

MEMORANDUM

To: **Wurts & Associates Clients**
From: **Eric Petroff, CFA, Director of Research**
Date: **November 14, 2008**
Re: **Hedge Fund Conundrum**

Hedge funds stand out in the capital markets universe as the one broadly accepted investment that cannot be defined as an asset class. This is because hedge funds do not represent any sort of systematic risk exposure such as stocks or bonds, but instead represent a myriad of strategies that repackage and leverage various investments and derivatives. This of course is why they are so complicated and difficult to understand for even sophisticated institutional investors.

Nonetheless there are some very simple factors that can affect hedge fund returns, especially during these tumultuous times in capital markets. Having given considerable thought to these factors, we are beginning to form some concerns about prospective returns for hedge funds.

Our first concern relates to the overall deterioration of credit markets and resulting financial de-levering. Because hedge funds are leverage (or debt) hungry entities, credit market conditions are making access to leverage more costly and difficult. Furthermore because markets have corrected so sharply, many hedge funds are being forced to de-lever positions in what could be described as an industry wide “margin call.” The HFR fund of funds index is posting double digit losses thus far in 2008 and managers could reasonably be expected to continue reducing leverage in anticipation of continued capital markets weakness or volatility. This then leads us to our second area of concern – industry cash flows.

Setting aside credit issues and their affect on returns, we must not fail to consider the potential effects of cash flows in and out of hedge funds. If you examine the hedge fund industry’s cash flows over time, you will find there has only been one year where flows were negative. This was in 1994 when the industry lost more than \$1 billion¹ (or about 0.70% of assets). In just the 3rd quarter 2008 *alone*, hedge funds had net outflows of \$32 billion² (or 2% of industry assets). The reasons for these outflows are not specifically known, but they probably relate to investors views on prospective returns and portfolio rebalancing. What is important to understand though is cash outflows could force de-levering and selling during a down market, potentially serving as a downward drag on hedge fund performance. So logically one must consider potential cash flows in the hedge fund industry, which we believe will be driven by two primary factors.

¹ Source: HFR

² Source: HFR

The first is hedge funds relative attractiveness to other asset classes such as equities and bonds. The primary argument for hedge funds over recent periods is they would provide equity like returns with less volatility in an environment when equities were relatively overpriced. So they seemed like a good idea from a risk/return standpoint. However, equity markets worldwide have corrected anywhere from 40-60% from their highs and valuations are cheaper now than in many years. On top of this, credit spreads have risen substantially, pushing prospective returns for diversified fixed income investments well into the high single digits. So one driving factor to hedge fund allocations has just been removed.

Secondly there is the mechanical aspect of portfolio rebalancing. Even though hedge funds have lost substantial amounts of money, their losses are nothing in comparison to equity markets. As clients review their portfolios relative to target allocations, institutions across the country will be pulling assets from hedge funds to place in cheaper equity markets. After all, hedge funds have served their purpose of protecting assets from a strong downturn in equity markets. Of course if equity markets rebound strongly, this would be much less of a concern, but we have no way of knowing if this is going to happen. Still, the hedge fund industry does seem poised for a period of declining assets.

So here is where the conundrum comes into play. If you believe hedge funds are headed towards near term pain through de-levering and withdrawals, do you really want to get caught up selling during a forced de-levering environment...well, probably not. On the other hand, do you want to miss out on buying traditional investments which will likely outperform hedge funds over the next ten years...well, probably not.

Our conclusions in this regard are broad and need specific application to your portfolio. If your portfolio has a relatively modest allocation to hedge funds, say less than 10%, it is probably in your best interests to maintain this position and perhaps engage in some modest rebalancing. One way or the other, the absolute size of the allocation changes between hedge funds and other assets will have a very modest impact on returns. On the other hand, if you have a large allocation to hedge funds (15-25%), then it would be best to analyze the potential cost of exiting during an inopportune time against the benefit of buying much cheaper traditional assets. Chances are this analysis will lead to the conclusion of liquidating a meaningful portion of the hedge fund allocation and placing those assets in public markets.

We understand these conclusions may sound a little “wishy-washy,” but the reality is we are currently faced with highly unpredictable capital markets conditions given the severity of the economic environment, as well as the potential, unpredictable effects of government intervention. Our primary goal therefore is to reduce poorly compensated risk in the face of this uncertainty. We believe hedge funds now fall into that category.