

# Funds of Hedge Funds Quarterly – Q309

October 2009

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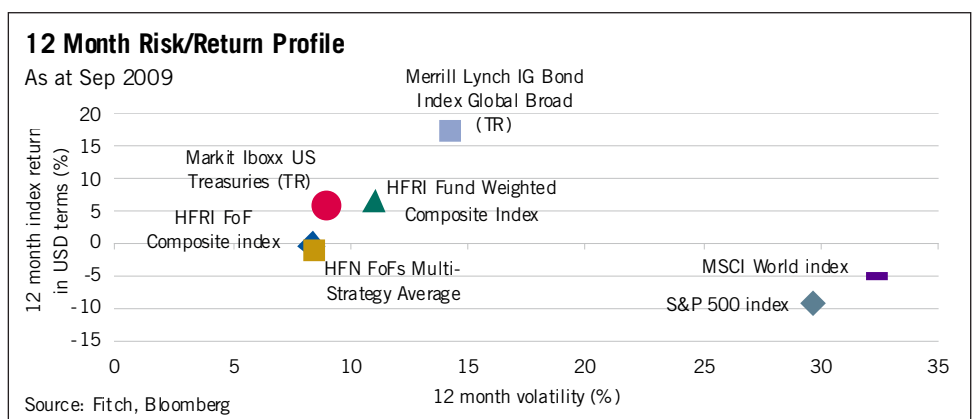
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## Executive Summary

- Q309 results confirm the hedge fund (HF) industry in general is en route to its best performance since 1999. Major trends that benefit HFs and FoHFs include: rising equities, lower credit spreads, and improved liquidity.
- Total HF assets bottomed out globally in Q109, but Q209 and Q309 witnessed net positive client subscriptions. The situation is less favourable for fund of hedge funds (FoHFs), which continue to suffer from net redemptions.
- Top-down macro positioning has been a dominant factor in terms of performance generation. Pure market-neutral strategies are less convincing. Convertible Bond (CB) Arbitrage and emerging markets strategies are clear winners in the alternative investments universe to date and market exposure is key.
- Hedge funds are progressing back towards directional trading; however, the risk remains that macroeconomic concerns thwart this impulse.
- Fitch notes the growing importance of top-down inputs and resources in FoHF portfolio management; in this newsletter the agency reviews the implications of this trend for FoHF managers.
- The investing public is concerned that FoHFs continue to underperform single-manager HFs; however, Fitch believes FoHFs may have different risk/return objectives and in this study tries to shed some light on 2009 figures.
- In search for marketability, transparency and liquidity, FoHF managers are currently launching UCITS vehicles; Fitch reviews the risks and challenges of such venture as well as the forms it may take.

## Performance Review of Funds of Hedge Funds

### Market Indices



## Market and Fund of Hedge Funds Indices (as at September 2009)

	Cur.	Q309 return (%)	Q209 return (%)	12-mth return (%)	12-mth volatility (%)	12-mth correl. with S&P500
HFRI FoF Composite index	USD	4.3	4.8	-1.3	8.5	0.73
HFN FoFs Multi-Strategy Average	USD	4.3	4.1	-0.8	8.4	0.75
HFRI Fund Weighted Composite Index	USD	7.0	9.2	6.5	11.0	0.88
S&P 500 index	USD	15.0	15.2	-9.4	29.6	
MSCI World index	USD	16.9	19.7	-4.7	32.2	0.99
Markit Iboxx US Treasuries	USD	2.2	-3.1	6.3	8.9	0.03
Merrill Lynch IG Bond index (broad)	USD	9.3	12.3	17.9	14.2	0.78

Source: Fitch, Bloomberg

## Commentary

### Q309 results are demonstrating HFs and FoHFs globally are en route to their best annual performance since 1999, while global assets under management (AUM) bottomed out in the first quarter of the year.

Several data providers (HFR, HFN, net, Eurekahedge) reported net gains in client money flows from May 2009, continuing into Q309. However, breaking down the figures for FoHFs leaves a more balanced picture. HFN reported net client redemptions in FoHFs were still evident in Q209, and these were not compensated for by their positive performance. In these conditions, concern remains as to whether FoHFs, as alternative investments vehicles, can continue to channel 50% of the global assets invested in hedge funds (as has been the case in the last ten years). Meanwhile, a number of large institutional investors are considering – and some have already done so – bringing their hedge fund selection back in-house (insourcing), though raising the share of strategic asset allocation devoted to alternative investments.

However, despite a visible upturn in performance, it is the economics and business model of hedge funds that are still at risk in the current environment, at least for the weakest firms. Market commentators have noted the interesting status of hedge funds' high water marks (HWM), which heavily impact a fund's capacity to generate revenues and profits. Examining the 1,100 largest hedge funds tracked by BarclayHedge data provider as at April 2009, TrimTabs research practice noted the following:

### Hedge Funds and High Water Marks (HWM)

	%
Proportion of funds that have reached a new HWM	13
Proportion of funds that are still more than 30% off their prior peak	18
Average difference (negative) per fund vs prior peak (off peak)	17

Source: Trimtabs, BarclayHedge

From the above data, it appears many hedge funds will indeed experience difficulties in maintaining appropriate revenue and profit levels that normally would be used to invest in new technology, hire and keep quality professionals

or even save cash for more adverse market situations. Again, one can easily see how such a situation may trigger forced consolidation in the industry and a year of good performance will not change the situation.

As at the end of June 2009, HFN reported global hedge fund assets stood at USD1.79trn (44% of which through FoHFs); this represents an overall drop of 40% as compared to the historical peak observed in Q208, when FoHFs controlled almost 50% of HF assets.

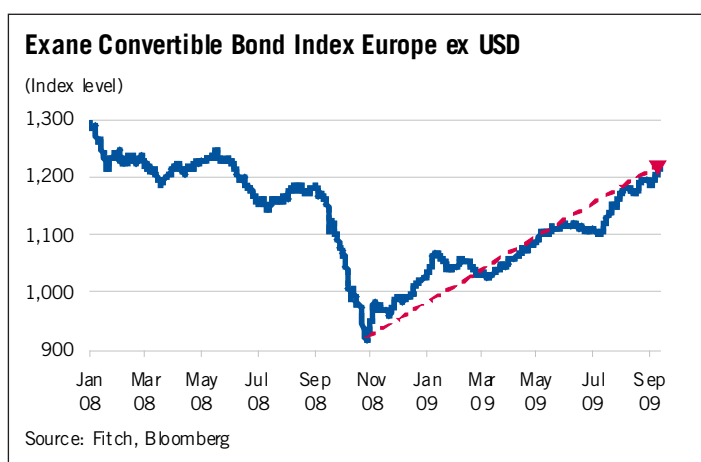
Although not necessarily a positive factor, the fundamental dilemmas of the current macroeconomic context have at least been made clearer, ie:

- ▶ The “inflation or deflation” puzzle remains a hot topic, notably because it is still unclear as to whether the observed health in global markets (equities, bonds) is a simple and technical reaction to massive government stimulus and inventory adjustments, or if the world economy has genuinely entered a new period of growth.
- ▶ As a result of the above, from March onwards, the effect has been:
  - equity markets have demonstrated unprecedented recovery (about +50% in developed markets since the trough in March 2009);
  - the US Treasury yield curve has shown decisive signs of steepening;
  - corporate bond spreads (swaps and cash) have been falling;
  - the spread between US T-Bills and LIBOR USD short-term rates has fallen to levels not seen since early 2007;
  - commodity prices are timidly back on a rising trend.
- ▶ However, fundamental “real economy” indicators are still depressed:
  - unemployment continues to rise (though at a slowing pace), which should put pressure on consumption;
  - lending activity is still feeble;
  - generally, the historically high indebtedness levels of governments has decreased their capacity to act and support the economy;
  - industrial over-capacity is patent and may weigh on recovery measures.

This analysis helps understand the trends experienced in the HF industry in the last two quarters.

## Relative Value Strategies

By and large, convertible bond (CB) arbitrage managers have posted the best results this year and may end 2009 with their best annual performance ever. Independently of any arbitrage strategy, CBs as financial instruments have technically benefitted from overly-depressed credit markets, a clear imbalance between supply and demand in 2009, falling corporate spreads and, as has now become clear, a definitive HF advantage (bargaining power) following the disappearance of bank “prop desks”. Two novelties from the second and third quarter of 2009 have been: 1) the increase in issuance volumes (though much lower than 2007 and 2008 figures) as corporations find CBs cheaper and more convenient to raise capital in current circumstances; and 2) better liquidity, according to CB and CB arbitrage managers. The following chart shows how long-only CB indexes have behaved in 2009, putting in an approximate +20% in return across Europe. Indeed, looking at figures, it appears the typical CB arbitrage strategy (long the CB/bond, short the stock, long the volatility) is not necessarily what is driving the returns in 2009. When we know that historical volatility reached a two-year low in mid-September 2009 (S&P 500)



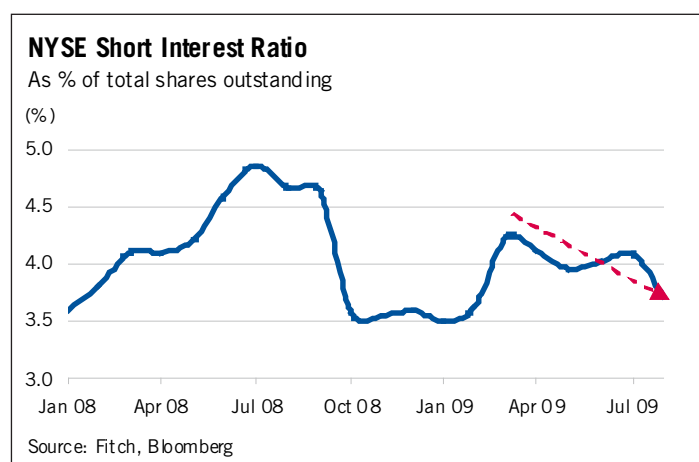
## Global Macro Strategies

Turning the spotlight on global macro traders and their systematic computer-driven peers – Commodity Trading Advisors (CTAs) and managed futures funds – both have experienced difficulties in 2009. This is largely due to the lack of identifiable trends in commodity markets, interest rates, inflation, volatility and currencies. Obviously, in such circumstances, discretionary macro traders are faring better, as they are normally more capable of grasping the “behavioural” aspects of markets that, currently, are still in search for at least medium term macroeconomic perspectives. However, Q309 seems to have offered some relief to both types of macro traders. As shown in the following charts, commodities in general are benefitting from a perceived

at 16%, while the implicit volatility of this same index (CBOE SP500 VIX) was 8 percentage points (pp) richer at 24%, this potentially indicates that the market is factoring in future increased volatility, suggesting a simple CB buy-and-hold strategy may continue to yield interesting returns for the foreseeable future.

## Equity Strategies

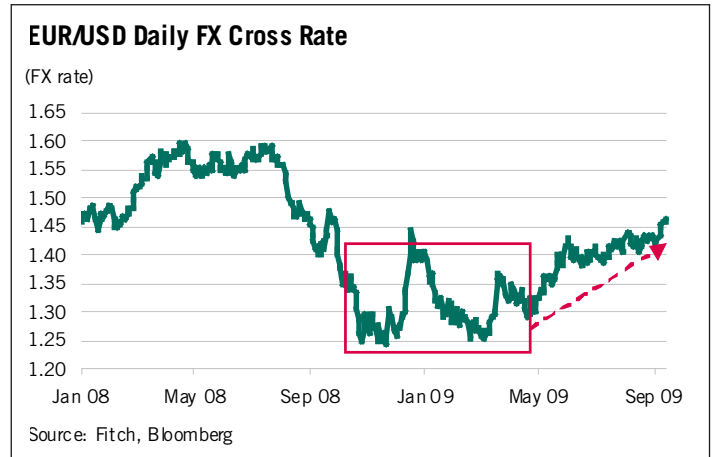
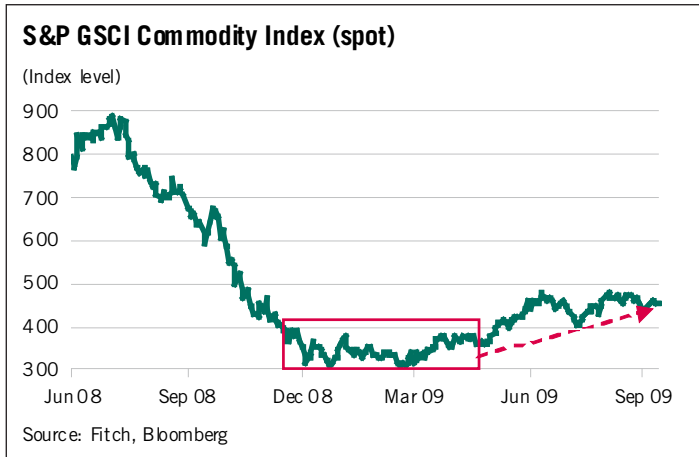
The story on Long/Short Equity funds remains simple. Globally, they were nimble and flexible enough to ride the equity market wave and progressively raise their exposure and sensitivity to the equity market factor (see also the section on “*FoHF Strategies*”). Looking at their market-neutral peers – which have produced lacklustre to flattish year-to-date (YTD) figures – the comparison highlights two issues: 1) L/S equity managers are deriving most of their performance from top-down market beta gearing; and 2) pure fundamental bottom-up research is not yet a compelling argument to generate returns from trading equities. From a technical standpoint, L/S equity managers may still continue to benefit from well-oriented equity markets, at least in the short term. A useful lead indicator is the NYSE Short Interest Ratio: as illustrated in the below chart, the proportion of shorted stocks on the NYSE has been on the downside since March 2009, which serves as a positive catalyst in terms of flows.



economic recovery and have thus progressed, since March 2009, in a clearer and more decisive fashion – again, for the time being, or as long as higher future demand figures are discounted in prices. In turn, the EUR currency is showing decisive signs of strengthening versus the USD (evident upward trend since mid-March), whereas the US yield curve (10Y-2Y) has somewhat seen its steepening momentum of first six months stall in Q3 and volatility is stabilising at rather low levels, not seen since early 2007).

## Event Driven Strategies

Event-driven HFs are among the top performers to date in 2009. Economic emergency measures by governments have at least ensured sufficient liquidity is flowing into markets,



thus helping support a new wave of corporate buy-outs and restructuring operations. The typical “balance sheet” trade (long or short the bond + short or long the stock) and merger arbitrage operations have seen positive return streams following an abysmal 2008 (characterised by an absence of liquidity, which naturally translated into fewer M&A deals).

**Distressed Strategies**

The new comer in the limelight of hedge fund strategy has produced stellar performance in 2009. Naturally, it had been among the worst hit groups in 2008, very much in line with the historical behaviour for such hedge funds, ie illiquid and complex instruments logically suffer during severe downturns but also tend to rebound strongly during recoveries. The interesting factor concerning distressed hedge funds this year is that they not only include securitised and corporate debt, but also leveraged loans, convertible bonds, equities and emerging markets, thus paving the way for multi-asset diversified vehicles that could be an appropriate way to capture a generalised macro-economic upturn.

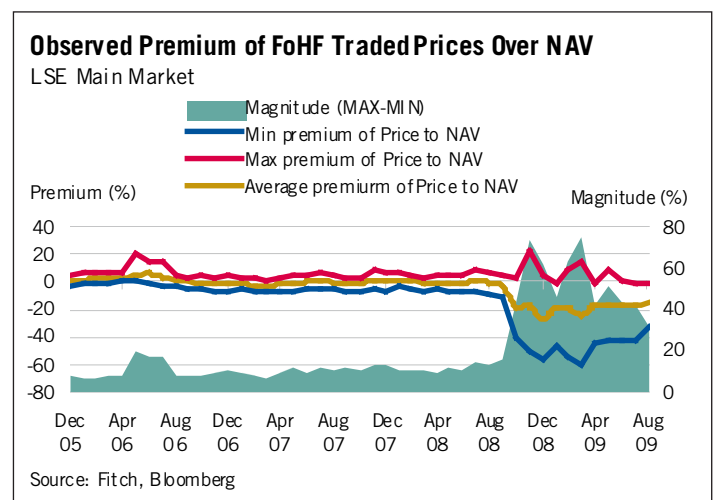
**Funds of Hedge Funds**

Returns for FoHFs are currently on course to register a 10-year high this year, providing they maintain their current pace. One nagging concern for FoHFs is that they lag multi-strategy single-manager hedge fund indices, thus occasionally prompting investors to doubt their appropriateness in adequately capturing current uptrends in traditional and alternative markets. This comparison is revisited later in this newsletter (see section *Industry Issues*). Nevertheless, in a similar fashion to other HF strategies, FoHFs are benefitting from positively oriented markets; they are even proving less volatile than single-managers, although their lower exposure/market beta and evidently higher cash pile is hindering them to an extent.

An interesting case of study, which reflects investors’ appetite and flows in FoHFs, involves closed-end FoHFs that have their shares listed and traded on an exchange. These funds differ from their open-ended peers in two respects: 1) they are

not subject to liquidity mismatches as their capital is fixed; and 2) they however must report the difference between the traded share price and the theoretical net asset value (NAV) per share to their shareholders, which can obviously be quite volatile, potentially forcing the fund to liquidate in certain conditions. For the purposes of this example, Fitch will limit this study to the London LSE Main Market – currently the largest market for such listings – and factor in 16 FoHFs (out of 18 technically listed on the market) with total AUM reaching GBP2.3bn.

For the typical (or average) FoHF, the discount to NAV reached an all-time high in December 2008, at -27%, with extremely distressed funds reporting discounts of up to -60%. The good news is that the average discount has significantly reduced in 2009, returning to -15% in August 2009; the bad news is that there is still a long way to go before we get back to a more normal situation (from 2005 to 2008 the average discount was -3% to +5%). The following chart summarises these findings.



For the industry as a whole, the key topics remain: consolidation, decreased AUM, and a reshuffle of the firm size rankings. Looking at the following table of the largest FoHF managers, the picture clearly differs from the end of 2008.

### Ten Largest FoHF firms Globally Ranked by Total Assets Under Management

Mid to end-2008		USDbn	June 2009		USDbn
1.	UBS Global AM A&Q	34.0	1.	UBS Global AM A&Q	31.4
2.	Union Bancaire Privée (UBP)	33.0	2.	Blackstone Alternative AM	25.0
3.	HSBC Alternative Investments	31.9	3.	Union Bancaire Privée (UBP)	23.8
4.	Permal IM	24.4	4.	Man Investments	23.0
5.	Blackstone Alternative AM	23.7	5.	HSBC Alternative Investments	22.3
6.	Goldman Sachs Hedge Fund Strategies	23.5	6.	Grosvenor Capital Management	21.0
7.	Credit Suisse	21.9	7.	Permal IM	18.7
8.	Grosvenor Capital Management	20.5	8.	Goldman Sachs Hedge Fund Strategies	18.0
9.	Man Investments	19.3	9.	Pacific Alternative Asset Management (PAAMCO)	16.2
10.	GAM Multimanager	18.4	10.	Lyxor Asset Management	16.1

New comers in green; Leavers in red

Sources: Absolute Return Magazine, The Hedge Fund Journal, InvestHedge

### Underlying Strategies and Capital Market Factors

#### Main Single Hedge Fund Strategies (as at Septembre 2009)

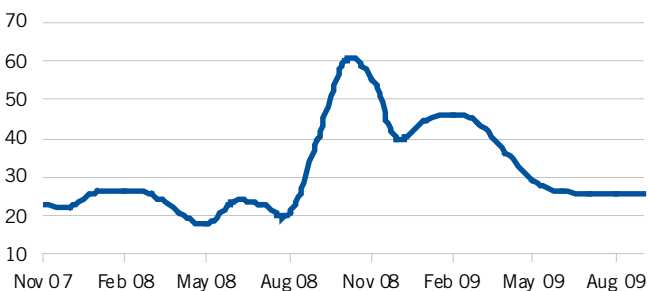
(%)	Cur.	Q309 return	Q209 return	12-mth return	12-mth volatility
Relative Value (HFRI Relative Value Total index)	USD	6.8	8.9	7.4	11.2
Macro (HFRI Macro Total index)	USD	3.0	2.2	8.1	4.4
Equity (HFRI Equity Hedge Total index)	USD	8.5	12.3	6.2	15.1
Emerging Markets (HFRI Emerging Markets Total Index)	USD	12.7	18.8	10.7	22.1
Event Driven (HFRI Event Driven Total index)	USD	9.6	9.7	4.9	12.8

Source: Fitch, Bloomberg

#### VIX Index

CBOE SP500 Volatility Index

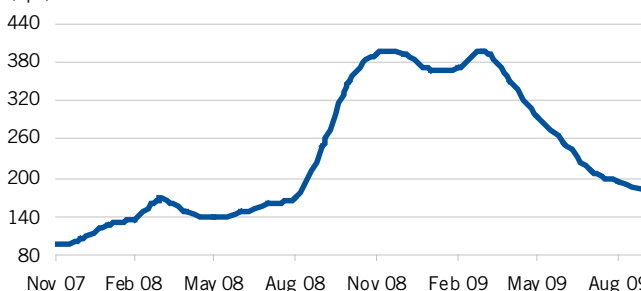
(index level)



Source: Fitch, Bloomberg

#### Merrill Lynch IG Bond Index Global Broad Asset Swap Spread

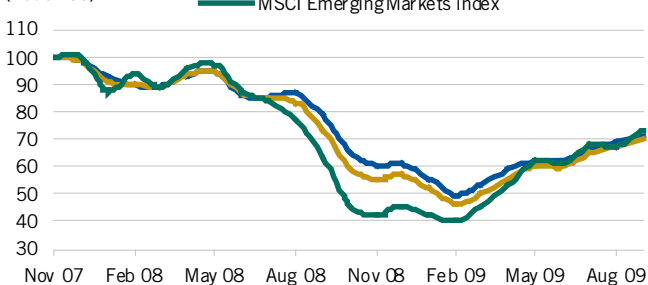
(bps)



Source: fitch, Bloomberg

#### Equity Market Indices

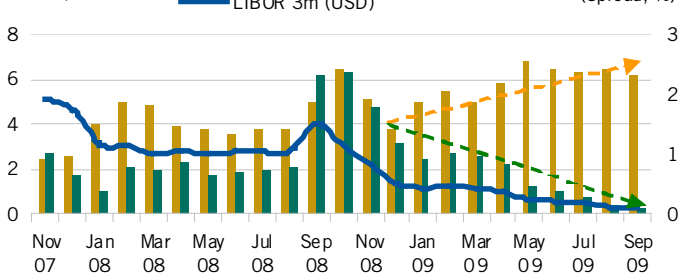
(Base 100)



Source: Fitch, Bloomberg

#### US Interest Rates and Spreads

(Yields, %)



Source: Fitch, Bloomberg

## FoHF Strategies and Asset Allocation Year-to-Date

Arguably, FoHF managers are still gearing their funds defensively. As Fitch has discussed in previous releases, many managers spent most of Q408 and Q109 cleansing portfolios, getting rid of unwanted positions/managers, shortening the liquidation profile of their portfolios, and rebalancing the asset-liability mismatch; all in order to raise the liquidity of portfolios in search of more flexibility. In 2009 so far, this strategy has had the following effects (compared to mid-2008):

- ▶ the cash portion of portfolios reached unprecedented levels; on average 15% to 30%, with peaks observed at 45%;
- ▶ reduced directional exposure (equity beta and net residual exposure);
- ▶ a preference for short-term oriented discretionary trading-style strategies.
- ▶ a preference for liquid strategies (L/S Equity, Global Macro, CTAs);
- ▶ in Q309, a typical multi-strategy FoHF had the following allocations (with obvious dispersion among managers): 20%-30% on L/S equity; 20%-30% on global macro and CTAs; 10%-20% on relative value; 5%-10% on event driven.

As such, Q3 is offering interesting observations. As was first seen in the second quarter of 2009 (and discussed in Fitch's Q2 newsletter), it seems hedge funds in general are back on the "re-risking" route. In this regard, the Goldman Sachs (GS) Hedge Fund Trend Monitor (released 24 August 2009) came up with two conclusions, hinting that hedge funds may be progressively gearing their positions more aggressively:

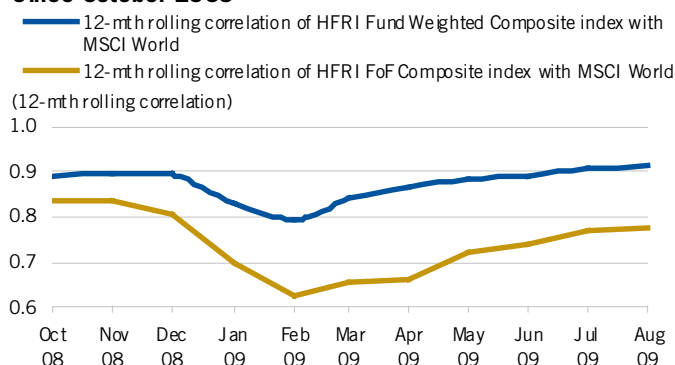
- ▶ equity-focused hedge funds have raised their net long exposure to 31%, which is the highest level GS has observed since June 2008;
- ▶ a sign that the stress in financial markets and lack of liquidity may be slowly receding is the fact that the HFs covered in the study switched their short financial stocks positions – held since Q108 – to long financial positions during Q209.

Automatically, the above issues are impacting FoHFs' sensitivity to equity markets, although less so than for single-manager HFs. The following chart illustrates the progression of HFs and FoHFs in historical correlation to equities (using a 12-month rolling figure).

This diagram helps explain the drivers behind at least part of the returns garnered by the HF industry so far in 2009. Historically, a peak in correlation was reached in June 2006, at 0.97 (the only time since 2000 both HFs and FoHFs have been equally correlated to equities). At the same time, the sensitivity factor (beta) experienced a similar upturn, but significantly less abruptly. The equity beta remains at very low levels in Q309 (about 0.2 for FoHFs and 0.3 for single HFs).

### Comparison of Correlation with Global Equities

#### Since October 2008



Source: Fitch, Bloomberg

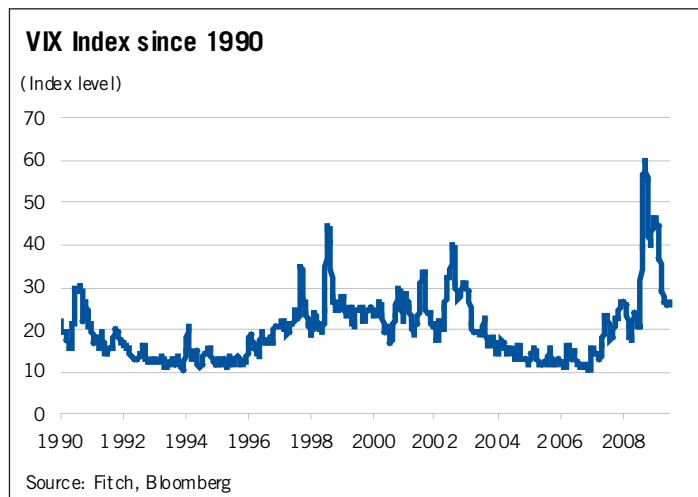
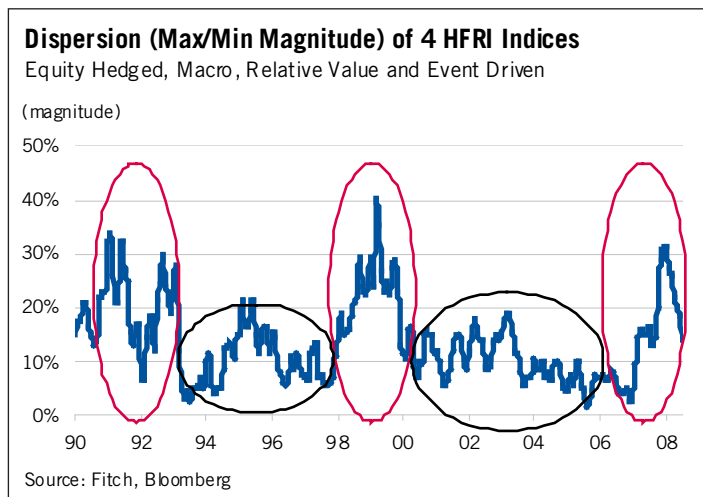
To conclude, Fitch would highlight the difference in mindset between FoHF managers and single-managers. Because of their intrinsically specific constraints, FoHF managers are undoubtedly still driven by prudence and caution. They clearly do not yet see decisive signs of economic recovery, or enough investor confidence to trigger a massive return to directional risk taking – they are also not yet ready to enter the distressed assets space. The latter issue remains under observation and managers are keeping cash available to invest when a decision is reached. As such, they remain largely in a wait-and-see mode (a key factor that should be considered when investors compare their performance to single-manager HFs).

## Industry Issues

### How do the New Macro Conditions Affect FoHF Top Down Processes?

Most FoHF managers claim they provide manager selection and monitoring services, together with macro/strategy allocation capabilities. All three aspects have been particularly critical in the last two years. Some FoHFs have suffered heavily from wrongly selected or poorly monitored hedge funds (either fraud-related like Madoff or wrongly positioned hedge funds); however, top-down processes have also failed in many instances, with some FoHF over-exposed to risky assets from the outset of the crisis (particularly bubble-like asset classes sensitive to deleveraging, eg commodities, emerging, credit, and asset-based lending).

Historically, top-down processes in FoHF have taken different shapes but their purpose was often more "marketing" than practical. Furthermore, the cost of top-down errors has been generally quite limited over the last decade, given the moderate dispersion of returns between hedge fund strategies (see chart above).



After two years where risk management and monitoring have played a key role, it is Fitch’s conviction that top-down resources and processes will be key differentiating factors among managers in the future. Fitch recently reinforced this belief when it updated its asset manager rating criteria (see report “*Reviewing and Rating Asset Managers*”, 18 June 2009).

Without wishing to make any long-term macro forecasts, it is worth considering the likely changes in a macro context, and how they will affect the way FoHF top-down processes operate.

### What is Changing in the Macro Picture?

First and foremost, the degree of uncertainty as regards markets is expected to be much higher than it was in the years 2003 to 2007.

- this means that the various measures of volatility are likely to exhibit much higher values;
- furthermore, capital markets are likely to be characterised by more frequent regime shifts;

- in other words, reversals of fortune at the asset class, strategy, or hedge fund level will be more frequent and therefore, will dramatically increase the cost of overreaction.

Such rising uncertainty can be attributed to the current large macro changes; these are likely to lead to increased volatility before “normal” service is resumed. The most widely discussed issues are listed in the table below.

It is Fitch’s belief that investors in FoHFs should not hesitate to challenge the managers they work with on each of these issues.

### What Secular Trends Still Exist?

#### Rapid Capital Flows and Asset Bubbles

Capital markets continue to be fuelled by global flows, massive amounts of liquidity in dire need of yields to meet liabilities (pension funds, insurance companies, individuals, etc.) and rapid circulation of information. This will continue

### A Changing Paradigm

#### ‘Old’ World (Pre-Crisis)

US-China imbalance

No apparent physical limitation to human activity

Sovereign Wealth Funds (SWF) and excess reserves in accumulation phase, focusing on preserving wealth value (as of December 2007, 32% of US debt owned by foreign official institutions)

Low inflation and interest rates

High leverage

Flat IR curves

“Normal” role of central banks and states

US dollar, natural reserve currency

5% nominal growth in US over last 15 years, fuelled by productivity gains, consumption and investments

Business creation

Source: Fitch

#### Potential New World

Rebalancing of US-China disequilibrium (Asia becoming less export driven and the US more export driven, emerging countries increasing domestic consumption). Pressure on commodities and more generally goods prices and gradual dissipation of disinflationary pressures

Global warming, reduced access to clean water, new energies

SWF and excess reserves in asset management phase (potentially buying less US treasuries and diversifying investments)

Inflation/interest rate transition

Global deleveraging creating creeping deflationary pressure

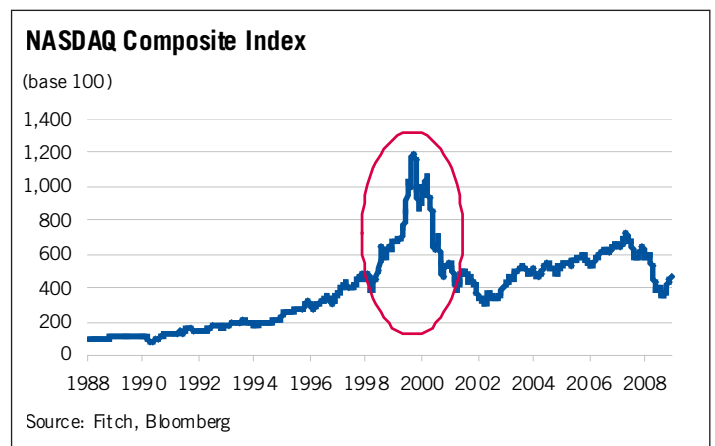
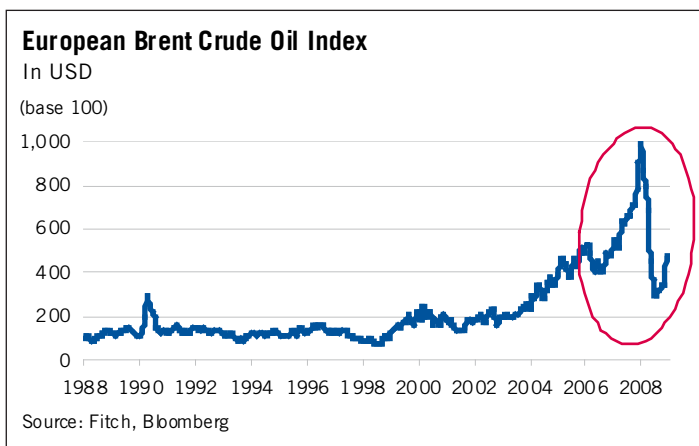
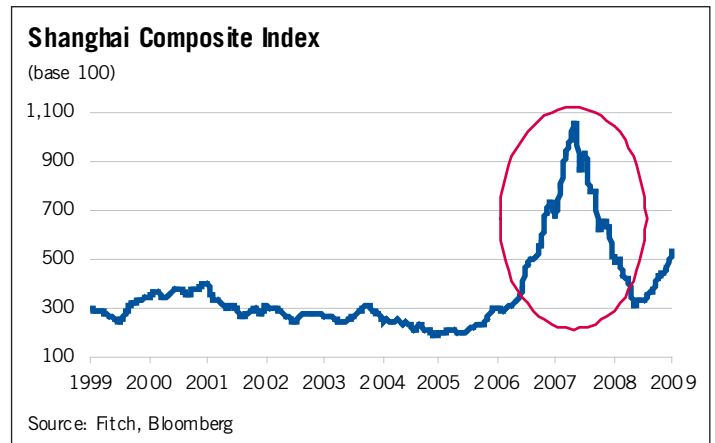
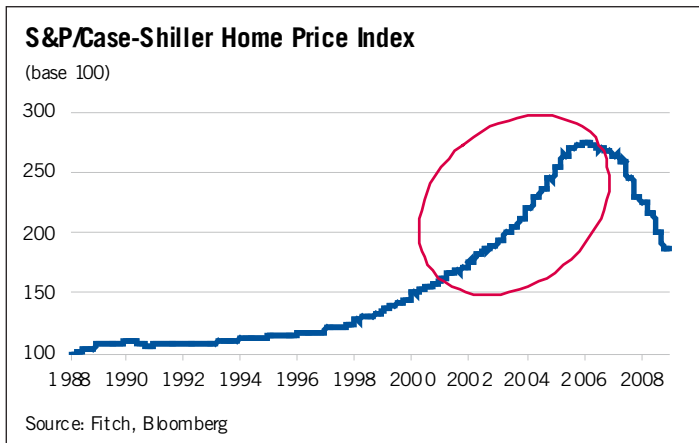
Steep curves

“Non-conventional” role of central banks and states in terms of public expenses and money printing – uncharted territories

Pressure for alternative reserve currencies

3% nominal growth

Schumpeterian destruction of excess production capacity



to fuel market correlation (between markets), autocorrelation (momentum phenomena) and self-fulfilling prophecies that ultimately result in frequent asset bubbles. While asset bubbles are not new in financial markets, recent examples, as illustrated in the graphs above, are particularly striking.

**Emergence of New Pools of Capital**

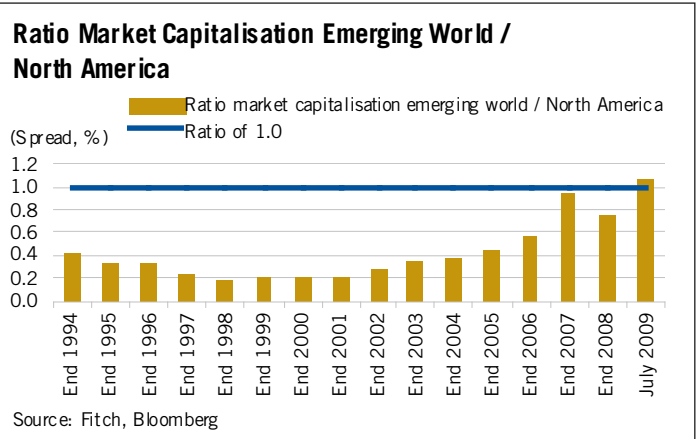
Sovereign Wealth Funds (SWF), excess reserves, hedge funds, and private equity – which together accounted for approximately 15%-20% of total AUM pre-crisis – are expected to remain important investors over coming years. Their allocation decisions will continue to play crucial roles in the pricing dynamics of capital markets.

**Globalisation of Market Capitalisation**

There is no evidence to suggest a halt in the secular evolution towards a more evenly distributed market capitalisation. As shown in the graph below, in 2009 – for the first time in history – Asia, Latam, and other developing countries accounted for more than North America in terms of exchanges' market capitalisation (source: World Federation of Exchanges).

**What Does all this Imply for Top-Down Processes?**

The current market environment – and that of coming years – is likely to make top-down decisions particularly challenging and critical. Changes are likely to be required at the top-



down level and as regards allocation processes; these may be particularly challenging for those managers who have grown comfortable with current practices.

Fitch expects FoHF management platforms will have to overcome numerous hurdles. When selecting managers, investors should pay particular attention to the following elements.

Fitch has already noted a strengthening of the top-down process among certain FoHF managers. This involves, eg the creation of a macroeconomic advising committee, the recruitment of investment analysts with a top-down focus, and the development of comprehensive top-down quantitative models to capture market and economic dynamics.

## Elements investors should focus their attention on when selecting managers

	Top-Down Process to Date	Top-Down Process Going Forward
Top-down framework	Traditional hedge fund strategy framework, based on historical peer groups and strategies	Top-down framework articulated around themes and transversal factors/opportunities, beyond traditional strategies; dispersion within strategies illustrates the existence of transversal factors/themes
Scope	Focus on close environment	Increasingly think global and beyond capital markets, eg technology, demography, geopolitics
Inputs and factors driving decisions	Source: PM/analysts' ground work (often reflecting underlying hedge funds investment strategies) Mainly technical factors (eg issuance, valuation metrics)	Macro-economic resources (advisers, think tanks) combined with PM/analysts' ground work Fundamental factors (including theoretical macroeconomics) and bubble formation elements (flow analysis and market participants' behaviour)
	Backward looking: analysis of recent evolutions of factors and extrapolation; creates some momentum bias	Forward looking, as the economic environment is largely uncharted territory
Decision-making process	Monthly or quarterly allocation committee with sequential review of strategies	Annual "view of the world", updated every quarter with hierarchical review of strategies
Output, impact on portfolio construction	No direct impact on overall risk budget as generally fully invested; beta resulting from HF positioning Allocation adjustments (relative approach)	Use of overlays, hedges, and cash, on top of HF selection  Sourcing of HF to implement or leverage a particular theme Where to put capital? (absolute approach)
	Ultimately, rather limited – somewhat "marketing" oriented	Essential: portfolio construction will directly reflect top-down views

Source: Fitch

## FoHFs' Underperformance Relative to Single-Manager HFs in 2009: Putting it into Perspective

A subject that becomes more and more of a concern among the investing public is the underperformance of FoHF indices in 2009 when compared to their single-manager peers. Even a cursory glance at mainstream global hedge fund indices is sufficient to conclude that FoHFs are behind the curve this year. Broadly speaking, multi-manager FoHFs had a six to eight percentage point lag over single managers, as at the end of the third quarter.

In current circumstances that could become a problem, because FoHFs have clearly emerged as one of the most criticised investment mediums following the worst period ever in alternative investment history, H208. Historically hailed as providers of stable, secure and uncorrelated long-term returns, the FoHF sector partially failed in 2008, in several regards: 1) many such funds were in fact hugely sensitive to equity markets; 2) the supposed superiority of investments, thanks to in-depth due diligence research, proved flawed, following a series of hedge fund blow-ups and frauds; 3) the very viability of the business model was put into question following the impact of asset/liability imbalances and liquidity mismatches; and 4) their performance failed to reap the rewards of the promised diversification mitigation factor.

In other words, the underperformance of FoHFs in 2009 is casting doubt on their ability to maintain (or regain) their prime position as a convenient and efficient provider of alternative beta/exposure for institutional investors lacking

the research resources, competence or simply the necessary time for venturing into alternative investments. The current consensus in the industry suggests that institutional investors around the world are actually raising the share of strategic asset allocation dedicated to alternative investments (HFs, real estate, infrastructure, commodities); as such, significant market share is at stake.

However, this simple observation of index return differences harbours two major shortcomings:

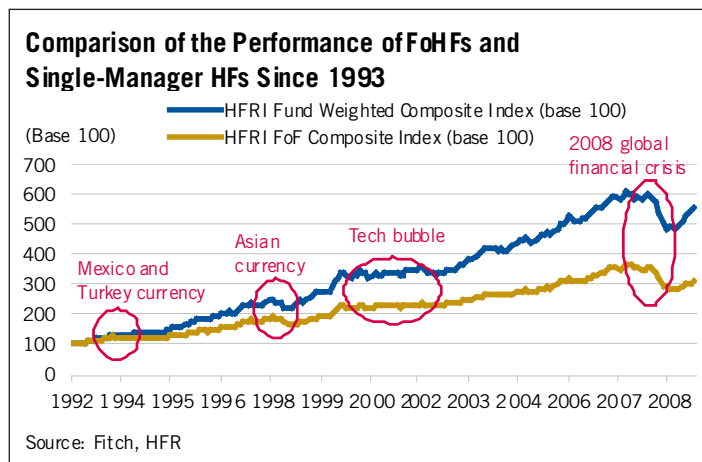
- › As HedgeFund.net (HFN) has noted in recent research – based on its own database of HFs and FoHFs – single-manager HF indices are much more exposed to the well known survivorship bias than FoHF indices. Although it is difficult to put precise figures on the exact degree of fund attrition (or funds still referenced but no longer reporting), it is apparent that FoHFs generally last longer as investment vehicles than single-managers. This means FoHFs are dragging badly performing single-HFs which, in turn, may no longer even be reflected in single HF indices. Fitch has noted this fact in previous newsletters (please see the Q4 2008 release of this newsletter) and explores the issue further in this edition. A potential conclusion could be that FoHF indices may be a better indicator of the overall health of the HF sector, less biased, and longer-term oriented.
- › Another observation – clearly demonstrated by events this year – is the shear level of cash held by portfolio managers. Again, this is not new to 2009. Because of the intrinsically less liquid nature of FoHFs (they are dependant on the liquidity schedules of their own underlying investments),

it is reasonable to accept that FoHFs will carry more cash on their balance sheet than single-HFs, a situation exacerbated by the events of 2008-2009. This makes FoHFs less flexible in terms of their ability to react to positive market orientation (lower leverage, lower equity market beta), a fact apparent in 2009.

As a consequence, simply looking at market indices may be misleading; a more considered examination of the available data may help shed light on the reality of FoHF performance in 2009. Fitch has chosen two avenues in so doing:

- › a historical comparison of index returns in order to establish whether the 2009 series has any materially distinct behaviour (index-based study);
- › a point-in-time study of 2009 monthly returns, as compared to single-manager HF strategies, for a select number of investment vehicles (vehicle-based cross sectional study).

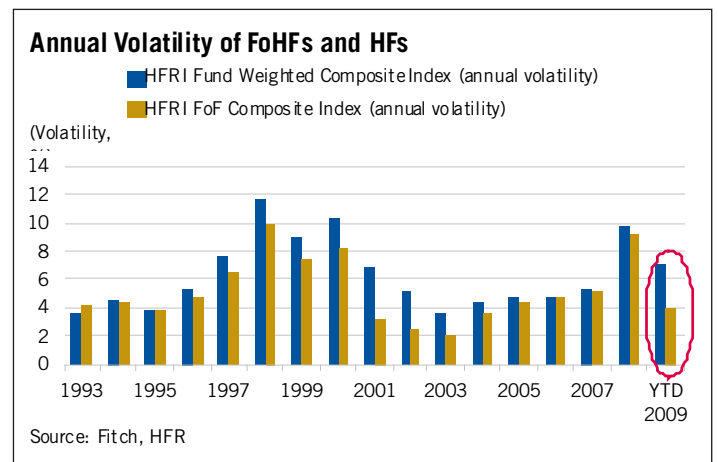
Firstly, when looking at the major indices, FoHFs have generally always underperformed single-HFs in absolute terms. The following chart illustrates the cumulative difference in returns since 1993 between FoHFs (HFRI FoF Composite Index) and single-manager HFs (HFRI Fund Weighted Composite Index).



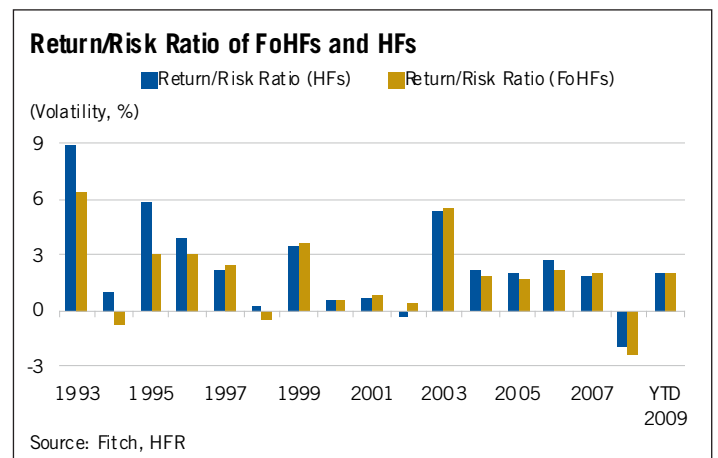
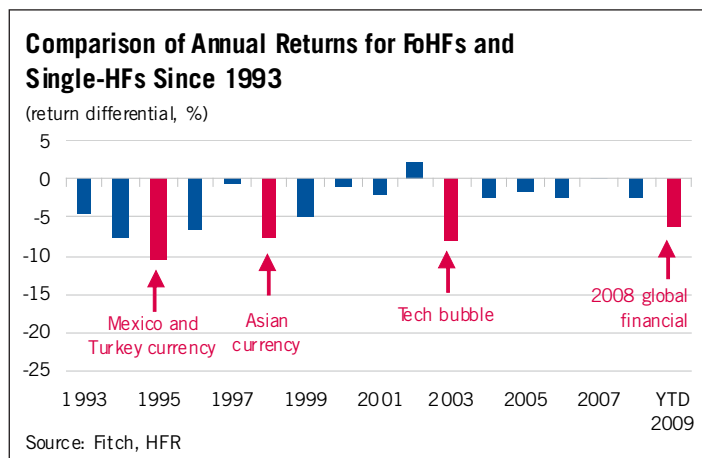
It is interesting to observe that the largest single-year return differences occur at times of economic recovery following major financial shocks. That is, for reasons explained earlier, FoHFs tend to react with less sensitivity to positively oriented markets. From that angle, 2009 has been reasonably standard in terms of expected performance.

Continuing with the analysis of these two indices, it is also important to consider the different levels of risk that each series demonstrates, as measured by the annualised standard deviation of monthly returns. As discussed in previous newsletters, FoHFs are promoted as lower-risk and more stable investment vehicles than their single-manager peers, and the following charts illustrate this. The main observations are:

- › almost yearly since 1993, FoHFs have demonstrated lower volatility than single-HFs;
- › The Return vs Risk ratio of both series appears much less in favour of single-HFs than the absolute return differential. They are in fact equal to date in 2009.



The following chart isolates annual returns for both series and presents the return differential between both series.



As a second step, Fitch also analysed the returns of a select groups of FoHFs and single-manager HF vehicles from a “micro” and cross-sectional standpoint. The objective was twofold:

- › overcome the typical index construction-related biases;
- › demonstrate FoHFs serve their stated purpose, ie purveyors of stable and reliable alternative beta (although they should not be viewed as competitors to single-manager HFs which clearly appeal to different kinds of investors and/or objectives).

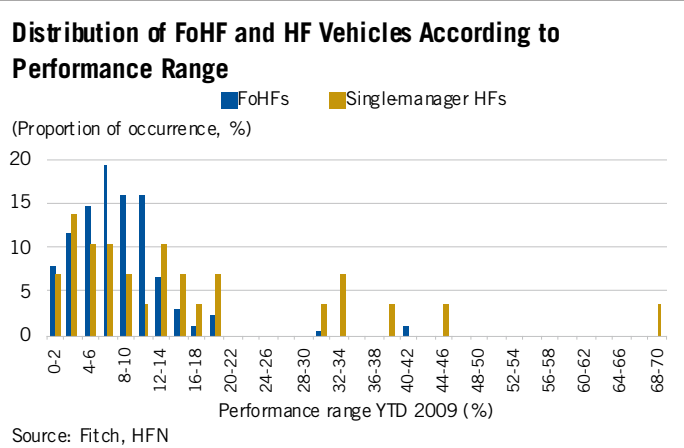
This study was conducted using HFN’s fund database which, in mid-2009, provides data on north of 7,100 investment vehicles globally.

The following table highlights how the FoHF universe diverges from that of the single-manager HF universe within the HFN database. Groups of vehicles which satisfied a pre-determined list of requirements – a minimum USD250m in client assets and at least five continuous years of operation – were identified, and specific statistics of performance and risk were determined for each series.

From the data below, it is clear that long-standing FoHFs with a significant level of assets have been more numerous and shown less outliers than single-HFs. However, fewer vehicles were able to generate abnormally high performance figures, ie above the aggregate hedge fund index of HFN. The graphical distribution of FoHF and single-manager HF vehicles according to their return range (YTD 2009) helps illustrate this concept (using only multi-strategy funds).

The below observations summarise Fitch’s findings:

- › market indices are significantly biased (survivorship) and tend to favour single-strategy HFs;
- › FoHF market indices may be a better and more consistent indicator of the true health of the hedge fund universe;



- › FoHFs as an asset class have traditionally – and continue to – underperform single-strategy HFs in absolute terms. In this respect, 2009 is no different (in magnitude or timing) to any other year and tends to demonstrate that the intrinsic and fundamental nature of FoHFs induces a slower reaction to market orientation (particularly during periods of recovery);
- › FoHFs have historically exhibited lower volatility than single-manager HFs;
- › return figures for FoHFs are more in line with single-manager HFs when considering the effects of risk (volatility);
- › in terms of strategic asset allocation, it is appropriate, convenient, and efficient to choose a long-standing and large FoHF, as opposed to cherry picking a single-strategy HF vehicle. Obviously, this statement appeals rather to investors that do not actually have the necessary resources to devote to hedge fund selection.
- › as investment vehicles, FoHFs are practical providers of stable exposures (beta) to alternative investments, as their returns exhibit less dispersion than single-manager HFs. However, the contra-side to this statement is that it is also reasonable to conclude that investors with the necessary qualifications, resources, time and inclination are more likely to yield abnormally high returns by conducting their own hedge fund selection, as opposed to relying on a FoHF manager.

### Comparison of the Profile of FoHFs with Single-Manager HFs

FoHFs	Single-manager HF strategies					
	Multi-strategy FoHFs	Single-manager HFs/ Multi-strategy	Single-manager HFs/Long-Short Equity	Single-manager HFs/Emerging Markets	Single-manager HFs/ Event Driven	Single-manager HFs/Macro
Total number of vehicles in HFN database (No.)	1,818	430	1,475	255	138	269
Number of vehicles compliant with size and history requirements (No.)	194 (11%)	39 (9%)	95 (6%)	16 (6%)	23 (17%)	34 (13%)
% of compliant vehicles with YTD2009 perf. > 0%	83	74	78	56	83	53
% of compliant vehicles with YTD2009 perf. > HFN Aggregate Average	6	36	38	25	44	27
% of compliant vehicles with YTD2009 perf. > MSCI World	2	26	35	25	30	24
Average 2009 volatility per vehicle (annualised)	11	14	16	24	12	15

Source: Fitch

## FoHF Enter the UCITS branding

In the absence of a harmonised European Union (EU) regulatory regime and due to cross-border distribution constraints applied to non-harmonised vehicles, some FoHF managers are choosing to set up FoHF solutions in a UCITS format. A number of FoHF managers have thus created Luxembourg- or Dublin-based vehicles, which are theoretically benefitting from a “passport” across the EU. Examples of existing or forthcoming initiatives include Lyxor AM, Man Investments, Collins Stewart, Black Square, GAM, 47 Degrees North, Permal, Kairos Partners and Alternative Asset Advisors.

In a UCITS-compliant environment, alternative investment strategies are fairly constrained. Three are available to managers:

- › replication of beta exposures of a basket of hedge funds, following a multifactor approach using listed instruments (futures contracts and/or options);
- › performance tracking with a total return swap (TRS) on a hedge fund index;
- › direct investment in UCITS funds applying hedge fund-lite strategies.

While this move towards the UCITS framework is still in its early stages (Fitch expects to continue commenting on this issue in forthcoming quarterly issues), certain risks and challenges have already been identified.

- › Firstly, it is essential to reckon that the purpose of UCITS is not fundamentally about promoting the cross-border distribution of alternative investment vehicles. The debate on the Alternative Investment Fund Management (AIFM) directive and the status of non-harmonised European funds illustrates this point. In reality, UCITS FoHFs are products on the edge of pan-European regulation. As regulatory lines are likely to change over time, the future of some of these products is by no means certain.
- › The replication avenue entails tracking risks that primarily stem from the structural instability of the beta factors and replication models ignore the alpha component in the performance of the underlying HF basket.

- › The TRS approach raises multiple questions. It supposes that the indices used comply with the Committee of European Securities Regulators (CESR) requirements (CESR’s guidelines concerning eligible assets for investment by UCITS are outlined in “The Classification of Hedge Funds Indices as Financial Indices”, July 2007). Notably, indices should be properly diversified; for example, a UCITS FoHF using strategy indices to implement allocation views may be confronted with highly concentrated indices (eg, in the Distressed segment, with only two or three underlying funds) and this may not be representative of the considered sub-strategies. Additionally, it is worth stressing that, in the case of a fund-of-fund where the objective is to mirror an underlying index, the index is rebalanced but not actively managed (as opposed to a mainstream FoHF). Finally, should the FoHF manager also be the index provider, transparency in the construction and rebalancing processes (number of underlying investments, weight of strategies, etc) is of paramount importance.
- › The third approach (investing in UCITS-lite hedge funds) is currently constrained by the limited number of products available (it is estimated that between 50 and 200 funds, depending on what is being considered as hedge fund-lite, are currently implementing HF strategies in a UCITS format). Many HF players are however contemplating the launch of UCITS vehicles – these are especially straightforward to structure as they use less leverage (ie, leverage is more constrained under UCITS) and as they focus on liquid strategies (investment in non exchange-traded assets, such as loans or physical assets, is currently quite limited under UCITS).

Finally, UCITS status should not replace proper due diligence on funds-of-funds, including scrutiny of disclosure; this is particularly true as a wider access to retail investors raises potential issues in terms of improper selling. As such, Fitch will closely monitor the developments as regards the possible creation of a pan-European regulatory regime for the manufacturing and distribution of HFs and FoHFs. In the meantime, the agency expects greater development of hedge fund-lite strategies under UCITS branding (due to investor demand and the clear regulatory framework), notably in the areas of long/short and macro.

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