

Cat's View #1

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Hedge Funds

Hedge fund industry facts

8200 hedge funds managed a total of 1.95 trillion US\$ as per the end of June 2008. Inflow of capital remains positive even throughout 2008 and performance in 2008 can generally be described as slightly down for the year up until the end of August. Two thirds of the funds surveyed (5500) have less than 100 million US\$ under management and about 10% of all funds manage more than 500 million US\$. Generally we can speak of 10-12 strategies with long/short equity being the largest group with approximately 36% followed by multi-strategy with 15% and CTA/Managed Futures with 10%. Regional distribution ranges across North (64%) and South America (3%), Europe (25%), Africa (0.15%), Japan (1%) and the rest of Asia (8%) with growth in all regions except for Japan where capital allocation dwindled by 40% in the last few years. Best performers in the last 12 months have been CTA/Managed Futures (+25%), Global Macro (+11%) and Multi-Strategy funds (+7%). (Source: EurekaHedge June report). Pension funds in Switzerland have an average exposure of 6.5% to alternative investments, half of which being in hedge funds or funds of hedge funds. Allocation to the hedge fund space by pension funds is growing and is likely to double in the next couple of years as modern portfolio theories replicating the likes of the Yale endowment increasingly make their entry to diversified portfolios. We believe that **smart money is here to stay**. However, as the industry grows, quality selection increasingly becomes a prerequisite for success.

Current environment

A decade of massive credit and asset inflation nurtured by a long lasting landscape of low interest rates and readily available liquidity coupled with increasingly imprudent business practices by global and local players reversed into asset deflation and credit contraction driven by deleveraging due to the sudden birth of risk averseness. Many seemingly unidirectional trends turned around to face the opposite direction simultaneously accompanied by an extended devaluation of the USD and soaring precious metals, commodities and oil prices. Basically a shrinking environment, a contraction across many economic activities, amplified by sinking stock prices, rising credit problems, bankruptcies, liquidations, rising inflation and most of all uncertainty and fear. Traditional investments and balance sheets are suffering and the captains in the world of finance and governments are attempting to navigate the ships clear of all small and large obstacles in order to keep markets afloat, the economies growing, inflation under control and foremost the system alive! The bubble must go on! ehm...sorry... the show must go on!

We know of 3 notable difficult years for hedge funds in the last 20 years: 1994 (Askin), 1998 (LTCM) and 2008 (the everything crisis?) and the smart money pools weathered them remarkably well. **The hedge fund industry will prevail and a good selection will protect capital better and outpace traditional investment styles as the world's financial system works itself through the cleansing process gradually.**

Hedge funds' approach

The current landscape may be described as a long valley with stretches of desert, and the weather a cocktail of big dark clouds casting long shadows, thunderstorms and short sunny spells. It's not a V-shaped drop and recovery, it's a drought which needs to be worked through meticulously, and here is the news: Hedge funds, even the best, are finding it hard to produce position returns in this environment. And just like the pong comes after the ping, you will be told that this is a fertile working field for hedge funds. Aren't they looking for mispricings, inefficiencies, dislocations, liquidations, opportunities and anomalies like a bear for the berries? Well, yes, but the returns... what about the returns? When you plant seeds for an apple tree, can you reap the fruits the following day? Patience is still a virtue! While the storm is lashing many of the opportunities present themselves and the risk-reward focused investors will beach-comb through them with a hawkish eye. **It is not about avoiding risk, it's about understanding and dealing with risk and taking advantage of opportunities diligently and yet boldly.**

Diversification and why we shouldn't redeem

"Risk is not wanted in Switzerland, it is not without reason that the pension fund managers in the land of chocolate are called administrators" (Professor Cuno Pümpin, Strategisches Investment Management).

Take a look at funds of hedge funds or mature multi-strategy hedge funds with a long track record (Catam Alternative Investment Fund, Reichmuth Matterhorn, Kensington Global Strategies Fund, Highbridge Capital, Stark Investments, just to name a few), **the only mistake one could have made in the past 20 years was to redeem**, full stop. They have proven consistent risk adjusted returns, through hell and high water. Is smart money getting stupid all of a sudden? No. On the contrary, why is UBS calling a hedge fund veteran into its advisory board? **The funds of hedge funds and diversified global multi-strategy approach are a long term commitment providing returns which outsmart directional investments especially in tough cycles.** Does anyone dare to call a short on a solid hedge fund?

The other reason not to redeem is hedge fund beta. "Is HF beta a good thing or a bad thing?" A quote from founding CEO Andrew Redleaf of multi-strategy hedge fund Whitebox Advisors (annual average +18% and YTD +2.5%). Analysing the behaviour of investors and fund of fund managers which constitute about 35% of the hedge fund investor's universe, it is easy to notice that redemptions occur when fear strikes and subscriptions increase when markets are in good shape. This comes close to buying high and selling low in directional terms. This eventually turns a hedge fund manager into a puppet and the investor into a miserable hedge fund manager. Thus the correlation between hedge funds rises merely due to the redemption/subscription practices and cycles. Therefore investors should learn to invest and hold on to their well chosen hedge funds when their chosen managers need the capital to take advantage of liquidations and rising inefficiencies and not the other way around. Hedge fund beta is a good thing if you let the managers manage. **Liquidity should be supplied to the smart money managers in times like we are going through now and not taken away.** Use hedge fund beta to your advantage, don't become a victim. The psychology of a dramatic and negative environment can be so overwhelming, that capital needs to be protected from our own sometimes irrational actions.

Short selling restrictions

There are hedge funds and hedge funds, ones with good industry practices and others with bad ones. A brief description of a hedge fund is an accumulation of capital where the managers can basically do as they please, secretly and cunningly. Originally though, the first investors in hedge funds were wealthy families giving mandates to not lose money and produce higher returns by seeking out the inefficiencies in the markets and hedging out most of the risk by

borrowing shares and selling them against their long position to establish a certain downside protection (covered short). In times of falling stock prices these shorts are gradually bought back, thus unintentionally supporting the market. Those funds still exist and we focus on this particular breed. You might call them honourable and old school funds.

The other kind however, a kind that has grown like mushrooms in the past 5 years, out to seek a trendy strategy, attract capital with short lockups and with higher leverage, will apply less honourable practices by sucking the juice in any way thinkable. It is among those cowboys mainly you will find the “naked” short sellers (no borrow), stock bashers, rumour followers and raiders.

The recent ban on short selling in various countries, on **naked** shorts and **covered shorts** has had a dramatic short term negative effect on most hedge funds leading probably to the worst 1 month HF industry average drop ever. Short selling used to hedge a genuine investment and protect it from sliding share prices applied by many long-term investors, including pension funds, was punished when the bans suddenly took effect. Luckily, a borrowed short with an adequate long position will have suffered mainly a mark to market loss until panic and short covering subsides. The naked short sellers however will have lost money for ever.

How authorities will regulate the shorting practices eventually is still in the air. For now, in times of drama and irrationality, the ban will remain in place but permanently under change and scrutiny and most probably until the markets stabilise and authorities recognise that the genuine practices of hedging are an important part in today’s investment management and techniques and a contribution to market balance. The regulators will have to do something about the excesses of short selling that we’ve seen and think about constructive regulations against them. Overall going forward we may rely on the flexibility and innovative force of hedge funds to deal with what’s ahead as they have done again and again in the past.

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