May 2010

Hedge Fund Roundtable

For a second consecutive year, Stratford gathered senior investment professionals from four prominent hedge fund of funds firms to participate in a roundtable discussion of current hedge fund issues and trends. The discussion included a look back on 2009, as well as thoughts on the return and risk expectations going forward. Stratford's Chief Investment Officer, Susan McDermott, moderated.

Moderator: **Welcome. Thank you all for participating. We appreciate it, especially the second time around. Let's begin with the biggest challenges for 2009. Have your underlying managers given you a sense of how they felt about 2009, and how they may think about 2010?**

Manager A: I think everyone will agree that 2009 was a strong year, particularly after the markets stabilized. In general, hedge funds protected well through the first quarter. They put themselves in a position of strength to take advantage of opportunities that came out of the tumult, both on the equity and credit side.

One of the key challenges was the volatility we had in the market. Exposure management was more difficult with the rapid sell-off through the first part of the year, and then the rapid ascent.

Another challenge was that the equity market rally was led by what many people have termed lower-quality and lower-earning companies. The companies that outperformed were those that investors were concerned wouldn't survive, and as things solidified these companies regained firm ground, at least in the short term.

Manager C: In terms of 2010, I think many managers are cautious because of the many macroeconomic headwinds and other risks. However, there are pockets of opportunity, and as a result, we expect greater price dispersion among securities, both in the equity and credit markets. There are good opportunities both long and short, but there likely will be less extreme market breadth; good security selection will be essential.

Also, managers are more involved in tail risk protection strategies as they are worried about another tail risk event. In the credit markets, notwithstanding the rally, we're seeing opportunities in mortgage and corporate distressed securities. We expect a big wall of maturities coming due that should provide additional opportunities.

Manager D: As we sit here today, risk has been embraced; and risk premiums have come in. You see that manifest itself in returns to low quality companies and significant headwinds to fundamentally oriented, quality-based strategies and securities.

Managers have been getting their teeth kicked in on the short side for quite a long time. Staying disciplined and being opportunistic on both sides of the book in the face of tremendous liquidity, and risk seeking has been difficult. In my view, a manager's biggest challenge right now is continuing to have a well balanced, hedged portfolio.

Moderator: **On that point, has your firm made allocation changes, or have you seen the underlying managers make changes across or within strategies to assure that they are properly hedged?**

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Manager D: I'd say yes on both counts. If you rewind a year or two ago, we were a bit disappointed that managers were slower to react than we anticipated. We did more active allocation than we might have expected.

We're constantly trying to evaluate the efficacy of different hedging oriented strategies. In the last year the risk/reward of an overtly hedged strategy, such as short equity or short credit, changed dramatically, depending on the time period. As we sit here today, I think our allocation shifts were more dramatic in the past 24 months than we anticipate they will be in the next 12 months or so.

Manager C: Because of the headwinds on both the short equity and short credit sides, there's been a shift toward hedging strategies that have a more asymmetric return profile. A number of managers have been participating in strategies that have limited or defined downside with potential for large payoffs in a crisis – for example, put spread strategies, volatility trading strategies, or shorting sovereigns.

I also think that managers have become more liquid than in 2007 and 2008. Most managers incurred larger losses than they thought they would due to illiquidity and have become more focused on liquidity.

Moderator: **What are your expectations for performance and risk, looking forward in 2010 and 2011?**

Manager B: Historically, the strategies that we've invested in have generated the best performance after periods of tremendous dislocation, with 2009 generating the best performance since 2000. Given the magnitude of the dislocation experienced in late 2008, coupled with the fact that there are still some very significant underlying problems in the broader markets, and the impending wall of maturities coming, there are significant opportunities. Obviously, the wildcard is macro-risk and whether there is another systemic shock around the corner.

Manager C: I agree. If we don't think that a strategy can earn at least 10% net annually, over the coming market cycle, then we have no interest. Many of the current opportunities within credit have yield to maturities in the high single to low double digits without any spread compression. If you get overall or idiosyncratic spread compression or some catalyst, you could be in the mid to high teens. Overall, we feel good about expected performance for 2010, but we also are willing to pay a little insurance premium given the headwinds that are out there.

Moderator: **Do you see any of the impending regulation having an impact on the hedge fund business? Also, do you see any pressure on the hedge fund industry from limited partners as you have recently seen in the private equity space by the ILPA?**

Manager A: I would say it's issue by issue. There are some that we think could be very helpful to hedge fund managers. If the Volcker rule passes, taking a large amount of capital that's been investing in alpha opportunities on a levered basis and telling them they can't do it anymore, while maybe causing dislocations in the short-term, it will be a great opportunity set for our managers collectively. It also will offer up a lot of talent to evaluate as managers make a move from that side of the investment universe to hedge fund investing, which I think would likely happen.

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Manager A: (continued)

Other rules, like the uptick rule, have been dealt with for many years, but we'll have to see how they are implemented. I think our managers have learned that rules can come out of left field with unintended consequences and to date they have been able to navigate those waters well.

Manager B:

I think it really is a sense of trying to understand the rules upfront; what they are and we'll play by them. If you think back to October of 2008, with the temporary ban on short sales in financials and substantially related securities, that made people very nervous given it was a knee-jerk reaction and not particularly well thought out.

Certainly, the new regulation, with respect to short sales, which I believe was enacted despite research that the new rule would have absolutely no effect, was done because they felt something had to be done, but that there weren't going to be any Draconian bans. Certainly, we've talked to a number of managers who think that, while the Volcker Rule doesn't stand a great chance of being enacted, it would be effectively their ultimate fantasy in terms of clearing out competitors and making available talent.

Manager C:

The Devil's in the details. Certain things could be positive, like registration. For example, registration could be a positive for the industry by lending credibility; however, it's certainly not a substitute for due diligence. Then there are things that could have unintended consequences. The banning of naked CDS could end up hurting banks; if the banks can't hedge against credit risk, they may lend less. Exchange-traded CDS are likely to be a positive as they increase liquidity and transparency.

Manager D:

Discussions in Europe are probably a little more alarming in terms of the AIFM directive. The notion of a reciprocal or comparable regulatory regime being the standard by which people in one country are allowed to do business in another is troublesome. The legislation was staved off for about a month so we'll see what happens there. There could be a real effect on the hedge fund business in terms of various participants' ability to do business in different places. In the U.S., I think the scenario of outcomes is fine. The European regulatory issues are potentially a bit more alarming.

In regards to the question about the ILPA and the principles they put forward in the private equity space, I view this as one of the real silver linings of the last couple of years. The arrangement between the hedge fund and the allocator of capital probably got out of hand. The legislation between provider/manager and allocator just didn't speak to certain issues.

It's been a slow process, but a lot of the re-legislation has been taking place over the course of one year and you've seen dramatic improvements in terms of governance and investor rights. You've also seen improvements in terms of amenability around transparency, provisions and protocol around liquidity, and economics, fees and incentives, as well.

The hedge fund industry is not where the private equity industry is in terms of having this notion of a consortium, going to market saying, "This is how we're going to do business." However, one-by-one, there's been tremendous headway made, and in aggregate, it's a tremendously positive development.

Moderator:

Have you seen fees decrease with your underlying managers? Have you witnessed fee pressure in any significant way?

Manager D: I would say that fee levels have come down moderately. It's more based on facts and circumstances and less about trying to take a hammer to hedge funds to take their fee levels down. We're trying to make sure incentives are aligned and that economics are based on performance achieved over time. When performance is achieved over time, the hedge funds should prosper. I think the focus is on making sure there are no egregious expense pass-throughs or base management fees that aren't aligned with that basic notion I just mentioned.

Manager C: I would also say yes, I think the baseline has come down. If a manager says I'm 2 and 20, then an eyebrow or two goes up. Not that you wouldn't still consider investing with the manager, but I think the baseline seems to be coming down a bit and the structures are definitely improving. All of us at this table, as leaders of the industry, have been helpful in pushing for improved fee structures.

Manager A: We've always had a very good partnership with our managers. However, over the last year and a half, they've all made moves towards the new reality of the environment. Over half our managers have done something that I would consider investor friendly, such as aligning incentives or increasing transparency, and I think that's very important.

Moderator: **You mentioned transparency and liquidity; how significantly did they improve as 2009 wore on?**

Manager B: With respect to transparency, we've always had certain requirements of our managers. In the past, there were certain managers unwilling to provide that and we were unwilling to invest with them. The list of managers that aren't willing to provide transparency has gotten a lot smaller. I will say that there's been an overall change in tone, where senior professionals are beginning to do quarterly investor calls and more managers are providing their data to risk reporting services. You're seeing more detailed risk reports and monthly letters.

With respect to liquidity, in light of late 2008, where you saw a lot of semi-liquid strategies or historically liquid strategies go totally illiquid, perhaps investors didn't place enough of an illiquidity premium on investments. We are seeing more of a move towards less inherently levered and more liquid strategies.

Moderator: **Any lessons learned that we may not have addressed that you think are shaping the hedge fund industry going forward?**

Manager B: With respect to the fund-of-funds industry and how this crisis will shape things going forward, I think you have seen a lot of the weaker players disappear. You also have seen more of an emphasis on realistic liquidity terms. Investors are demanding value added processes and a lot of the fund-of-funds that weren't providing that are now gone. It also will offer up a lot of talent to evaluate as managers make a move.

Manager C: A big lesson learned has been the importance of operational risk. We're all probably more focused on counterparty risk considerations, the operational infrastructure, business viability of the underlying manager, and on the matching of liquidity of the positions in the fund's portfolio to the fund's liquidity terms. Although we focused on those things in the past, I think there is now an enhanced degree of focus.

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Manager D: One of the lessons learned in 2008, which is a reoccurring one, was that leverage is a dangerous proposition. Another would be that you're not able to know everything that's happening in the market. The unexpected events are ones that'll be profound and very important to your portfolios via the short selling ban or the decrease in liquidity. You have to think about those things in advance.

Moderator: **With the increased emphasis on operational due diligence and manager stability, will smaller managers get less of an allocation going forward?**

Manager D: I guess it depends on how small. It also depends on what strategy you're talking about. There's no reason that a few hundred million dollar manager can't have the appropriate standards and infrastructure to do business the right way from an investment and from an operational standpoint.

Manager A: There was a time period when it was easy for new managers to get into the business. I think that in any industry that's growing quickly, the initial barriers to entry are lower, and when the industry matures, the barriers to entry increase. It's a little harder for some of the managers that may have been able to raise capital in 2007, some of which we were probably scratching our heads about, to do so now. This is especially true as a lot of the well established managers are now open to capacity.

Moderator: **Do you still see managers that you like having ample capacity, or do you see capacity starting to shrink?**

Manager A: It was an incredible dynamic at the start of 2009. The capacity situation is not as great as it was then, when just about every manager was open for capital. Certainly, it's still an attractive situation and better than it was towards late 2007.

Manager B: We tend to invest with managers that take in dollars as they're seeing opportunity. Managers, across a wide variety of strategies, are seeing significant opportunity and are open to new dollars. The unfortunate truth is that people tend to want to least invest when the opportunities are greatest and that the most capital tends to chase great performance when opportunities aren’t as prevalent. There are a couple of managers that have performed very well throughout the recent cycle that are beginning to close or do have capacity constraints.

Moderator: **In terms of looking at 2008 and 2009, there were a lot of redemptions from hedge funds in general. When you look at your client base and the client base of some of the managers that you work with, which were the stickiest clients? Did you see any change in that as 2009 progressed?**

Manager B: I would say that the majority of redemptions in the post-2008 period were concentrated at the beginning of 2009 and they tended to be high net worth investors. We actually saw very few full redemptions on the institutional side. The majority were partial redemptions, largely due to liquidity needs or rebalancing. The balance has begun to shift over the last couple of quarters, where redemptions have really decreased and subscriptions are beginning to increase. The majority of subscriptions have been additional contributions from existing institutional clients along with several new institutional clients.

Manager C: What I find interesting is that in light of all the poor press about 2008 performance, when the CIOs of corporate pension plans or other plans sat back and looked at the world, their hedge fund portfolios or fund-of-funds portfolios performed better than other risk assets. When all the dust settled, they realized that the value proposition that we'd put forth was actually true and we have started to see inflows again.

Manager A: In the past decade, the S&P was down 9% in aggregate and hedge fund portfolios did quite well over that same time period. It's difficult to invest in assets with negative growth over a 10-year period in an asset/liability framework that pension and endowments manage to. Some investors, who had situational specific issues that caused the need for withdrawals in early 2009, have re-invested now that things have settled.

Moderator: **Why don't we talk about emerging markets? We've seen a shift towards international and emerging markets over several years. Do you see that shift within the equity-oriented strategies in your portfolios?**

Manager D: We have seen that to some extent. Our equity managers have been more focused on non-US regions over the last couple of years and I imagine that'll continue to tick up a little bit. However, some managers gain emerging market exposure through U.S. and other developed market countries through companies that generate revenues from emerging markets such as Colgate, Proctor & Gamble, and Nestle. I do think that as liquidity improves in emerging markets, as structural issues improve, and as the ability to borrow stocks improves, then there'll be a continued increase.

Moderator: **But not a major shift in that way? You'd say most of the portfolios are more domestically oriented at this point?**

Manager B: I would put it in three buckets; U.S., then Europe and Asia, and then emerging markets. We haven't seen a massive shift. I'd say the U.S. exposure has probably gone from around 77% down to 70%, with the majority of the pickup in European and Asian exposure. Emerging markets has been in the 2 to 3% range. All of our managers that have emerging markets exposure have offices in those countries and really are looking at situation specific opportunities, rather than trying to pick up any emerging markets beta.

Moderator: **Is there anything that managers are doing to be more focused on absolute returns as opposed to relative returns?**

Manager D: One of the unanticipated lessons coming out of the environment was the commonality of style and correlation of returns and/or value-added alpha. If you rewind back to 2007, you saw this blip around the market-neutral space. There was a lesson to be learned there in August of 2007 regarding issues that were going on below the surface that availed themselves again in late 2008.

I think there's more sensitivity and proactiveness to not have portfolios that look and feel a lot like everybody else's. There is also more focus on basis risk and the type of risks owned on the long and short side.

Manager B: Some of it is semantics. I would view absolute return as more alpha-driven strategies rather than beta-driven returns. In the minds of some investors, absolute return meant positive returns in absolutely all environments. You're beginning to see certain allocators rename this strategy from absolute return to diversified alternatives.

Regardless of what you call it, our view of the space is that it is a collection of strategies that tend to be alpha driven. Obviously, those returns are not risk-free and there are going to be periods of downside or drawdown during systemic shock when rational pricing breaks down. People do need to understand that, regardless of what they may be calling the strategy.

Moderator: **At one point, fund-of-funds were characterized as fixed income substitutes with higher expected returns, but similar standard deviation. How are you setting your client expectations going forward in terms of return and risk?**

Manager D: The value proposition for a well selected, diversified group of hedge funds performs well over a long time period. If you're building a portfolio today and are backward looking, a government bond index or the Barclay's Aggregate looks high because it performed pretty well with low volatility. However, as we sit here today, the yield to maturity on the Barclay's Aggregate Index is about 3.4%. It's going to be awfully hard for something like the Barclay's Aggregate to do well over the next five years. It could do moderately well and it may do poorly, however, it's almost impossible to do extremely well given the reality of the math behind it. Equities have generated moderate returns over time and have been incredibly volatile.

I think that the value proposition of a hedge fund portfolio, against the backdrop of an incredibly volatile asset like equities and/or high-grade fixed-income, looks pretty good. If it can perform even remotely close to how it did in the past, not withstanding 2008 and 2009, and certainly if we can avoid that by lessons learned, then it can do even better than that.

We don't have one specific way of targeting returns. We target returns using LIBOR plus a spread over some period of time. Over a longer period, we'd expect low correlation, which is not to say that it's zero or negative.

Creating expectations around what the downside case is in different environments is important. 2008 was worse than we would have anticipated, even in the worst case scenario, and we're trying to make sure that doesn't happen again. Ultimately, if we continue to generate LIBOR plus a good premium with low correlation statistics to other asset classes, it should add tremendously to diversified portfolios, particularly to those investors that are trying to match to a liability stream over time, like pension funds and so forth.

Manager B: It's particularly important to look at the track record over 5, 10, or in many cases 15-plus years. People who just focus on the fourth quarter of 2008, without looking at the track record, are unable to see the attractiveness of the asset class. Having a target of the risk-free rate plus 400/500 basis points, over time, is a very obtainable target with the understanding that there will be periods of systemic shock where funds will tend to underperform for some short period of time.

Manager C: I agree with all of that, but I think from a downside perspective, clients have to decide whether 2008's performance was the new normal or just an anomaly. Our viewpoint, and probably those of my peers, was that it was an anomaly and that, on a forward-looking basis, the downside is less than it was in 2008. We generally have less leverage, more tail-risk protection, more liquidity, and more diversified counterparty exposure than in the past.

Manager A: I don't think the 2008 downside will repeat itself and we've been able to recover from it as hedge funds and fund-of-funds have approached their high-water marks. When you're down 40 to 50 percent for other asset classes, you're looking at a 100% return to get back to your high-water mark. Whereas, hedge funds were down around 20%, and that's a much more attainable hurdle to recover from. That shows the importance of risk management and volatility management.

Moderator: **I think this group always worked with managers that use multiple prime brokers, is that correct? That hasn't really been a new factor for you?**

Manager B: That is correct. There are any number of reasons why a manager should have multiple prime brokerage relationships. These include counterparty risk, general mitigation of risk, and being able to play prime brokers off each other for competitive pricing. It's always something we've looked at.

Manager A: A lot of managers have moved their excess cash outside of the prime brokerage system in further attempts to make sure that the assets are as safe as possible, a trend we definitely saw through, and as a result of the crisis.

Moderator: **Separate accounts were the big buzz last year about this time. Everyone was going to move to separate accounts and it was going to guarantee them liquidity and safety. There was a lot of controversy over that. Did you see that move happen? Did you encourage it for certain managers?**

Manager A: We continue to feel that the best place to be invested is in the commingled fund alongside the manager and his capital, and that the liquidity that's available there has been appropriate. In terms of transparency issues or advantages that you get from separate accounts, we've always invested only with managers that provided the transparency we need. We've already overcome that hurdle.

Manager C: We've done some separate accounts. I generally agree that they are certainly not the panacea that everybody thought they were. In some cases, it could actually be less liquid than the commingled fund. There also can be conflicts of interests that arise, an increased administrative burden, and increased expenses.

There is a place for separate accounts. In our view, if you're going to customize something, perhaps that's the appropriate time to do a separate account. I think there's a role for it, but I don't think it's as big of an issue as the press has made it out to be.

Manager B: If you invest through a separate account structure in less liquid strategies you don't have the ability to piggyback off the cash flows in and out of the funds. Effectively, you own those assets and if you tell the manager "I don't want to be invested with you anymore," the manager can either fire-sale them or give them back to you in-kind.

Moderator: **Were there any other changes during 2009 that we haven't covered?**

Manager D: At the margin there was a move towards absolute full third-party administration. The preponderance of managers, certainly offshore, used third-party administrators. There was probably some fraction of very high quality managers that did onshore administration themselves and those managers generally started to use external administration. That was probably one development that we saw as a general trend in the industry.

Moderator: **Well, thank you all very much. You can definitely sense that the markets are not as crazy as last year, and we are in a much more normal environment.**

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