

# An Alternative Scenario

## *The enduring logic of a well-constructed hedge fund portfolio*

As a result of the turmoil that characterized the equity and fixed-income markets these past 12 months, institutional investors are seriously reconsidering the roles hedge funds play in their overall portfolio. *ai5000* talked to three Northern Trust executives about the lessons that institutional investors can take away from this period of unprecedented volatility: John Krieg is Director of Global Investment Product Management; Jens Vinje is Product Manager, Hedge Fund of Funds; and Anthony Zanolle is Senior Portfolio Manager, Hedge Fund of Funds. Despite the returns experienced during 2008 and the expectations of increased regulation and transparency, deleveraging, and fee scrutiny, they believe the value proposition of hedge funds remains intact.



**ai5000:** In both relative and absolute returns, how did hedge funds on a composite basis fare this past year?

**Vinje:** It makes sense to look at both absolute and relative performance together because looking at one or the other in isolation demands including caveats in order to give a clear or fair depiction of performance. On an absolute basis, 2008 was not a pretty year: Major hedge fund composites—and this is aggregating all sorts of strategies—lost in the neighborhood of 20%, with funds-of-funds composites posting similar results. The experience was particularly painful for some investors because they had really bought into the notion of positive absolute returns irrespective of the broader market and, if you are evaluating your hedge fund performance relative to a zero return, T-bill return, or something similar, you clearly would be disappointed with the results.

On a relative basis, however, hedge funds performed better than a lot of traditional asset classes. If you assume a loss for the average hedge fund of 20%, outperformance versus major U.S. and international equity indices was in the range of 17% to 20%, and versus various high-yield bond indices was about 7%. So, relative to a significant piece of many investors' portfolios, hedge funds posted strong performance.



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*“It really would be next to impossible to predict the second and third order effects of the crisis and how those effects would affect performance.”* — Vinje

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In sum, on the one hand, you’ve got performance outside of expectations, large withdrawals, and liquidity issues, but, on the other hand, you’ve got strong relative performance and there are some significant dislocations in the market now that may be accessed most effectively by unconstrained vehicles like hedge funds—which is all to say that past performance does not necessarily indicate what the future’s experience will look like.

**ai5000: Drilling down to specific hedge fund category performance, was the level of dispersion in any way predictable?**

**Vinje:** There was a very high level of dispersion among various hedge fund strategies, and further among managers within those strategies. You can always expect some level of dispersion between strategies for a lot of factors: different markets invested, securities employed, degree of risk, and amount of leverage. As a result, in different market environments, some strategies will perform better or worse than others, and you see this in looking at relative or ranked performance by strategies over time—the rankings are

rarely the same from year to year. Now, if you had the foresight to predict extreme market conditions, you would likely be inclined to predict also that the spread between various strategies would spike.

It really would be next to impossible to predict the second and third order effects of the crisis and how those effects would affect performance. As a consequence, while it’s not surprising that an environment of elevated volatility saw increased performance dispersion among strategies, making the predictions on an ex-ante basis as to which strategies will perform best and worst would be extremely difficult.

**ai5000: Are there specific manager characteristics that can be identified that account for the performance dispersion within like hedge fund categories?**

**Vinje:** There were some factors—and they tended to be unique to various strategies—that appeared to explain some of this performance differential last year. In the hedged equity space, one such factor is manager size. A lot of Investors in the past probably were attracted to the large

marquee names because of their supposed superior risk management abilities and the notion that they were “safer” than younger or smaller hedge funds, which does seem rational. However, the sheer size of some of those funds made it very difficult for them to navigate markets last year. Managers running these large portfolios—even if they held historically very liquid equities—became constrained in their ability to adjust their portfolios in response to market shocks, while managers running smaller portfolios were able to react and trade more nimbly.

Another factor akin to agility determining performance in the long/short credit and equity spaces was whether or not managers realized the nonfundamental forces acting on valuations, and whether or not they factored those forces into their security selection. There were a number of these nonfundamental factors significantly having an impact on prices—particularly in the second half of last year—including the potential widespread impact of the financial crisis, liquidity traps fueled by mutual fund and hedge fund redemptions, political interference, and the like. Managers who

were married to fundamentals without an eye toward these other factors were caught off guard by the severity of the declines in what they had believed to be very cheap stocks. Those managers who did take such exogenous factors into account typically ran lower net books and managed with discipline to their risk budgets, not their return targets.

**ai5000: What are the most valuable takeaways from 2008 from an institutional investor standpoint with regard to hedge funds? Specifically, what lessons were learned that now can be applied to manager and strategy selection?**

**Vinje:** if nothing else, we need to take away from 2008 some important lessons for hedge fund investing. The first lesson is that manager selection is fundamentally important to performance. The dispersion of performance between managers in a given strategy speaks to the consequences of choosing poor, mediocre, or superior managers. A thorough understanding of a given manager and full confidence in his/her skill, personnel, structure, and operations are prerequisites to any



*“There has been a wake-up call that due diligence is critical, and not just a ‘check the box’ exercise.”* — Zanolla

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potential investment. Second, given weak persistence of returns to individual hedge funds from year to year, the 2008 experience speaks to the need for an actively managed portfolio versus a passive, buy-and-hold one. A number of factors can change either externally, meaning in the broader market, or internally, within a given hedge fund, that would invalidate the original investment thesis. The fund that may have performed very well last year should not necessarily be a core holding this year. Consequently, continuous dialogue and due diligence of all of a portfolio’s hedge funds are very important. Third, last year’s experience highlights the risks to highly concentrated hedge fund portfolios. Volatility spikes, concentrated holdings, illiquidity, politicians: Many of these forces conspired to create massive and rapid market shifts last year that caught some of the most astute risk managers by surprise. Even in the case of a well-run fund, there is significant idiosyncratic risk and, as with most types of investments, investors should be very wary of having too many eggs in one basket.

**ai5000: How will the events of these last nine months affect investor due diligence? How will gatekeepers be viewed?**

**Zanolla:** It’s clear that given the recent events in the hedge fund industry — Madoff, Stanford, Petters — there has been a wake-up call that due diligence is critical, and not just a “check the box” exercise. Investors now will place additional emphasis on due diligence, not only on the fund but also extending to service providers and counterparties. Additional due diligence and scrutiny will be placed on auditors and administrators in particular—as these functions are key to independent verification of the existence and pricing of fund assets. Counterparty exposure also has come to the forefront in the wake of the collapse of Lehman Brothers. Complex derivative portfolios may be constructed to weather market turmoil but remain vulnerable to the counterparties the trades are entered with. With that said, many investors who previously invested directly may be overwhelmed with these risks and look to gatekeepers to provide the additional layer of due diligence they may not be equipped to handle. Larger investors may have the

critical mass to commit additional people and resources to address the issues, but smaller institutions and individuals—where it does not make economic sense to staff up given the asset levels they invest—will likely look to gatekeepers, whether they be funds of funds or consultants, as a solution.

**ai5000: Will hedge fund risk management (however defined) become singularly important? More important than it is in the long-only sector?**

**Zanolla:** I think risk management is more important with respect to hedge funds versus the long-only sector. Hedge funds are unconstrained; they may use leverage, futures, options, and an array of other derivative instruments in their investment approach. The aperture to take risk is much wider in a hedge fund than in a long-only product where the investment approach is much more defined and benchmarked. In this regard, given the experience of the last 12 months, risk management is likely to stay on the front burner for a while. It’s important for investors to understand the risk management philosophy of a hedge fund—what risks they take and how much. How do they measure risk? How is risk likely to change in the portfolio over time? It’s key to establish a set of parameters and expectations for each fund at the onset and to monitor them on an ongoing basis.

**ai5000: How much more transparency will institutional investors demand now—and in what areas?**

**Zanolla:** Transparency has become a hot topic of late. There was a trend toward

increased transparency prior to Madoff, but it has accelerated dramatically since this fraud was uncovered. Many institutional investors are exploring a move to separate accounts where not only do they get complete position-level transparency, but also they can see all the trading activity and maintain an additional level of control as the account owner. In terms of areas, it has been across the board, but there has been increased focus on pricing, leverage, and liquidity—particularly in credit and relative value strategies. Pricing is less of an issue with exchange-traded instruments, such as equities, currencies, and futures, but remains an issue in the credit markets. Transparency in these strategies is helpful in ensuring that the manager and/or the administrators are marking the book properly and that the pricing process itself is clearly defined and transparent. The issues around transparency and leverage have been long-standing. There is no industry standard for reporting leverage; funds report leverage in their own way. For example, with CDS contracts, we’ve seen instances where some funds report the notional value of a contract while others only report the exposure based on the profit or loss on the position, which show very different results. These are some of the challenges that investors are looking to address through increased transparency.

**ai5000: Do hedge funds of funds face the same challenges in this regard as the underlying hedge funds?**

**Zanolla:** They definitely do. Many funds of funds already disclose their positions; where the challenge lies is proving to their

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clients that they know what is in their underlying fund investments, and that the risks are identified, monitored, and managed. Funds of funds investors are asking the funds of funds about their due diligence process and what they are doing to ensure they do not have the next Madoff in their portfolio. This is driving the demand for increased transparency and separate accounts as funds of funds managers look to beef up their capabilities in order to put their own investors' fears to rest.

**ai5000: Leverage will, one presumes, find a way of reinventing itself—but how?**

**Zanolla:** This is less of an issue in the current environment. While it is true that prime broker financing is more difficult and costly to obtain, many of the asset classes that were leveraged by the prime brokers, such as converts and loans, have dropped to levels where they present potential attractive rates of return on an unlevered basis. The increased level of volatility also creates trading opportunities without the need for large amounts of leverage. Leverage still is available in many segments of the market through derivative instruments; futures, options, swaps are all means to obtain leverage for funds. At the end of the day, markets will continue to innovate and, if the demand for leverage returns, Wall Street will find a solution for them.

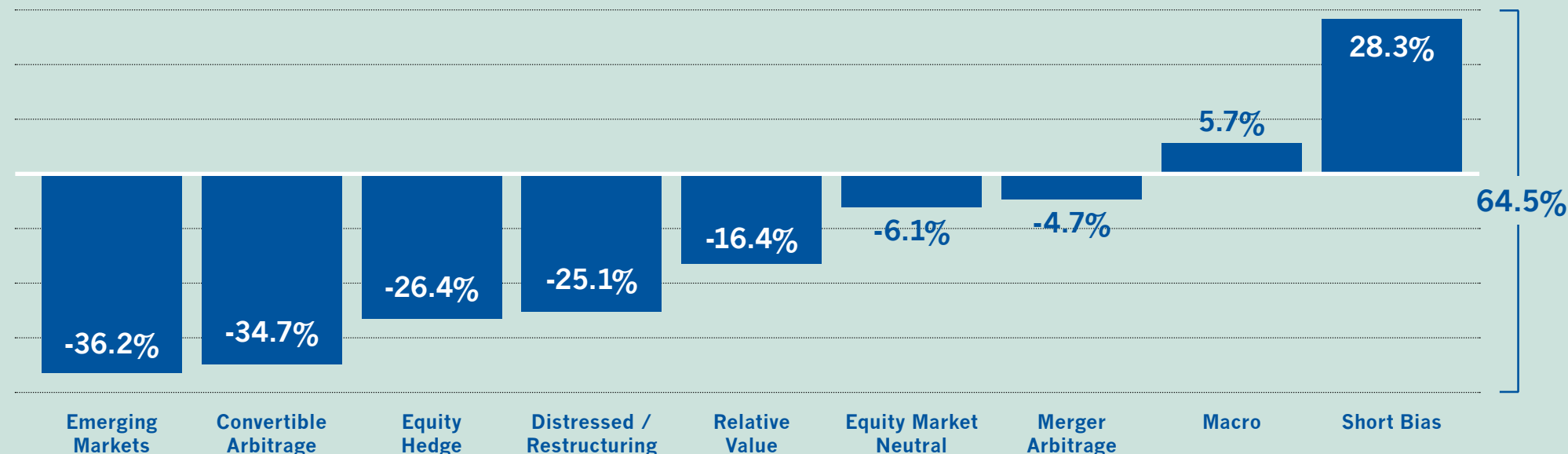
**ai5000: Whither hedge fund fees?**

**Zanolla:** We have seen a few different approaches in some areas with respect to fees. Managers that have had a liquidity mismatch are going back to investors seeking longer-term capital and are willing

**The hedge fund industry has seen a very wide dispersion of returns throughout a very volatile 2008. This dispersion is both between and within various hedge fund strategies.**

**Performance dispersion between hedge fund strategies**

HFRI Index Performance: 2008



Source: Hedge Fund Research, Inc., as of January 15, 2009. Returns are net of fees. Past performance is not indicative of future results.

to give a fee break for longer lockups or reduced liquidity. In other cases, managers with subpar performance have tried to entice investors to stay with reduced fees or modified high-water marks. Some of the new funds that are launching in this environment are offering discounts to investors who come into the fund in the first few months or who are willing to be part of the first \$100 million into the funds, for example. By and large, though, for managers that have performed in line with expectations, fees have remained steady.

**ai5000: How will institutions now use hedge funds in their portfolios?**

**Krieg:** Despite the returns experienced during 2008 and the expectations of increased regulation and transparency, deleveraging and fee scrutiny, we believe the value proposition of hedge funds remains intact. We believe investors will continue to use hedge funds as risk stabilizers or return enhancers in their portfolios. Also, we believe more nimble investment strategies (not buy and hold) are gaining traction with both institutional and personal investors and, as a result, the asset allocation used in the past may be replaced by more outcome-oriented approaches that tend to utilize a wider range of products and strategies—

including hedge funds.

**ai5000: Will portfolio construction itself change, or will the greater focus be on manager selection?**

Investors need to revisit their risk tolerance and investment horizon and increase their focus on both portfolio construction and manager selection. A well-structured portfolio must offer an attractive expected rate of return as well as good downside protection. Concentrated exposures, with their high degree of idiosyncratic risk, are harder to justify.

Manager selection and choice of hedge fund

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are critical aspects of portfolio performance as evidenced by the return dispersion among funds with various strategies. Investors can't overlook basic "blocking and tackling" due diligence because of a perceived need to invest with a hot manager.

### **ai5000: Do the benefits of funds of funds still loom as large in the post-2008 world?**

**Krieg:** An important decision for many hedge fund investors is whether to invest directly or via a fund of hedge funds approach. One of the historical arguments against a fund-of-funds structure was the added layer of fees or costs. However, these costs reflect a number of benefits and services, including full-time dedicated professional staff who build and maintain portfolios; continuous monitoring, negotiating and leveraging on fees, monthly reporting and, finally, consultative services and customized solutions.

Think about the costs associated with these additional benefits. As an investor, if you have the resources to manage a hedge fund program and the assets to develop a well-diversified portfolio, then a direct

investment approach is a viable option. If you don't have the resources to perform the previously mentioned functions, then a fund-of-funds investment may be considered but you still need to go through the thorough due diligence.

Several recent hedge fund studies identify funds of hedge funds as expected to capture significant flows over the next three to five years—especially in the U.S. Given limited capacity to conduct the necessary due diligence and ongoing review, funds of hedge funds may be really the only viable approach for many investors.

### **ai5000: Where are we on the question of hedge funds as a stand-alone asset class?**

**Krieg:** The mean/variance optimization process and resulting asset allocation used by many investors lends itself to an asset class framework—hence, a naive allocation to alternatives, for example, 10% to 15%, is an approach taken by many investors. Often, fiduciaries feel the importance of accounting for hedge funds as an asset class in their policy portfolios and to monitor this exposure given certain

*"There is no industry standard for reporting leverage."* — Zanolla

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unique characteristics of hedge funds.

Are hedge funds an asset class or a strategy? More investors are recognizing that hedge funds themselves are not an asset class but a collection of alternative strategies with exposures to various asset classes and unique investment themes. We believe investors will begin using hedge funds and other alternatives in different ways in their overall portfolio construction.

### **ai5000: Where will the flows that come into hedge funds be originating? Are they coming from some pre-set "alternatives" exposure, or from long-only assets?**

**Krieg:** While both channels likely will continue to originate flows into hedge funds, we believe the long-only space could be a greater source over the next few years—especially from investors that have the longest hedge fund experience.

Investors are recognizing that hedge funds are not an asset class but rather an investment strategy. As a result, a hedge fund or the fund-of-funds structure can be constructed to act as a substitute for part of their fixed-income or equity exposure.

For example, when deciding how to implement the large-cap exposure (say S&P 500) in an asset allocation, an investor has an array of choices, including index funds, enhanced index, quantitative or fundamental active, and even synthetic structures, like futures or total return swaps. Hedge funds, like hedged equity, are also an option. Hedged equity may provide exposure and upside capture to large-cap equities while significantly reducing downside volatility. Comparing the S&P 500 versus the equity hedge universe over the past 10 to 15 years (as measured by Hedge Fund Research) points to hedged equity having higher annualized returns, good protection of capital when the equity markets suffer, and 60% of the volatility of the S&P 500.

### **ai5000: How has investor tolerance for volatility and illiquidity changed?**

**Krieg:** Investors understand that earning a return above the risk-free rate is a function of volatility and less than perfect liquidity. No doubt their tolerance for volatility and illiquidity was tested over the past six to nine months. Going forward, investors



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need to have increased transparency and clear expectations as to the embedded volatility and illiquidity in their portfolios.

The dispersion of returns in hedge funds over the past year demonstrates the wide array of categories and liquidity profiles. Certain strategies inherently have higher liquidity than others. Better understanding of hedge fund categories and profiles will lead investors to select the appropriate hedge fund strategy given their portfolio objective.

**ai5000: Will hedge funds that blocked redemptions be out of bounds for most investors?**

**Zanolla:** Not all—it will be on a case-by-case basis. It is clear that many funds have experienced some liquidity issues as markets seized up in the fourth quarter. Many of these funds have gated or suspended redemptions and are unlikely to see inflows until these issues are resolved. Then, there are other funds that may have had liquidity to meet redemptions but

invoked the gate or suspended redemptions purely to stem the outflow of assets—funds in this case have most likely agitated their investors and will be unlikely to see new flows in the future.

Funds that try to balance the interests of investors are more likely to see further flows down the road. We have seen many funds create redeeming or liquidating share classes to address significant redemptions without changing the character of the entire portfolio and potentially harming remaining investors. As an example, we have seen a number of funds that had strong performance in 2008, holding significant amounts of cash, receive significant redemptions. Rather than use the cash to pay redemptions and leave the fund unable to make opportunistic investments, many have created a “liquidating” or “redeeming” share class that will distribute the pro rata amount of cash and liquidate positions over time. This approach attempts to meet the liquidity needs of redeeming investors while preserving the competitive position of the fund and its remaining investors.

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