

# Hedge Fund Performance 2009 and Outlook 2010

## Hedge Fund Performance Table 2009:



### **Outlook 2010:**

#### Managed Futures:

Investors flocked to CTA's at the beginning of 2009 relative to other strategies for the outperformance of the strategy in 2008. Performance in 2009 was -1.99%. Trend followers tend to create a synthetic long volatility profile (just as mean reverts create a short volatility profile) and the mean reversion of volatility from the acutely elevated levels in 2008 to more normal levels in 2009 coupled with the sharp inflexion point in market levels in March and the difficult trading patterns from June onwards wrong-footed most CTAs. The future for CTAs is as unclear today as it has always been for the strategy.

#### Global Macro:

Global macro was another preferred strategy at the start of 2009 because of its outperformance in 2008 when large market dislocations and economic policy conspired to provide macro with a clear outlook on which to trade. This evaporated in mid 2009 as trading conditions became more uncertain with regard to policy, economic growth, FX, and markets. It is highly illustrative of investor behaviour that their 2 preferred strategies for 2009 turned out to be the worst performers. The outlook for macro is interesting, however, as economic policy becomes a more important driver of asset pricing in the coming year. The problem with finding talent in macro is that it is particularly difficult to discern between skill and luck in

this strategy.

#### Convertible Arbitrage:

The worst performer in 2008 became the best performer in 2009 from a confluence of a recovery in credit spreads and equity markets. A normalization of financing conditions also helped convertible bonds immensely. Convertibles suffered acutely in 2008 as leverage for convertible bond investors provided by the banks was withdrawn wholesale as the banks found themselves capital impaired. This led to forced selling of the asset class and artificially depressed pricing. The recovery has been an easy trade. What lies ahead is a much less directional market where arbitrage and hedging become more important. Given the scale of capital withdrawn from this strategy the convertible market remains an interesting space for arbitrageurs and will likely produce robust returns in the coming year. The long credit and long delta game, however, is likely over.

#### Equity long short:

Equity long short returned 26% as a strategy. We can infer from the near flat performance of equity market neutral that the bulk of the returns have come from maintaining a long bias and or market timing. Given the difficulty of timing the market, it is safe to assume that returns have come from net long exposure. Given the importance of macro policy on market direction going forward long biased funds are vulnerable to increased volatility going forward.

#### Equity market neutral:

Equity dispersion, a proxy for idiosyncratic risk, had risen in 2008 only to collapse and steadily decline in 2009 and remains depressed. Without dispersion, equity market neutral strategies will struggle to produce returns per unit of leverage. The outlook for equity market neutral is highly dependent on dispersion rising again. While markets continue

to be driven by macro policy idiosyncratic risk will take a back seat to systemic risk. With time, policy will be withdrawn or fade in relevance to asset markets, at which time market neutral strategies will regain their traction.

#### Merger Arbitrage:

Merger deal flow has accelerated then slowed then accelerated again. Deal premia have been rich as the volume of arbitrage capital has remained low following the crisis in 2008. 2008's credit crisis had profound impact on private equity sponsored leveraged buy outs which in turn impacted merger arb funds via increased deal breaks and later a dearth of deal flow. The recovery has seen some recovery in deal flow but these of a more strategic nature. Deal spreads have been rich enough that required leverage has been low. Merger arb returned a paltry 11.3% in 2009, well below potential. Part of the reason has been the low barriers to entry to the strategy which has seen dilution of quality. The merger arbs known to and preferred by us have generated well above average performance even exceeding the returns of convertible arbitrageurs. The prospects for merger arbs remains good, provided one invests with the right manager. Deal spreads remain elevated, deals are less uncertain, derivative markets are not crowded and can be applied to trade construction.

#### Fixed Income:

Volatility in rates, a steeper yield curve, diminished distribution and uncertainty in inflation expectations conspired to help fixed income arb achieve a 22% return on fairly low volatility in 2009. The environment looks unchanged. Macro policy will likely maintain the elevated volatility, volatility in commodity prices and the pace of economic recovery will likely sustain the uncertainty around inflation expectations, and increased issuance is likely to create idiosyncratic opportunities in basis and relative value. The yield curve is likely to flatten, however, which

would take away any static carry. Fixed income arb is expected to produce robust returns going forward at least until the factors that drive returns fade, namely that inflation expectations become fully priced, debt distribution is restored to pre crisis levels and indeed is improved to handle the expected increased issuance and the yield curve flattens out.

#### Distressed:

The HFRI Distressed investing index returned 27% in 2009. The story here is interesting in that the number of workouts has actually not been that high. While default rates have surged in 2009, this has occurred in a time frame insufficient to support the returns experienced in 2009. Instead, the returns have been more likely the result of a general credit spread tightening across all credit qualities from investment grade to high yield. What this implies is that we are at the early stages of the default cycle and that on the one hand there is ample time to invest in distressed debt, the best of the returns are not behind the strategy but ahead of it, but that in the interim there may be more volatility than investors expect. Most of the spread tightening has occurred in the larger to mega caps. For the small to mid cap manager there is an element of beta available to be captured, if that is the objective. The small and mid cap space also presents a more interesting hunting ground precisely for its more reasonable pricing

#### Capital structure arbitrage:

There is no index to represent this strategy. Anecdotally we are aware that many funds have done well in this space in 2009. The volumes of capital deployed in this area shrank precipitously in 2008 and some funds had to gate and suspend redemptions. Proprietary trading desks certainly had to exit these strategies to free up bank capital. The meltdown in the markets in 2H 2008 resulted in capital structures becoming

dislocated and thus mispriced due to the nature of the selling, based on capital utilization and funding as opposed to no-arbitrage pricing. The systemic nature of the recovery from March 2009 has not restored capital structures to efficient pricing and thus longer term investors have the opportunity to participate in structurally sound arbitrage strategies. The strategy needs appropriately stable capital provisions.