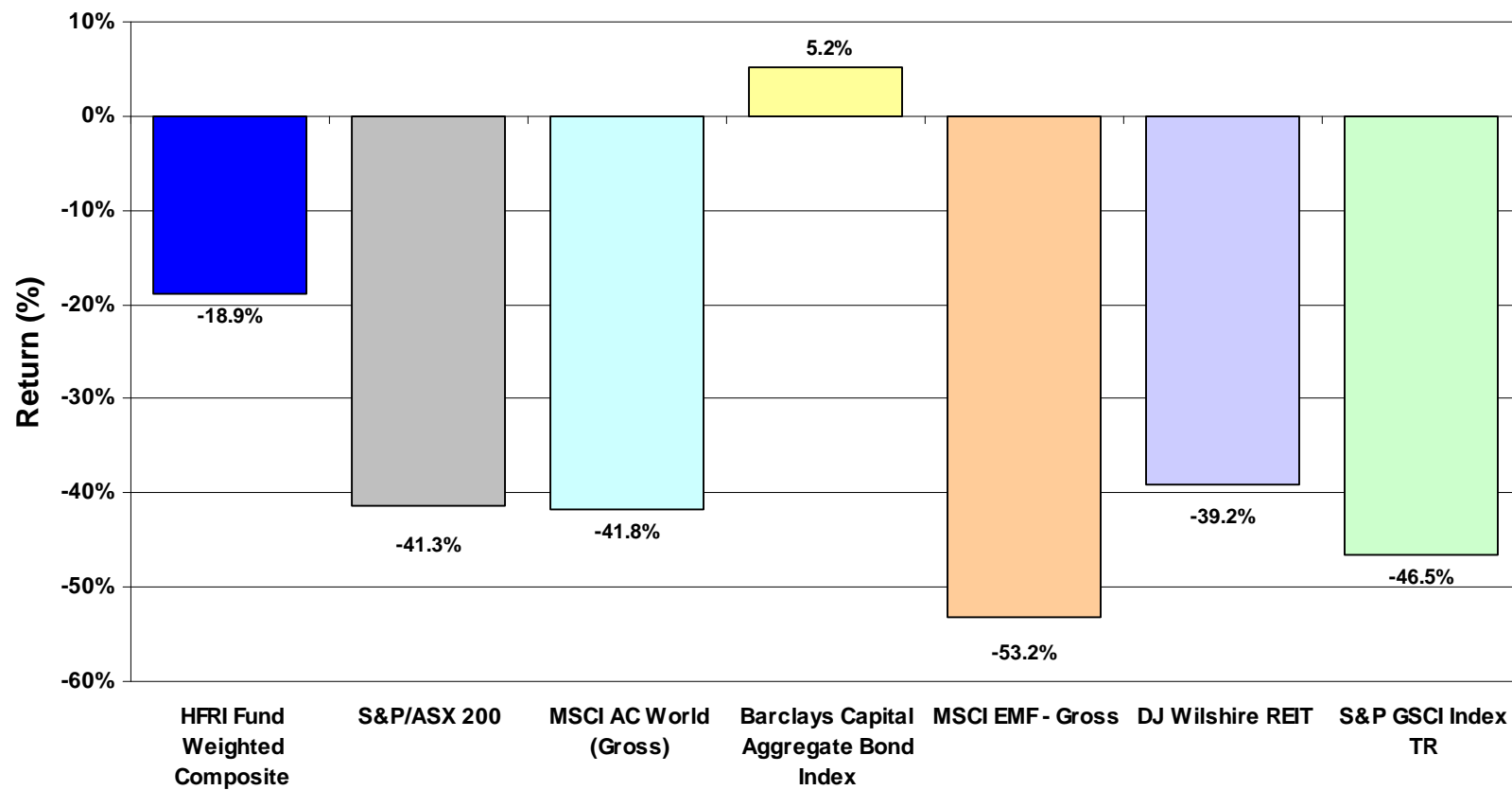


# HEDGE FUND OVERVIEW: RETURNS THIS DECADE



Sources: Hedge Fund Research, Inc., Pertrac, Bloomberg

## 2008 HEDGE FUND REVIEW



Sources: Hedge Fund Research, Inc., Pertrac, Bloomberg

## 2008 HEDGE FUND REVIEW

- **Credit Tightening:** Banks around the world drastically reduced lending, weakening outlooks for a variety of strategies
- **Restrictive Financing:** Investors had little choice but to sell securities to meet increasing margin calls; and financing for new positions was very restrictive; both caused forced selling in the market
- **Government Intervention:** Eleven countries implemented some form of ban on short sales, eliminating a portfolio manager's ability to hedge their portfolio and protect capital in a down market
- **Liquidity Concerns:** Investors submit redemption requests, exacerbating liquidity problems hedge funds are already experiencing
- **Fraud:** Instances of fraud are not limited to hedge funds, but exists in all lines of businesses. Fraud has occurred in the past (see Madoff, Bernard L.), and unfortunately, will occur in the future.

## HISTORICAL PERSPECTIVE

- The current market cycle is not unprecedented
- 11<sup>th</sup> such cycle for the broader economy since World War II
- Below are seven of the most recent examples

<b>MSCI World Index (Gross) Returns</b>			
<b>Peak</b>	<b>Bottom</b>	<b>Duration</b>	<b>Decline</b>
3/2000	9/2002	30 months	-45.3%
12/1972	9/1974	21 months	-41.5%
12/1989	9/1990	9 months	-27.9%
8/1987	11/1987	3 months	-24.3%
12/1969	6/1970	6 months	-18.9%
7/1998	9/1998	2 months	-13.9%
Average decline for prior 6 events:			-28.6%

This current cycle so far (through 11/08):

10/2007 - 11/2008 13 months -50.4%

Average return for the 3 months following the bottom of a cycle: +10.8%

Average return for the 12 months following the bottom of cycle: +27.9%

## HISTORICAL PERSPECTIVE

- Same cycle present in hedge funds, on more muted basis
- Current cycle so far is longest and steepest decline

<b>Peak</b>	<b>Bottom</b>	<b>Duration</b>	<b>Decline</b>
7/1990	10/1990	3 months	- 5.38%
4/1998	8/1998	4 months	- 11.42%
8/2000	11/2000	3 months	- 6.39%
5/2002	9/2002	4 months	- 5.72%
10/2007	12/2008*	14 months	- 19.73%
<u>Average</u>			<u>- 9.73%</u>

\*Dec. 2008 estimate

Average Recovery after 6 months: + 8.40%

Average Recovery after 12 months: +18.66%

- Market dislocations continue to generate outstanding opportunities for strong hedge fund returns
- Maintain focus on risk management while looking to take advantage of current market opportunities

## **CURRENT HEDGE FUND MARKET**

- While hedge fund flows reversed in 2008, very few market participants removed hedge funds completely from asset allocation programs
  - Approximately \$150B flowed out of hedge funds in 2008 as total assets were still a solid \$1.4 trillion
- Cash remains high at the investor level
- Consolidation is occurring at the hedge fund and investor level

## **CURRENT HEDGE FUND OPPORTUNITIES**

- Historical valuation dislocations
- Hedge Fund Darwinism
  - Shrinking number of hedge funds → less competition
  - Fewer investment bank prop desks → less competition
  - Best risk managers have survived → better investment choices
- Increased transparency environment
- Favorable terms

## **OPERATIONAL RESEARCH AND RISK MANAGEMENT**

- A properly structured “institutional quality” research process is critical for any investor in a fiduciary capacity
- “Integrated” approach with members of investment, operational and risk management teams all working together to evaluate a hedge fund ensures relevant information is not lost
- Separating the investment research and operational due diligence teams is a structural error that leads to the loss of critical information
- Risk management should be integrated directly into the investment process and not a separate entity reviewing decisions after the fact
- Investment team members should have direct investment experience
- Firms with identical processes will have a variation of results since investment performance ultimately depends on the intellectual capital and judgment of the decision makers

## OPERATIONAL RESEARCH AND RISK MANAGEMENT

**While hedge fund opportunities are attractive, investors must always be diligent to prevent fraud. Best practices include:**

- **Direct access:** inability to have meaningful dialogue with the portfolio manager firm may result in difficulty in fully understanding the firm and investment process
- **Third-Party Custodian:** presence of a verifiably independent, unaffiliated, third-party custodian, administrator or prime broker provides assurance that the securities exist and are accounted for properly
- **Independent Pricing:** accurate pricing of securities is critical to all accounting and valuation functions, and process should not be influenced or controlled by the investment manager
- **Transparency:** traditional holdings-based analysis is of limited value due to the dynamic trading utilized by a majority of hedge funds
- **Independent Audit Firm:** lack of an independent auditor should be an automatic fail in the due diligence process
- **Track Record:** a hedge fund's track record should be appropriately similar to price movements of peers in the strategy or the differences should be clearly explainable

## **REGULATORY UNCERTAINTIES**

- Self-Regulatory Organizations (SRO's)
- Position Disclosure
- Mandatory Registration
- Ban on Short Sales
- Up-Tick Rule
- Standardized "Best Industry Practices"

## **HEDGE FUND OF FUNDS: GOALS AND EXPECTATIONS**

### **Diverse Investment Goals:**

- Provide more stable and consistent positive returns than the markets
- Meet or exceed most of client's actuarial assumptions over market cycle
- Low correlations to equity and debt markets
- Reduce manager specific risk
- Eliminate headline risk
- Mitigate liquidity and transparency risks
- Take advantage of more complex and non-traditional strategies
- Global perspective (global market cap weighted)

## **HEDGE FUND OF FUNDS: GOALS AND EXPECTATIONS**

### **Hedge fund investors' return expectations:**

- Lag the market when markets are doing extremely well
- Outperform the market when markets are flat or doing poorly
- Produce positive returns more frequently than the markets
- Hedge funds are not loss-proof; they will have negative months and quarters, but the frequency and magnitude of the losses will be less severe than the broader markets

## CONCLUSION

- The hedge fund universe will shrink over the next year
- Most hedge funds with the strongest expertise and risk management will survive
- Hedge funds that will survive will thrive
- Over the course of economic cycles, investors in hedge funds will continue to enjoy non-correlated, positive returns by focusing on best practices

**Thank you very much for your time this afternoon.**

**Any Questions??**