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Hedge funds ripe for post-crisis investment

By Staff Writer on Monday, September 14, 2009

The global financial crisis and structural changes that the hedge fund industry underwent in 2008 have resulted in a compelling case for investing in the asset class in the current environment, said a new report.

First, the dislocations that occurred in the financial markets present dramatic opportunities for investing and trading that hedge funds have historically been able to exploit. Second, the reduction in the size of the hedge fund industry as a result of the financial crisis, means that fewer managers and less assets are left to profit from these opportunities. Thirdly, the dispersion of returns among managers and hedge fund strategies has increased resulting in greater diversification benefit for investors in hedge funds. Last, in order to regain assets lost in the deleveraging and the 'flight to quality' that occurred last year, many hedge fund managers are offering investors incentives and other concessions to attract assets.

The report – Hedge funds: a more compelling investment – released yesterday by Capintro Research, an investment placement specialist, said these factors present one of the most attractive environments for investing in hedge funds in many years.

Hedge funds have historically had higher returns and lower volatility than most other asset classes. This is true despite the perception that hedge funds only earn outsized returns by taking higher risks.

Good returns

Since 1992, the performance of the hedge fund industry has exceeded that of global equities as measured by MSCI World. Even in the aftermath of the technology bubble in 2000, hedge fund performance remained positive despite the prolonged correction that global equities experienced.

The annualised returns of both single manager hedge funds and funds of hedge funds exceed that of the other major asset classes, dating back to 1991. The volatility (as measured by the annualised standard deviation) is lower for hedge funds than for other asset classes excluding global bonds and treasuries. Likewise, risk adjusted returns (as measured by the Sharpe ratio) and trading are higher for hedge funds than for other asset classes except bonds. The results remain similar even when accounting for reported biases in hedge fund indices of up to three per cent for single managers and up to one per cent for funds of hedge funds.

The financial market dislocations of the last two years have reduced the assets of both investors and money managers. This turmoil, however, has also presented expanded opportunities for investing and trading.

In global equity markets, volatility reached unprecedented levels in 2008 as equity prices plummeted across the globe. Volatility remains high despite the rebound in global equity markets in 2009. Likewise in credit markets, spreads on debt across all parts of the capital structure have widened dramatically from very tight levels prior to start of the financial crisis.

In equity markets, high volatility is potentially profitable for hedge fund managers with the trading systems to take advantage of the volatility. Lower equity valuations that accompany the decline in equity prices can be profitable to managers, who are skilled in security selection. Furthermore, as the credit markets return to more normal functioning, credit spreads such as the high yield spread (see graph) will tighten again offering opportunities for skilled credit and multi-strategy managers. Other hedge fund strategies, such as global macro and commodity trading, should also benefit in that environment.

The report said that the five structural changes that are expected will make the hedge fund industry more attractive to investors.

Reduction in assets

As the events of 2008 unfolded, many hedge fund managers posted negative performance, while risk aversion among investors increased. These factors caused a large number of investors to exit their hedge fund investments. As a result, the assets managed by the hedge fund industry declined dramatically.

Data from Thomson Reuters shows that hedge fund industry assets peaked in second quarter of 2008 at $1.55 trillion (Dh5.68trn) and ended first quarter of 2009 at $1.08trn. This represents a decline of approximately 30 per cent in industry assets. The reduction in assets was accompanied by a significant reduction in leverage provided by prime brokers to hedge funds further exacerbating selling pressure and negative performance.

Liquidations

More than 275 funds of hedge funds were liquidated in 2008, according to Hedge Fund Research (HFR), setting a record. The total number of hedge funds declined on a net basis by eight per cent, according to data by HFR. The total number of liquidations in 2008 was 1,471 representing an increase of more than 70 per cent from the previous full year record of 848 liquidations set in 2005.

According to the Lipper Tass Asset Flows Report for Q1 2009, the number of hedge funds followed by them decreased from 5,106 in Q1 2008 to 4,685 in Q1 2009.

This steep reduction in the number of managers is complemented by a significant reduction in the number of proprietary trading desks at global investment banks. This decreased level of competition should create wider spreads and opportunities for hedge fund managers to exploit.

Hedge funds have historically outperformed following periods of crisis due to their ability to identify and opportunistically take advantage of dislocations in the market through long and short positions.

For the first seven months in 2009, HFR's Fund Weighted Index had positive performance of more than 12 per cent.

Lower correlation

The dispersion of returns among hedge fund strategies has declined substantially from 2000 to mid?2007 and then started to pick up again through 2008 and into 2009. At the same time, the dispersion of manager returns has increased. This increased dispersion of returns leads to lower correlation among managers and strategies, also known as intra?correlation.

Having lower intra?correlation among managers and hedge fund strategies leads to higher levels of diversification for investors as well as higher risk?adjusted returns.

Incentives

Given the magnitude of client redemptions in 2008, hedge fund managers are offering investors greater concessions in order to attract assets. These concessions may include:

- Additional capacity with managers which may have been soft or hard closed.

- More favourable liquidity terms through improved liquidity share classes or other fund structures (such as UCITS, as well as a more accurate match between assets and liabilities.

- Higher levels of transparency and reporting.

- Reduced or more competitive fees.

- Tighter terms in the offering memorandum.

The current environment is one in which emergence from the financial crisis is taking place slowly, but there are possibilities for reversal. Hedge fund strategies that are able to take advantage of directional moves and adapt to the adjustments and possible pullbacks that may take place in financial markets are best suited to outperform.

In Capintro's opinion, strategies that invest in liquid asset classes are the ones most likely to meet such criteria, particularly if periods of extreme liquidity constraints return.

First, traditional non-global macro managers have the ability to participate in a variety of markets and invest using a top?down approach. These managers typically invest in highly liquid securities and can also take advantage of broad directional changes and trends in markets.

Second, arbitrage and event?driven managers, particularly in the credit space are also well-positioned to outperform. Considerable volatility and directional moves remain in the credit markets due to both technical and fundamental factors.

Arbitrage managers can take advantage of pricing discrepancies that can be found between similar assets. Further, in these uncertain times event-driven and activist managers should be able to realise value in distressed credit, where defaults have not yet peaked. Managers who understand the post?default process can realise exceptional value.

Third, equity hedge fund managers are likely to be able to distinguish between equity issues that have declined to become undervalued following the financial crisis and others that have rebounded too aggressively in the recent rally and may now have become over?valued. Managers with the ability to generate alpha through security selection should outperform as the global economy rebounds and equity markets discount the recovery.