momentum

viewpoint

May 2012

global investment management

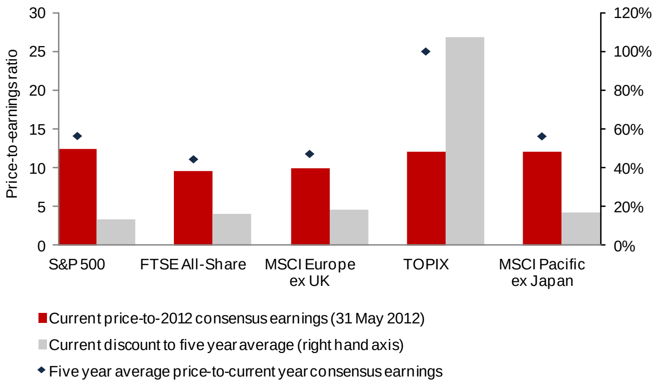
Concerns over a Greek exit from the Eurozone, softer data from the US and the apparent easing of Chinese growth combined to push asset prices down in May. Global equities fell by 8.6% in US dollar terms last month, eroding year to date gains and wiping USD 2.6 trillion off the value of global stocks. Despite retreating by 6.1% over the period, the US stock market is now the best performing region year to date, comfortably ahead of its developed peers as well as emerging markets. The latter declined by 11.2% during May, as the prospect of lower external demand and foremost a slowdown in China weighed on the outlook for these economies.

Equity volatility has increased markedly since the end of the first quarter. During the first three months of 2012, the global aggregate's average daily price movement was approximately 50 basis points (0.5%), whilst positive trading days dominated negative ones by 3-to-2. During the subsequent two months, volatility has increased to 75 basis points accompanied by a strong reversal in this underlying trend.

Yields on core developed market government bonds fell during the month, as investors sought safety in perceived high quality debt. US 10 year yields ended May at 1.56%, compared to 1.20% in Germany and 0.82% in Japan, whilst in the UK rates traded through 1.9% for the first time in the Bank of England's 318 year history. These moves are indicative of investor fears over the outlook for global growth. French OATs (Obligations Assimilables du Trésor) appear to have regained their 'safe haven' status in investors' minds, with prices rallying during May. The spread between French and German 10 year government bond yields has fallen by 0.75% since peaking at 1.9% in November 2011.

As a result of these divergent moves by equities and bonds, the 12 month trailing dividend yield on the S&P 500 index now stands above the US 10 year yield for only the second time since the 1950s. In Japan, equities are once again trading below book value, whilst price-to-earnings ratios on major stock indices are more than 10% below their five year averages:

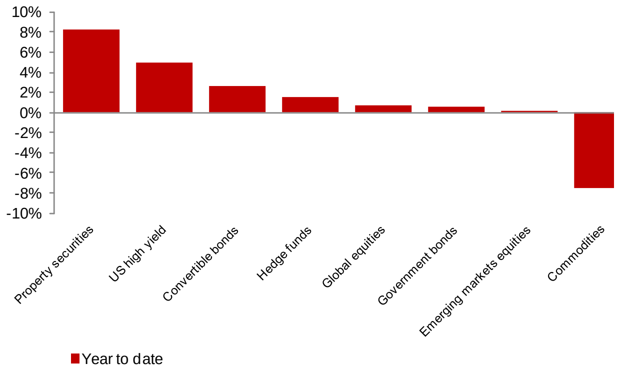
Figure 1: Price-to-earnings multiples on major stock indices



High yield bonds in the US declined by 1.3% during May, cutting year to date returns to 5.0%. High yield is now the second strongest performing asset class in 2012, as shown in Figure 2 overleaf.

Source: Bloomberg/ Lipper Hindsight. May 2012.

Figure 2: Total returns by asset class (US dollar terms)



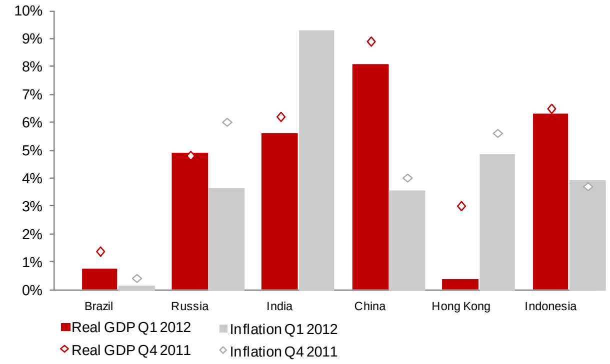
Political change appears to be gaining momentum in Europe, after France's Socialist party won control of the country for the first time in 17 years at the start of the month. Meanwhile in Greece, two thirds of voters rejected the main pro-bailout parties in national elections during May, as both the political Left and Right enjoyed gains at the polls. The failure of any party to form a coalition government saw Greece return to the polls on 17 June. Reports from Greece have confirmed a victory for New Democracy, with circa 30% of Sunday's vote. Syriza – with its very public opposition to the austerity measures imposed by Greece's creditors – came second. New Democracy will now try to form a 'pro-programme' government alongside Pasok and the Democratic Left, leaving Syriza to sit in opposition. Antonis Samaras, leader of New Democracy, is likely to be received tentatively by European leaders, given his reluctance to explicitly support the country's rescue plan over the last two years. History suggests that austerity requires a strong electoral mandate in order to be successful, and in this regard it is perhaps worrying to see a sizeable portion of Greek voters continue to opt for anti-bailout parties over the weekend. More integration as opposed to less still appears to be the order of the day in Europe. Policymakers have mooted using a levy on banks to raise capital for a new rescue fund, alongside a Europe-wide guarantee on bank deposits to assuage depositor fears and prevent panic withdrawals.

Eurozone gross domestic product was unchanged in the first quarter, surprising economists who had been expecting a contraction in the region's output. Commentators continue to focus on the capital needs of Spain's banking sector, which remains weighed down by troubled property loans. The government subsequently elected to partially nationalise Bankia – Spain's fourth largest lender – during the month, by converting EUR 4.5 billion of government preferred stock into ordinary voting shares. Symptomatic of the crisis, investors quickly concluded that the steps were insufficient, pushing the country towards a bailout from the European Union.

The debate over the US 'fiscal cliff' is expected to gain prominence as the year progresses. This cliff refers to the steep fall in output that is anticipated to occur when automatic spending cuts come into effect in 2013. US payroll data has consistently disappointed forecasters since March, with the private sector adding a mere 69,000 jobs in May. The ISM manufacturing index underperformed economists' forecasts last month, at 53.5 versus 53.8 expected, whilst the non-manufacturing index alternatively outperformed.

Both growth and inflation have fallen in emerging markets year to date, as summarised in Figure 3.

Figure 3: Emerging markets real GDP growth and inflation



The People's Bank of China (PBOC) cut interest rates by 25 basis points to 6.31% post the end of May, adding to expectations for a new round of easing from Beijing. Chinese authorities injected RMB 4 trillion into the economy in 2008/09 in order to aid a V-shaped recovery, including subsidies for rural consumption and spending on infrastructure. New spending in 2012 is unlikely to be on the same scale, in mind of the credit boom that resulted post 2009 and the political transition to take place at the end of this year.

Currencies displayed high volatility last month, with the euro, British pound and Australian dollar depreciating by an average of 6.2% versus the US dollar, which benefitted from a renewed flight to quality by investors. The Swiss National Bank (SNB) has managed to maintain the EURCHF floor, put in place in September 2011, with fewer resources than

Source: Bloomberg/ Lipper Hindsight. May 2012.

required in previous interventions. The SNB's balance sheet reveals that the central bank has begun diversifying away from the euro in its foreign exchange reserves. At the same time, the Norwegian sovereign wealth fund – Europe's largest equity investor – is also set to reduce its European holdings, putting further downward pressure on the euro.

The Rogers International Commodities index fell by 11.5% in US dollar terms during May, as a general supply glut alongside weakening demand pushed prices down. Gold, the perceived bear market hedge, equally fell by 5.6%, reinforcing the wisdom that valuation, and not current market conditions, offer the most reliable guide to future returns. Crude oil prices declined by 12.7% in May. Oil production in Saudi Arabia is currently running at 10 million barrels per day, a 10% increase in output compared to this time last year, whilst geopolitical tensions over Iran have eased since April.

Source: Bloomberg/ Lipper Hindsight. May 2012.

		To 31 May 2012		
Asset class/region	Index	Currency	Month	Year to date
Developed markets equities				
United States	S&P 500 NR	USD	-6.1%	4.9%
United Kingdom	FTSE All Share TR	GBP	-6.8%	-1.4%
Continental Europe	MSCI Europe ex UK NR	EUR	-6.6%	-1.3%
Japan	Topix TR	JPY	-10.5%	-0.2%
Asia Pacific (ex Japan)	MSCI Pacific ex Japan TR	USD	-11.8%	-0.4%
Global	MSCI World NR	USD	-8.6%	0.8%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	-17.9%	-4.7%
Emerging Asia	MSCI EM Asia NR	USD	-9.5%	2.4%
Emerging Latin America	MSCI EM Latin America NR	USD	-13.1%	-4.2%
BRICs	MSCI BRIC NR	USD	-13.2%	-3.0%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	-11.2%	0.1%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.8%	2.0%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	1.8%	4.8%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.8%	4.3%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	-1.3%	5.0%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	4.5%	2.9%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	2.0%	4.7%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	1.1%	4.5%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.1%	6.0%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	-2.3%	9.5%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.6%	1.4%
Australian Government	JP Morgan Australia GBI TR	AUD	4.1%	5.9%
Global Government Bonds	JP Morgan Global GBI	USD	-0.1%	0.6%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-1.0%	0.9%
Global Convertible Bonds	UBS Global Convertible Bond	USD	-4.9%	2.6%
Emerging Market Bonds	JP Morgan EMBI+	USD	-2.9%	2.9%

Source: Lipper Hindsight. May 2012.

		To 31 May 2012		
Asset class/region	Index	Currency	Month	Year to date
Property				
US Property Securities	MSCI US REIT NR	USD	-4.6%	8.3%
UK Property Securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-1.9%	8.8%
Europe ex UK Property Securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	EUR	-0.8%	6.6%
Australian Property Securities	FTSE EPRA/NAREIT Australia TR	AUD	-1.3%	11.9%
Asia Property Securities	FTSE EPRA/NAREIT Developed Asia TR	USD	-8.7%	9.1%
Global Property Securities	FTSE EPRA/NAREIT Developed TR	USD	-6.3%	8.2%
Currencies				
Euro		USD	-6.6%	-4.8%
UK Pound Sterling		USD	-5.2%	-1.0%
Japanese Yen		USD	1.8%	-1.9%
Australian Dollar		USD	-6.8%	-5.4%
South African Rand		USD	-9.5%	-5.7%
Commodities & Alternatives				
Commodities	RICI TR	USD	-11.5%	-7.5%
Agricultural Commodities	RICI Agriculture TR	USD	-8.6%	-8.2%
Oil	ICE Crude Oil CR	USD	-12.7%	-2.9%
Gold	Gold Index	USD	-5.6%	1.8%
Hedge funds	HFRX Global Hedge Fund	USD	-1.7%	1.5%
Interest rates			**Current rate**	**Change at meeting**
United States	25 April 2012	USD	0.25%	-
United Kingdom	7 June 2012	GBP	0.50%	-
Eurozone	6 June 2012	EUR	1.00%	-
Japan	23 May 2012	JPY	0.10%	-
Australia	5 June 2012	AUD	3.50%	-0.25%
South Africa	11 June 2012	ZAR	5.50%	-

Source: Lipper Hindsight. May 2012.

Focus: Are fund of hedge funds still the black sheep of the asset management industry?

1. Executive summary

The last few years have seen a seismic shift in perception towards the funds of hedge funds industry, from the darlings of the investment world to the black sheep of the family. Of course, there was some gross negligence and wholly inappropriate management, but this was not specific to funds of hedge funds; it was widespread across the financial services community and major governments worldwide. However, the fund of funds community is still reeling post the 2008 crisis, far more than any other sector or investment specialism. This paper reviews the rise and fall of hedge funds and funds of hedge funds and asks whether there is still a place for them in client portfolios. The following points outline our views on the asset class and the market:

- Hedge funds are still attracting capital
- Hedge funds remain a tiny part of the financial markets
- Returns for the industry are attractive from both an absolute and portfolio perspective
- Correlation to equities has increased post 2008, but is likely to decrease in future
- Hedge fund investing exposes investors to a unique set of risk factors
- Small, new managers tend to outperform large old managers
- Investing through consultants is likely to limit the investible universe to less than 10% of the total market
- Hedge fund replicators require investor skill to select, defeating their raison d'être
- Hedge funds of funds who managed capital successfully through 2008 and with a track record of investing in smaller managers are still a viable investment solution

2. Introduction

"Whom the Gods would destroy, they first put on the cover of *Business Week*"
-Paul Krugman

Hedge funds, and by extension funds of hedge funds, have endured persistently bad press post the 2008 collapse of Lehman Brothers. Typical bones of contention are they are expensive, illiquid and have underperformed. An article in The Economist published in December 2011 was by no means unique when it announced "Hedge funds have had a horrible year - and it could get worse". Is the criticism an example of the notoriously contrarian "magazine cover indicator"? After all, the same publication ran an article in 1999 making the case for oil at USD 5 a barrel. Similarly, Business Week announced the death of equities in August 1979, only for the S&P 500 Index to annualise at +13.6% over the following 20 years! Or does the hedge fund industry really have some serious charges to answer?

Assuming there are investors seeking to allocate to hedge funds, what is the best method? Should investors allocate directly to hedge funds, perhaps with the help of a consultant? Or does the much maligned fund of hedge funds model still have something to offer?

Data source: Miport, May 2012

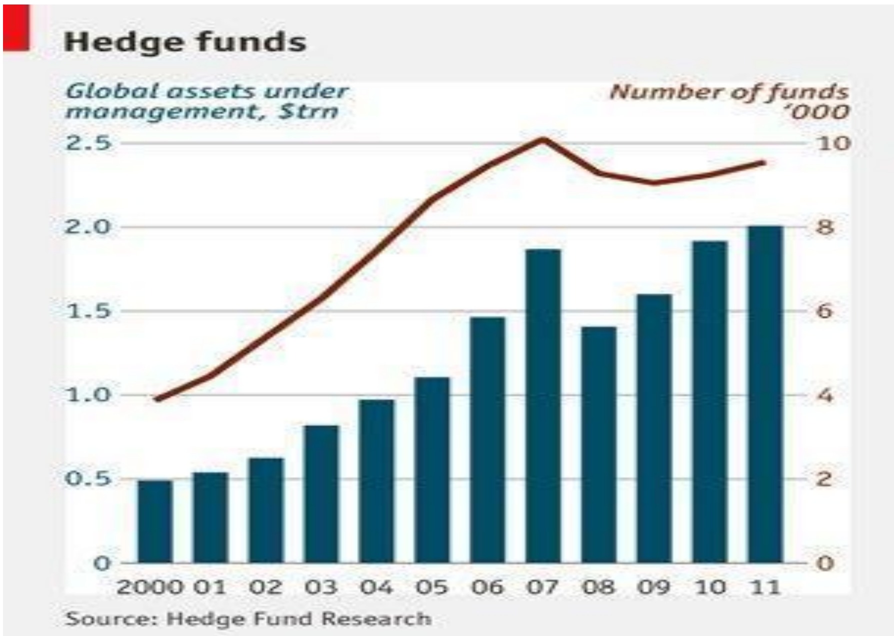
3. Hedge fund performance

"All right, but apart from the sanitation, medicine, education, wine, public order, irrigation, roads, the fresh water system and public health; what have the Romans ever done for us?"
-John Cleese as Reg in "Life of Brian"

Alright, but apart from the uncorrelated return stream, opportunities to co-invest with the brightest minds in finance, access to niche investment strategies and consistently outperforming all other mainstream asset classes; what have hedge funds ever done for us?

If money talks, the message is clear; investors are happy with their hedge fund allocations. Data from index provider hedge fund research (HFR) indicates the industry has stabilised post the traumas of 2008. Even if the number of funds has not fully recovered, assets managed by the industry are now back at their previous USD 2 trillion peak.

What about leverage? Do not hedge funds use it to punch above their weight in terms of the amount of assets they control in relation to their assets under management? Our experience indicates not; hedge fund leverage is well within sensible limits, particularly in the context of that used by bank trading desks. "Hedge funds are presently leveraged one to three times; if they are mad, five times; if they are insane, 10 times... but 15 or 20 times was normal for bank prop desks" Michael Hintze, the Chief Executive of the USD 9 billion London-based hedge fund CQS, told the Financial Times in 2010. Whilst he may be talking his own book, in aggregate we broadly agree with Hintze's 3x geared estimate. Furthermore, the most leveraged strategies (typically fixed income and futures related) tend to be in the largest and most liquid of the financial markets. It is also a fact that even if hedge fund managers wanted to pile excess leverage into their strategy the scarcity of bank capital has made this more difficult post 2008. As Nick Roe, global head of prime finance, said to the FT "Gone are the days of free balance sheet".



Despite the normalisation of their assets under management, hedge funds remain very much a niche asset class in relation to the broader financial universe. According to their website the world's biggest bond managers PIMCO had

Data source: Miport, May 2012

USD 1.36 trillion in assets under management as of 31st December 2011 (although this number will almost certainly include an allocation to hedge funds), i.e. one bond firm has more than two thirds of the assets of the entire hedge fund industry under management! The market cap of the S&P 500, again as of year-end 2011, was USD 11.4 trillion. According to the BIS (Bank for International Settlement), there were USD 65.166 quadrillion (!) notional in foreign exchange derivatives, USD 6.841 quadrillion notional in equity linked derivatives and USD 25.182 quadrillion notional in credit default swaps all outstanding as of June 30th 2011.

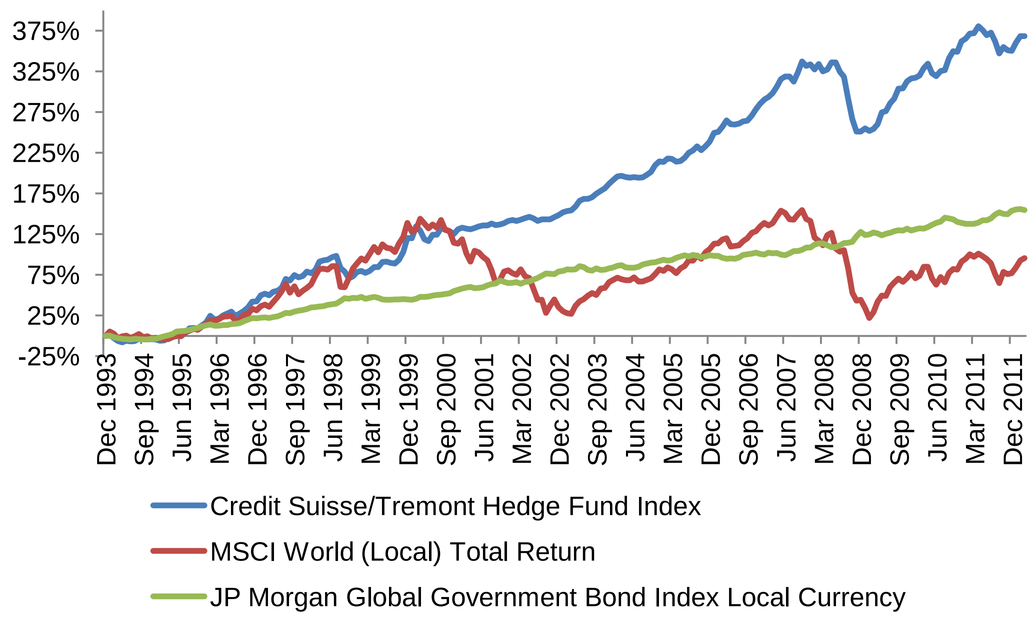
In summary, whilst they are undoubtedly becoming more of a mainstream asset class, hedge funds remain minnows in the context of global financial markets.

How about the criticisms over performance. How have hedge funds performed? The answer, according to one of the longest running industry indexes, is very well. The Dow Jones Credit Suisse Hedge Fund Index ('Tremont') is asset-weighted, comprises of approximately 8,000 funds. The funds have a minimum of USD 50 million assets under management, a 12-month track record and audited financial statements. The Index is calculated and rebalanced on a monthly basis and reflects performance net of all hedge fund performance fees and expenses.

Since its inception in January 1994 up to the end of March 2012 (the last date available at the time of writing), the index has returned an average of +8.83% per year with volatility of +7.59%.

Putting these numbers into context, equities in the form of the MSCI World Local Index including dividends returned +3.74% annualised over the same period with volatility of 14.70%. Bonds, despite the period including the most dramatic cycle of coordinated rate cuts in history, returned +5.26% annualised with volatility of 3.18%. Furthermore, unlike equities, the hedge fund index is now above its pre 2008 peak. If a hedge fund investor with spectacularly bad timing had made his one and only allocation at the end of October 2007- i.e. the top of the market prior to 2008, he would still be sitting on a positive return of +7.17% as of the end of March 2012. An equity investor over the same period would have seen a loss of -23.23%. So whilst 2008 was clearly a difficult period for hedge fund managers, it would have to be a very recent investor in the asset class to be sitting on a negative return.

Hedge fund, equity & bond index performance – December 1993 to December 2011



Data source: Miport, May 2012

4. Are Hedge Funds' best years behind them?

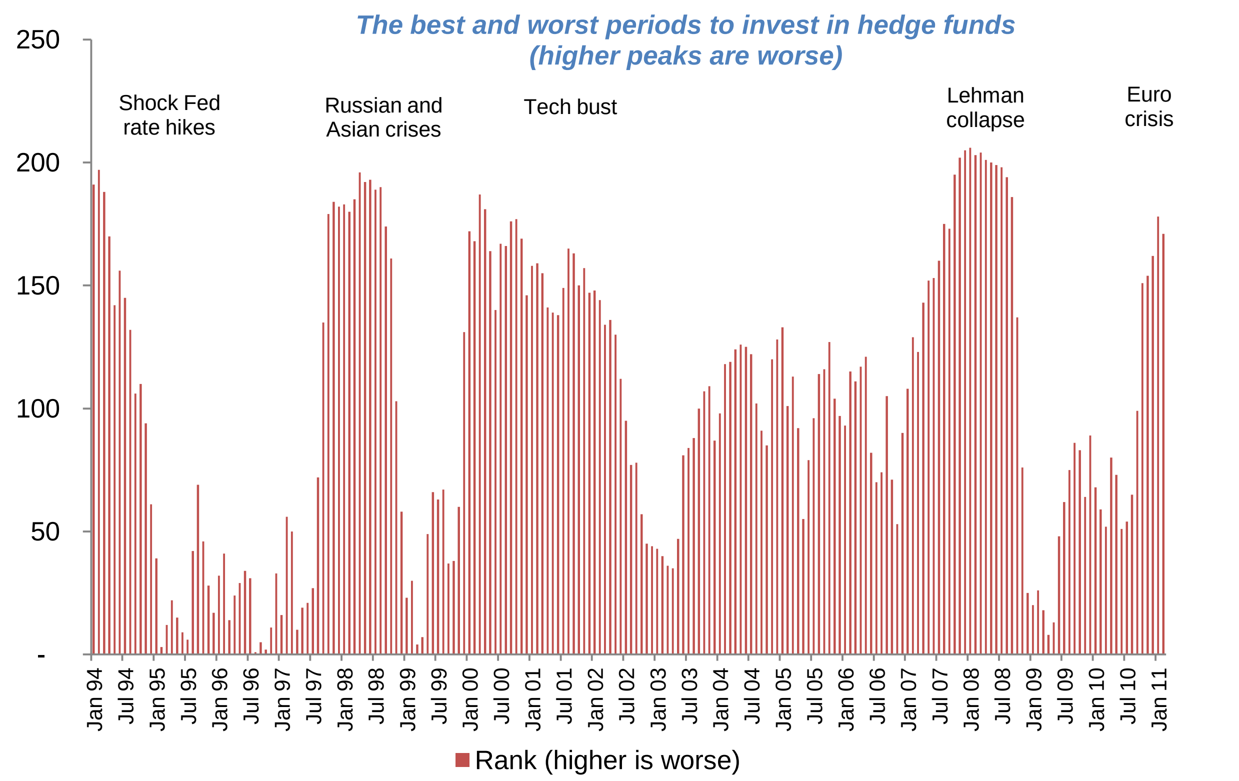
Mr Praline: I'll tell you what's wrong with it, my lad. It's dead, that's what's wrong with it!

Shopkeeper: No, no, it's resting, look!

- The dead parrot sketch, Monty python's flying circus

Despite their excellent long term returns, the fact remains hedge funds in aggregate lost money in 2008 and 2011. So, are they merely resting; or have hedge funds ceased to be? Are their best years behind them or do they still have the capacity to generate returns in line with their historic averages? On balance we think they do.

Looking at the Tremont Index's returns since inception yields some interesting results. For the purpose of equalising the comparison we deducted the risk free rate available at the time from each month's return; the rationale being it is harder and (more valuable to investors) to generate 5% in a year when the risk free rate is 0% as opposed to when it is 6% (this goes for any asset class, not just hedge funds). We therefore stripped out the 'free lunch' to see if the component of hedge fund returns generated purely by manager skill has deteriorated over time. The answer is not really. True, an investment into hedge funds around the start of 2008 would have yielded poor returns, but then again so would an investment in January 1994, January 1998 or early 2000. Similarly whilst an investment in early 1995 would have yielded spectacular returns, so would one in early 2009. To illustrate, we have ranked and charted every 12 month period of returns available to investors from January 1994 up to February 2011. A lower red bar on the graph typically precedes better 12 months' returns. Similarly, the higher the bar the poorer the subsequent 12 months returns. If hedge fund returns really were on a serial decline the chart would show the bars steadily increasing in height from the far left to right. Clearly this is not the case.



Data source: Miport, May 2012

What the study does show is hedge funds have always been vulnerable to systemic events. The Fed's decision to double interest rates over the course of a year in 1994, the Asian and Russian crises of 1997 and 1998, the initial shock of the tech bubble bursting in 2000, the collapse of Lehman Brothers in 2008 and the recent Eurozone crisis were all precursors for lower hedge fund returns. However, when compared to equities, hedge funds tend to have shallower, shorter lived drawdowns with stronger recoveries relative to the initial loss. Consider the case of an investor who invested in hedge funds at the worst possible time - at their previous peak in October 2007. He would have recovered all of his losses by September 2010, whereas an investor in global equities (including dividends) would have been nursing a loss of -30.40% over the same period.

Data source: Miport, May 2012

5. Hedge fund correlation characteristics

Hedge funds not only add value from an absolute return perspective, their correlation characteristics mean they also offer a great deal from a portfolio construction standpoint. Since its inception in January 1994, the Tremont Index has outperformed both equities (MSCI World total return in local currency) and bonds (JP Morgan Global Government Bond Index in local currency). Over the 18 year period for which hedge fund performance data is available they have only underperformed equities and bonds twice (in 1994 and 1998) and have been the best performing asset class of the three for seven out of 18 years (1995, 1996, 1997, 2004, 2006, 2007 and 2010). They have also shown little in the way of persistent correlation with either equities or bonds.

	Cumulative return	Annualised volatility	Correlation to hedge funds	Correlation to bonds	Correlation to equities
Hedge funds	+368.20%	7.60%	+1.00		
Bonds	+155.77%	3.18%	-0.01	+1.00	
Equities	+92.65%	14.73%	+0.63	-0.07	+1.00

One concern both we and our investors share is the recent increase in correlation hedge funds have displayed against equities. Over the 18 year period for which data is available, correlation is a useful (from a portfolio construction perspective) +0.63. However, it has increased to +0.80 since the equity market last peaked in October 2007. Such an increase in correlation has happened before; immediately post 1998's Russia crisis rolling 12 month correlation between equities and hedge funds rose to +0.88, before breaking down to an average of +0.38 during the prolonged equity bear market of the early noughties. So what has driven this latest increase in correlation and is it likely to persist? Our observation is all risk assets have recently shown increased correlation with each other as 'risk on risk off' sentiment has taken precedence over fundamentals. For example intra stock correlation within the Dow Jones Equity Index has until recently been at all time highs. From the 8th August until 29th December the 21 trading day (i.e. typical trading month) average has been at least 80%, peaking at 91.23%.

In other words, for almost half of last year the movement of the index could explain at least 80% of the movements of any of its underlying constituents. This was extremely unusual; correlation has briefly peaked above +0.80 over four periods since 1st January 2000, however it has never stayed at such peaks for such a prolonged period of time as it did over the second half of last year. Consequently any active equity related strategy (long-only as well as hedge) faced a headwind as diversifying hedges were nigh on impossible to find and stocks were driven by broader market movement as opposed to fundamentals. The good news is such a prolonged period of elevated correlation is unprecedented and since the start of 2012 it has steadily declined towards more normal levels. Consequently we expect hedge fund returns to normalise in that their correlation to equity markets should fall.

Data source: Miport, May 2012

6. What's the catch? The pitfalls of hedge fund investing.

So what is the catch? After all there is no such thing as a free lunch in the investment world and hedge fund investing is no exception. The truth is there are a number of unique risks associated with hedge funds, all of which potential investors must consider before making an allocation. As with all investments, you really need to understand what you are buying.

Illiquidity

Generally speaking, hedge funds are illiquid. For this reason alone it is unlikely they will ever be a core investment for anyone but the most specialised of investors. Whilst the industry does make sporadic attempts to produce more liquid offerings (whether it be listed hedge funds, structured products, 130:30 funds and more recently UCITS) the reality is the bulk of hedge fund strategies (certainly most of the interesting ones) are illiquid. Furthermore, trying to offer more liquid versions of what are fundamentally illiquid investments is a dangerous game. At best it leads to disappointing performance and at worst it leads to severe losses. Our view is that whilst nearly all futures based strategies and some equity strategies are suitable for weekly or possibly daily liquidity, most other hedge fund strategies are not.

Investors must therefore have sufficient expertise to judge whether the liquidity terms offered by their hedge fund managers are in line with the liquidity of the underlying securities in the portfolio.

For example, investing in a distressed debt manager offering daily liquidity would be a recipe for disaster because of the fundamental mismatch between the manager's terms and the underlying liquidity of the instruments in the portfolio. It also indicates the manager knows nothing about the asset class he purports to be an expert in. We once had a telephone conversation with distressed debt hedge fund manager which started (and ended very shortly) as follows:

Momentum: "...so what are the liquidity terms"
Manager: "they're supposed to be quarterly, but what would you like?"
Momentum: "??!!"

On the basis he had probably had similar conversations with other people, the manager in question revealed three things in this short-lived exchange:

1. He did not care about the risks associated with borrowing short and lending long;
2. He was willing to put his existing clients at a disadvantage to win new business
3. It was unlikely his current client base really understood the asset class.

We did not invest.

“A man I do not trust could not get money from me on all the bonds in Christendom.”
— J. Pierpont Morgan, American financier and banker, 1837-1913

Lack of regulation, fraud and operational risk

Whether it is holders of Polly Peck, Parmalat, Tyco, WorldCom or Enron equity, or indeed holders of Greek sovereign debt; any investor is vulnerable to deception by insiders. By the same token, anyone can buy a brass plaque, hire an office in mid town Manhattan and announce they are a hedge fund manager. Indeed lots of people have, although most of them set up in Florida. It is therefore absolutely critical for investors to conduct thorough due diligence and background checks as part of their pre-investment process. Furthermore any hedge fund manager, at least any manager worth investing with, is likely to be smarter than you. He also knows much more about his particular strategy than you ever will. As a potential investor you are therefore at an immediate disadvantage. However, if you accept this information asymmetry as a fact of life (when it comes to investing), you are then in a position to do something about it to minimise the potential risks.

There is no substitute for experience and knowledge of the market; it is staggering how often the same faces with selectively edited backgrounds keep cropping up trying to attract capital. Over the years we have discovered (and vetoed!) an Asian manager with unpaid mobile telephone bills, a manager purporting to run a European equity fund trading US Pink sheets from his shed in Mallorca, funds with potential cross liabilities, managers without independent service providers, firm’s without independent directors - the list goes on. The point is there is no universally recognised minimum standard or best practise. Investors have to set their own standards and do sufficient work to ensure they only invest with managers that meet these standards. It is not particularly glamorous and it is hard work, but it is an absolutely essential component of successful hedge fund investing.

In short the easiest way to make money is to not lose it and the easiest way to lose it is through taking operational risk.

Buyer beware: the assumption amongst some investors that UCITS structures negate the need for independent due diligence is also a real concern. After all, despite its UCITS wrapper, the New Castle Equity Market Neutral fund’s two co-managers were still charged with insider trading by the SEC. This is not to say there is anything wrong with UCITS, just that the wrapper should not be used as a short cut. Part of the due diligence process should also be about setting minimum requirements in terms of transparency between manager and investor and USING THEM! All the transparency in the world is of no use if it is not used and interpreted in a timely and intelligent way.

We believe the differences in strategies and managers make a one size fits all set of risk metrics useless. Investors must collect data and create a unique and specific risk template for every manager they invest in.

No benchmarks

Whilst hedge fund managers are typically put in broad strategy buckets by investors, the reality is all strategies and managers are different - there are as many strategies as there are managers. Furthermore, at any one point in time there will be managers making money and managers losing money; so for every RAB Special Situation fund (-69.72% in 2008) there is a CQS ABS (+72.82 in 2008) or BlueTrend (+43.35% in 2008). Similarly, there are no universally accepted benchmarks in terms of strategy or manager allocation. The result is a double edged sword in that investors can select from an enormous universe of potential managers, but they need to be clear about the potential risks associated with each and how they potentially fit into a balanced portfolio. Whilst there is potentially something for everyone in terms of risk appetite and available strategies, investors need to be very clear about what they expect from their hedge fund exposure. Is it tail protection, capital preservation, steady capital appreciation, do they want to get rich or stay rich, how much correlation with equities can they tolerate, what is the time horizon and liquidity restrictions? The reality is most investors have a wish list akin to wanting equity upside with zero tolerance for losses, daily liquidity and no fees! The job of any responsible advisor is to establish which of these mutually contradictory desires should take precedence and help tailor a portfolio or recommend a product accordingly.

Vulnerability to systemic risk

Hedge funds are not a silver bullet; they are not guaranteed to make money in all market conditions. In aggregate they are a risky asset class and as such they have always been vulnerable to systemic shocks. 2008, when the Tremont Index lost -19.07%, is the most recent and severe example. That said there are a number of strategies and managers that can and do generate outsized returns during periods of severe stress, albeit with differing degrees of negative carry during more benign periods. The key is to be able to identify these managers ahead of time. Similarly once the worst is over and the systemic issues have passed, hedge funds will tend to make money even if equities continue to sell off. For example hedge funds started generating positive returns in late 2008, prior to the equity market bottoming in March 2009, they also made money consistently though the long equity bear market post the dot.com bust.

"There is only one boss. The customer. And he can fire everybody in the company from the chairman on down, simply by spending his money somewhere else."
— Sam Walton, Wal-Mart founder

Multiple liquidity terms, gating and restricting liquidity

Sam Walton clearly never had a redemption request restricted by a hedge fund manager. In 2008 many investors seeking to get capital returned had a rude awakening as managers dusted off long forgotten clauses in their documents to restrict liquidity. Ralph Stockman's sentiment that "a man has no more character than he can command in a time of crisis" was never truer than at the peak of the Lehman crisis. Some hedge fund managers had no choice but to restrict liquidity; others chose fee income and track record preservation over the best interests of their clients. Whilst it was an extraordinary time, clues were available to investors leading up to the crisis. Managers offering artificially generous liquidity terms in relation to the underlying assets are always going to be vulnerable to redemption requests. Similarly, any manager in highly leveraged illiquid positions will always be more likely to restrict liquidity in market downturns; after all, the only thing worse than being trapped in a falling market is being forced to realise losses in a falling market. 2008 showed how important it is for investors to ensure they understand their managers, the underlying portfolios, to read the offering memorandum and to construct their portfolios accordingly.

In summary, investments in hedge funds can be extremely rewarding but there are potential pitfalls. So what is the best way to gain exposure? There are broadly three options; invest directly with hedge fund managers, invest in a replicator or invest through a fund of hedge funds. All have their pros and cons.

Data source: Miport, May 2012

7. What is the best way to get hedge fund exposure?

"In those days he was wiser than he is now; he used to frequently take my advice"
— Winston Churchill

Direct investment and consultants

The direct investment route is attractive for many, as investors can construct portfolios completely in line with their risk / return parameters whilst minimising fees. However, as the earlier points illustrate, hedge fund investing is not simple; there are pitfalls and it requires skilled personnel with the requisite experience. The alternative is to outsource some or all of the selection expertise to a third party. Investment consultants could be a potential solution, although choosing a consultant (given the niche skills required) has its own difficulties. The client will need the skills, experience and confidence to judge whether or not their consultant is any good at selecting hedge fund managers. (it is a very different skill set from researching equity and bond managers) After all, few consultants invest directly in hedge funds, nor do they typically publish an investment track record. It is very difficult to establish which hedge funds they put their clients into in 2008 or how their clients have fared in terms of returns or having liquidity restricted. Furthermore, consultants can be more restricted in terms of the managers they will look at due to pre-defined critium; minimum requirements are typically a three year track record and at least USD 1 billion of assets under management.

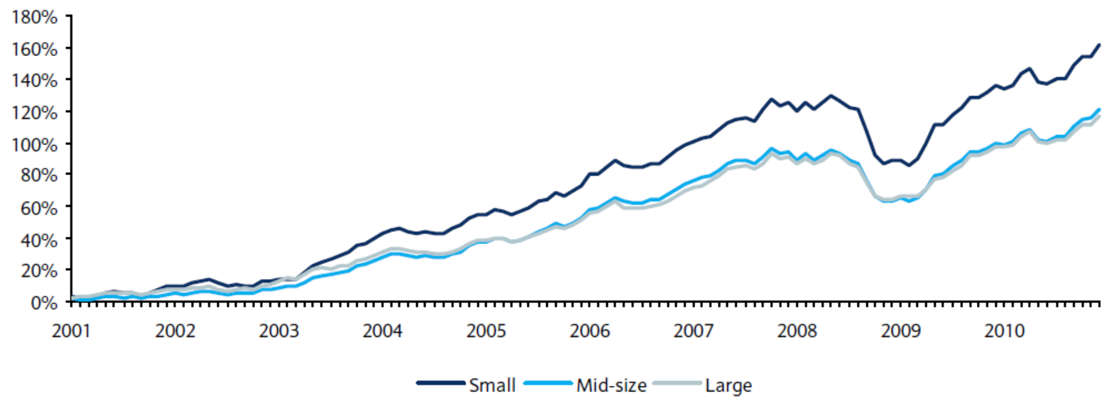
Big fund blow ups: big ain't always beautiful

We have seen no evidence suggesting clients are better served by the restrictions mentioned above. There is no guarantee that large funds with long track records are less likely to have problems than smaller ones - just ask investors in Amaranth, Peloton, Atticus, Ospraie, Drake, Cheyne or Long Term Capital Management! In simple terms, size and track record are no free passes on the requirement for due diligence. However, they are free passes for lacklustre returns; there are numerous studies indicating small and young are best when it comes to profiting from investing in hedge funds. Perhaps the best known study is Aggarwal and Jorion's 2009 paper 'The Performance of Emerging Hedge Funds and Managers'. Adjusting for survivorship bias they found strong evidence that the first two to three years of a hedge fund's existence are the best time to invest, with each additional year of age decreasing performance by -42bps.

This is not to say established managers cannot make money; just that their best days are probably behind them by the time the average consultant gets interested. Our own internal research indicates a similar phenomenon, as does Simon Lack in his recent book 'The Hedge Fund Mirage' and a report published by Barclays Capital in April 2011. The Barclays report concludes that on average small funds outperform medium and large funds, although the spread of potential outcomes makes small manager selection more important. The report also showed that on average young funds generally outperform middle aged and old funds.

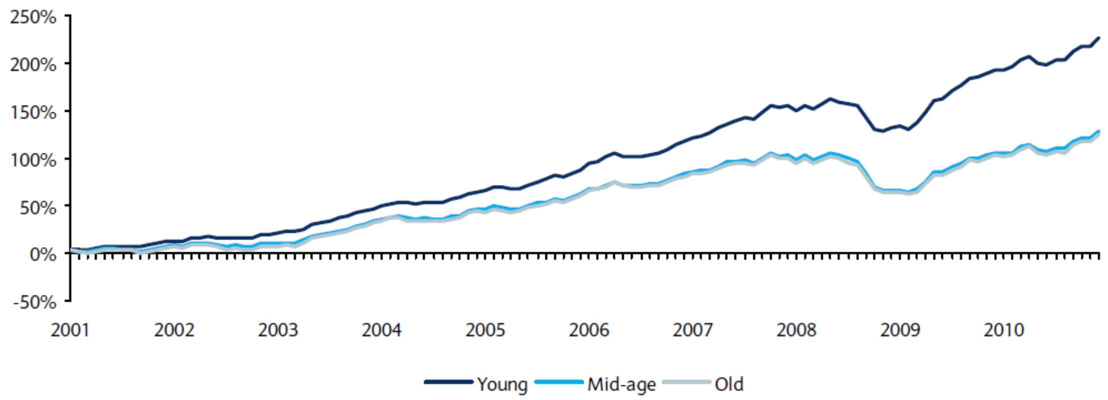
Data source: Miport, May 2012

Cumulative returns of size based hedge fund indices January 2001 to December 2010



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Small	9.31%	3.42%	23.49%	11.16%	11.60%	14.43%	13.78%	-16.10%	24.52%	11.36%
Mid-size	4.48%	3.16%	16.62%	9.08%	11.42%	13.85%	11.79%	-15.78%	21.89%	10.76%
Large	7.12%	3.60%	16.13%	7.13%	9.60%	12.40%	12.42%	-13.94%	20.08%	9.64%

Cumulative returns of age based hedge fund indices January 2001 to December 2010



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Young	12.02%	7.42%	22.42%	12.01%	14.16%	15.81%	17.21%	-9.10%	26.36%	11.04%
Mid-Age	7.49%	2.60%	20.69%	9.99%	10.47%	13.30%	11.48%	-18.67%	23.88%	10.75%
Old	6.10%	0.72%	23.11%	9.90%	10.85%	13.07%	10.58%	-17.71%	23.30%	10.95%

Source: Barclays Capital, Hedge Fund Plus, April 2011

By number, small funds represent 68.4% of the entire hedge fund universe; medium funds an additional 23.6% and large funds only 8% (source Barclays). However, large managers control approximately 85% of assets. AR Magazine in March 2012 reported restricting the search universe to those US funds with a minimum of USD 1 billion assets under management yielded just 241 single manager funds. Given the concentration of large funds in the US it therefore seems unlikely the global universe of USD 1 billion managers is much larger than 300 names; or 3% of the hedge fund universe by number using HFR data. Furthermore, the investable number of funds is likely to be much lower given larger managers are more likely than smaller managers to be closed to new investments. The simple truth is making money is difficult enough; it is therefore completely irrational to stack the odds even further against it by only looking at 3% of available managers.

Data source: Miport, May 2012

Our experience also shows there are factors other than performance in favour of smaller managers. Access to key decision makers and transparency is better. Since the client base tends to be smaller, managers are happy to talk to clients whenever required, something that simply does not happen with larger managers where investors are typically limited to one meeting a year. Furthermore, investment professionals at big houses are normally accompanied by a dedicated investor relations person to ensure nothing "off message" (i.e. useful) gets revealed in meetings. Smaller managers are hungrier and their interests with their clients are better aligned. A manager charging a 1.5% management fee on USD 20 billion will have a very different investment approach compared to one charging 1.5% on USD 100 million. Finally, it is easier to manage smaller amounts of capital. There are simply more opportunities and niche trades available; at any point in time there will be more trades available to generate 10% on USD 100 million than there are to make 10% on USD 20 billion! We are not saying large managers cannot generate returns; we are saying their best days are likely to be behind them and the odds favour smaller, younger managers.

Replicators

Hedge fund replicators are designed to offer beta exposure to the asset class. They do not invest directly in hedge funds, instead the structurer (typically an investment bank - big flashing warning light!) seeks to replicate the return profile of a portfolio of hedge funds. They do so through regression analysis using a hedge fund index and a number of beta factors. The model will then blend the factors with the highest explanatory powers and replicate them through going long and short a series of foreign exchange, bond, rates and equity futures. The main problem for potential investors is the huge spread of returns generated by the replicators when the whole point of an index is to achieve the same return as the target market. However, the returns of seven hedge fund replicators over the period May 2008 to December 2008 (when the hedge fund industry was most stressed) varied between down 1% and down 28%. The difference in returns clearly indicates there is an element of skill required to distinguish between hedge fund replicators, entirely defeating the object of index investing.

Funds of hedge funds and Momentum Global Investment Management's expertise

"This is no time for making new enemies."
— Voltaire, on being asked to renounce the Devil, on his deathbed

Many investors have made the decision to renounce the fund of hedge fund model, indeed if the financial press is to be believed its demise is long overdue. However, funds of hedge funds represent a quick and easy way for investors to get exposure to hedge funds and they still account for approximately 35% of all assets invested in the asset class. Whilst some have clearly over charged and under delivered in terms of their due diligence and performance, should investors write off the entire asset class? We believe not. There are products available with long term performance exceeding that of the Tremont Index net of all fees. Furthermore it is easy to establish through their published and audited track records whether a manager has been successful. In some ways the events of 2008 have done investors a favour in that it was the ultimate test. A track record through 2008 makes it much easier to identify fund of fund managers who have demonstrated the requisite skills in portfolio construction, manager selection and liquidity management. So, what do investors need to look for from a potential fund of funds manager? Evidence of a consistent approach, an audited track record over at least one investment cycle including 2008, no back tested data, an experienced stable team and no history of side pocketing or restricting liquidity would all be good places to start. Similarly, a long standing history of adding value through both manager selection and asset allocation net of all fees should be a pre-requisite, along with a proven ability to successfully invest with smaller, younger managers where returns are typically better. Clients wanting to invest in the large well known hedge funds should be prepared for future returns to disappoint. Those looking to get the best from investing in hedge funds may be better served by moving away from the herd currently crowding into the big funds and re-engaging with some of the investment industry's black sheep.

John Caulfield, CIO Alternative Strategies

Data source: Miport, May 2012

Manager meetings

	Long Only		
Manager	**Asset Class**	**Date**	**Location**
Tradewinds	GEM	01-May-12	London
Jennison	Global	01-May-12	Boston
Vulcan	Global / US Small Cap	02-May-12	Birmingham, Alabama
Hotchkis & Wiley	Global	03-May-12	Los Angeles
Cove Street Capital	US Small Cap	03-May-12	Los Angeles
Neovara	Mezz Fund	03-May-12	London
BNY Mellon AM	Global Bonds	03-May-12	London
Tradewinds	GEM	04-May-12	Los Angeles
Huber Capital	US Small Cap	05-May-12	Los Angeles
Baobab	Global	08-May-12	London
ING	Loans	09-May-12	London
Pimco	IG Credit	09-May-12	London
Schroders	Global Economic Outlook	10-May-12	London
Muzinich	High Yield	10-May-12	London
Wellington	Global	11-May-12	London
Majedie	Global	15-May-12	London
Prusik	Asia ex Japan	15-May-12	London (Conf Call)
Sky Investment Council	Global	15-May-12	London (Conf Call)
Schroders	Strategic Bond Fund	15-May-12	London
Invesco	Liquidity	16-May-12	London
Cohen & Steers	Property	16-May-12	London
Artemis	Global	17-May-12	London
Principal	Property	17-May-12	London
TwentyFour AM	RMBS	17-May-12	London
BBH	US Large Cap	21-May-12	London
Victoria 1522	GEM	22-May-12	London (Conf Call)
Fidelity	Global Inflation	22-May-12	London
Hotchkis & Wiley	Global / US Large Cap	25-May-12	London
S&P	Credit default research	25-May-12	London
BlackRock	UK	29-May-12	London
Polar	GEM	29-May-12	London
Pioneer	Global Aggregate	30-May-12	London
Stratton Street	EMD	31-May-12	London

	Hedge Fund		
Manager	**Asset Class**	**Date**	**Location**
	Event driven	01-May-12	London
	Convertible arbitrage	01-May-12	London
	Macro	01-May-12	London
	Macro	01-May-12	London
	Credit	01-May-12	London
	FIA	02-May-12	London
	Credit	02-May-12	London
	Credit	02-May-12	London
	Volatility	02-May-12	London
	Equity long / short	03-May-12	London
	Macro	03-May-12	London
	Equity long / short	03-May-12	London
	FIA	03-May-12	London
	Equity long / short	04-May-12	London
	Equity VS	04-May-12	London
	Convertible arbitrage	04-May-12	London
	Credit	08-May-12	London
	Equity	08-May-12	London
	REITS	13-May-12	London
	FIA	14-May-12	London
	Equity	15-May-12	London
	Equity	15-May-12	London
	Equity long / short	15-May-12	London
	Equity long / short	15-May-12	London
	Event driven	16-May-12	London
	CTA	17-May-12	London
	Convertible arbitrage	21-May-12	London
	Credit	21-May-12	New York
	Distress	21-May-12	New York
	Convertible arbitrage	21-May-12	New York
	Macro	21-May-12	New York
	Credit	21-May-12	New York
	Credit	22-May-12	New York
	FIA	22-May-12	New York
	Credit	22-May-12	New York
	Credit	22-May-12	New York
	Capital structure arbitrage	22-May-12	New York
	Distress	22-May-12	New York
	Event driven	23-May-12	New York

	Hedge Fund		
	Volatility	23-May-12	New York
	Credit	23-May-12	New York
	FIA	23-May-12	New York
	Equity long / short	23-May-12	New York
	FIA	23-May-12	New York
	FIA	24-May-12	New York
	FIA	24-May-12	New York
	Credit	24-May-12	New York
	Volatility	28-May-12	London
	CTA	31-May-12	London

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Our investment mandates in alternative strategies and hedge funds permit us to invest in unregulated funds that may be highly volatile. Although alternative strategies funds will seek to follow a wide diversification policy, these funds may be subject to sudden and/or large falls in value. The illiquid nature of the underlying funds is such that alternative strategies funds deal infrequently and require longer notice periods for redemptions. These Investments are therefore not readily realisable. If an alternative strategies fund fails to perform, it may not be possible to realise the investment without further loss in value. These unregulated funds may engage in the short selling of securities or may use a greater degree of gearing than is permitted for regulated funds (including the ability to borrow for a leverage strategy). A relatively small price movement may result in a disproportionately large movement in the investment value. The purpose of gearing is to achieve higher returns associated with larger investment exposures, but has concomitant exposure to loss if positive performance is not achieved. Reliable information about the value of an investment in an alternative strategies fund may not be available (other than at the fund's infrequent valuation points).

Under our multi-management arrangements, we selectively appoint underlying sub-investment managers and funds to actively manage underlying asset holdings in the pursuit of achieving mandated performance objectives. Annual investment management fees are payable both to the multimanager and the manager of the underlying assets at rates contained in the offering documents of the relevant portfolios (and may involve performance fees where expressly indicated therein).

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