General market environment in the Fourth Quarter of 2001

By Dr. Philipp Cottier | Harcourt AG

The fourth quarter of 2001 was dominated by the rebound of global stock markets in the aftermath of the tragic September events. Over the whole quarter, the MSCI World gained +8.37%, the S&P 500 increased by +10.29%, the NASDAQ was up +30.13%, the MSCI Europe up +12.45%, and the SPI up +7.28%. Even the Nikkei was up +7.86%.

With respect to fixed income markets, the US Fed cut rates another three times during the quarter, reducing the Fed Fund rate further from 2.75% to 1.75%. Simultaneously, USD 3-month interest rates decreased from 2.3% to 1.75%. Long term rates, however, did not move accordingly. USD 30-year rates increased slightly from 5.3% to 5.5% and the yield curve continued its steepening. In Europe, short term rates decreased from 3.5% to 3.2% while 10-year rates increased by 20 bps to 4.94%. The JP Morgan Global Bond Index lost -3.18% in the fourth quarter and the Pictet Swiss Bond Index was down -0.26%. The DLJ High Yield Spread Index decreased from 990 bps to 860 bps over Treasury.

The US Dollar strengthened over the course of the third quarter. The Euro decreased from 0.91 to 0.88, the CHF weakened from 1.62 to 1.68, and the JPY continued its fall from 119 to 131. Gold finished the third quarter at 277 per ounce, breaking its uptrend. Brent Crude Oil continued its downtrend from USD 22.8 to USD 20.4.

Hedge Fund Industry in Year 2001

The hedge fund industry moves in cycles. 1994 was a bad year, sparked by the Fed's surprise interest rate raise. 1998 was another one, triggered by the Russia and LTCM crisis. And 2001 was yet another bad year for the industry. The falling stock markets and very high volatility made it difficult for most strategies to perform, with the exception of convertible arbitrage, distressed securities and MBS arbitrage.

Supply side of the hedge funds industry: Big is not beautiful anymore in strategies where a lot of flexibility and an opportunistic approach is needed. One example is the long/short equity strategy where some big players like Zweig DiMenna, Bowman and FLA have not done very well in 2001. Bowman Capital has actually decided to give all money back to investors and stop trading investor money. To counter their capacity problems, many of the larger hedge funds have started to diversify into other strategies and to lock in investors as long as possible with redemption fees and lock-up periods. The other interesting news was that Monroe Trout is retiring after many years of successful trading.

2001 was the year of the Asian hedge funds. The universe now probably contains around 150 managers, of which as a very rough guess approximately 30 are located in Tokyo, 30 in Hong Kong, 20 in Singapore, 10 in other Asian cities, 35 in Australia, and 80 in Europe and the US. Asia-based hedge funds and overseas hedge funds pursuing Asian strategies currently manage in excess of USD 12 billion in assets. The largest firms include Joho, Sparx, Penta, Platinum, Whitney, Grinham and Sofaer. The strategy diversity among Asian hedge funds is increasing, with more firms pursuing strategies outside of the typical long/short equity arena, such as Japanese convertible arbitrage, Japanese event driven, Asian debt, property stocks, commodity arbitrage, and CTA futures trading.

Demand side: Demand for hedge fund products continues to be strong in the US, Europe and Japan. According to TASS, the third quarter of 2001 saw new inflows that were only slightly below those of the second quarter. The most desired strategies were long/short equity, convertible arbitrage and distressed securities while CTAs and emerging markets hedge funds were faced with net outflows. Macro hedge funds saw net inflows for the first time since early 1998. European and Asian hedge funds (particularly long/short Japanese equity funds) continued to feel strong investor interest.

Funds of funds: With +2.46%, the performance of funds of funds was rather low in 2001. They continued to underperform their hedge fund indices, albeit by a lesser margin than in the past. The reasons for the difference are probably not poor selection but rather the additional fee layer, survivorship bias, the lower bull market bias of most funds of funds, and a potential selection bias in the databases. We strongly believe that in our still quite inefficient industry, active hedge fund picking ought to be more successful than passive index investing or «dart throwing», especially when top-down asset allocation and bottom-up hedge fund selection are done in a sophisticated way. What might increase in the future is the turnover of manager inside the funds of funds. The reason is that investors are increasingly looking at smaller funds with shorter track records as the larger funds with longer track records are often closed or have become too big and inflexible. The new game of the industry is therefore to detect hedge funds early enough - actually, sometimes before they start trading - and invest with them before they grow too big and start limiting new asset inflows. The shorter track records, however, might mean a higher turnover of the fund of funds portfolios.

Research: A very interesting and readable research piece on hedge funds called «Understanding Hedge Fund Performance» has recently been published by Lehman Brothers. The research was done by Prof. Tom Schneeweis and looks at several performance related issues such as survivor bias and alpha, as well as the impact of certain factors like size, vintage, performance fee, lock-up and domicile on performance. The study can be ordered via jpescato@lehman.com.

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The ISMA Center of the University of Reading in the UK has recently published a study that looks at the attrition rate of hedge funds and comes up with an estimate of 5-12% pa. According to the study, the attrition rate has been increasing steadily from 1994 to 2001. It is based on the number of funds dropping out of databases. Now, we think that the assumptions are flawed as only a tiny part of the hedge funds that stop reporting to databases do that because they went bankrupt and lost 100% of their capital. The largest part are hedge funds that stop reporting because they have no more capacity and are closed to new inflows; because they don't feel like reporting anymore (such as Harcourt who stopped reporting to one database, which means that technically, we have attritioned ourselves); or because they retire. Another part are hedge funds that close shop not because of poor performance but rather because they could not raise sufficient assets to support their trading operations. And even of the hedge funds that close because they had dismal performance, many did not lose all of their capital but rather -20% to -50%. In other words, we estimate the survivorship bias to be much lower than the above 5-12% pa. Harcourt's inhouse research indicates that the survivorship bias inherent in hedge fund indices is roughly 1.5% pa, or between 1.0-2.5% depending on the strategy. Now, of course the attrition rate of very small and young hedge funds must be higher than 1.5% pa, but for more established hedge funds, or on an asset-weighted basis, the bias should not be significantly above this figure. To put this in context, 1.5% pa is about twice the survivorship bias of stock indices, in other words not unusually high - ever heard of Swissair, Enron, Kmart?

Performance of Hedge Fund Strategies in the First Quarter of 2001

From October to December 2001, the equal-weighted HFR Composite was up +5.95%, the HFR Fund of Funds Index up +2.46%, and the asset-weighted CSFB/Tremont Index up +2.18%. The quarter was positive for all strategies except for short-sellers, CTAs and market neutral equity. Obviously, long/short equity funds benefited most from the strong rebound of global stocks.

Hedge Fund Strategy	Return Q4 2001	Return YTD 2001	Return pa 1994-2001
HFR Funds of Funds	2,46%	2,88%	7,86%
HFR Hedge Funds	5,95%	4,75%	12,96%
CSFB/Tremont Hedge Funds	2,18%	4,41%	11,63%
Emerging markets	13,94%	10,82%	6,01%
Sector specialists	10,90%	-4,20%	17,18%
Fund market timing	8,68%	5,09%	13,62%
Long/short equities	5,78%	0,37%	17,77%
MBS arbitrage	5,78%	21,16%	10,09%
Macro	5,48%	7,95%	10,42%
Statistical arbitrage	4,50%	1,19%	9,51%
High yield	3,72%	5,32%	5,95%
Reg D arbitrage	3,25%	-2,81%	16,77%
Distressed securities	3,02%	14,37%	10,86%
Merger arbitrage	1,79%	2,61%	12,62%
Convertible arbitrage	1,60%	13,50%	11,44%
Fixed income arbitrage	1,35%	4,54%	5,20%
Market neutral equity	-0,17%	6,41%	10,30%
CTAs	-1,07%	1,03%	5,84%
Short-selling	-12,55%	10,99%	1,20%
MSCI World	8,36%	-17,84%	8,14%
JPM Global Bonds	-3,18%	-0,78%	4,80%

Source:Hedge Fund Research Inc., Barclay Training Group Ltd.

Directional Equity Strategies: In the last quarter stocks continued the rally which had started in the second half of September (MSCI World +8.37% in Q4). As usual, the recovery was initiated by the US, but then embraced all major equity markets worldwide. The strong market rebound in Q4 from its September lows was mainly driven by the technology sector (MSCI World IT +32.22% in Q4). This is also underlined by the strong performance of many NASDAQ stocks (NASDAQ +30.13% in Q4). Index heavy-weights like Cisco Systems (+49%), Intel Corporation (+58%) and Yahoo (+101%) rose significantly and approached their record valuations of early 2000 again, measured by P/E etc. There were plenty of reasons for this. During the whole year we have seen unprecedented levels of monetary stimulus by the Fed with 11 Fed rate cuts resulting in a decrease of 475bps, and unprecedented levels of fiscal stimulus in the US (ie USD 38 b of tax reductions). This combined with lower energy prices and a retrenchment of excess inventories in some cyclical industries such as semiconductors finally produced a strong upside momentum for the equity markets worldwide. The «earning seasons» in Q1 will show if this recovery is sustainable or if the world-wide synchronous recession will last longer than we all hope. On average long/short equity managers produced positive results in Q4 (up +5.78% to +10.90%). For many long/short equity funds however, the comparatively low market exposure which had successfully protected them during the September turbulences proved to be a real performance drag, especially in October and November. In addition, some of the typical short candidates with high valuations were among the strongest rebounders in Q4 which lead to a negative short side contribution for long/short equity funds. Overall, the dedicated short-sellers lost -12.55% in Q4. While on average the long/short US equity managers underperformed their European and Japanese counterparts in the first three quarters, most were able to catch at least a part of the rebound in the fourth quarter (Harcourt L/S US Index +5.77%) while European (-0.24%) and Japanese (+0.23%) long/short equity managers were basically flat. The dispersion of returns within these long/short categories continues to be significant.

Relative Value Equity Strategies: Convertible arbitrageurs were up +1.60% for the quarter, but the figures hide a slightly contrasted picture. Implied volatilities fell to 37% in the US, causing losses that were compounded with widening credit spreads and fewer re-hedging opportunities. In Europe however implied volatilities increased slightly in an environment of high realized volatility and narrowing credit spreads, enabling managers to mark the value of

their positions up. Deal flow continued to be attractive. The US saw a large USD 2.2 bn Fiat into GM exchangeable bond top up a record year of new issuance (USD 100 b), even though the credit of the issuer was not attractive. Europe saw several smaller and more attractive deals, such as Lufthansa and France Telecom into ST Micro, bringing total European issuance for the year to more than EUR 50 b. The Japanese convertible market was hit hard in December when the Chugai issue was called due to the takeover bid by Roche, and the whole market subsequently repriced their bonds to account for callability risk. Merger arbitrageurs moved back into positive territory with +1.79% for the quarter. There was some deal shake out, most notably Enron/ Dynegy, Compaq/HP, Cooper/ Danaher with concerns over asbestos litigations, and NextWave/ Verizon with the settlement over NextWave wireless licenses being adjourned. However, the markets' return to a more normal environment helped the arbitrageurs. December winners were Williamette/Weyerhaeuser whereby Weyerhaeuser increased its offer by 10%, and C.R.Bard/ Tyco with the market getting confident that antitrust approval would be won and the deal would close in the first quarter. Statistical arbitrageurs were up +4.50% for the quarter, with most September market dislocations being reversed and markets returning to a more normal environment. Market neutral equity managers were down -0.17%.

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Relative Value Fixed Income Strategies: Fixed income arbitrageurs suffered from the strong reversal of US interest-rates during November and generally had difficulties coping with the dislocations in the USD yield curves toward the end of the year. They were up +1.35% for the quarter, benefiting partly from the Fed's massive pumping of liquidity into the markets. In the mortgage-backed sector, the high interest-rate volatility and the steepening yield curve created many mispricings in mortgage derivatives markets resulting in strongly positive returns (up +5.78%). The widening OAS spreads provided continuing opportunities for carry trades. In addition, the falling interest rate environment accelerated prepayments (albeit at a rate below the one predicted by many prepayment models), and hence new mortgage-backed security issuance. For the first time, more business was created out of new issues than from secondary market. 25% of these new issues were CMOs. There was also huge demand for floaters from banks, leaving the other tranches underpriced.

Directional Fixed Income Strategies: After the sharp dislocations in the high yield market in September, prices of high yield and distressed paper readjusted during the last quarter. High yield credit spreads recovered over 150 bps from their September highs and so high yield managers bounced back, ending the quarter up +3.72%. The supply of distressed paper continued to provide good opportunities on both the long and the short side. Distressed funds ended the quarter up +3.02% despite a negative ruling in the NextWave case.

CTAs lost -1.07% in Q4 2001, bringing YTD performance to a meager +1.03%. The CTAs performed strongly in October with profits primarily made in the interest rate markets which rallied because of global economic worries. In November the unexpected reversal of short-term and long-term rates significantly reversed the profits made the previous month. With -4.44% it was actually the worst month in CTA history since February 1996. In December, CTAs moved back into more positive territory, benefiting from gains in the currency sector as the JPY tumbled to a three-year low and trended down against all major currencies. Macro hedge funds were up +5.48% for the quarter.

Going forward, we are bullish on MBS arbitrage, distressed securities, high yield, long/short Japanese equities, and multi-strategy funds. Fixed income arbitrage should be positive but only with single digit returns in view of the low level of Libor rates. Long/short US equity managers will continue to face difficult equity markets. Particularly in Europe, bottom-up stock pickers should do better than in 2001 going forward. We remain bearish on merger arbitrage, Reg D arbitrage and short-sellers.

Performance of hedge fund strategies in Year 2001

2001 was the year of the convertible arbitrageurs. It was also the revival of distressed securities. Major disappointments, on the other hand, were market neutral equity funds and short sellers who did not manage to benefit from the falling markets, and encountered difficulties dealing with the high volatility and the frequent sharp market rebounds.

Directional Equity Strategies: With +0.37%, the long/short equity managers underperformed their long term absolute return targets significantly. Sector specialists were down -4.20%. Most managers reduced their market exposure considerably to cope with the turbulent markets. This helped to limit the losses in the first nine months, but prevented them to participate in the fourth quarter rally. Disappointingly, a lot of managers were not able to add value on the short side even though markets fell substantially. The sharp liquidity induced rebounds in April, October and November made shorting very difficult. Based on our internal databases, long/short US equity funds (+1.23%) and long/short European equity funds (+1.20%) did worse than their Japanese counterparts (+4.50%), which is very interesting to note given the Nikkei's underperformance of US and European stock markets. In general, managers who were able to opportunistically adapt their exposure, did often better than the pure bottom-up value players.

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Relative Value Equity Strategies: Convertible arbitrageurs thrived on the unusually high volatility and ended the year up +13.50%. The convertible new issue market virtually replaced the traditional stock IPO market, and of course the abundance of new issues helped the hedge funds. According to industry estimates, hedge funds now hold some 40% of outstanding convertible issues. 2001 was a mostly disappointing year, however, for merger arbitrageurs who had in earlier years become accustomed to steady double digit returns. The major reasons were deal flow falling 50% compared to 2000, shrinking deal premiums, as well as general market uncertainty, accompanied by a high number of deal breaks, most notably Honeywell/GE. With the exception of August 1998, September 2001 has been the worst month for merger arbitrageurs since 1990 (-2.79%). European merger arbitrage outperformed US merger arbitrage, and will probably continue to do so given the ongoing Euro induced consolidation. Statistical arbitrageurs did not do well in 2001, up +1.19%. Similar to their market neutral equity counterparts, they had difficulties coping with the high volatility and the many market dislocations in an environment where fundamentals played a lesser role.

Relative Value Fixed Income Strategies: The dominant theme in the USD interest rate markets in 2001 were the aggressive rate cuts by the Fed and the huge amounts of liquidity pumped into the market after the September 11 events. The yields dropped across the curve until a sharp reversal in November brought long-term rates back to where they had been at the beginning of the year, thereby significantly steepening the curve. Although volatility is usually welcome in the arbitrage business, fixed-income arbitrage outside the mortgage-backed sector was positive but not extraordinarily high (up +4.54%). MBS arbitrage, on the other hand, had a superbe year, thriving on the steeper yield curve, high volatility and the supply of new issues. The low interest rate environment triggered a huge refinancing spree of mortgages and consequently new issues of MBS of which about a quarter in the form of collateralized mortgage obligations (CMO), or mortgage derivatives. The enormous demand from financial institutions for CMOs created many arbitrage opportunities for hedge funds, partly because these end buyers were not always able to correctly price the more complex securities in the volatile interest rate environment.

Directional Fixed Income Strategies: Overall, 2001 has been an interesting year for distressed and long/short high yield funds. During the year we saw credit spreads and corporate default rates reach historic levels not seen since 1990. The flood of low quality paper issued in the high yield

market during the euphoric years of 1997-2000 provides today a flood of opportunities for distressed securities players, on the long side as well as on the short side. In September 2001, distressed and high yield managers had to book mark-to-market losses due to a sharp repricing of lower-grade securities. The price dislocations have however corrected since then. European high yield looks increasingly interesting.

CTAs: 2001 was a difficult year for most CTAs (up +1.03%). Some trend-based CTAs did well, with returns highly dependent on the interest rate sector, however. The short term CTAs performed mixed in 2001. Most were caught in erratic market movements such as the one caused by the September 11 events. The currency managers were also affected by this event, ending the year flat.

Are hedge funds here to stay?

Yes, of course. Our vision of the asset management industry is that hedge funds will become a 'boring' mainstream investment within a few years, and merge with the traditional long-only asset management industry. Why? Because the value chain in asset management will increasingly be segregated into beta and alpha. Let us illustrate this: Today, an institutional investor is normally faced with the choice between allocating to active or passive mandates. The often frustrating outcome in the past has been that the active mandates underperform their passive benchmarks particularly in more efficient markets. What will happen in the future therefore is that portfolios will be separated into a BETA exposure part, acquired via low cost index certificates and ETFs, and an active ALPHA part, produced by very active, hedge fund-like mandates. In other words, traditional semi-active long-only mandates (and mutual funds, for that matter) will have to evolve into either low cost index trackers; or high added value, high fee, active mandates with maximum flexibility looking like hedge funds. To repeat my Q3 comment: «we will be faced with a financial industry where investors buy index certificates to gain market beta exposure and then add a basket of hedge funds for the active alpha part». Over time, the regulators will catch up with this trend, with the result that the traditional asset management world (incl mutual funds) will become more flexible, and hedge funds will become more readily accepted across the world.

This is good and bad news for today's hedge fund industry. The good news is that the current 25% annual growth rate will continue and might even accelerate. The bad news is that the large inflows might have an impact on returns over the long run. Also, capacity will become scarcer. Capacity will actually become the buzzword of the future. There will be more and more capacity 'gurus', intermediaries who buy up capacity with long lock-ins, and broker the fund shares on the secondary market with hefty fees but better liquidity conditions. Nevertheless, I think that capacity should not be a problem in the next 3 years for most strategies for the following four reasons:

- Hedge funds still account for less than 1.5% of global stock markets and 9% of global mutual funds.
- Investment banks continue to reduce their proprietary trading desks. While the slack is being taken up by hedge funds – they have in fact become the new providers of liquidity to the global market place (eg convertible arbitrage) – the overall trading and market making volume has remained more or less stable
- Some strategies such as long/short equity have per definition unlimited capacity, in the sense that any semi-active stock mutual fund could be looked at as an index with a long/short overlay
- Hedge funds are much better prepared for the next bubble than in 1998, and are positioned accordingly. They have less leverage, a lower net exposure, more sticky investor capital, more stable funding, and monitor their capacity much closer.

In other words, while returns might be a bit lower going forward and the odd hick-up can never be avoided, hedge funds will continue to grow and to provide comparatively attractive risk-adjusted returns.