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# Hedge Fund Investing: The Perspectives for 2009

*February 2009*

# Agenda

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- **What went wrong in 2008?**
- **The long run performance of HF**
- **The consolidation of the HF industry**
- **The impacts of the financial crisis on the HF industry**
- **OCM investment views for 2009**
- **Focus on Global Macro and Credit**

# What went wrong in 2008?

## *Alpha generation when markets are out of order is difficult*

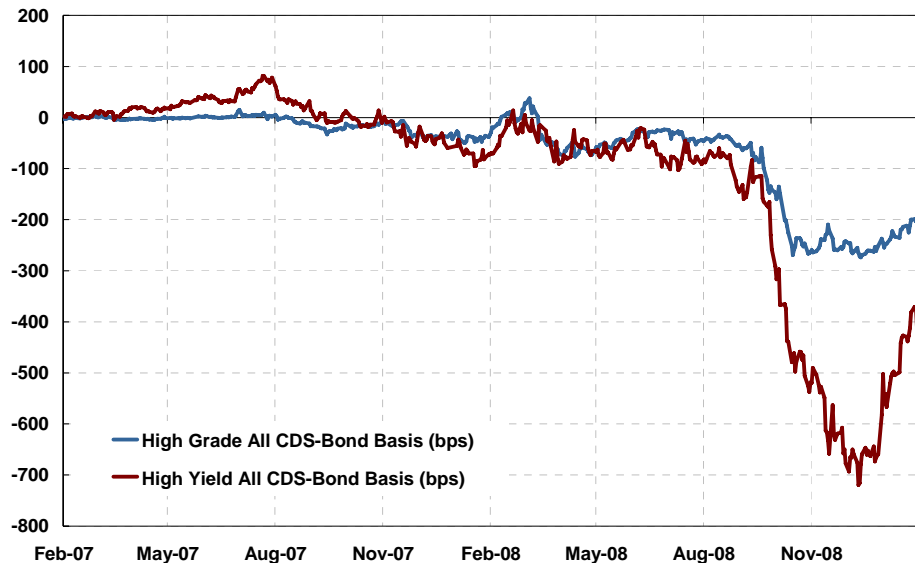
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- HF managers can be blamed for having ignored known risks
  - ▶ The risk of being too leveraged (see LTCM)
  - ▶ The fact that there is a feedback between positions' size and market prices (even with small positions)
  
- HF managers can't be blamed for having ignored unknown risks
  - ▶ Inability to take short positions
  - ▶ The solvency risk that the LB failure posed to the banking system
  - ▶ The complete failure of derivative instruments in providing protection for their portfolios
  - ▶ The complete dry up of the liquidity in some segments of the market
  - ▶ The heightened uncertainty created by repeated (and erratic) government interventions
  
- When humans have to deal with a type of uncertainty that they cannot recognize, they tend to behave irrationally → irrational and unpredictable movements in financial markets

# What went wrong in 2008?

## Price dislocations on derivative instruments

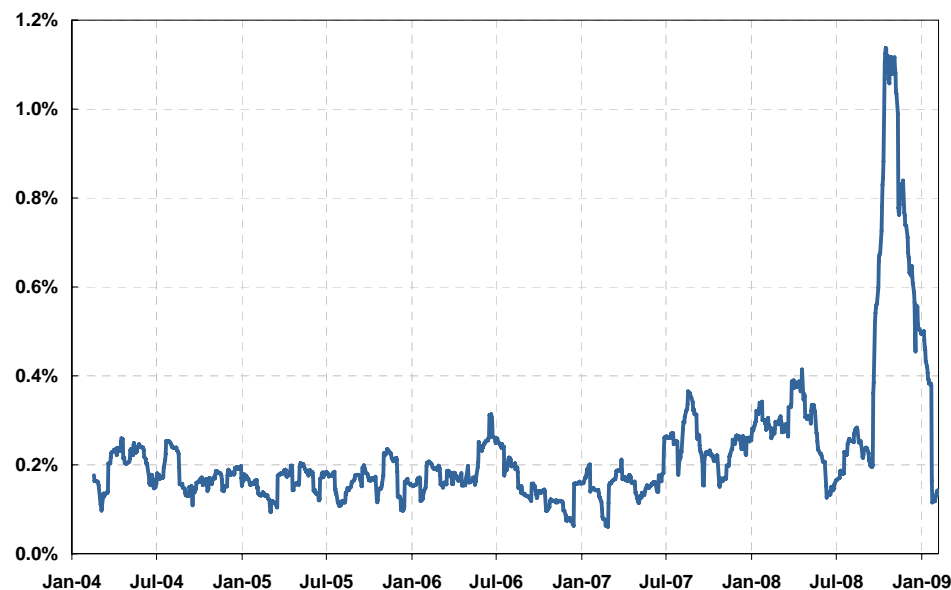
**CDS Bond Basis**



The huge demand for CDS protection created significant discrepancies between physicals (bonds) and CDS indices

Hedging equity markets with trackers proved to be extremely dangerous.

**S&P500 (SPX) vs. Tracker (SPY) Tracking Error (Std Dev. of daily return difference; 30-day window)**



# The long run performance of HF

*Despite a disappointing year in 2008, the out-performance is significant*

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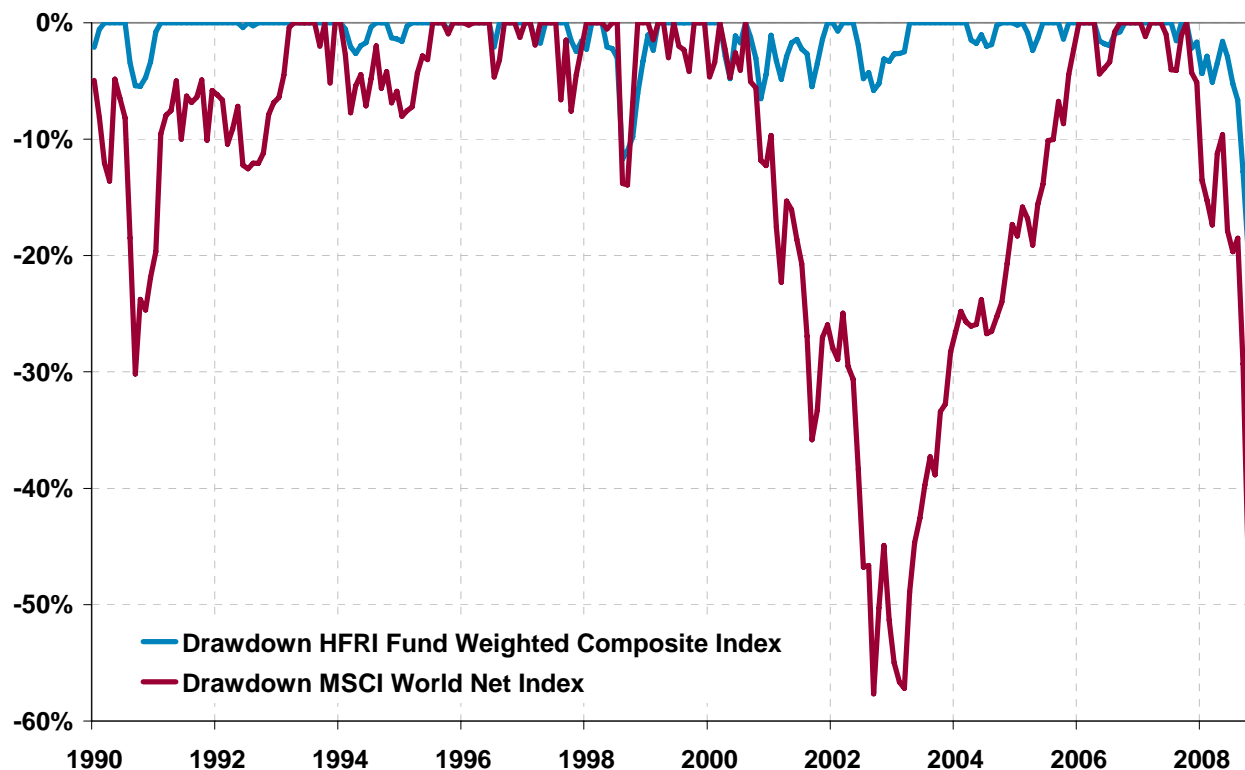
*Cumulative and annualized returns over 10 years, 1999-2008, in USD*

	Rendement total 1999 - 2008 [%]	Rendement annualisé 1999 - 2008 [%]	Rang
HFRI Fund Weighted Composite Index	104.5%	7.4%	[1]
HFRI Fund of Funds Composite Index	68.6%	5.4%	[2]
Citi WGBI 5+years Index LC!	65.9%	5.2%	[3]
ML Global High Yield Index !	24.1%	2.2%	[4]
MSCI World Net Index LC !	-10.6%	-1.1%	[5]
S&P 500 (Composite)	-26.5%	-3.0%	[6]

# The long run performance of HF

*HF have a tendency to rebound sharply after major drawdowns*

**HFRI Fund Weighted Composite vs. MSCI World Net Index: Historical drawdowns, 1990-2008**



HFRI Fund Weighted Composite Index					
Drawdown	Peak date	Trough date	Recovery (months)	Perf 12 following months	Perf 24 following months
-20.20%	Oct-07	Nov-08	-	n/a	n/a
-11.42%	Apr-98	Aug-98	7	+23.9%	+22.8%
-6.39%	Aug-00	Nov-00	14	+5.0%	+5.5%
-5.72%	May-02	Sep-02	8	+16.2%	+26.7%
-5.38%	Jul-90	Oct-90	4	+29.5%	+55.3%

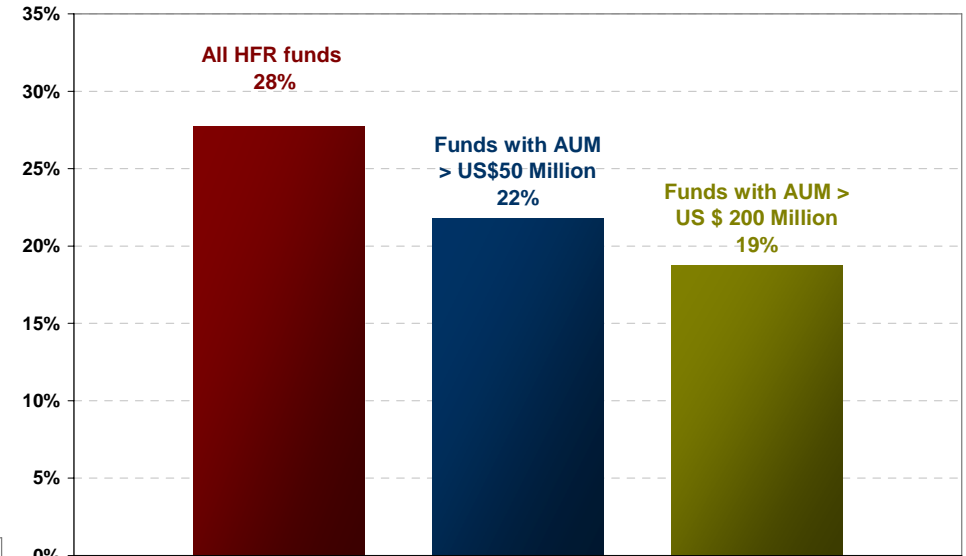


# The consolidation of the HF industry

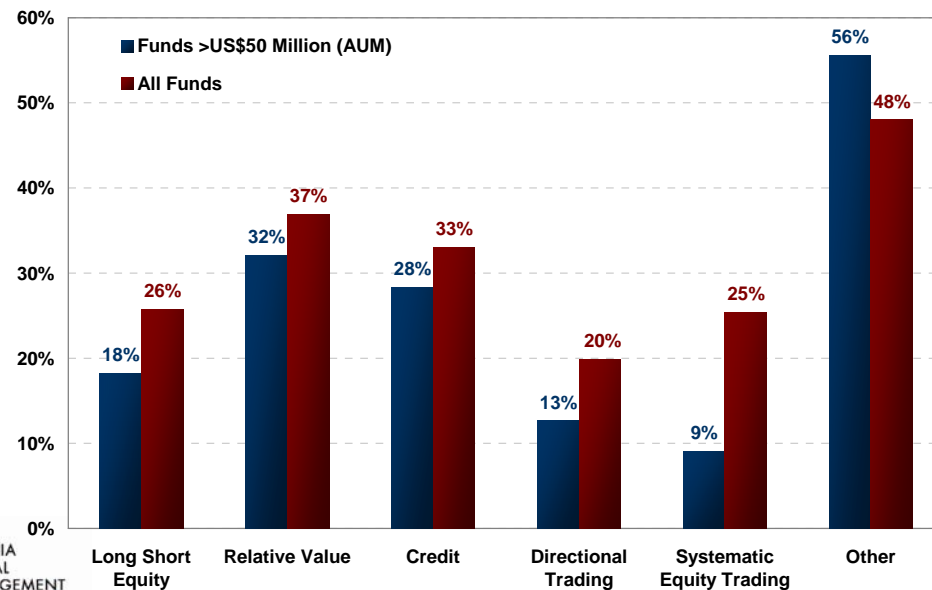
## The industry will shrink by 30-40% in 2008/2009

As of the end of November 2008, 28% of the HFR universe had disappeared from the database.

Estimated attrition rate in 2008 (HFR database)



Estimated attrition rate by strategy in 2008 (HFR database)




Relative Value managers and FoHFs were the most affected by the crisis.

# The impact of 2008 on the industry

## *The negatives*


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- Several HF had to restrict the liquidity of their funds as a result of:
  - ▶ Bad asset and liability management and style drift
  - ▶ Significant decrease in the liquidity of the traded instruments
  - ▶ Greed



Negative for the industry as some investors will have to wait for the money that they were entitled to receive

- The biggest fraud of the industry's history tarnished the reputation of FoHFs
  - ▶ Casts doubt on the Operational and Strategic DD methodology of some FoHFs
  - ▶ But, it will force the whole industry to become more transparent



Do not invest in what you do not understand!

# The impact of 2008 on the industry

## *The positives*

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- The industry will be less leveraged
- The un-skilled (lucky) managers will not survive
- There will be fewer players chasing huge opportunities
- Very good managers that were closed to new investments are re-opening
- The industry will be more regulated and transparent
- Fees will decrease but only for new managers
- Hedge funds will re-focus on their core strategy

The proportion of skilled managers in the industry will increase → the overall alpha will increase.

Less crowded trades

Capacity will not be a problem any more for FoHFs

## Our views for 2009

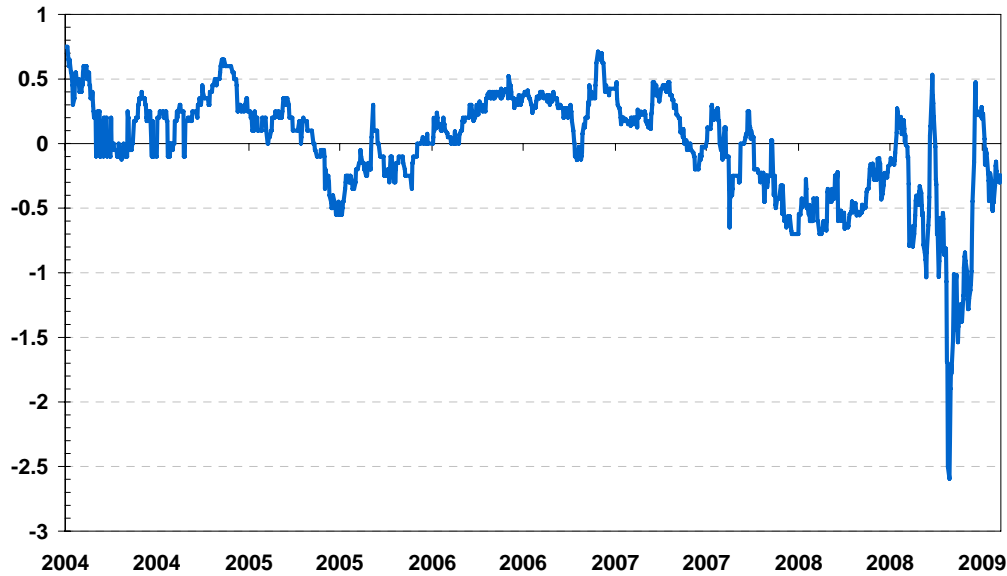
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- Most of the deleveraging exercise is behind us
  - ▶ HF and Investment banks have significantly reduced their market exposure
  - ▶ Markets should not behave as they did in the Fall of 2008 except if there is an other big bank failure
- In this highly uncertain economic environment, volatility will remain high
- Liquidity should come back in some asset classes but it will be lower than before the crisis as:
  - ▶ Investment banks have left the ground
  - ▶ The hedge fund industry is contracting
- Default rates will jump as corporations will be hurt by the recession and the contraction in credit
- The US housing market will continue to contract → the ABS market will continue to suffer
- The gigantic fire sale of H2 2008 will create tremendous opportunities in all asset classes
- Central banks and government interventions will maintain the volatility on the FX and interest rates markets at high levels → inter-market and across market trade opportunities

# Our views for 2009

## Uncertainty is still high in financial markets

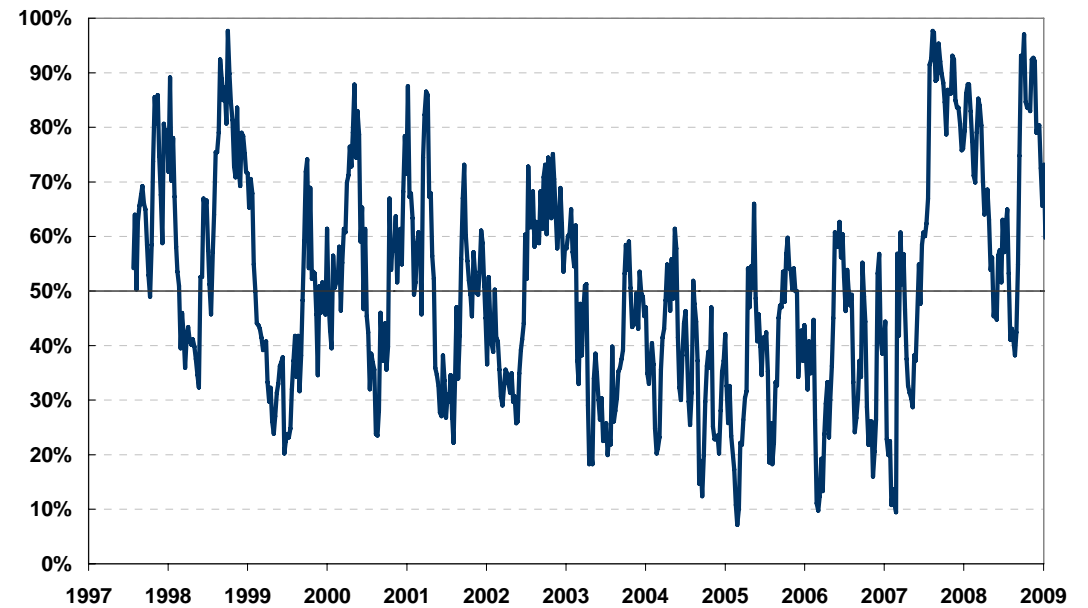
*EUR/USD Risk reversal from 3M-Options*



**The market is still expecting drawdowns in some asset classes**

**The overall perceived risk is still extremely high on all asset classes**

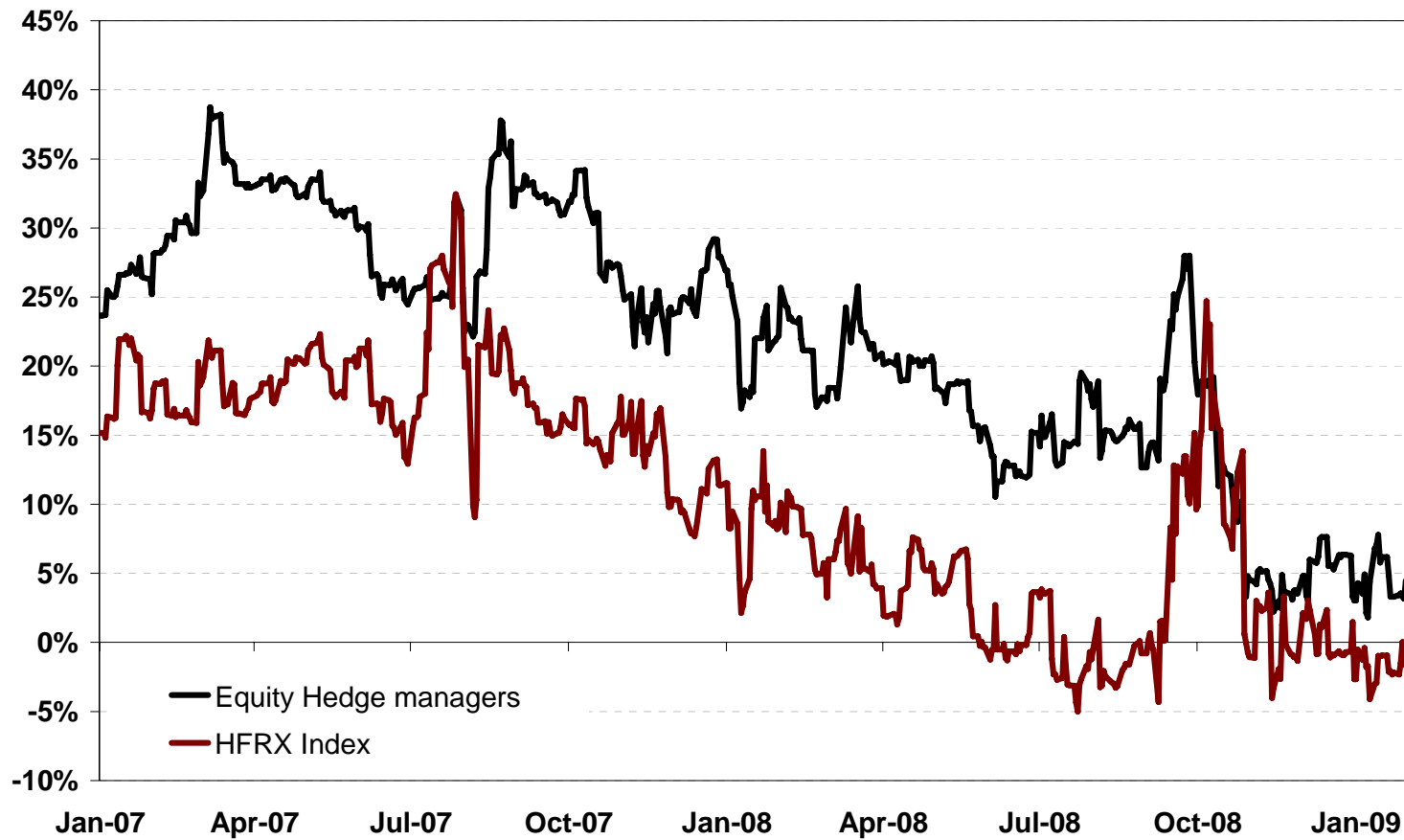
*Risk Index (rolling 52 weeks)*



Source: OCM, Bloomberg

# HF's' leverage is historically low

*Estimated net equity exposure of hedge fund managers*



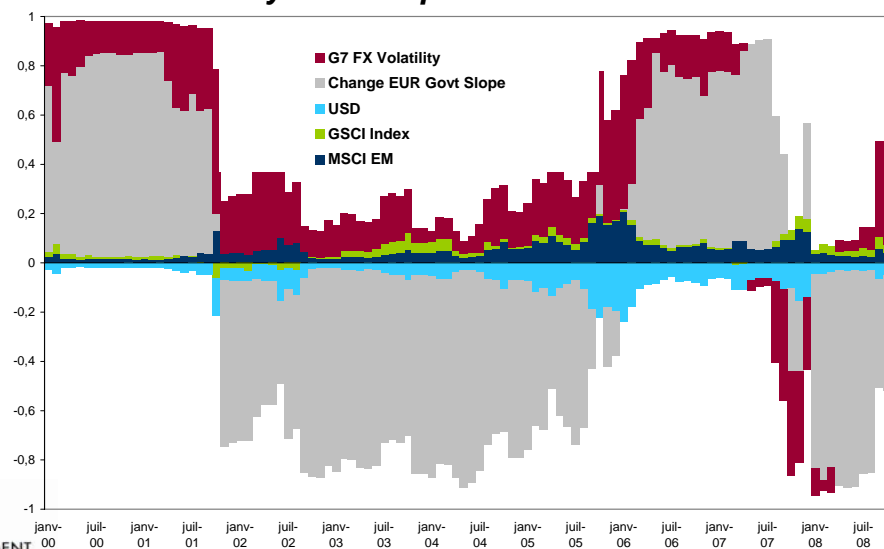
## Hedge Fund strategies outlook

STRATEGY	VIEW	ACTION
Global Macro	<b>Bullish</b>	Favor directional traders and liquid managers.
Volatility Traders	<b>Bullish</b>	Increase the exposure. Favor managers trading volatility of volatility.
Trend Followers	<b>Bullish</b>	Increase the exposure. Favor short-term traders who will profit from high volatility on the markets and hedge our portfolios vs. long-term trend followers (until we see a clear trend). Pipeline: investigate momentum driven short-term traders.
Credit	<b>Neutral</b>	Maintain the current exposure to managers who are <u>short corporate credit</u> and are still profiting from the current crisis to hedge our portfolios. Start working on a pipeline of long biased credit and distressed managers (6-9 months horizon).
Fixed Income Arbitrage	<b>Bearish</b>	Decrease the exposure to be completely out of the strategy.
Multi-Strategy	<b>Bearish</b>	Maintain the exposure at the lowest level.
Emerging Markets	<b>Bearish</b>	Maintain the exposure at the lowest level.
Commodities	<b>Bearish</b>	Decrease the allocation of directional commodity managers (typically commodity long/short managers). Favor relative value strategies and allocation through our global macro and CTA managers.
Quantitative Long/Short	<b>Neutral</b>	The strategy should rebound as dispersion increases.
Convertible Arbitrage	<b>Bearish</b>	Decrease the exposure to be completely out of the strategy, as the current environment is clearly unfavorable to the strategy.
Long/Short Equities	<b>Bearish</b>	Further decrease the exposure to the strategy and the Beta to the equity markets. Favor trading oriented vs. fundamentally driven managers.
Event Driven	<b>Bearish</b>	Further decrease the exposure. Keep the managers with distressed capabilities.

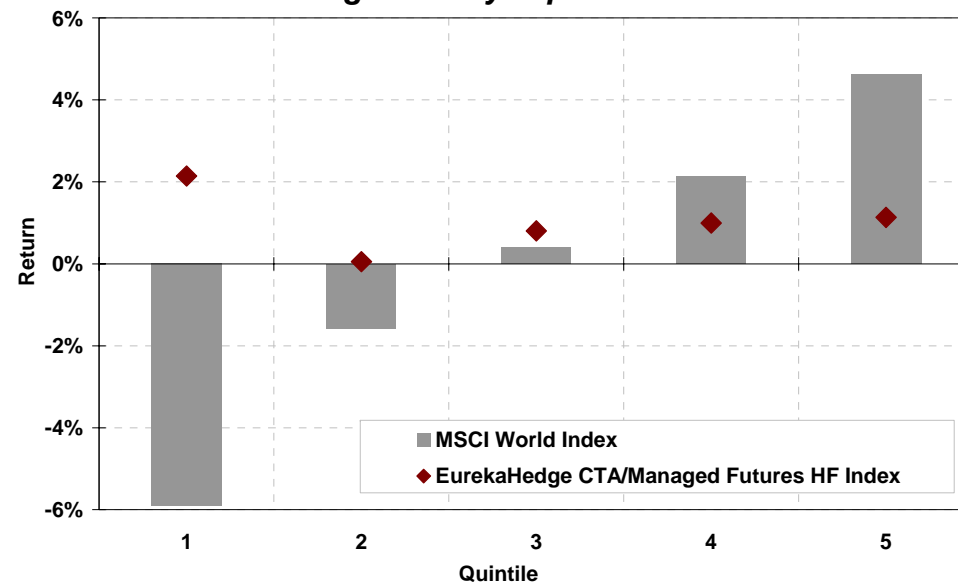
# Global macro and CTAs in the current environment

- Why are directional trading strategies a good investment in the current market conditions?
  - ▶ World events will be dominated by macro factors (recession, inflation, deficits etc.) rather than company specific factors. Macro factors will play on the directional strategies managers' strength (currencies, rates, equity indices, commodity prices).
  - ▶ They trade liquid instruments
  - ▶ The cost of leverage is small (mainly through derivatives)
  - ▶ They can implement strategies that can profit from the crisis and the recovery
  - ▶ They have a long volatility profile
  - ▶ They have a dynamic trading strategy

**Dynamic exposures of GM HF**

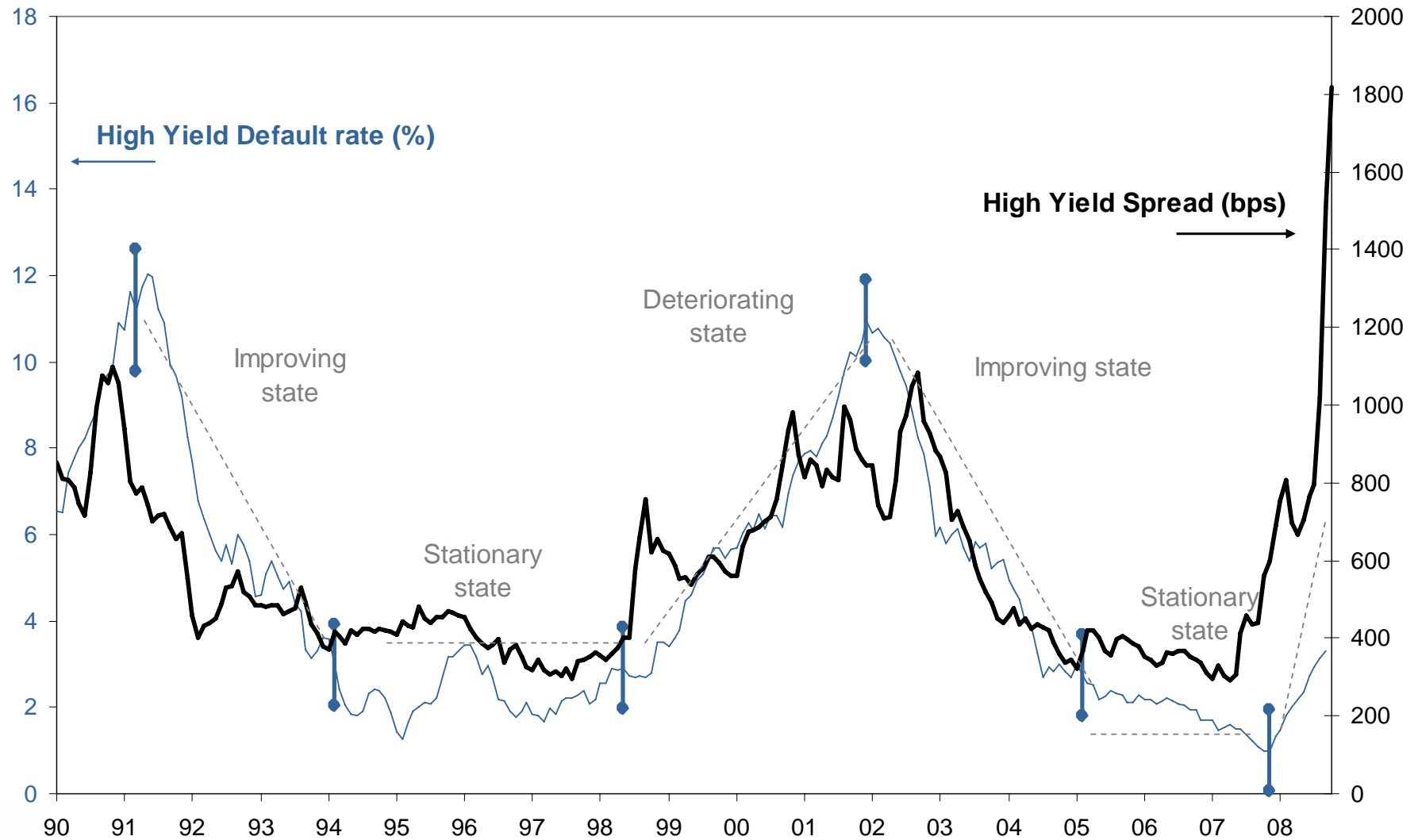


**Long volatility exposure of CTAs**



*Source:* OCM. The graphs shows the returns of the EurekaHedge Macro HF and EurekaHedge CTAs/ Managed Futures Indices from January 2000 to August 2008 during compared to the performance of the MSCI World Index, ranked by quintiles, from January 2000 to August 2008.

# The credit market cycle: the three states



# State 1: the deteriorating credit state

## Market characteristics

- ▶ Rising/high volatility
- ▶ Liquidity dries up
- ▶ Widening credit spreads
- ▶ Falling recovery rates
- ▶ Bond value falls
- ▶ Equity value falls

## Investment Thesis

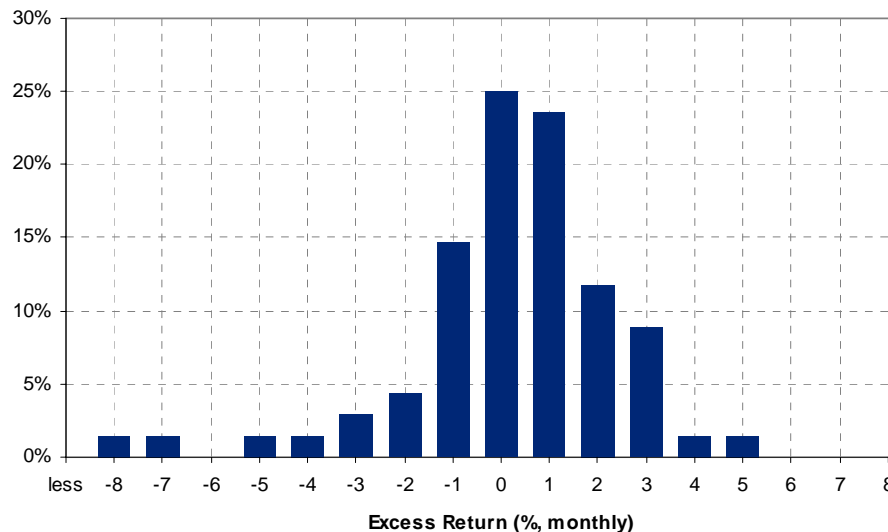
- ▶ Search for capital preservation trades
- ▶ Low/negative net exposure
- ▶ Low/moderate leverage

## Typical trades

- ▶ Relative value strategies
- ▶ Capital Structure arbitrage: long senior vs. short junior
- ▶ Build long-term positions in undervalued assets for the 'improving' state

### Excess return of HF Credit managers in the deteriorating credit states

**Histogram**



**Statistics (in USD)**

	HFRI Distressed Index	ML High Yield Index
Mean excess returns (annualized)	-3.8%	-10.7%
Std dev. (annualized)	7.9%	11.9%
Skewness	-1.4	-1.6
XS Kurtosis	3.8	6.2

The deteriorating periods are :July 1998 – December 2002 ; October 2007 – November 2008.

# State 2: the improving credit state

## Market characteristics

- ▶ Falling/low volatility
- ▶ Liquidity improves
- ▶ Tightening credit spreads
- ▶ Falling default rates
- ▶ Increasing recovery rates
- ▶ Bond value increases
- ▶ Equity value increases

## Investment thesis

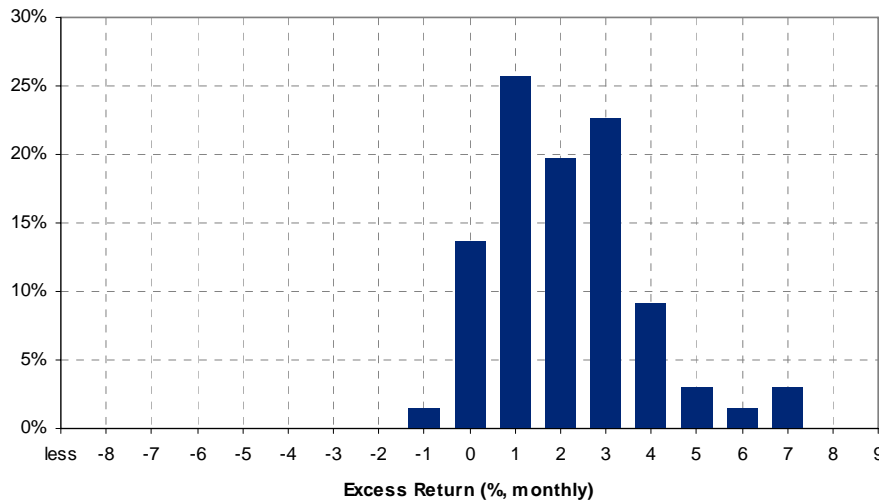
- ▶ Search for capital appreciation trades
- ▶ Increase net long exposure
- ▶ Increase leverage

## Typical trades

- ▶ Long “high beta” securities: unsecured, junior and subordinated debt

### Excess return of HF Credit managers in the improving credit states

**Histogram**



**Statistics (in USD)**

	HFRI Distressed Index	ML High Yield Index
<b>Mean excess returns (annualized)</b>	<b>20.6%</b>	<b>14.7%</b>
<b>Std dev. (annualized)</b>	<b>5.5%</b>	<b>5.9%</b>
<b>Skewness</b>	<b>0.9</b>	<b>0.7</b>
<b>XS Kurtosis</b>	<b>1.1</b>	<b>4.8</b>

*The improving periods are January 1991 – March 1994 and January 2003 – March 2005.*



# Conclusion

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- The cocktail of tight coupled markets and complexity was the ideal formula for an accident to happen on financial markets.
- Attempts to add additional layers of safeguards or regulation to prevent the disasters may actually do the opposite by increasing the complexity of the system.
- The deleveraging exercise is almost over → it will enable HF to apply their strategy in much better conditions than in 2008
- The 2008 crisis will have more positive than negative impacts on the industry.
- In the current context, trading-intensive and long volatility strategies should be favored.
- We see significant opportunities for:
  - ▶ Global macro and CTAs
  - ▶ Credit strategies

# Disclaimer

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