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## Hedge Funds: Are Investors Throwing the Baby Out With the Bathwater?

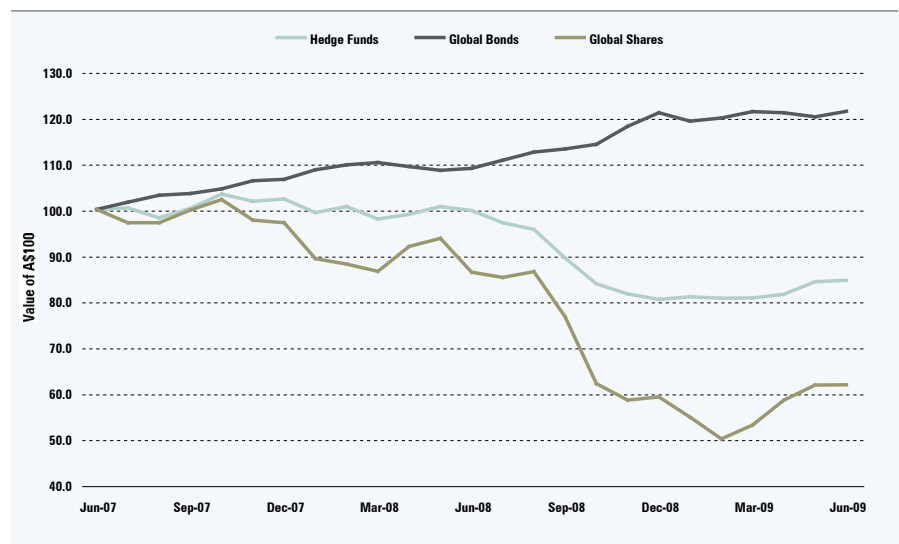
Is there still a role for hedge funds in diversified portfolios? Many Australian superannuation funds redeemed from fund-of-fund hedge funds this year after suffering losses and frozen or delayed redemptions from 2008. In this Ibbotson Insight, we revisit the case for including hedge funds in a portfolio, explore how hedge funds compare with other alternative assets, and discuss key issues including liquidity and the outlook for returns.

Our conclusions are that hedge funds remain a valid diversifier, and that the outlook is the best in years, thanks to less capital competing for an unusually wide range of opportunities. Our own experience has shown the value of using internal and external research to tailor hedge fund strategies for diversified portfolios and get better outcomes than generic hedge funds have delivered. Ibbotson continues to dedicate substantial research resources to hedge funds, which remain a core part of our alternative investment portfolios.

### Performance During Global Financial Crisis

We can use fund-of-fund hedge funds as a proxy for the experience of investors with diversified hedge fund portfolios during the global financial crisis. As Figure 1 shows, from July 2007 to June 2009 hedge fund returns were -8.0 percent per annum compared with -21.40 percent per annum for global shares over the same period (using the MSCI World ex-Australia \$A hedged benchmark) and 10.20 percent per annum for global government bonds (JP Morgan World ex-Australia \$A hedged).

**Figure 1.** Performance of Fund-of-Fund Hedge Funds Relative to Global Equities and Bonds, 30 June 2007–30 June 2009.



Source: Intech Desktop Consultant. Hedge funds represented by Hedge Fund Research Fund of Hedge Fund Composite Index, global bonds by JP Morgan Ex-Australia Index; global shares by MSCI World ex-Australia Hedged \$A Index.

Investors who funded their hedge funds from shares did get a diversification benefit, but if they funded them from bonds, they ended up with higher risk and lower returns.

Note that most of the losses for hedge funds occurred in September and October 2008. Hedge funds did a good job of preserving capital before September 2008, and in 2009 preserved capital early in the year and benefitted from the normalisation of markets in the second quarter. So the majority of the negative returns from hedge funds occurred in a three-month period in the fourth quarter of 2008.

### Reasons for Poor Performance in 2008

Barely 10.0 percent of hedge fund strategies generated positive returns in the fourth quarter of 2008. This is the lowest on record based on Hedge Fund Research data back to 1990 (Figure 2). Such widespread failure suggests that the causes are less to do with individual hedge fund managers 'getting it wrong', and more to do with an inability to hedge portfolios or to make enough money from short positions.

What makes hedge funds different from long-only strategies is the former's ability to use leverage, hedge their portfolio using derivatives,

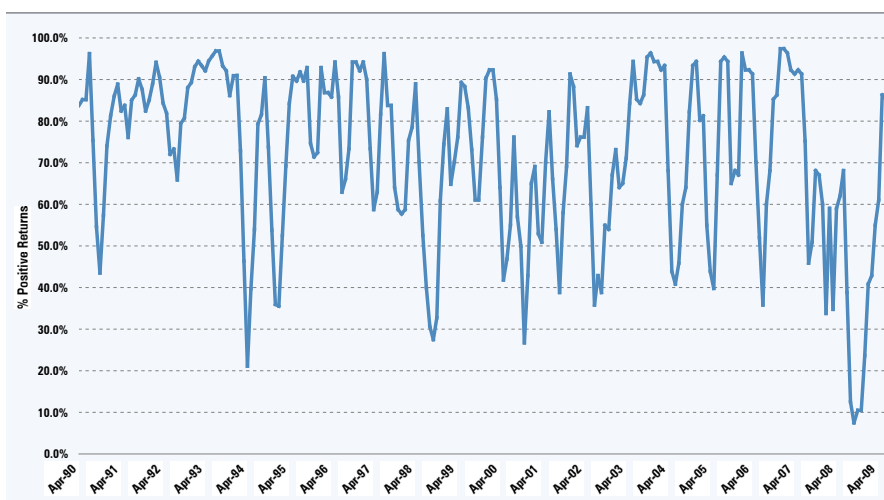
and profit from negative views by shorting markets or individual securities. Many of these levers were removed in September and October 2008, coinciding with large negative returns for hedge funds and even larger losses for sharemarkets, as Figure 3 shows.

Three key factors had the greatest impact on hedge fund returns over this period. The first was investor redemptions. About US\$150.0 billion of capital was redeemed from hedge funds in 2008, mostly in the second half of the year. These outflows were dominated by European retail fund-of-fund hedge funds and leveraged funds, some of which offered daily liquidity to investors. These in turn redeemed from their underlying hedge funds, which then sold what they owned and bought back their short positions, causing the funds to lose money on their long and their short positions. The large scale of these transactions contributed to overall losses, as selling put downward pressure on the prices of long positions while buying put upward pressure on short positions. The result was that hedge funds lost money on both their long and their short positions. Worst affected were managers in 'crowded trades' which held the same long and short investments as many other hedge funds.

The second key factor behind the poor returns from hedge funds during the final quarter of 2008 was the withdrawal of debt financing. Investment banks through their prime brokers are the primary sources of debt hedge funds use when investing in individual company debt or equity securities. The demise of Lehman Brothers and the near collapse of major US investment banks triggered large cutbacks in lending and more stringent terms. To reduce their gearing, hedge funds once again sold their long positions and bought back their short positions to raise capital, triggering losses.

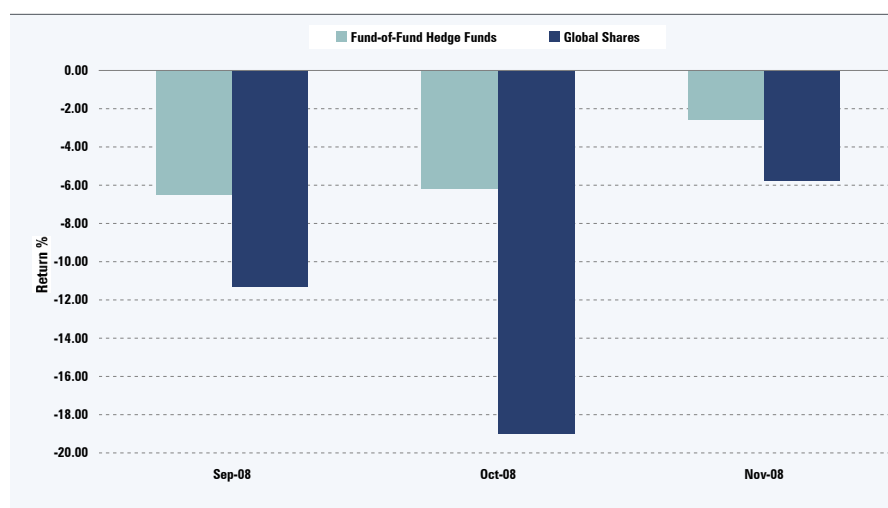
Short-selling bans was the third key factor. New limits on short-selling in many markets affected a wide range of strategies that invest in corporate equity and debt including equity long/short and convertible bond arbitrage. These bans triggered selling by investors unable to hedge their portfolios, and contributed to a growing divergence between the price of credit derivatives and the value of the underlying

**Figure 2.** Percentages of Hedge Fund Strategies with Positive Three-Month Returns, 30 June 1990–30 June 2009.



Sources: Hedge Fund Research, Intech.

**Figure 3.** Monthly Returns from Fund-of-Fund Hedge Funds Relative to Global Shares, 30 September–30 November 2008.



Sources: Intech Desktop Consultant (Hedge Fund Research Fund of Hedge Fund Composite Index, MSCI World ex-Australia \$A hedged Index).

baskets of securities. This discrepancy, usually arbitrated out by investors, resulted in many derivative hedges failing to offset losses on comparable long positions.

These major one-off factors were abating by January 2009, and hedge funds were subsequently able to preserve capital during the selloff in equities in the first two months of the year.

#### Performance Compared to Other Alternative Assets

Private equity, unlisted property, and infrastructure form the largest part of Australian investors'

alternative portfolios. These assets are valued less frequently than hedge funds, so markdowns in valuations have lagged, and investors forced to redeem quickly have taken further losses by selling at discounts in the secondary market.

Returns from these asset classes have so far been comparable to hedge funds, with average losses of 20.0 percent to the end of September 2009. Unlisted property fund returns for the 12 months to 30 September 2009 range from -13.20 percent for Australia to -24.50 percent for Europe, based on Mercer and IPD indices. Private equity suffered a similar fate, the State Street

Private Equity Index showing a -22.0 percent return for the same period. (There is insufficient data for unlisted infrastructure to report returns for this period.) The bottom line for investors is that hedge funds performed in line with unlisted assets, as the fall in corporate earnings, rents, and listed asset values flowed through to markdowns in valuations.

### Are Hedge Funds Illiquid?

Some investors were disappointed at the lack of liquidity in hedge funds, many of which deferred redemptions and took six to 12 months to pay out the majority of 2008 redemptions. Worst affected were investors in fund-of-fund hedge funds that offered monthly, weekly, or even daily liquidity, but whose underlying assets could not provide this liquidity. Even in these cases, investors still received the majority of their redemptions much faster than they would have from unlisted assets.

Hedge funds are ultimately only as liquid as the assets in which they're invested, so strategies invested in less liquid assets – typically small company shares, sub-investment grade corporate debt, and hybrid securities – are by nature less liquid, irrespective of the redemption terms offered by managers. Liquidity-constrained investors can limit themselves to global macro, equity long/short, and commodity trading strategies.

By doing so, however, they may miss out on investment opportunities to which only hedge funds can get access, such as arbitrage and distressed debt, two of the best-performing strategies this year. Returns may also be lower if investors confine themselves to managers offering the most liquid terms, thereby excluding many of the better-performing managers which seek a stable investor base. Overall, hedge funds are more liquid than alternative assets like private equity and property, but are less liquid than shares and government bonds.

### Outlook for Hedge Funds

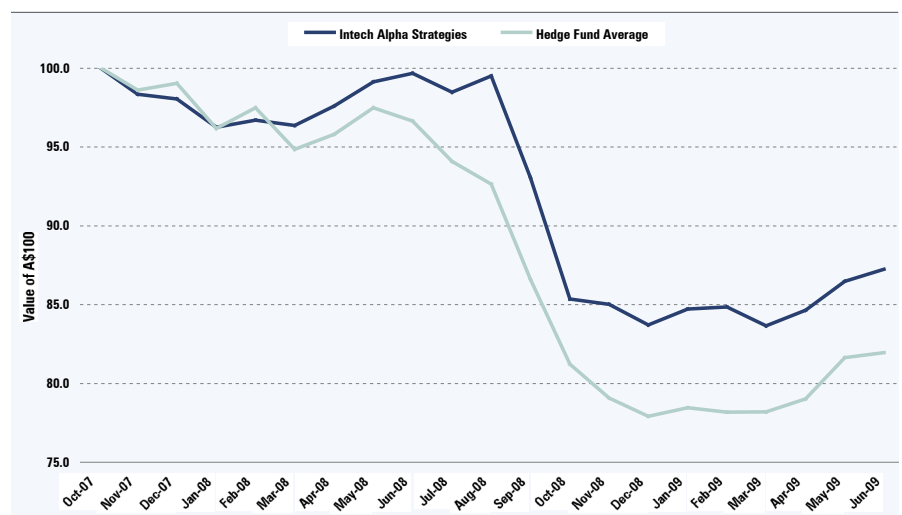
Investment opportunities and competition are two key drivers of returns for hedge funds, and both factors are very supportive for the coming years. The transition from extreme monetary and fiscal stimuli to policy settings more consistent with economic recovery provides opportunities

**Figure 4.** Hedge Fund Annual Net Flows in \$USbn, 1998–2009.



Sources: Intech, Hedge Fund Research. 2009 data is from 1 January to 30 September.

**Figure 5.** Value of A\$100 Invested in Intech Alpha Strategies Trust and Average Fund-of-Fund Hedge Fund, 30 September 2007–30 June 2009.



Sources: Intech, Hedge Fund Research. 'Average fund-of-fund hedge fund' represented by Hedge Fund Research Fund of Fund Composite Index. The inception date for the Intech Alpha Strategies Trust is 30 September 2007.

for macro hedge fund managers to exploit large changes in interest rates and consequent potential effects on exchange rates and bond markets. Similarly, the ongoing unwinding of extreme leverage in companies and investment funds is forcing more hard catalyst events such as refinancing, mergers, asset sales, and bankruptcies, which can be exploited by event-driven credit and equity managers.

There is now much less competition to exploit these opportunities, following the exit of US\$300.0 billion from hedge funds over the past two years (Figure 4), widespread deleveraging

by hedge funds, and scaling back by investment banks of proprietary trading capital. Less leverage is needed to generate returns compared to the period from 2005–07. Hedge funds also look relatively attractive now that share and credit markets are no longer cheap. Having a hedge fund manager that can add value from shorting individual companies and manage overall sharemarket exposure now looks more attractive relative to long-only managers.

The risk of a repeat of the 2008 factors is low, given the fall in investor hedge fund exposure and given that investment banks are starting

to grow their balance sheets. The regulatory outlook remains unclear, but greater disclosure and monitoring looks more likely than outright global bans on specific strategies. The impact is also likely to be muted, given the dominance of larger, well-resourced hedge funds following the consolidation of the hedge funds industry over the past two years.

### What Can Investors Do?

Hedge funds remain a valid diversifier for portfolios dominated by shares, and offer better liquidity than unlisted assets. To get the most benefit there are five strategies investors can follow. The first is to focus on differentiated strategies, thereby reducing the risk of crowded trades and the impact of other investors. Investors should also choose managers which hedge and seek to profit from negative views, as this reduces sensitivity to market ups and downs.

Thirdly, to get best results from hedge funds investors should trade off liquidity to get access to a wider talent pool, more opportunities, and ultimately higher returns or more diversification. The strategy should also be tailored to fit the needs of a broadly-diversified portfolio by combining dedicated internal expertise and customised research from external specialist research. Finally, investors should allocate enough to hedge funds to make a difference to total portfolio returns.

We have found that this approach yields higher returns and better diversification benefits: Figure 5 shows that Ibbotson's portfolio of hedge funds has since inception outperformed the average fund-of-fund hedge fund, resulting in an 0.25–0.50 percent boost to total portfolio returns for Ibbotson diversified funds.

### Conclusions

Last year's disappointing returns from hedge funds were due more to one-off factors than fundamental problems with strategies or managers. Returns during the global financial crisis were comparable to unlisted assets, with markdowns in property and private equity valuations merely occurring later in the cycle. The outlook for hedge fund returns is positive now that there is less money competing for the wide range of opportunities presented by today's policy extremes and a large default cycle. Hedge funds remain an effective diversifier for investors, but those seeking highly-liquid strategies may find they miss out on the better managers and the full range of investment opportunities. Investors can do better by tailoring hedge fund strategies to fit the needs of a diversified portfolio, which is why Ibbotson is committed to a dedicated alternatives capability. **■**

For further information on investment management products and services, please contact our Investment Services Team in Sydney on +61 2 9276 4550.

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