

RESEARCH PAPER

PRODUCTS
(ALTERNATIVELY)

Hedge funds in the modern portfolio

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Over the last two decades, hedge funds have moved from being predominantly the preserve of wealthy private individuals to being part of mainstream investing. Are hedge funds a passing fad or a new asset class? The darlings of the 2000-02 bear market have once more come under scrutiny as many investors look at apparent dwindling returns and try to assess whether there is still value in including hedge funds in portfolios. This paper reviews the impact of institutional investors on risk and return, the emergence of strategy specific solutions to boost returns, the value of accepting less liquidity, incubator funds, structured products, capacity issues, and what this all means for portfolio construction today.

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Global investors' interest in hedge funds increased dramatically as the 2000-02 bear market set in. By the final days of the tech bubble, hedge fund icons such as Julian Robertson had thrown in the towel and was winding down the Tiger Group, citing (among other reasons) that he felt he no longer understood the markets and that his short tech positions could no longer be justified. Had he held out for another 12 months, some estimate Tiger's returns would have bounced over 100%, justifying everything he had believed. Ironically for Robertson and his peers, as equity markets fell and fell, investors found a relatively safe harbour in hedge funds and enjoyed cash enhanced returns for the following three years as hedge funds outperformed global equity markets by in excess of 50%.

Today, the view is shifting again, with many investors reconsidering hedge fund exposures in the light of perceived lower returns.

Various industry events have been the catalysts for major changes in the past 10 years, resulting in a more diversified range of options that have, in turn, been accelerated by the growth in interest in alternative investments. This paper touches on major events in the hedge fund space that have shaped the industry, geographic and strategy-specific hedge fund of funds (FoF) that provide building blocks to traditional multi-strategy FoFs, diversification that can be achieved through de-correlation into CTA funds, the benefits of less liquid strategies, the latest trends and benefits in hedge fund structured products, and incubator funds.

The last ten years

Intuitively, we know risk and return are inextricably linked and that in order to generate higher returns, we need to take higher risk. The low interest rates of the past three years have created an environment where all assets have risen on the back of extremely cheap borrowing. The risks taken are not dramatically lower, only our perception of them against our short-term successes. Hence for the past three years, equities, high yield and emerging markets have been seen as relatively safe places to invest, and have set the benchmark for

investor's typically mid-teen and certainly double digit return expectations (Figure 1 overpage).

The single biggest event in the hedge fund industry was the spectacular collapse of Long Term Capital Management (LTCM) in September 1998. For those unaware of the event, one of the largest and most respected hedge funds imploded following the default of the Russian government. The impact on financial markets was nearly catastrophic and many investment banks that had fuelled LTCM's returns watched nervously as their own balance sheets looked like imploding. However, a major global financial meltdown was avoided and the investment banking community learned a valuable lesson. From that point, the aggregated leverage of major hedge funds has become a principal risk tool for all prime brokers. This was a turning point for hedge funds in terms of risk/return, and today we live in a world with a lower appetite for risk.

The second most significant development in the industry during the last 10 years has been the rise in the number of institutional investors now using hedge funds. US institutions had always been investors in alternative assets, predominantly private equity and real estate, but the zero return world of Japan in the late 1990s and early 2000 led to a significant rise in Japanese assets allocated to hedge funds. The depth and breadth of the post tech bubble bear market led many more international institutions, especially those with liabilities to fund, to reconsider hedge funds.

The end user of hedge funds has moved from being wealthy private investors with a higher tolerance for risk, to investors with redefined LIBOR-plus targets. This has changed the game very subtly. Unfortunately, in this drive to garner longer-term, more stable assets, hedge funds have in certain circles lost some of their spirit. Hedge funds, unlike mutual funds, tend to take far more interest in who their investors are and after LTCM are more concerned with attracting so-called sticky capital. As such, they have accepted the need for greater transparency, better investor communications and, above all, a keener appreciation of risk and return with the emphasis on risk.



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Hedge funds have grown up from the more cavalier money managers of the pre-LTCM era to being investment houses of choice for many of the world's leading institutions. In part, the explosion of FoFs as the hedge fund vehicle of choice has led to as much return diversification as risk diversification. This has left an increasing band of higher risk takers reflecting on whether 3% to 4% over LIBOR is what they really want. In many ways, the search for enhanced alpha has commenced.

Strategy and geographic focused funds

Despite the influence of easy markets over the last three years perhaps clouding some investors' risk appetite, recent developments enable a higher risk/return profile to be accommodated through more streamlined strategy/geographically-specific FoFs.

Lesson 101 of managing risk in hedge funds is that diversification across strategies and diversification across managers within strategies are two of the simplest and safest ways to avoid calamity. It is for this very reason that FoFs have made huge progress over the past 10 years. Today, they represent 35%¹ of hedge fund assets, versus 19% only five years ago, with little sign of the increase in market share slowing. In many cases, FoFs are providing exactly the sort of returns institutional clients are expecting, within the narrow bands of volatility demanded. This has become more complex as the number of indices that seek to measure their progress has risen.

The dynamics of investing in hedge funds have also changed, with talk of capacity being the biggest challenge now faced. Ten years ago one could simply pick 15 or 20 talented managers with limited attention to strategy and have a world-class portfolio or FoF. Today, those same 20 managers consistently deliver 15% plus net returns. The problem is the funds are closed and can only be found in FoFs with longer-term track records. As a result, strategic allocations take on far more significance. It is this need to adopt a moderately tactical overlay to hedge fund allocations that has led to the growth of both strategy-specific FoFs such

as equity long/short, macro or Commodity Trading Advisors as well as geographically-focused FoFs. The latter vary, with some providing multi-strategy options across a region or combining a very focused approach to European equity long/short managers, for example.

How can investors use these funds? In essence, using the traditional core and satellite concept, by using the traditional multi-strategy FoF as the core, and then weighting the portfolio in line with either shorter-term views or in many cases, areas where the core FoF is underweighted. This has been particularly noticeable with North American multi-strategy funds that historically have had a very US-centric focus and have not ventured to the emerging markets or Asia in search of hedge fund talent. The ability to add building blocks to an existing diversified portfolio has enabled investors to more closely align investment objectives without having to create segregated accounts.

There are varying types of single strategy or single sector hedge FoFs. In many cases, they are quite concentrated, with 10 or 12 managers in the fund. This tends to make them more suitable add ons to an existing multi-strategy fund, adding concentration in the area of focus. It also tends to provide a higher level of transparency, although this is not always the case. The more diversified single sector FoFs (for example, those focused on Asia) will typically come in two styles – concentrated funds (most likely with a focus on long/short managers) and multi-strategy funds (which may have 40 or more positions). This type of offering has appeal to those who may be embarking on their FoF experience for while it may carry the geographic risk of Asia (including Japan, India and Australia), it offers a multitude of opportunities across managers trading equities, fixed income, convertibles and distressed securities. The medium-term returns from these types of funds are double digit and their volatility is well below 10%. Clearly, the risk is another Asian crisis and a melt down in the region.

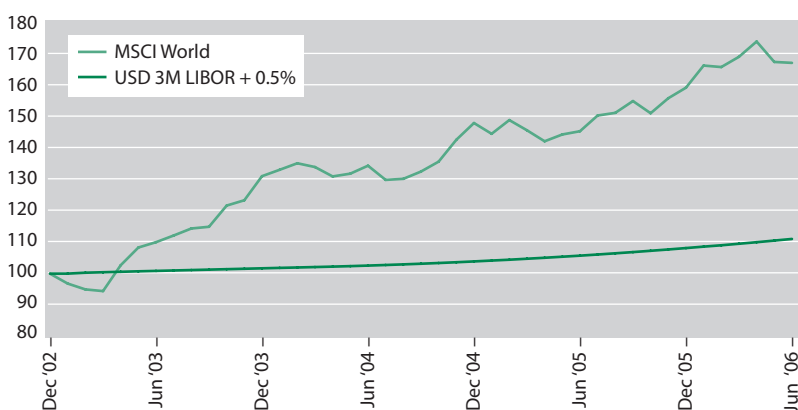
Commodity traders by name, not assets

A subset of single strategy that provides diversification insofar as correlation is concerned is Commodity Trading Advisors (CTAs). It is somewhat of a misnomer – the vast majority of trades are in equity, interest rates and currency futures, rather than commodities markets. Managed Futures is a more accurate label for these funds.

Considered by most to be the black sheep of the hedge fund community, CTAs tend to be volatile and as the hedge fund world has positioned itself as the keeper of low volatility, many multi-strategy managers either exclude this subset from portfolios or at best included it at very modest levels.

This fear of volatility is often misplaced. CTAs tend to be uncorrelated with the vast majority of hedge funds and negatively correlated in periods of extreme market stress (Figure 2). As such, when added to a typical multi-strategy FoF, CTAs reduce overall portfolio volatility over time. Just as importantly, their

Figure 1: MSCI World Index vs 3M LIBOR +5%



Notes: Jan 2003 to Jun 2006

Source: Bloomberg

ability to provide protection in market crashes has been witnessed in many of the market events of the past 12 years (Figure 3).

The CTA space is dominated by a small number of significant single manager funds. Many tend to be systematic, relying on proprietary model-driven trading systems. Some systems perform better in short-term trending markets and others better in longer, slower moving trends. The ability to combine a number of these into one fund reduces some of the short-term volatility experienced with a single manager while maintaining the strategy's longer-term uncorrelated characteristics. This seems to meet all parties' objectives and enables investors to increase exposures to the strategy without changing the core. This can be particularly important if there is concern over market turbulence with the possibility for a major event.

The price of liquidity

It is now more or less accepted that, by and large, hedge funds are priced monthly, accept new investments monthly, and offer redemptions monthly or quarterly. FoFs have helped fill some of the gaps by offering monthly liquidity with 30 or 40 days notice.

A preference for the most liquid strategies has excluded many investors from participating in arguably the highest skill set in the hedge fund world, the event-driven space. This strategy encompasses a multitude of assets and styles but the essence is in longer-term corporate events such as restructurings, bankruptcies or hostile mergers. The managers that operate in these areas do not tend to be traders and are typically longer-term, strategic investors. In many respects, their willingness to provide liquidity for less conventional trades is a key source of return (Figure 4).

As many hedge fund strategies become more commoditized and less profitable as a result, the longer-term, event-driven space has a much higher barrier to entry. Although a number of proprietary desks of the investment banks participated in the distressed bull market of the early and mid 1990s, they hastily retreated after the Russian default and resultant market shake out, and there is limited evidence to suggest they have returned. In addition, the rise in corporate restructurings in Europe (and, to a lesser degree, Asia)

as well as hostile takeovers, means the opportunity set is as abundant today as it has ever been.

It is now common to read of corporate raiders or activists pushing management of public corporations to move in a direction they believe will benefit the company's shareholders (of which they will have a healthy proportion). A high-profile example is the purchase of Manchester United Football Club, which was funded by three hedge funds that loaned the Glazer family the necessary capital to complete the transaction. As interest rates rise, this type of asset backed loan origination is a highly profitable strategy, with managers charging 800 to 1000 basis points over LIBOR.

These managers tend to have higher minimums (typically \$US5m) and offer liquidity after an initial lock up period of one-to-three years. As such, they fit somewhere between hedge funds and private equity and, as a result, are seldom included in hedge FoFs.

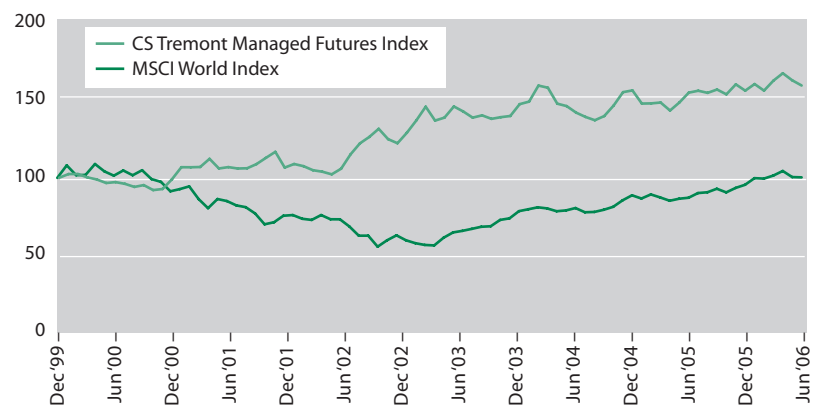
There is a move within the hedge fund industry to offer these managers in a FoF structure with the corresponding liquidity. This is to be welcomed as the returns generated are much less market dependent and far more determined by the skill of the underlying manager in being able to access and evaluate complex restructurings and deals. As we head into a period of rising global interest rates and historically low bond

Figure 2: CTA correlations – Jan 1994 to Jun 2006

	CSTREMONT MANAGED FUTURES INDEX
MSCI WORLD INDEX	-0.08
MSCI FAR EAST FREE USD	0.03
NASDAQ COMPOSITE INDEX	-0.16
DOW JONES INDEX	-0.16
JP MORGAN GOV'T BOND INDEX	0.35
HEDGE FUND RESEARCH COMPOSITE INDEX	-0.05

Source: CS Tremont Hedge Index, Bloomberg

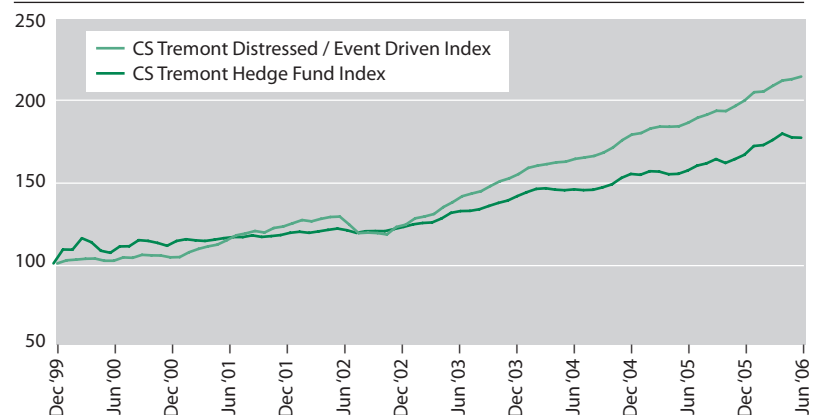
Figure 3: CS Tremont Managed Futures Index vs MSCI World Index



Notes: Jan 2000 to Jun 2006

Source: Bloomberg, Credit Suisse Tremont Hedge Index

Figure 4: CS Tremont Distressed / Event-Driven Index



Notes: Jan 2000 to Jun 2006

Source: Bloomberg, Credit Suisse Tremont Hedge Index

spreads and corporate default rates, it is fair to expect the returns from the long-term event managers to increase, making them a more compelling option – provided investors can handle the liquidity issues. These potentially higher returns are achieved at the price of liquidity and may not be every investor's cup of tea, but may suit more long-term, non-liquidity constrained investors (large family offices or endowment funds, for example). They should be a welcome addition to a diversified portfolio when corporate activity is strong.

Structured products come of age?

Structured products (principal guaranteed funds) were at their height of investor demand when the last bear market was at its fiercest, as interest rates collapsed and the cost of a guarantee spiraled. Looking forward, there are plenty of storm clouds on the financial horizon and, with interest rates in the dollar block nearing some likely peak, now may not be a bad time to revisit this often-thorny subject.

The key reason not to consider a principal guaranteed FoF was always cost and its impact on performance. Most practitioners will tell you that a properly diversified multi-strategy FoF does not need a principal guarantee, and the structures that were used compounded this by giving very poor participation rates at outset. As one client put it, offering a simple capital guarantee on a well-diversified portfolio of hedge funds is like selling flood insurance to the inhabitants of the Sahara desert – all in all, a bad deal!

Issuers of notes offer their firms' balance sheets as the prize if the FoF goes into long-term melt down, and so quite naturally load the odds in their favour when assessing risk. However, experience over the past five or six years has led them to conclude, in common with the FoF community, that a properly structured, well diversified fund is unlikely to be worth substantially less than its offer price in five or 10 years. As such, the amount of risk they are prepared to accept has increased and the premiums charged for it have reduced marginally. The key major advance is issuers' willingness to offer leverage and income distribution.

The reverse engineering of being more strategy focused is to be more diversified, with a sensible amount of leverage. Structured note providers are now producing structures that give an immediate 1.5:1 exposure, in some cases rising to 2:1 subject to the underlying fund performing in excess of cash returns. Quite quickly, investors can find themselves with \$2 invested for every \$1 of capital and, while interest costs on the borrowing and the issuer's guarantee fees have to be met, this will push a typical high single digit performing fund into double digit returns.

Clearly, this is the best case scenario and markets are never kind to the overly optimistic. So what downside protection is there? Programmes today automatically reduce this leverage if underlying fund performance is below trend and looks to affect the long-term security of the guarantee. To this extent, there is a self-adjusting mechanism that will reduce exposure and the

impact of leverage in a systematic, rules-based fashion. Unfortunately, the impact of deleveraging past a point will mean the interest rate costs and guarantee will most likely drag returns below the long-term return of the underlying investment. There are no free lunches. Figure 5 illustrates the reasonably consistent low volatility of hedge funds as an asset class and their outperformance of cash, and poses a strong argument for gearing.

Various features now exist that can make this risk/return scenario more palatable. The ability to strip out gains in good years and pay them as income coupons is gaining increased acceptance by income-hungry institutions such as insurance companies, as well as investors looking to diversify away from traditional fixed income assets. The fact that FoFs and hedge funds in general have a low to negative correlation to fixed income over most periods² raises some interesting portfolio diversification opportunities in rising interest rate periods.

For institutions taking a first step into hedge fund investing, the promise of their money back after five or so years provides most investment committees with sufficient comfort to take the step. While the purest investor may well remain skeptical about the multi-layer of fees, with properly structured leverage, you can today create a vehicle that will, under the right prevailing conditions, outperform its underlying fund and guarantee principal against catastrophe. This should appeal to both the overly optimistic and overly pessimistic among us.

Incubator funds – diamonds in the rough

The subject of incubator funds is inextricably linked to capacity. The fact that hedge funds are principally in the business of making money not raising assets means they close when a level of assets under management is reached at which the manager feels opportunities are of a reduced quality. This desire to maintain an optimum fighting weight is in part driven by the fact that performance fees generated are the life blood of the business in retaining and recruiting the best talents – hence the paradox of having great performance but no capacity.

In reality, however, capacity is not a black and white issue. Even great managers have redemptions and investors are sometimes forced to redeem for non-economic reasons. Where do these redemptions go? All hedge funds will have preferred clients (often the early investors or sometimes later stage investors who have demonstrated stability in turbulent times). For example, the shake out in convertible bond managers during 2004/05 hurt many managers who are now back in demand as the strategy stabilises. Whose money will they take? In short, those investors who stuck with them through the tough times and didn't compound their problems by redeeming.

The latest hot trend in the FoF space is the incubator or emerging manager space. The prospect of not only finding the next George Soros but sharing in the long-term success of both his fund and his management

company is indeed reason to embark on a treasure hunt. The question is whether these funds work – and, in short, it’s far too early to tell. The more mature funds are only a few years old, so there is limited data from which to draw any meaningful conclusions.

There is also a phenomenon – the rookie effect – whereby a manager’s performance in its first two years will be greater than its long-term average (Figure 6). The best time to invest would clearly be at the opening of a new manager with a view to redeeming once the fund reaches the stage that performance starts to slow. Many successful FoFs have allocated capital to new managers and profited from the rookie effect. However, as with flying, you are at greatest risk in a hedge fund at take off rather than at cruising altitude. There is a clear balance between the outsized returns attributed to the rookie effect versus the additional operational risk of backing a new enterprise. The more conservative would argue that the loss of 2% or 3% of annual performance from one position that may be 4% of a total portfolio is acceptable against the prospect of losing 100% of the capital in the event of a business failure.

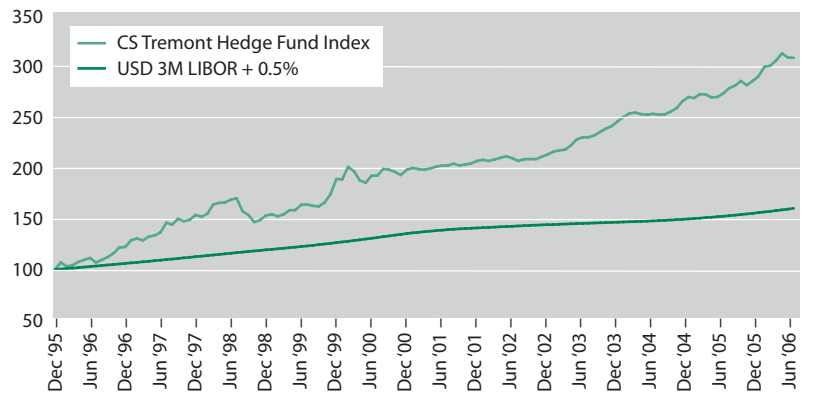
Aside from the superstar hedge funds that raise billions of dollars at launch and are closed at inception, the rest are very much the have-nots. Despite the considerable efforts of their prime brokers and other service providers to promote them, they struggle to get on key players’ radars quickly and spend the first year or so of existence with just the capital of the principals and their families and friends. These are the key candidates for the incubator FoF. In the hedge fund jungle, the rules are very simple – under \$US100m, a fund struggles. Regardless of where in the world a manager is based, to build a credible infrastructure with the right caliber of investment professionals, annual revenues of \$US1m are a bare minimum, with \$US2m a much healthier number.

In a manner somewhat similar to private equity (which in essence this is) FoFs will exercise a range of options in terms of the control they take in the relationship, ranging from:

- continuing and guaranteed capacity rights after launch to reward loyalty in seeding the fund, even if the fund closes in the future;
- preferred management and performance fees, contained in commonly-termed side letters; and/or
- taking either a stake in the management company or having an arrangement tied to the economic value of the business. The added risk corresponds with the potential reward.

In cases where a hedge fund has sold part of the management firm’s equity to an initial seed investor, it is usual for the agreement to be for a finite period. There will most likely be a pre-agreed buyout formula that will be exercised by the hedge fund. Again, all parties leave happy – the FoF gets an equity kicker and the now

Figure 5: CS Tremont Hedge Fund Index vs USD 3m Libor +0.5%



Notes: Jan 1996 to Jun 2006 Source: Bloomberg, Credit Suisse Tremont Hedge Index

Figure 6: The Rookie effect – Jan 1995 to Dec 2004³

		< 2 YEAR	HFRI FOF
10-year	Return (%pa)	16.91	6.38
	Std deviation	5.25	5.21
5-year	Return (%pa)	11.13	5.17
	Std deviation	4.52	4.44
3-year	Return (%pa)	9.37	6.35
	Std deviation	3.20	2.96

Notes: HFRI FOF = HFRI Fund of Funds Index. Source: Hedge Fund Research, Inc

stable and thriving hedge fund takes back full control of revenue.

The discovery of new talent should be a constant part of the due diligence process of all FoFs. A responsible FoF manager will evaluate all aspects of a new hedge fund managers business (both superstar and unknown) and will come to a level of conviction as to whether to invest or not. Prudence dictates that few FoFs would invest 20% or 30% of a new fund’s capital so by definition, investments will start small. A lower risk strategy is clearly the non equity ownership option that allows the FoF to grow with the hedge fund manager on some preferred terms for the FoF manager’s initial faith.

The future belongs to the best resourced

If you are a large investor in hedge funds with a regular flow of new funds, you can afford to ride out strategy declines if it means keeping money with the best managers in that strategy. This may seem at odds with optimising performance but even in the dark days of Convertible Bond Arbitrage (March and April 2005 after the GM debacle), the top three or four managers in the strategy were able to eke out reasonable single digit returns – a small price for FoFs to pay for capacity now the strategy is back in favour. And, of course, large investors are the ones who receive the visits on the road shows for the jumbo launches. Smaller investors are

disadvantaged and while many continue to enjoy great relationships with high quality hedge funds, the hedge fund universe is moving at such a fast rate that they cannot keep up with the now commonplace weekly launches and closures. This will ultimately lead to consolidation in the FoF industry. Today, the need is for coverage and scale. For example, operational due diligence is a very time consuming but essential part of the selection process, so FoFs must be deeply resourced and multi-jurisdictional. The days of a team in New York or London making quarterly visits in the opposite direction are coming to an end. We may well soon see tie-ups between US and European boutiques seeking to leverage each other's local connections but capacity will be the issue to overcome if the relationship is to work. Boutiques may well end up as the providers of specialist regional or strategy-specific FoFs, or as the key providers of incubator products. Alternatively, they may bow to the consolidation that appears inevitable and align with the larger global players.

The range of hedge fund solutions available may appear daunting (FoF, structured products, core and satellite or individual single-manager funds), and will doubtless continue to expand. But the fact remains that as the investment benefits become more widely known, more and more investors will request these products. Consequently, the pressure will increase on advisers to obtain high quality hedge fund expertise for clients.

This paper has provided broad insights into the direction of the multi-strategy hedge fund business, and the evolution of building blocks as a tool to enhance returns and diversify or decorrelate portfolios. To place hedge funds into one box is no longer appropriate if aiming to maximise the available benefits. As the space has become more complex and is inherently complicated, the need for a specialist advisor in this field is imperative, be it a FoF manager or an advisor to your building blocks, or a segregated discretionary account of hedge funds – as in many things in life, access to an experienced specialist is essential.

ENDNOTES

1. *HFR Q2 2006 Industry Report*.
2. The HFRI Fund of Funds Index had a correlation of -0.08 versus the JP Morgan Government Bond Index over the 10-year period to 30 June 2006. Source: Bloomberg, HFR.
3. HFR Asset Management, "Emerging Manager Out-Performance: Alpha Opportunities from the Industry's Newest Hedge Fund Managers" www.hedgeweek.com/download/2085/Emerging%20Manager%20Outperformance.pdf

ABOUT THE AUTHOR



Patrick Tuohy is Senior Director and Asia Head, Alternative Funds Group, Investment Management, with HSBC Private Bank. He joined HSBC in May 2004 as the Head of the Alternative Funds Group based in Hong Kong and has overall responsibility for the hedge fund investment platform in Asia. Patrick has over 24 years of industry experience and has been directly involved in the hedge fund business and managing client portfolios while at his own firm Tresidder, Tuohy and Partners since 1996. Prior to joining HSBC, Patrick was involved in the hedge fund of funds business in Hong Kong where he established Momentum Asia Limited in 1998 jointly with Momentum Asset Management, the Bermuda-based alternative funds specialists. As Managing Director of the Asian business, Patrick was involved in managing key relationships and advising on Asian manager selection. Patrick began his career in financial services in the UK working for the life insurance and mutual fund manager, Clerical Medical. He was one of the early members of their offshore subsidiary CMI and established their businesses in Spain and the Middle East before moving to Hong Kong in 1990.

The HSBC Group is one of the largest banking and financial services organisations in the world with 9,500 offices worldwide and over \$US1.738 trillion in assets as of 30 June 2006. Within HSBC, the Alternative Investment Group (AIG) covers a wide spectrum of services for both institutional and private investors, including hedge fund advisory, discretionary management of hedge fund portfolios, structured products based around hedge funds and hedge fund custody. HSBC AIG is one of the top three hedge fund investors worldwide, with over \$US32 billion of client assets invested in alternative investments as of 31 March 2006.