

# Hedge Fund Roundtable

The financial crisis has severely altered market conditions for hedge funds: nervous investors are seeking redemptions, tighter credit is dampening some managers' ability to execute strategies, and deleveraging is putting downward pressure on asset values. The recent Madoff Ponzi scheme, which potentially wiped investors out of billions, will add pressure for increased transparency and industry regulation. To lend some perspective on events in the hedge fund asset class, we assembled our hedge fund experts to share their views on the future of the industry, the impact on managers and where we likely will find the best opportunities moving forward.

Roundtable participants include:

Ted Berenblum, Head of Alternative Investments, BNY Mellon Wealth Management; Sean Cumiskey, Managing Director, IVY Asset Management Corp.; John Langelier, Managing Director, Optima Fund Management, LLC; and Daved Langguth, Sales and Marketing Manager, EACM Advisors, LLC.

## What will the future landscape of hedge funds look like?

### Sean Cumiskey

Hedge funds will continue to be an important part of the investment landscape as investors seeking active management continue to place more emphasis on absolute returns versus tracking specific market benchmarks. We believe the hedge fund model is undergoing a natural evolution as investor terms, transparency and regulatory frameworks change over time. Many of the coming changes, especially those regarding fees and terms, will potentially benefit investors. We should see an industry of fewer players, with perhaps more than 50% of hedge funds going out of business within the year. Less competition for deals will be positive for the industry. Surviving managers will be those who are more stable and more experienced and have the demonstrated ability to produce alpha without using much leverage.

### Daved Langguth

There will be fewer hedge funds and investment bank proprietary trading desks competing to capitalize on the broader opportunity set. That said, we believe the vast majority of top-tier firms will survive. Over the longer term, we view this as being quite positive for our investors, given the nature of managers we have access to, their longevity and our proven due diligence process which monitors their risk controls.

## What caused recent disappointing hedge fund returns?

### Ted Berenblum

Hedge fund annual returns, as of December 31, 2008, outpaced the broad equity asset classes on a relative basis, in spite of significant headwinds in the industry. However, performance was much lower than expected (see Exhibit J). Massive amounts of deleveraging, record requests for redemptions, the Securities and Exchange Commission's (SEC) short-selling ban, which was imposed on hundreds of financial stocks, frozen capital markets and record-high volatility, among other factors, negatively impacted the hedge fund industry. These factors forced hedge funds and investment bank proprietary trading desks to sell billions of dollars of securities at fire-sale prices in order to meet the demands of investors as well as lenders. Managers were caught in a vicious cycle as lenders required additional cash when the value of securities used as collateral decreased and investors, disappointed with performance, liquidated their investments.

## Exhibit J

### Negative Absolute Performance in Hedge Funds

2008 Returns	HFRX Index	S&P 500	Over Performance	MSCI EAFE	Over Performance
HFRX Global Hedge Fund Index	-23.25	-37.00	13.75	-43.38	20.13
HFRX Absolute Return Hedge	-13.09	-37.00	23.91	-43.38	30.29
HFRX Equity Hedge Index	-25.45	-37.00	11.55	-43.38	17.93

As of 12/31/08  
Source: HFRX

## What can we expect from hedge funds in the near term?

### Sean Cumiskey

We will continue to experience occasional choppiness in hedge fund performance until some stability returns to the overall financial system. While hedge funds do not necessarily need a benign economic environment in order to achieve positive returns, they are dependent upon functioning capital markets to trade or finance positions. Credit remains tight, thus it is difficult for some managers, particularly those who rely on leverage, to finance their strategies. At IVY, we do not actively allocate to highly leveraged strategies. But, as the deleveraging process continues, some strategies — for instance, fixed income arbitrage — should be more affected than others. It is important to note that the most significant deleveraging pressures have come from global banks, not hedge funds, as the banks seek to shrink their balance sheets and dispose of billions of dollars of securities. Right now we are probably about halfway through this process and, as liquidity returns to the market, managers will be better able to capitalize on pricing anomalies and dislocations. By the second half of 2009 we should see a return to more normal capital market conditions.

## Where are the opportunities in this marketplace?

### John Langelier

On the positive side of the deleveraging process, we see several areas of opportunity. We are excited about convertible arbitrage and long/short equity, both of which were negatively impacted by the short-sell ban. There has been a lack of fundamental analysis driving the market; consequently, long and short positions became highly correlated. This ultimately challenged long/short managers and hurt many strategies. As the market returns to fundamentals, strong stock pickers will have ample opportunities.

As part of a multi-strategy approach, convertible arbitrage strategies, which invest in convertible bonds and typically short the underlying company stock, have had to sell off positions to meet collateral calls. Thus, convertible bonds are extremely cheap, as hedge funds have had to liquidate these securities to meet redemptions. As a result, convertible arbitrage offers downside protection and an equity appreciation opportunity.

This environment reinforces the need for our stringent due diligence process that selects those managers we feel have a proven, repeatable process for identifying value, strong risk controls and a long-term investment focus.

### Sean Cumiskey

Broadly speaking, we see near-term opportunity in areas where we expect mean reversion in pricing of securities. That is to say, we believe pricing in many sectors will revert to levels that reflect true or intrinsic value rather than the artificially depressed levels we see today. An example of this would be leveraged loans: during this crisis, banks and other investors have been forced to sell high quality, first-lien loans at deep discounts. This has created an abundance of supply in an environment where few buyers exist. Bank leveraged loans generally are high in the capital structure of a company, are often first in line for payment in the event of a bankruptcy and are secured by real assets. These securities have decreased as much in value as less secure — or even unsecured — lower-level debt, so the buying opportunity is very attractive, without having to take on additional risk.

Within a multi-strategy approach, there should continue to be opportunity in certain tactical trading strategies, such as systematic trend following and discretionary macro trading. As central banks around the world grapple with the current crisis, we would expect to see a continuation of actionable trends in currency, interest rates, stock indices and commodities, among other areas. Tactical managers' strategies have the additional advantage that much of their trading is executed in the futures markets, which by and large have been unaffected by the global financial crisis and continue to function normally.

#### **Daved Langguth**

In fear-driven crises, short-term liquidity and psychological factors overwhelm fundamentals. As we have seen in the past, this disconnect is creating a range of opportunities for managers who focus on fundamentals. Currently, this is especially true in the credit arena, across a variety of instruments.

### **Given all the discussions on regulatory reform, do you expect any changes for the hedge fund market?**

#### **John Langeler**

We anticipate industry discussion to determine the extent of future hedge fund regulation. The SEC ban on short-selling, imposed in September 2008, hurt many trading strategies that rely on short-selling, such as long/short strategies and convertible arbitrage. Although the short-selling ban has been lifted, the industry expects further disclosure requirements regarding shorted stocks. We also probably will see the uptick rule reinstated to prevent front running of falling stocks and enhanced disclosure requirements.

#### **Daved Langguth**

While regulatory initiatives such as increased transparency or registration may affect hedge funds, we do not anticipate measures that will significantly limit most managers' ability to implement their strategies. Clearly, well designed measures intended to limit potential market abuses generally will be positive for market participants, including hedge funds.

### **Do hedge funds still make sense as part of a diversified portfolio?**

#### **Ted Berenblum**

Hedge funds still play an important role in a diversified portfolio. The managers who survive this consolidation phase will be able to take advantage of extreme market dislocations and generate excess returns for investors. We believe that the fund-of-funds approach is the best way to diversify risk across multiple managers and leverage each manager's specialized skill at uncovering value. It also is important to remember to employ single manager hedge funds only as a complement to a well diversified fund-of-funds strategy, given the underlying risk involved with single manager investments.

This environment reinforces the need for a stringent due diligence process that selects those managers we feel have a proven, repeatable process for identifying value, strong risk controls and a long-term investment focus. Our managers are positioned well for the future — they have a strong capital base, adequate cash balances and talented professionals who can successfully navigate difficult environments. We believe that, over the long term, hedge funds will accomplish their goal of providing absolute returns while minimizing downside risk for many investors. ■