The Future of Alternatives and Their Role within Asset Allocations

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Stable markets and the search for higher returns led investors of all stripes to alternative investments, both ‘traditional’ and ‘alternative’ strategies. That trend is now reversing as investors reach for safety amidst a global de-risking process. What does the future hold for Alternatives?

While many of the principles and conclusions from this discussion may be readily applied to other alternative investment strategies, we will focus on hedge funds and examine three key questions:

- What does the recent experience of hedge funds look like (distribution of returns, strategy performance, key return factors)?

- What defining changes does the hedge fund industry face?

- How will investors employ hedge funds in their portfolios?
2008: A difficult year for most markets

Hedge funds generally performed better than traditional asset classes last year – though still struggled amid the market’s extreme events.

2008 Hedge Fund Performance:
Comparison to traditional assets

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<th>Annual Return</th>
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<td>-50.00%</td>
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<table>
<thead>
<tr>
<th>‘Traditional’</th>
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<tr>
<td>-42.2%</td>
<td>-25.7%</td>
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<td>-37.0%</td>
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*Returns are gross of fees for ‘Traditional’ assets, net of fees for ‘Alternative’ assets
*Past performance is not indicative of future results. Please see important information about performance following this presentation.
The hedge fund industry has seen a very wide dispersion of returns over 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. Please see important information about performance following this presentation.
Many managers within a given category have similar investment theses, trades, degrees of leverage, etc. This may signify their having similar exposures to the same risks, thus causing comparable reactions to various market events.

- Convertible Bond Arbitrage
- Distressed
- Relative Value Arbitrage

The dispersion among strategies argues for a diversified portfolio of hedge funds.
Despite factors that contribute broadly to a strategy’s performance, there have been funds operating in difficult realms that have done very well (and vice versa). For example, in the long / short equity space...

**Performance dispersion within hedge fund strategies**

Long / Short Equity Managers:
2008 Average Returns by Decile

- 123456789 1
- 0 85.3%

*Source: EurekaHedge and PerTrac., as of January 15, 2009
**Returns are net of fees
***Past performance is not indicative of future results. Please see important information about performance following this presentation.
So what are some drivers of this dispersion, and what conclusions can we draw from it?

- Outperforming long/short equity funds that managed and adapted to heightened volatility exhibited one or more of the following attributes:
  - Superior top-down macroeconomic view formulation
  - Smaller size and a more nimble, trading-oriented approach
  - Excellent stock selection / portfolio construction

- This performance relative to peers is likely a key factor in determining which funds survive, and which die

- Highlights importance of manager selection in portfolio construction
Recent Hedge Fund Performance
Reality versus ex-ante expectations

2008 proved a rude awakening and a (good?) learning experience for many hedge fund investors.

- Average returns and volatility were much different than the past, regardless of reference period

- Liquidity disappeared quickly and five-standard deviation moves became commonplace

- VAR and other risk measurements proved to be almost ineffective in many cases

- Certain fund characteristics (e.g. size) that were attractive to investors in the past were not necessarily a benefit to funds in the current environment

- Strategies that have historically produced attractive returns may not be viable in the future
The upheaval in global markets will have longer-term effects on the hedge fund industry. Some things – the pursuit of alpha, for example – will remain the same, while many others will change.

4 areas ripe for a transformation are:

- Due diligence and risk management
- Leverage
- Fees
- Regulation & Oversight
Hedge funds and their investors will refocus on effective risk management

- Hedge funds with effective risk management over the past year will be much more likely to see capital inflows.

- Surviving funds will need to demonstrate appropriate operational structures that withstand heightened scrutiny by more seasoned (and less trusting) institutional investors.

- Increased transparency will be a by-product of market forces and heightened regulatory scrutiny.
Defining changes face the hedge fund industry
Due diligence and risk management

Hedge funds of funds will see their share of changes too

- Strenuous markets have differentiated the funds of funds which are adding value from those to which a 1% management fee is gross overpayment

  ◆ Rigorous due diligence will replace ‘Checking the box’ everywhere

  ◆ Transparency moves to the front burner: Investors will be less willing to accept a fund of funds’ non-disclosure of their asset allocations

  ◆ The importance of risk management personnel in these organizations will rise

  ◆ Firms with established track records and stable institutional investors will emerge much stronger relative to their younger, retail counterparts
The days of cheap and abundant leverage appear to be disappearing

- Leverage will play a reduced role in hedge funds’ futures:
  - Volatility-wary investors will allocate capital to funds offering sufficiently attractive risk-adjusted returns without heavy use of leverage
  - Leverage has become less available and more expensive as many providers have exited the marketplace

- But…
  - Many relative value strategies no longer require high leverage to deliver attractive returns
  - Fewer market participants means less competition, more opportunity, and less leverage required to produce attractive returns
  - Exchange traded derivative instruments such as options and futures that provide leverage without counterparty risk will provide an attractive alternative to traditional financing
There is pressure building on the traditional 2/20 fee regime

- Institutional investor pressure will be brought to bear on fee structures
- We already see numerous funds offering reduced fees in exchange for new assets or reduced liquidity
- Further alignment of investor interests with manager incentives may take the form of longer-term performance measurement periods
- Fee income for 2008 and the near future will be drastically reduced – little collected in incentive fees, while management fees suffer on reduced asset bases (due to performance and withdrawals)
Momentum is towards increased regulatory oversight of hedge funds, but the content and timing of such rules are far from certain

- Heightened political scrutiny as policymakers look for places to lay blame
  - Congressional and Parliamentary panels grilling prominent hedge fund managers

- General shift from less to more oversight of capital market participants

- Recent reform efforts by both government and industry entities:
  - Hedge fund registration requirement (US, 2005) and repeal (2006)
  - Hedge Fund Standards Board (January 2008)
  - PWG Best Practices for Hedge Fund Participants (April 2008)
  - Hedge Fund Transparency Act (proposed by Levin-Grassley, January 2009)

- Legislative future unknown, but likely to have biggest impact on smaller managers due to costs of compliance
Implementing a Hedge Fund Program
A renewed focus on due diligence and risk management

The value proposition of hedge funds is intact, but investors must have an increased focus on risk management and due diligence in selecting managers

- Portfolio Construction
  - A well-structured portfolio may 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
  - Choice of hedge funds is critical to portfolio performance, as evidenced by the dispersion among funds within various strategies
  - Do not overlook due diligence fundamentals because of perceived ‘need’ to invest with a hot manager; there is a lot of talent available
The decision of whether to invest direct or via a fund of funds is critical

- A fund of funds offers a number of benefits including
  - Full-time dedicated staff of professionals who build and maintain portfolios
  - Continuous monitoring of underlying funds
  - Negotiating leverage on fees, transparency, and access that may not be available to all investors
  - Monthly reporting, outsourced control, potentially customized solutions

- But a fund of funds must be carefully considered - thorough due diligence is still required!
  - Look for a significant track record, stable organizational structure, strong risk management capabilities, good investor profile (lots of institutional capital), reputable audit firm, reasonable portfolio liquidity and redemption terms, and other factors you would consider when investing in an individual hedge fund
  - Demand portfolio construction information – know where your capital is invested
Hedge Funds themselves are not really an asset class, but more a collection of strategies with exposures to various asset classes and unique investment themes.

A portfolio of hedge funds, however, can be constructed to act as a substitute for part of a portfolio’s equity or fixed income exposure.

- Example: A ‘Hedged Equity’ portfolio might seek the returns of the S&P 500 in ‘up’ markets with the objective of providing significantly reduced volatility and downside capture.
  - Does not need to be composed entirely of long/short funds
  - Improves portfolio efficiency
  - Protection of capital should more than outweigh costs
Superior long-term risk-adjusted performance is driven by lower volatility and more importantly smaller drawdowns in bear markets.

**Growth of $100 (Jan 1990 - Dec 2008)**

Annualized Returns
- S&P 500: 7.3%
- Lehman Agg: 7.1%
- HFRI Equity Hedge: 13.7%

*Source: Hedge Fund Research, Inc., and Northern Trust Global Investments

**Returns reflect the reinvestment of dividends and other earnings and are shown before the deduction of investment management fees, unless indicated otherwise. It is not possible to invest in an index. Please see important information about performance following this presentation.
Comparison of volatility and returns...

- Lower Volatility
- Higher Annualized Returns
- Good protection of capital when equity markets suffer
- Correlation: 0.7+
- Beta: 0.44

*Source: Northern Trust Global Investments

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Opportunities, Conclusions, and Recommendations

An allocation to hedge funds or other alternative assets may improve portfolio efficiency and is expected to play an important role in many investors’ strategic asset allocations.

- The recent dislocations will be resolved and markets will adapt
  - Markets continue to function
  - Talent finds excess returns
  - Hedge funds are expected to continue to attract talent and be prominent in the investment landscape

- Recent dislocations have created a rich environment for hedge funds to prosper
  - Wider spreads and more attractive risk premiums
  - Increased inefficiencies and imbalances in global markets
  - Less competition
Areas of Opportunity

And certain strategies are attractive now or have significant opportunity sets building...

- Distressed Credit
- Statistical Arbitrage
- Global Macro, CTAs
Q & A

Thank you.
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