# “Hedge Funds – Panacea or Pure Speculation”

Thomas Weber, LGT Capital Partners
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# Hedge funds – panacea or pure speculation ? Trends in the current market environment

- **Hedge funds defined – exceptional talent and aligned interests**
- Hedge fund industry trends – growth, institutionalisation and focus on quality
- Hedge fund investment trends – active style management, access to funds and focus on quality
- Conclusion – well managed hedge fund portfolios are recommended for any market environment

# Convincing hedge fund manager philosophy aligned with investors' interests

- Highly qualified specialists in specific market segments (often former "proprietary traders").
- High flexibility in making investment decisions (all securities, derivatives, borrowing).
- The manager invests a large part of his personal wealth in the fund (with the same conditions as the investors) and the manager's income is mainly determined by his investment success and is only partially dependent on the amount of assets under management.

**"Entrepreneur"**

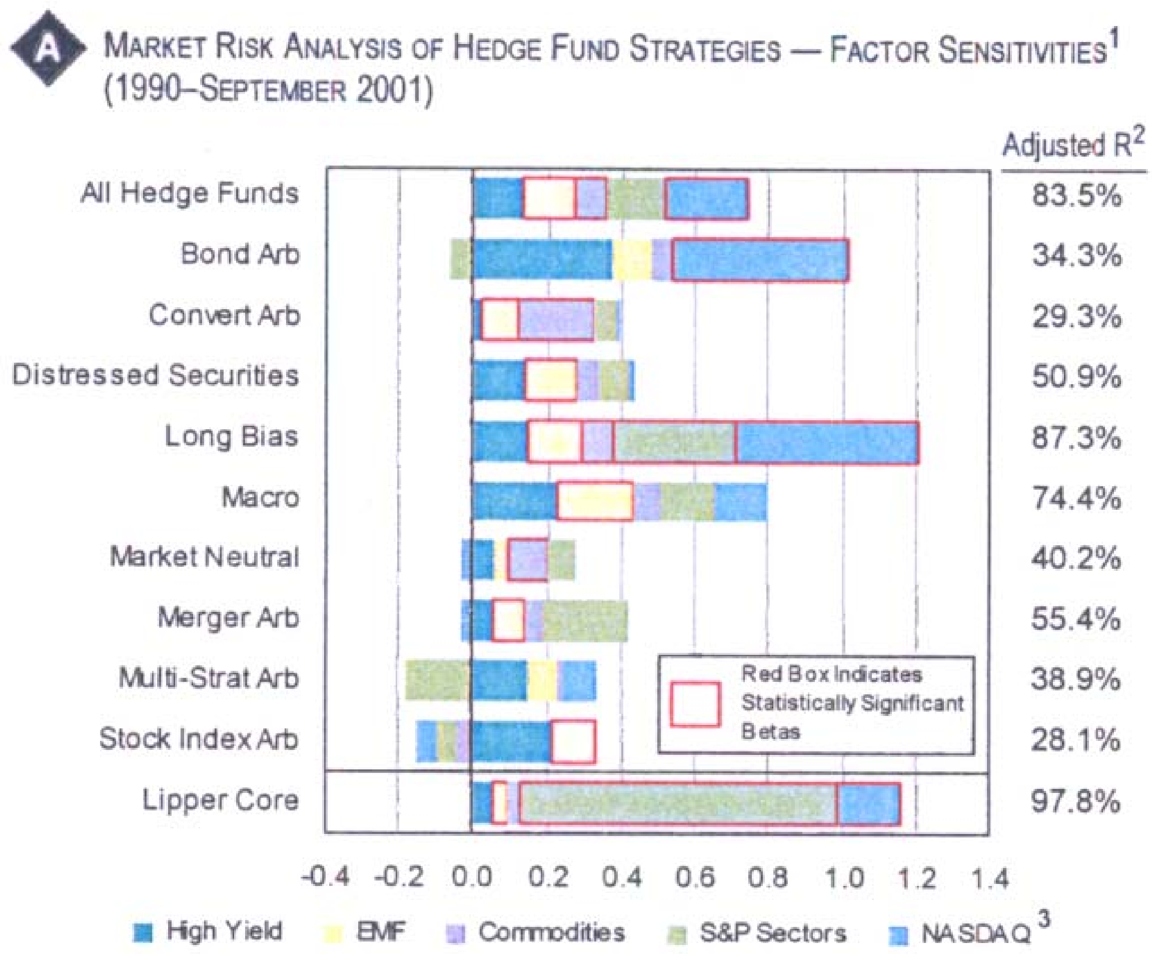
**"Opportunist"**

**"Capitalist"**

# Hedge funds constitute a skill class rather than an asset class

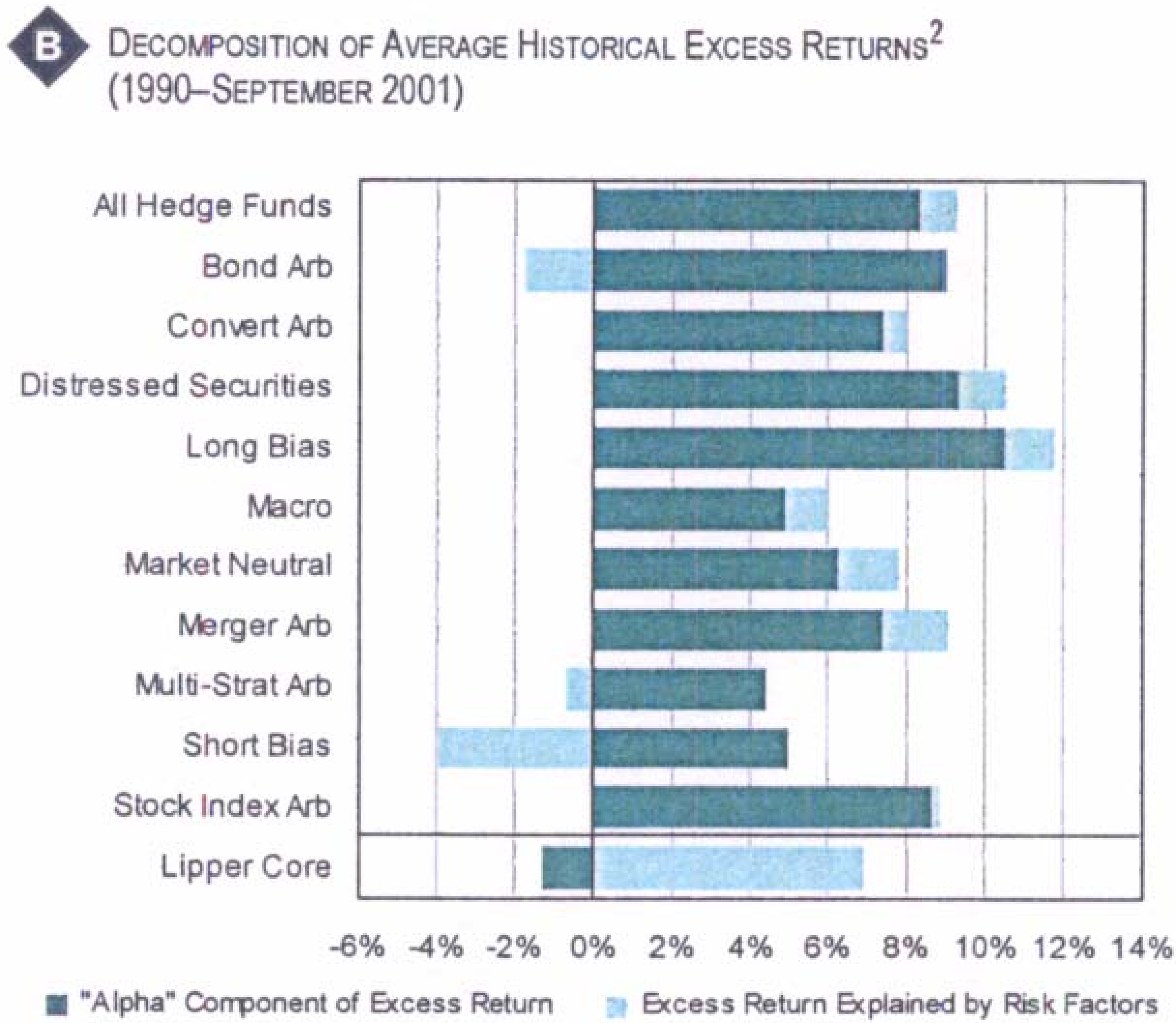
- Hedge funds invest in a broad range of mainly financial assets
- And have absolute return objectives (no benchmarks)
- They aim at generating alpha by exploiting inefficiencies and applying their talent

# Hedge fund risk is not well explained by market factors and ...




Source: Morgan Stanley Quantitative Strategies

# .. hedge funds excess returns have a high alpha component.

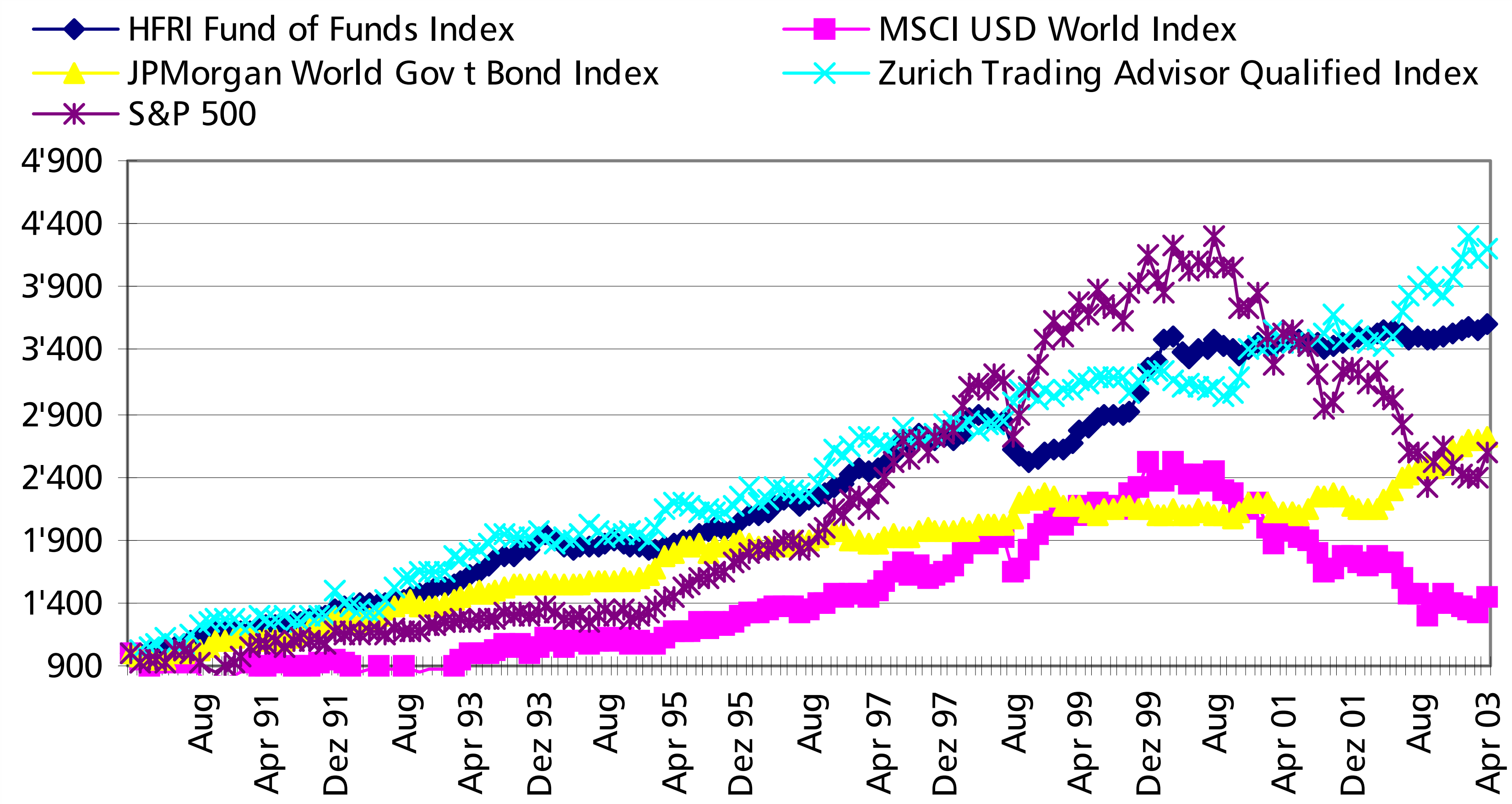



Source: Morgan Stanley Quantitative Strategies

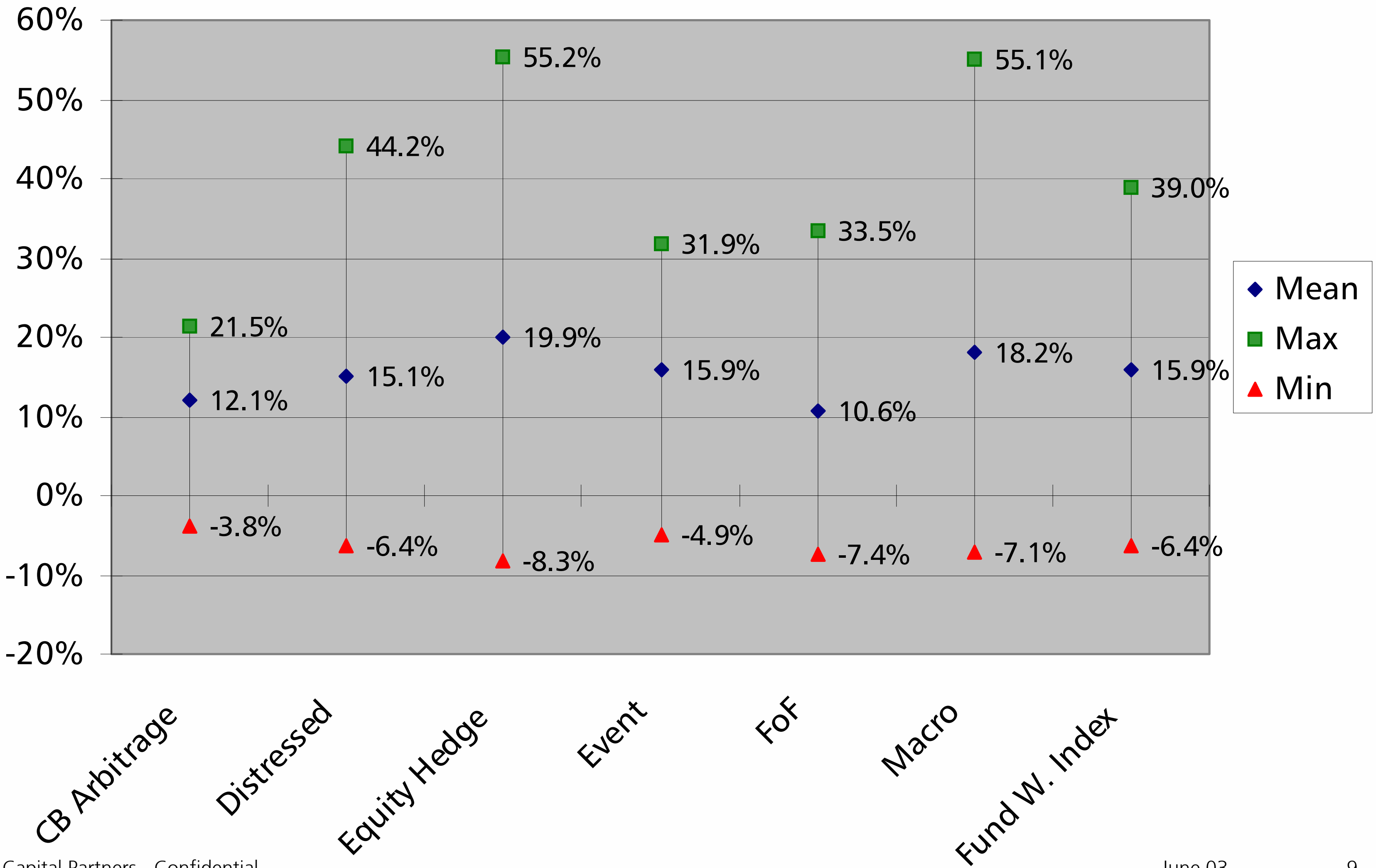
# A few myths about hedge funds

- "Hedge funds are hedged" - every fund is different and when everything is hedged, one earns the risk-free rate of interest.
- "Hedge funds are able to continuously attain very high Sharpe ratios" - the numbers don't show all the risks.
- "Hedge funds are non-cyclical and always generate positive return" - see 1970s, 1990, 1994, 1998.
- "The turbulence in 1998 show that hedge funds are highly correlated" - short-term correlation rises during turbulence, but correlation is a long-term concept (low correlation doesn't mean hedged!).

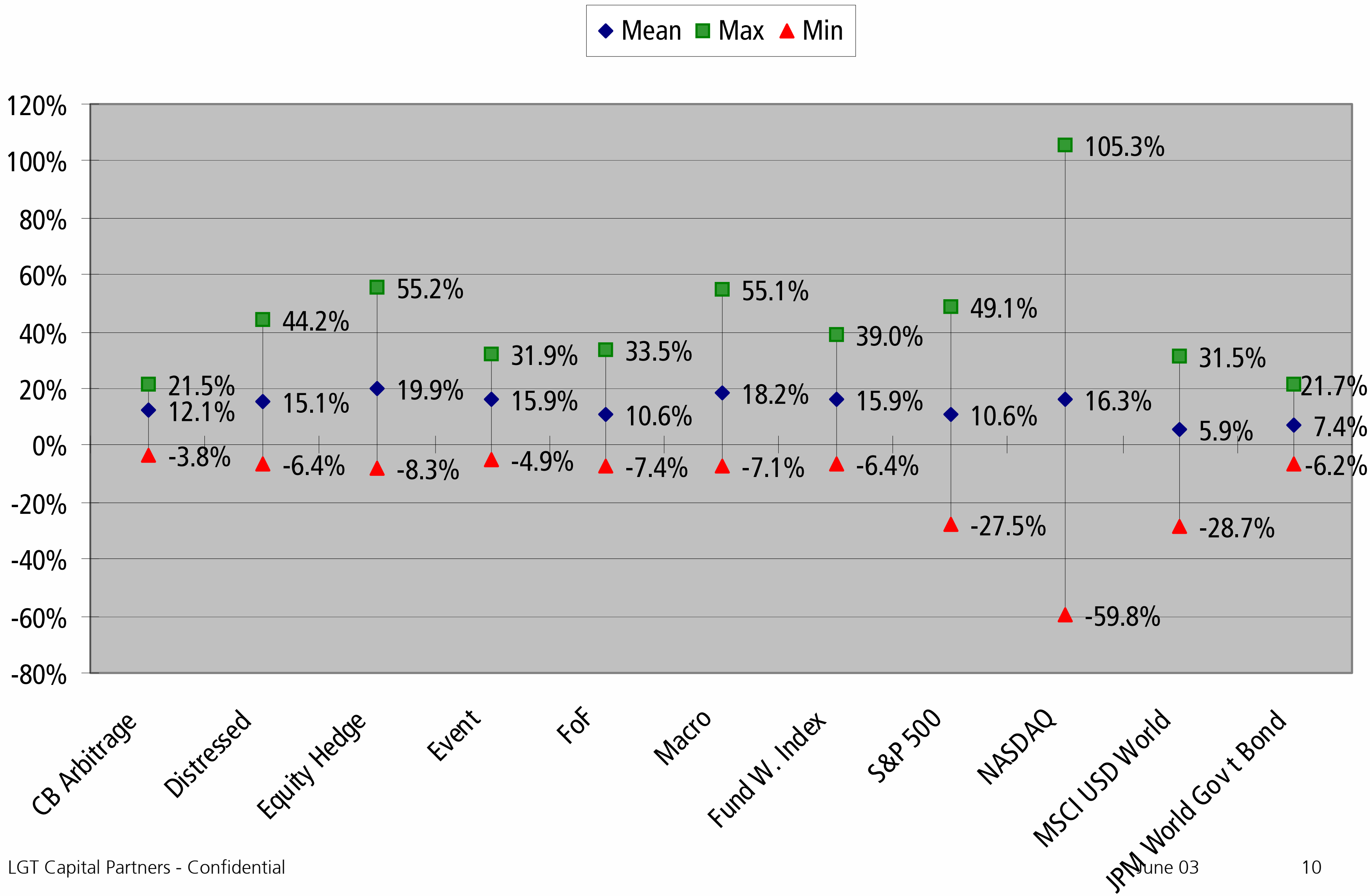
# Hedge fund of funds and traditional markets



# Performance of HFRI style indices (rolling 12-month returns Jan90 - Dec02)



# Performance of HFRI style indices versus traditional markets (rolling 12-month returns Jan90 - Dec02)



# Hedge funds apply talent and exploit inefficiencies to generate superior risk-adjusted returns

- Structural elements attract and reward exceptional talent
- Broad range of instruments can be utilized to create alpha
- Result: superior risk return characteristics and low correlation of hedge funds to traditional assets

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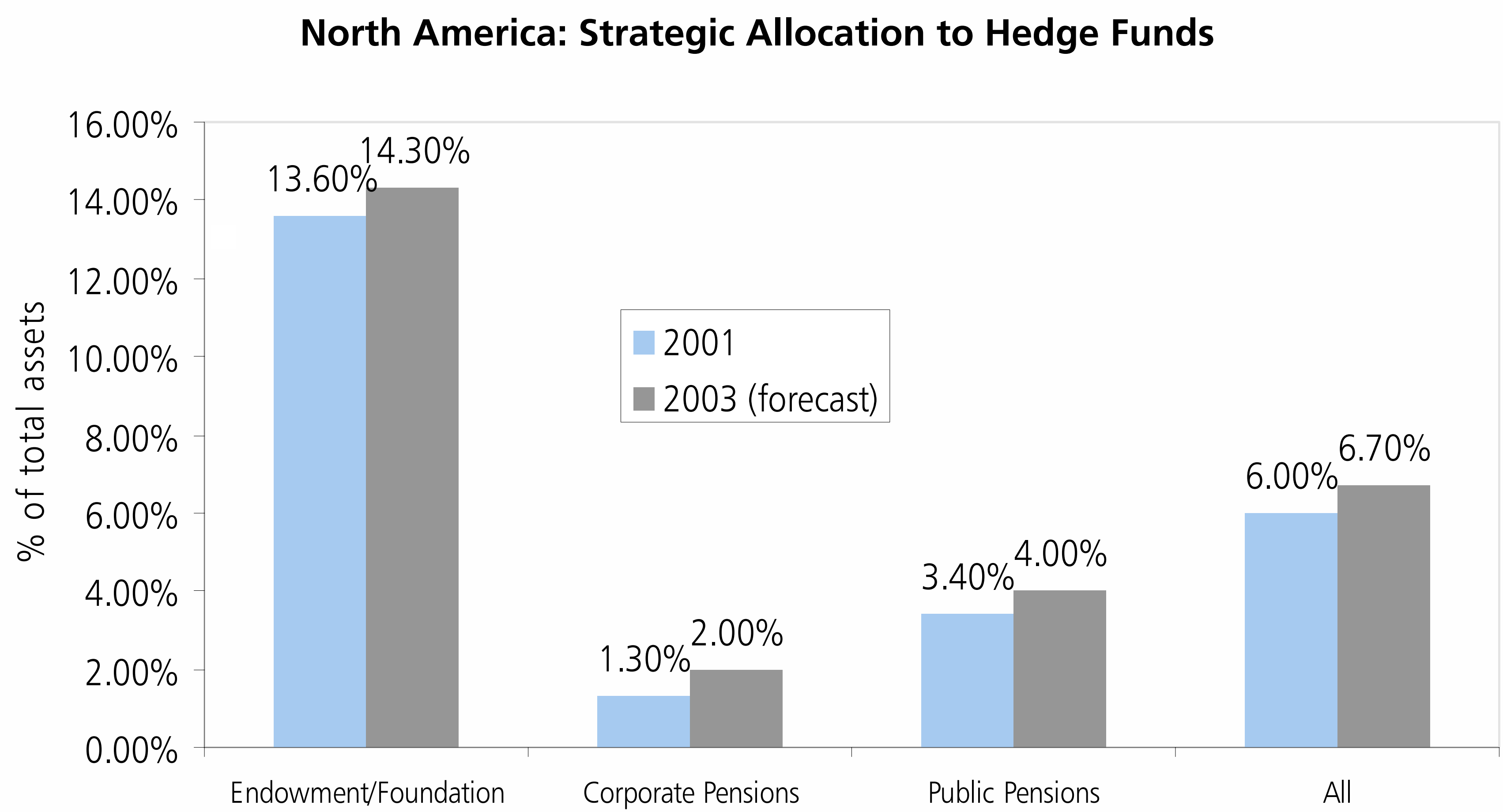
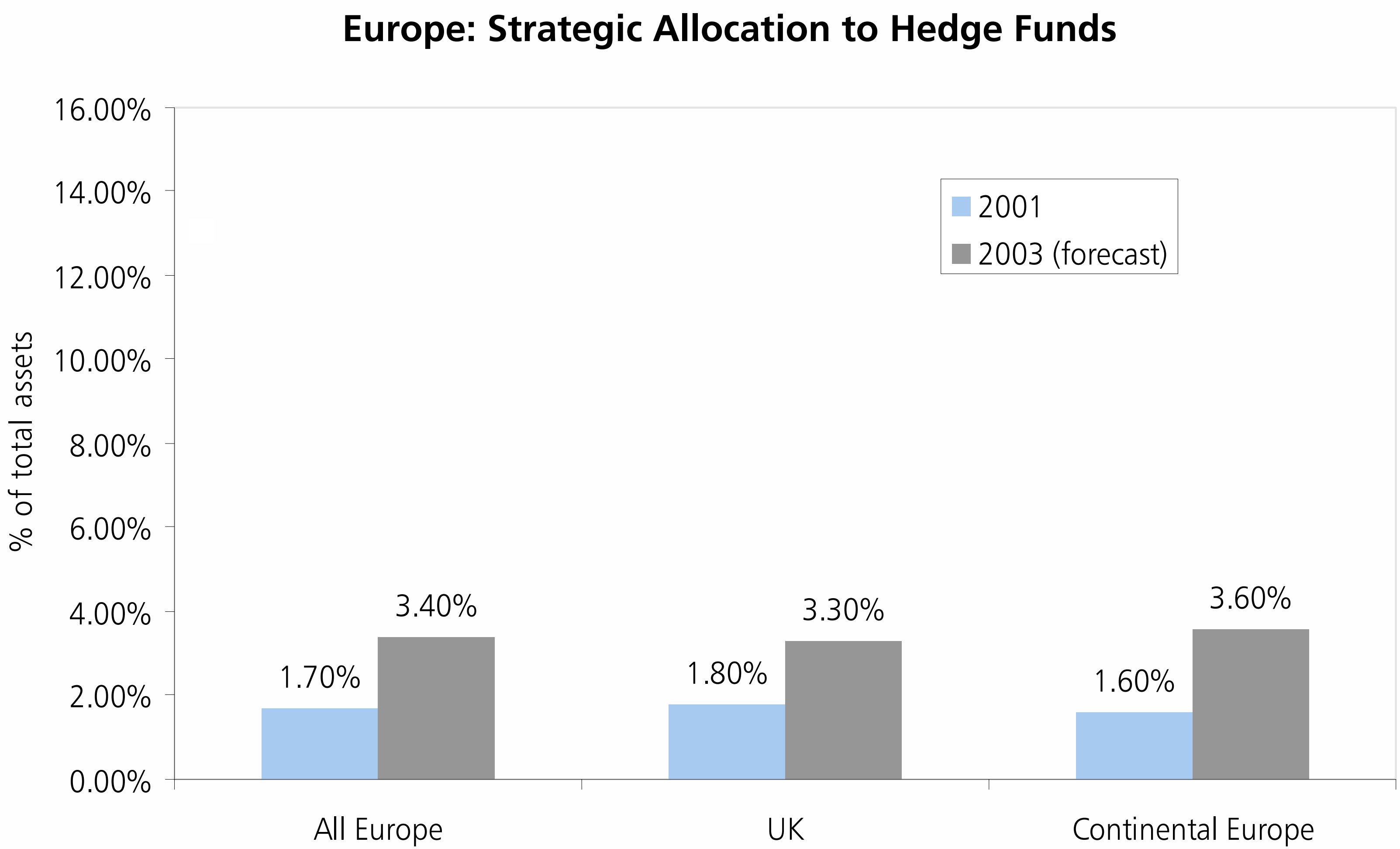
# Average hedge funds allocation of US institutional investors




Source: "Alternative Investing by tax-exempt organizations", Goldman, Sachs & Co and Frank Russell Company

# Average hedge funds allocation of European institutional investors




Source: "Alternative Investing by tax-exempt organizations", Goldman, Sachs & Co and Frank Russell Company

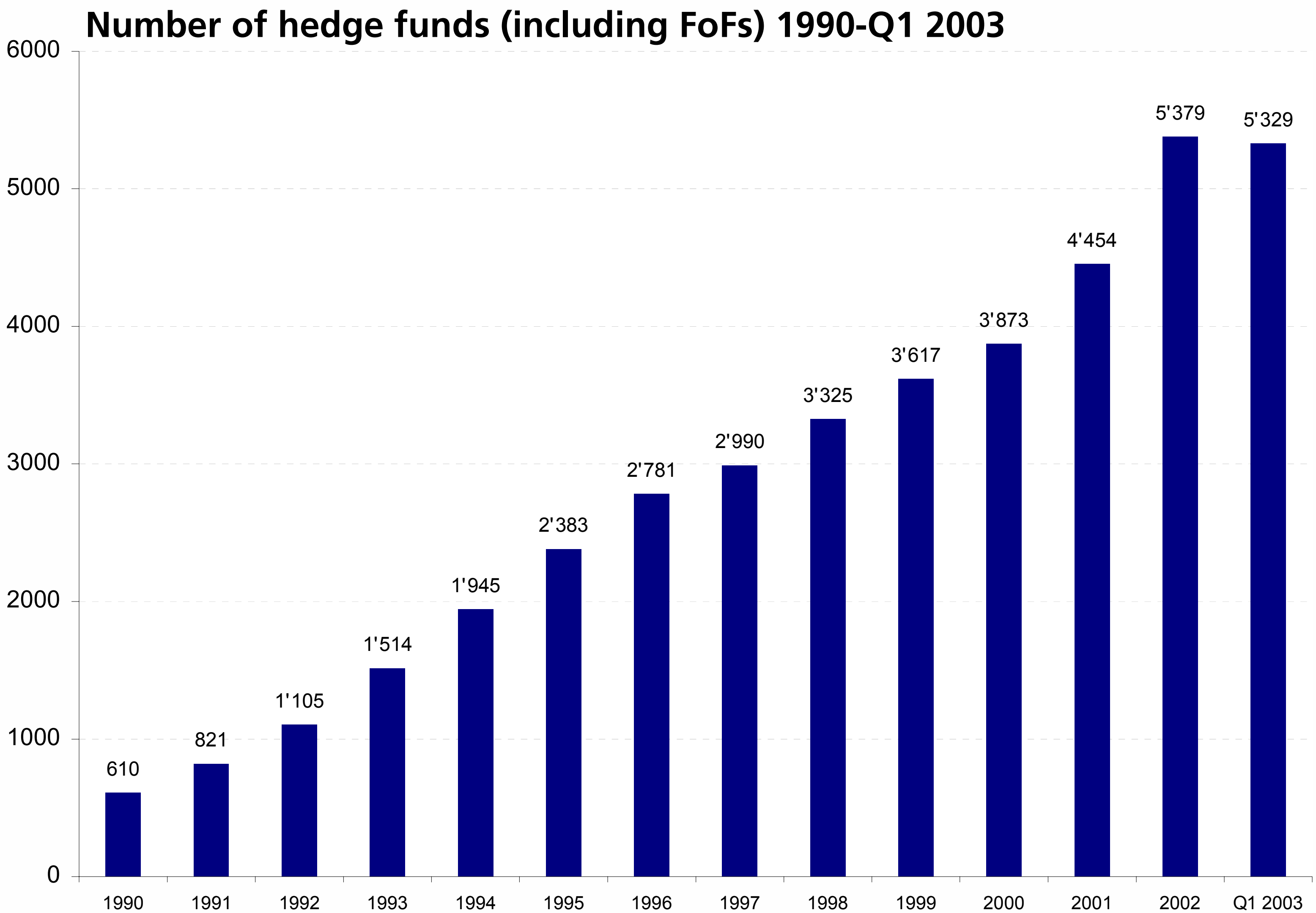
# Experienced investors are increasing their allocations to alternative assets

- USD 1b+ endowments doubled their exposure to hedge funds in fiscal 2002 versus 2001 (17.8% versus 9.6% according to National Association of College and University Business Officers "NACUBO")
- Third annual Commonfund Benchmark study shows increase of alternative asset allocation with endowment and foundations (total allocation 32%, 26%, 23% in the last three years)
- Hennessee Hedge Fund survey finds that hedge funds met or exceeded expectations for 82% of hedge fund investors and 43% would increase their hedge fund allocations
- Yale Foundation increased hedge funds to 25% (2002 annual report)

# Low entry barriers attract large supply

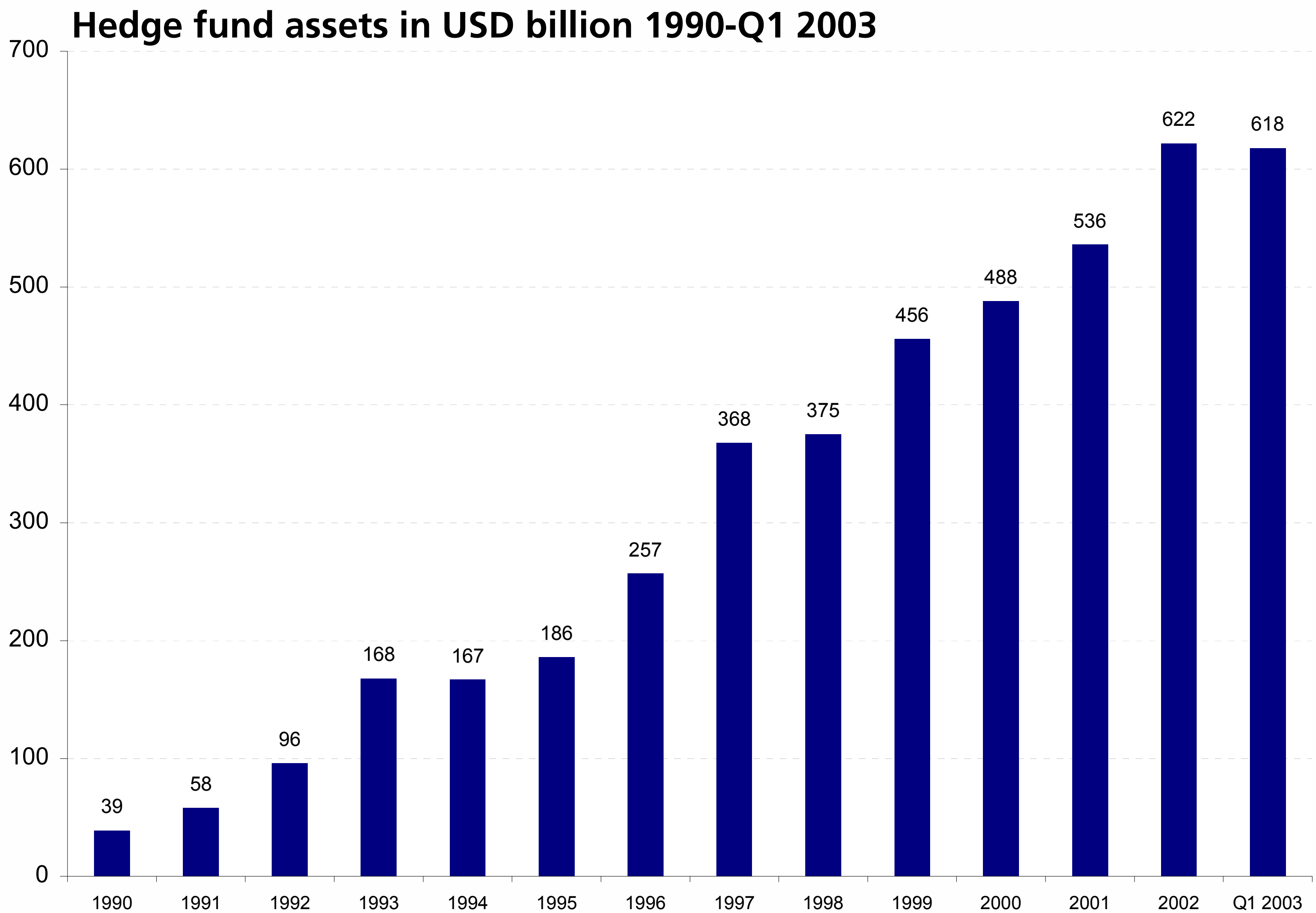
- Traditional asset management lost attractiveness
- Profit potential as hedge fund manager is high (option on performance fee)
- Low start-up costs
- Prime broker and other service providers offer help
- Traditional asset management companies are launching hedge fund departments to retain top talent and generate interesting fee income (Gartmore, MAM, Merrill Lynch, Barclays Global Investors, Schroders, HSBC, Jupiter, State Street, Henderson, AIM, Putnam, Franklin Templeton etc.).

# The number of hedge funds continues to grow




Source: HFR

# Hedge fund asset continue to grow




Source: HFR

# But: Many managers are closing shop

- Unsuccessful hedge funds without performance fees close down, especially long/short managers
- Experts estimate up to 800 hedge fund closings in 2002
- Problem cases in the area of relative value (Lipper, Beacon Hill) and long/short (Eifuku)
- A fifth of the 1979 managers of the CSFB/Tremont Index stopped reporting data by the end of October (versus 4% in the prior eight years)

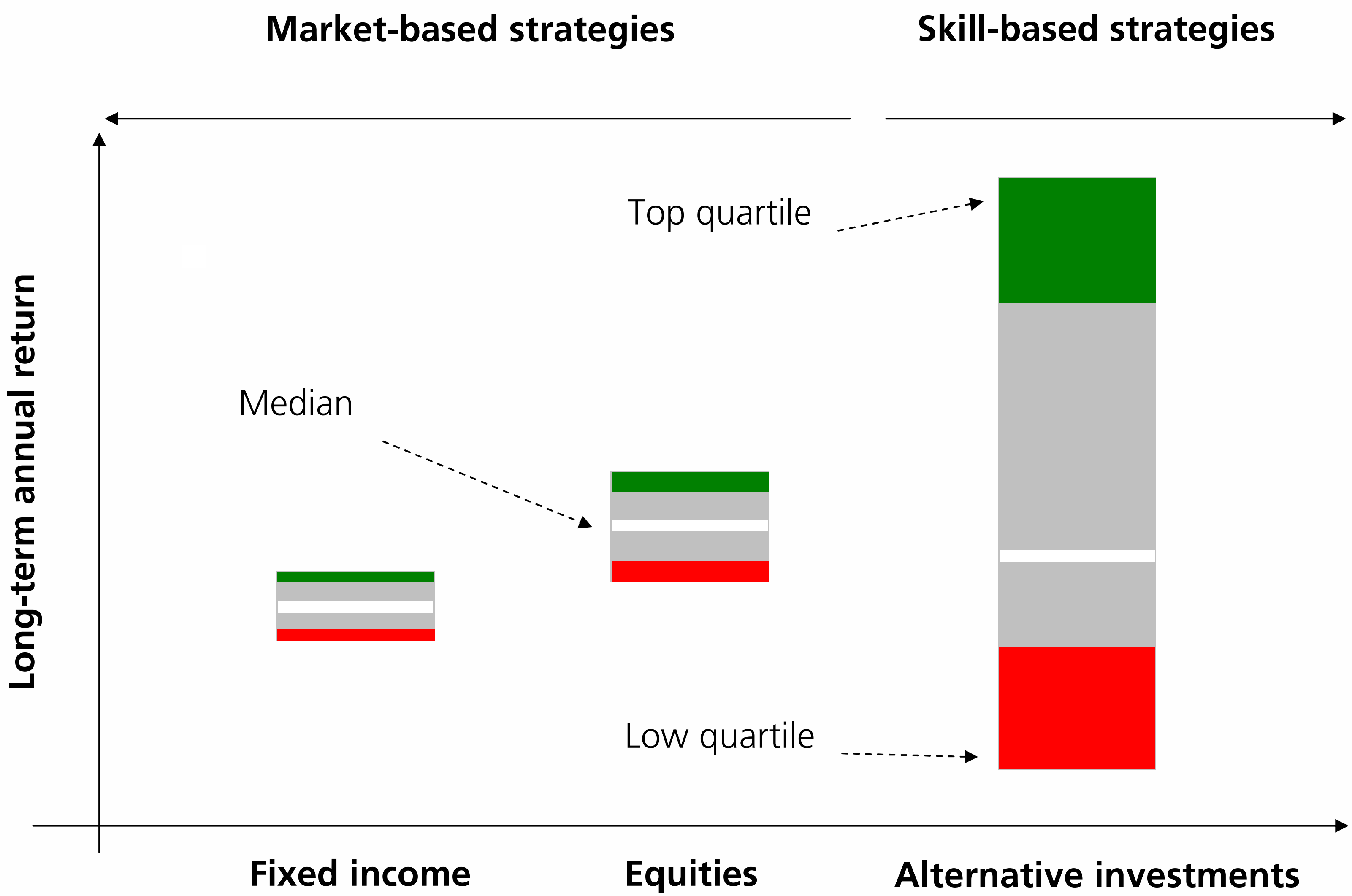
# In addition, exceptional talent is scarce and inefficiencies are limited!

- Capacity to grow is constrained as excellent managers are scarce and inefficiencies/opportunities are not scale-able

- The hedge fund business model restrains growth as managers profit more from performance fees than from management fees (growth of assets)

- Always look for alignment of interest

# Skill-based versus traditional assets



# Institutionalization of the hedge fund industry continues

- Transparency increases
- Infrastructure and division of responsibilities improved
- No clear development regarding fees
- More regulation and on-shore structures
- More and more benchmarks and hedge fund indices, but no clear industry standard

# Transparency increases

- Transparency in general has increased due to investor demands
- Hedge Funds provide access to their portfolios, selected positions or risk information directly or through prime brokers/external service providers
- Hedge fund managed account platforms offer position level transparency and detailed risk management possibilities (SocGen/Lyxor, DB etc.)

# Investor Risk Committee (IRC) on „risk transparency versus position transparency“

- Investor Risk Committee (IRC) was founded by IAFE in January 2000 and comprises  hedge fund managers and institutional investors (details under: www.iafe.org/committees).

- Working group analyzed „Hedge Fund Disclosure for Institutional Investors“, and IRC-members concluded that
  - „full position disclosure by Managers does not always allow them to achieve their monitoring objectives, and may compromise a hedge fund‘s ability to execute its investment strategy“
  - „full position disclosure by Managers is not the solution“
  - „the reporting of summary risk, return and position information can be sufficient as an alternative to full position disclosure.

Investor Risk Committee

IAFE

# Risk transparency versus position transparency

- Quality of summary statistics depends upon:
  - Content
  - Granularity
  - Frequency
  - Delay

- IRC Sub-Committees propose clearly defined "risk buckets" for disclosure of the portfolio and associated risks:
  - Option Exposure (Greeks)
  - Credit Rating
  - Duration
  - Sector
  - Currency
  - Equity Exposure--long, short, net
  - Derivatives exposure
  - Cap Ranges
  - Beta
  - Average Position Wt.
  - Distribution of Returns
  - Call Risk
  - Counterparties
  - Top 10 positions
  - Geographic

Investor Risk Committee

IAFE

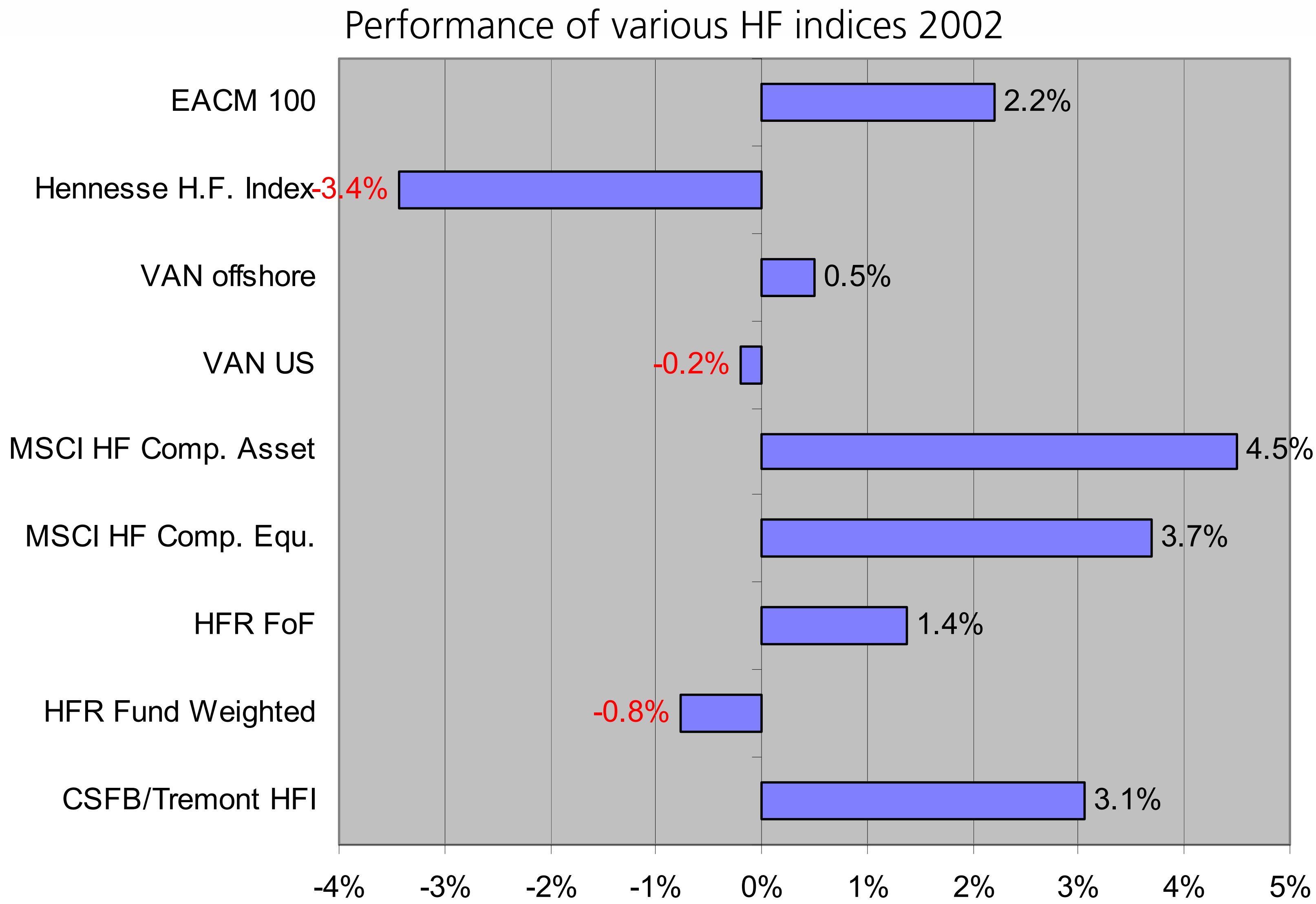
# Risk transparency is already being used by established organization

- Co-operation between independent “risk providers”, investors and hedge funds; data is fed into risk providers database by fund administrators, prime brokers or hedge funds

- External risk providers deliver (aggregated) risk reports; individual non-disclosure agreements ensure confidentiality, where requested

- Large hedge fund investors (CALPERS, AP7, WorldBank, etc.) are already using the services of external risk providers (Measurisk, Riskmetrics, GlobeOp, Reech, Sunguard etc.)

# No consistent industry benchmarks exist



# Specialization still low – most institutional investors use broadly diversified HFoF portfolios

- Typical entry product: broadly diversified fund of funds portfolio with expected double-digit returns, single-digit volatility and low correlation to equity and bond markets

- Some institutions are adding or considering more specialized applications of hedge fund of fund portfolios as part of their overall asset allocation
  - Portfolios with a large CTA/macro component as a complement to their equity investments
  - Portfolios with a large long/short component as a more "efficient" way to implement equity exposure

# Conclusions hedge fund industry trends

- Supply and demand continue to increase
- Hedge funds are a skill-based asset class – average returns will be not enough
- Institutionalization continues – demands regarding transparency, risk management, product structuring, reporting increase
- Quality remains key

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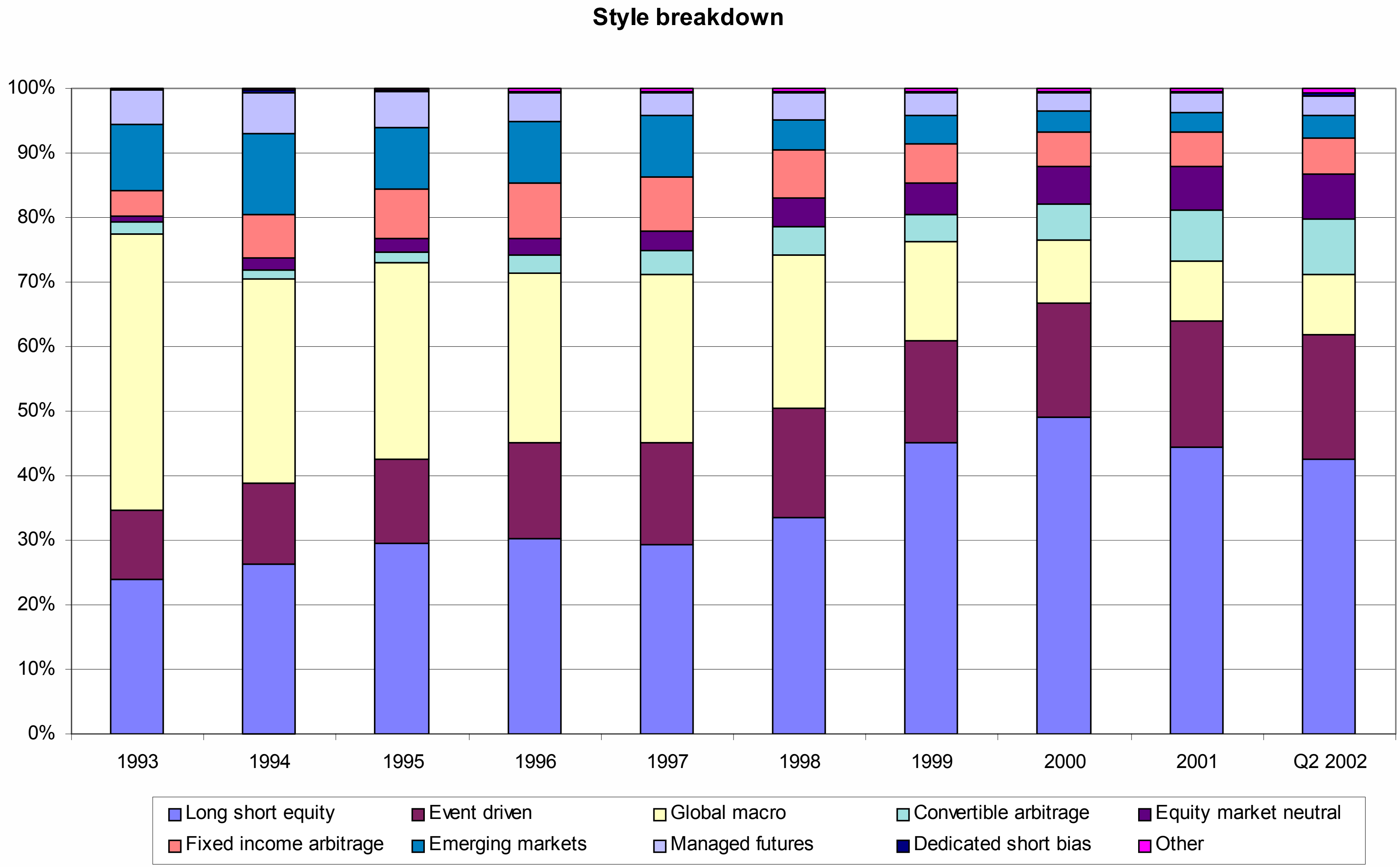
# Hedge fund investment trends

- Hedge funds styles follow fashions and fads
- Diversification and active management add value in turbulent markets
- More problem cases
- Quality remains “key”

# Pro-cyclical development of hedge fund styles over time




Source: Tremont Advisers

# Current "fashions"

- Still convertible arbitrage and relative value in general
- Distressed/high yield
- CTA/macro

# The various hedge fund strategies have different performances over time

| 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|
| Global Macro 30.67% | Emerging Markets 34.50% | Global Macro 37.11% | Managed Futures 20.64% | Long/Short Equity 47.23% | Convertible Arbitrage 25.64% | Global Macro 18.38% | Managed Futures 18.43% |
| Long/Short Equity 23.03% | Global Macro 25.58% | Emerging Markets 26.59% | Long/Short Equity 17.18% | Emerging Markets 44.82% | Dedicated Short Bias 15.76% | Convertible Arbitrage 14.58% | Dedicated Short Bias 18.15% |
| Hedge Fund Index 21.69% | Event Driven 23.06% | Hedge Fund Index 25.94% | Equity Market Neutral 13.31% | Hedge Fund Index 23.43% | Equity Market Neutral 14.99% | Event Driven 11.49% | Global Macro 14.67% |
| Event Driven 18.34% | Hedge Fund Index 22.22% | Long/Short Equity 21.46% | Hedge Fund Index -0.36% | Event Driven 22.26% | Global Macro 11.67% | Equity Market Neutral 9.30% | Equity Market Neutral 7.44% |
| Convertible Arbitrage 16.57% | Convertible Arbitrage 17.87% | Event Driven 19.96% | Global Macro -3.64% | Convertible Arbitrage 16.04% | Event Driven 7.26% | Fixed Income Arbitrage 8.05% | Emerging Markets 7.36% |
| Fixed Income Arbitrage 12.50% | Long/Short Equity 17.12% | Equity Market Neutral 14.83% | Convertible Arbitrage -4.40% | Equity Market Neutral 15.33% | Fixed Income Arbitrage 6.29% | Emerging Markets 5.84% | Fixed Income Arbitrage 5.73% |
| Equity Market Neutral 11.04% | Equity Market Neutral 16.60% | Convertible Arbitrage 14.48% | Event Driven -4.87% | Fixed Income Arbitrage 12.11% | Hedge Fund Index 4.85% | Hedge Fund Index 4.42% | Convertible Arbitrage 4.04% |
| Managed Futures -7.10% | Fixed Income Arbitrage 15.93% | Fixed Income Arbitrage 9.34% | Dedicated Short Bias -6.00% | Global Macro 5.81% | Managed Futures 4.24% | Managed Futures 1.91% | Hedge Fund Index 3.05% |
| Dedicated Short Bias -7.35% | Managed Futures 11.97% | Managed Futures 3.12% | Fixed Income Arbitrage -8.16% | Managed Futures -4.69% | Long/Short Equity 2.08% | Long/Short Equity -3.67% | Event Driven 0.16% |
| Emerging Markets -16.91% | Dedicated Short Bias -5.48% | Dedicated Short Bias 0.42% | Emerging Markets -37.66% | Dedicated Short Bias -14.22% | Emerging Markets -5.52% | Dedicated Short Bias -3.58% | Long/Short Equity -1.60% |

Source: Tass/Tremont.

# More problem cases document need for sophisticated risk management on the FoF level

- SEC sees increase in the number of fraud cases (2 enforcement actions in 1999 versus six in 2000, seven in 2001 and twelve in 2002)

- Some high profile cases happened last year

- Hedge fund troubles are mainly caused by
  - Illiquidity
  - Leverage
  - Fraud/hubris
  - Intransparency
  - Size

# Quality remains key

- Difficult markets dinstinguish the „men from the boys“
- Excellent managers are getting more expensive and more restrictive – bargaining power of good managers increases
- Active capacity management continues to be extremely important – capacity with established funds and exceptional start-ups

# Conclusions investment trends: good fund of funds offer

- Access to exceptional hedge fund talent
  - Active capacity management
  - Selective new investments
- Active management of style- and manager allocations
- Sophisticated risk management as well as portfolio and manager monitoring

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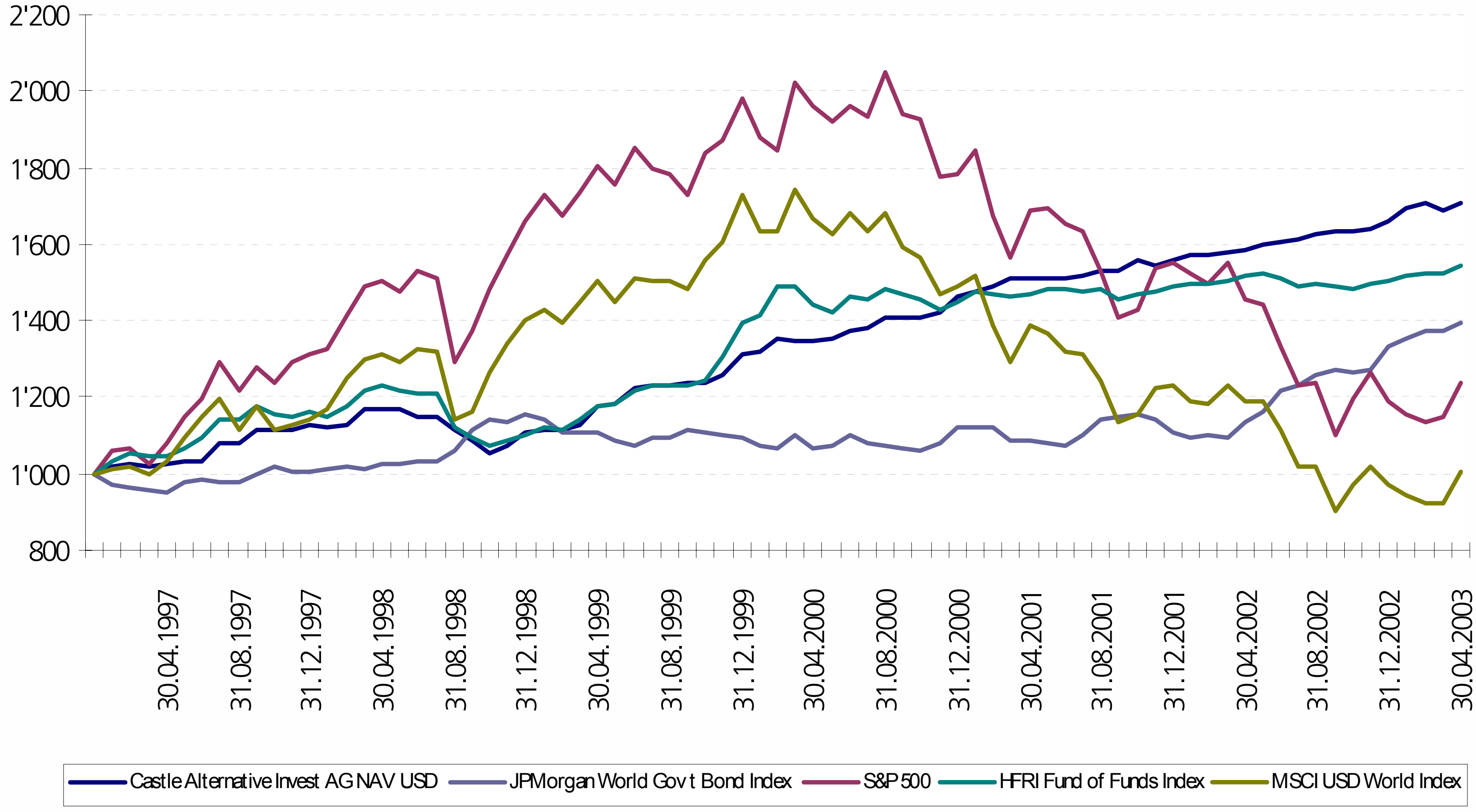
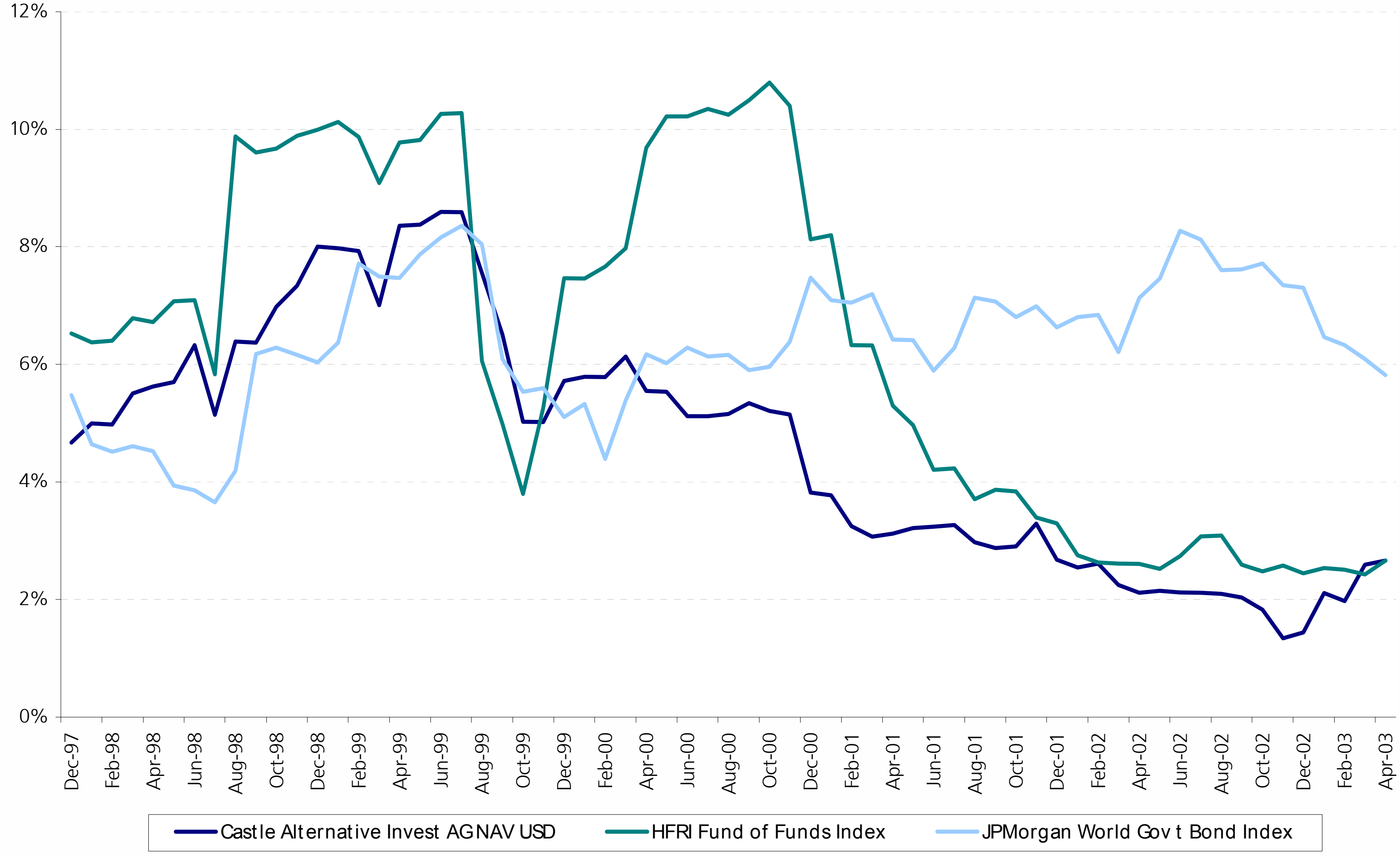



Source Bloomberg, LGT Capital Partners

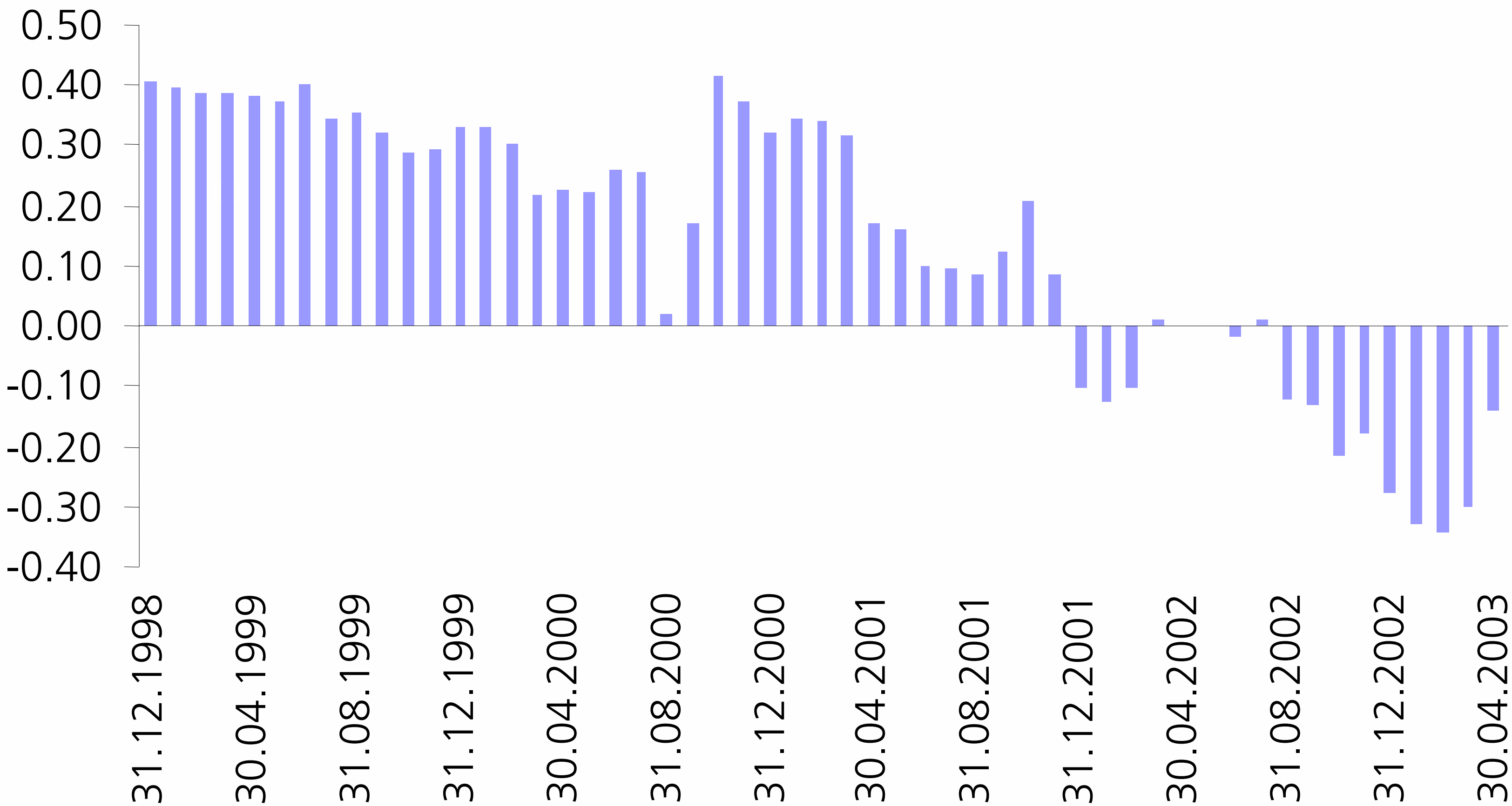
# The volatility* of hedge fund of funds versus JP Morgan Global Bond Index




* 12 month rolling volatility

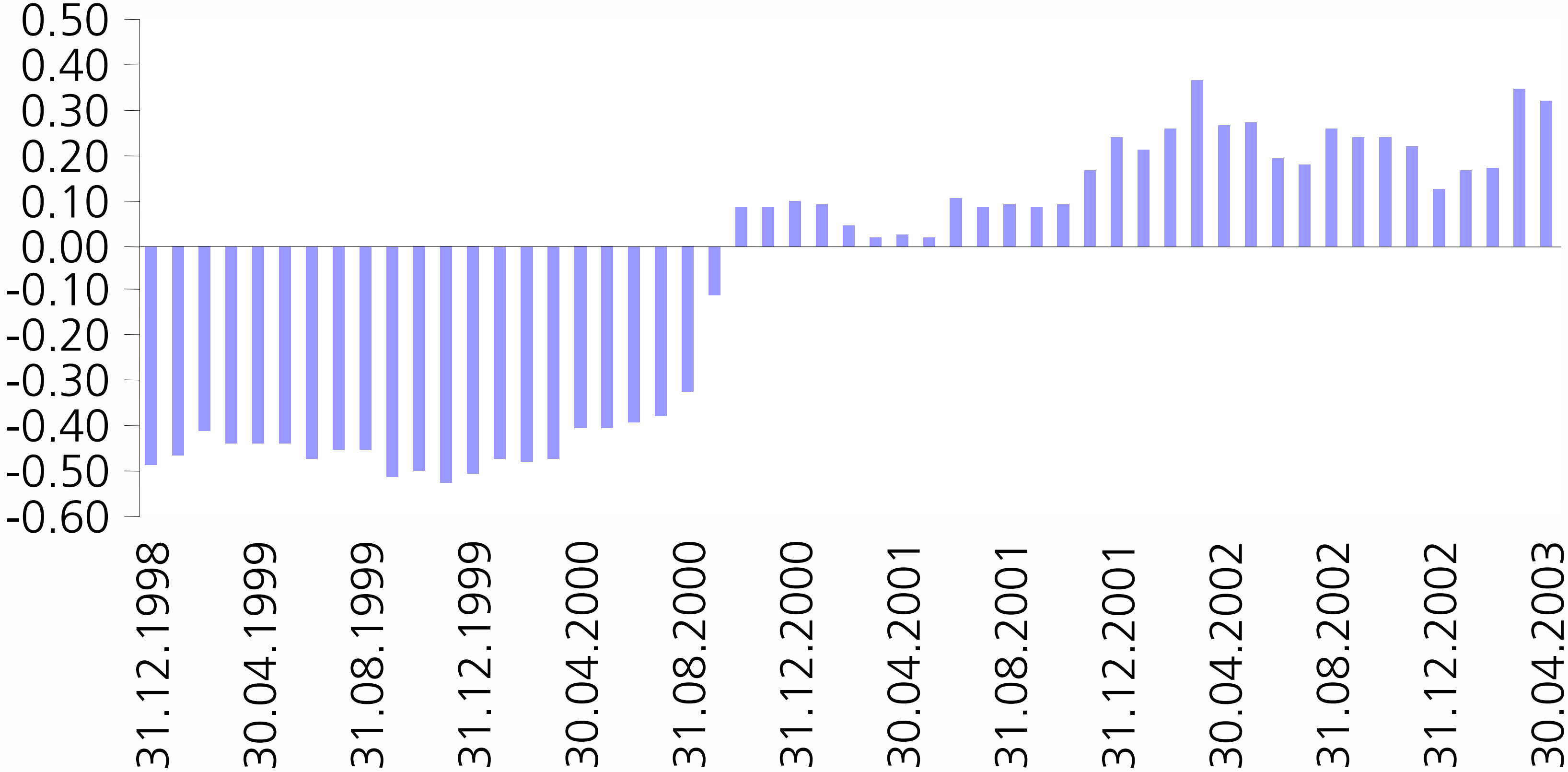
Source: Bloomberg; Altvest.

# Low correlation between hedge fund of funds and the S&P500




24 month rolling correlations Castle to S&P 500

# Low correlation between hedge fund of funds and JP Morgan Global Government Bond Index




24 month rolling correlations Castle to JPM World GBI

# Low correlation of hedge fund of funds to S&P 500, MSCI World and JPM Global Government Bond Index

| | CAI | S&P500 | CAI | MSCI World | CAI | JPM GB |
|---|---|---|---|---|---|---|
| Number of months | 76 | 76 | 76 | 76 | 76 | 76 |
| Number of positive months | 59 | 41 | 59 | 40 | 59 | 41 |
| Percentage of positive months | 78% | 54% | 78% | 53% | 78% | 54% |
| Average monthly return (up months) | 1.20% | 4.50% | 1.20% | 3.86% | 1.20% | 1.79% |
| Number of negative months | 17 | 35 | 17 | 36 | 17 | 35 |
| Percentage of negative months | 22% | 46% | 22% | 47% | 22% | 46% |
| Average monthly return (down months) | -0.95% | -4.36% | -0.95% | -4.03% | -0.95% | -1.11% |
| Avg. mon. return in index up months | 0.95% | 4.50% | 1.06% | 3.86% | 0.40% | 1.79% |
| Avg. mon. return in index down mon. | 0.45% | -4.36% | 0.34% | -4.03% | 1.10% | -1.11% |

Data: Jan 1997 – Apr 2003

# Summary – well managed hedge fund portfolios make sense in any market environment

- Hedge funds do not constitute an asset class but a skill pool – average hedge fund returns will not be enough in the future
- Well managed hedge fund portfolios have proven that they can deliver active returns irrespective of turbulent equity markets
- Hedge funds are increasingly used by institutional investors (as absolute return generator, complement to equity portfolios, or more efficient equity investment)
- An active and independent style management, access to excellent funds and sophisticated risk management are key success factors going forward