

## UBS Hedge Fund Report – February 2009

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UBS Global Asset Management - Alexander Ineichen, CFA, CAIA, FRM

A&Q Industry Research - Hedge Fund Industry Update

### Summary

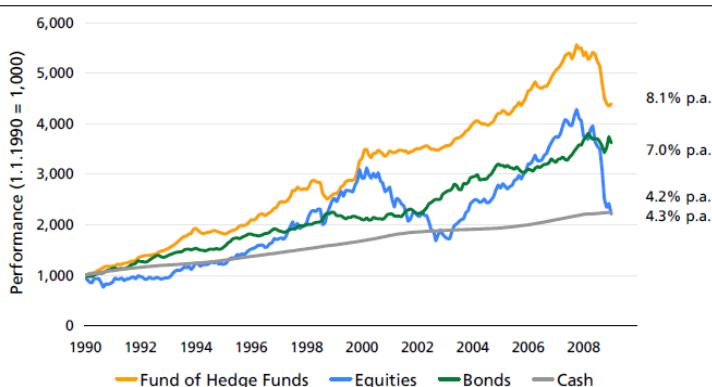
- 2008 was not a good year for hedge funds. One of the worst nightmares of any risk manager is not when markets fall but when markets fail.
- Hedge funds have turned out to be part of the financial system. In a situation where there is extreme duress, there is no “de-coupling.” The hedge fund industry is most likely to survive the storm. However, relationships between managers and providers of risk capital, investors and banks, is changing. Hedge funds need some form of normality before starting to recover from their drawdowns. January and February 2009 are first indications that this is currently happening.
- We believe assessing risk of investment opportunities must be an active approach, not a passive one. In a world that is changing and uncertain, it does not make much sense to invest in a fashion that worked well in the past. What worked in the past could be regime specific. As the regime changes, so do the opportunities and the strategies and approaches to unlock value and survive whatever stress the markets put upon us.
- Compound annual rate of return (CARR) of the HFRI Fund of Funds Composite Index was 8.1% for the period from January 1990 to January 2009. Equities compounded at 4.2% and bonds at 7.0%. Long-term hedge fund absolute performance as well as relative performance, therefore, seems intact.
- A hypothetical investment of USD100 in hedge funds as measured by the HFRI Composite Index at the beginning of the decade stood at 155 at the end of January 2009. A hypothetical investment of USD100 in the MSCI World Total Returns Index stood at 66. We believe this to be a big difference.
- The decision to reallocate capital from equities and bonds into hedge funds has added value throughout most of the decade. The decision not to reallocate capital to hedge funds has not.

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## PERFORMANCE

Long-term absolute and relative performance of broadly diversified fund of hedge funds remains intact, despite the “annus horribilis” that was 2008. Chart 11 shows the nominal HFRI Fund of Funds Composite Index, one of the most frequently used proxies for diversified hedge fund portfolios net of two layers of fees, compared to equities, bonds and cash (gross of fees). We believe the long-term superior performance of hedge fund portfolios relative to more traditional investment alternatives as important. Investors want compensation for the lower transparency and liquidity and higher complexity and headline risk.

Chart 11: Long-term performance (Jan 1990 – Jan 2009)



Source: A&Q Industry Research, Thomson Financial

Based on USD total returns of HFRI Fund of Funds Composite Index, MSCI World Index, Barclays Global Aggregate Index, Merrill Lynch US T-Bill 3M Index. Figures on the right show CARR (compound annual rate of return).

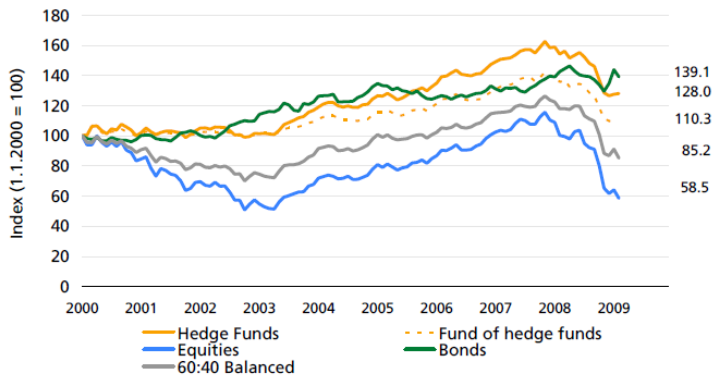
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

A hypothetical investment of USD100 in hedge funds as measured by the HFRI Composite Index at the beginning of the decade stood—adjusted for inflation—at 143 at the end of 2008. A hypothetical investment of USD100 in the MSCI World Total Returns Index stood at 64. We believe this to be a big difference.

Equity markets have lost around 50% for the second time in this decade. This resulted in many balanced portfolios not keeping up with inflation, as indicated in Chart 12. A reading below 100 in Chart 12 means compounding capital at a negative real rate of return.

One of the one-liners we often repeat is that large losses kill the rate at which capital compounds. While the risk management capabilities of hedge funds can easily be ridiculed after 2008, it is active risk management which is the main product differentiator to long-only vehicles. With risk management it is a group of individuals who are responsible and accountable for avoiding losses. With a long-only portfolio it is market forces that determines the risk of the portfolio and therefore the avoidance of large losses is not part of the package.

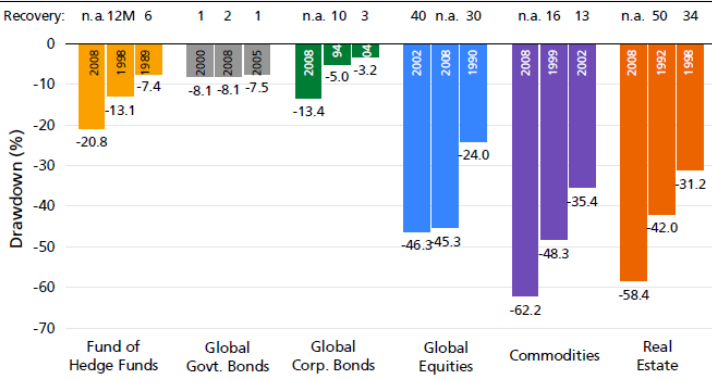
Chart 12: Inflation-adjusted performance in this decade so far (Jan 2000 – Jan 2009)



Source: A&Q Industry Research, Thomson Financial  
 Based on USD total returns of HFRI Fund Weighted Composite Index, MSCI World Index, Barclays Global Aggregate Index, Merrill Lynch US T-Bill 3M Index. Balanced portfolio was comprised of 60% equities and 40% bonds and monthly rebalanced. Figures on the right show end value of hypothetical investment of 100 at the beginning of decade in real terms. OECD CPI was used to adjust time series for inflation.  
**PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

One aspect of 2008 was the high correlation of nearly everything. Chart 19 shows the three worst drawdowns for the main asset classes since 1985. The number at the top shows the number of months it took to recover from the losses, i.e., from the nadir to the previous high.

Chart 19: Severe drawdowns and high correlation in 2008



Source: A&Q Industry Research, Thomson Financial  
 Graph shows three worst drawdowns since 1985. Fund of Hedge Funds: 1985-89: AIS estimates (based on a basket of fund of funds); 1990-12.2008: HFRI Fund of Funds Composite. Global Bonds: JPM Global Government Bond TR Index (since 1986); Corporate Bonds: Barclays Capital Corporate Intermediate; Global Equities: MSCI World TR Index; Commodities: S&P GSCI Commodities TR Index. Real Estate: GPR 250 PSI TR Index (since 1990). Date in bar marks trough of drawdown.  
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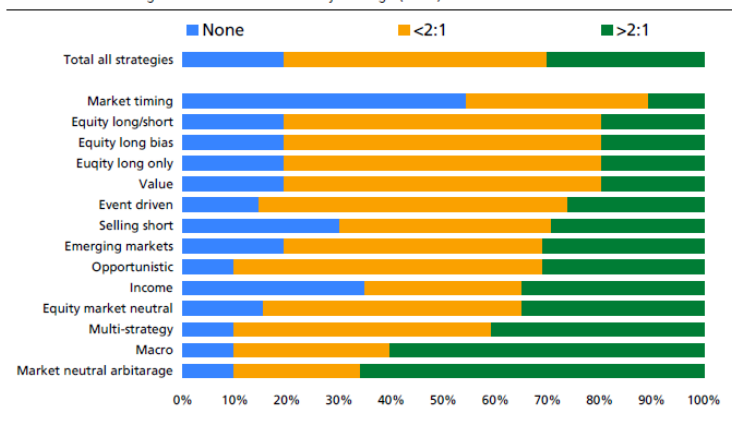
## LEVERAGE AND REDEMPTIONS

The topic of leverage always comes up in discussions between hedge fund professionals (who often perceive leverage as a tool to control risk) and their clients (who often perceive leverage as a pure risk amplifier and/or excessive). One of the aspects that many hedge fund professionals have been pointing out is that leverage is low when compared to banks. Today this argument is arguably stronger than a couple of years ago. The fact that banks lever their balance sheet between 20-30 times while hedge funds lever their balance sheet by a fraction of that number. In addition it turns out that banks often

“warehoused” risk while hedge fund took over the previous role of banks, i.e., intermediate risk. Hedge funds lost money not because a certain credit went down but because the hedge did not work, i.e., higher quality longs went down more violently than lower quality shorts. The reason for this is that this time around it was not a “flight to quality” where quality is bought and junk is sold but a “flight to cash” where everything that is most liquid (typically investment grade credit) is sold for cash.

Chart 24 shows an estimate of hedge fund leverage prior to the current financial crisis. Around 70% of hedge funds were levered less than 2:1. The table was sorted by strategies with leverage less than 2:1. This exhibit is reasonably consistent with other findings, i.e., that around two thirds of the hedge fund industry uses leverage less than 2:1. These indications for leverage are obviously in stark contrast to banks where leverage is 20:1 or higher.

Chart 24: Global hedge fund assets breakdown by leverage (2007)



Source: Lipper, BCG analysis

Note: Leverage corresponds to the ratio of the value of the fund to money received from subscriptions.

## SHORT SELLING BAN

An LSE analysis of banned short stocks showed that the short-selling ban had been a mistake, as many had suspected. We believe the consensus view on the short selling ban is that it did not work. We are not going the challenge the consensus view on this one. On 17 December 2008 an academic research paper from Professor Ian Marsh and Norman Niemer of Cass Business School, London, has been released by ISLA (International Securities Lending Association), AIMA (Alternative Investment Management Association) and LIBA (London Investment Banking Association). The paper, for what it is worth, finds no strong evidence that the emergency short selling restrictions imposed in various markets around the world have changed the behavior of stock returns.

The three associations jointly commissioned this independent research to contribute to the wider regulatory reviews ongoing by various national and international regulatory bodies, including IOSCO (the International Organization of Securities Commissions) and CESR (the Committee of European Securities Regulators). The researchers examined daily returns on UK, US, Italian, French and German shares before and after the introduction of restrictions on short selling, including shares which are subject to the restrictions, and those which are not.

The main findings of the research were:

1. No strong evidence that restrictions on short selling changed the behavior of stock returns. Stocks subject to the restrictions behaved very similarly both to how they behaved before their imposition and to how stocks not subject to the restrictions behaved.
2. Comparing behavior across countries where the nature of the restrictions differed, the authors found no systematic patterns consistent with the expected effect of the new regulations, i.e. no evidence of a reduced probability of large price falls.
3. The authors also found no sign of any detrimental impact of the constraints in terms of reduced efficiency of pricing.
4. Regression analysis suggested that changes in stock returns were driven mainly by other factors affecting the financial sector as a whole rather than the restrictions on short selling. That is, some systematic changes in the behavior of financial sector stocks could be discerned, but no strong evidence of a systematic impact of the restrictions could be identified.

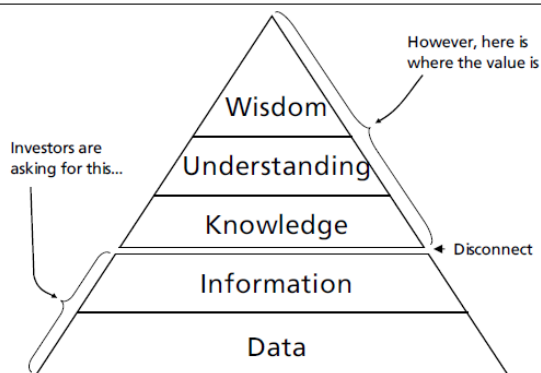
The report refers to one caveat which relates to the shortness of the post-restrictions period in most countries, which does not appear to the authors to change the robustness of their findings.

## TRANSPARENCY

We believe there is a disconnect between information and knowledge. Investors and regulators require more and more data and information. More data and information without knowledge and understanding is useless at best.<sup>2</sup> It is more likely that more data is harmful. The reason why many people want more and more information is because it gives some sense of security. However, the sense of security is false while knowledge is not gained by amassing information. Information without understanding is most likely harmful.

We believe sophisticated institutional investors have been moving up this Knowledge Pyramid over the past ten years with respect to alternative investments in general and hedge funds in particular. This means they learnt, i.e., acquired knowledge to better understand what was going on.

Chart 30: The Knowledge Pyramid<sup>2</sup> applied to quest for transparency



Source: A&Q Industry Research, concept adapted from Ackoff (1989)