Picture: «The Matterhorn» (white dot) taken from the top of Mont Fort 3330m | Verbier | Switzerland | Photographer: Christian Forrer

Hedge Fund Industry Commentary: Fourth Quarter 2002

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General market environment in the Fourth Quarter of 2002

The last quarter of 2002 started on a very upbeat note with a tremendous stock market rally and US and European indices producing double digit returns. October was the strongest month led by large cap and technology stocks. November continued full steam ahead as the rally became broader based, including smaller cap and value stocks. There was no real news to fuel the rally, which was attributed to previous overselling as well as getting the earnings seasons and downgrades out of the way. Tensions in the Middle East and Korea, as well as the ensuing increase in oil prices, then all put an abrupt halt to the party: major indices around the world gave up most of their November gains. In Japan, internal issues on the banking sector and non-performing loans in particular were at the forefront, resulting in a negative index return for the whole quarter. All told, from October to December, the MSCI World, S&P 500, Nasdaq, and MSCI Europe increased by +7.32%, +7.92%, +13.95, and +4.15% respectively, while the Nikkei declined by -8.57%.

The major event on the interest rate front was the US Fed's lowering of the Fed Funds rate from 1.75% to 1.25% in early November, which was followed by bonds rallying on the short end of the USD yield curve. USD 3-month interest rates dropped from 1.55% to 1.18% and USD 2-year rates fell from 1.72% to 1.67%. The long end of the curve, however, increased eg 10-year rates from 3.60% to 3.86%. In Europe, short term rates dropped only slightly from 3.18% to 2.80% while 10-year rates stayed more or less steady around 4.2%. The JP Morgan Global Bond Index gained +4.16% in the fourth quarter, part of which was due to currency gains, while the Pictet Swiss Bond Index was up +2.17%. The Merrill Lynch High Yield Index was up +8.34% based on to narrowing credit spreads.

On the currency front, the US Dollar weakened due to the threat of a pending war on Iraq and the general state of the US economy: The Euro ended the quarter at 1.04 (up 5 Cents), the JPY strengthened slightly from 123 to 120, and the CHF strengthened from 1.48 to 1.40. Gold rallied from 318 to 351 USD per ounce in the fourth quarter. Brent Crude Oil, on the other hand, ended the quarter at USD 31.1, up 2 USD from its previous quarter-end price.

Performance of hedge funds in the Fourth Quarter of 2002

From October to December 2002, the equal-weighted HFR Composite Index was up +2.82% and the asset-weighted CSFB/Tremont Index up +2.13%. This brings the 2002 results for the two indices to a meager -1.18% and +3.05%, respectively. The performance of the HFR Funds of Funds Index was similarly disappointing, particularly compared to longer-term absolute return expectations, at +1.39% for the quarter and +1.09% for the year. The dispersion of individual strategy returns was again very wide. For once, most strategies were positive, with the exception of short-sellers (not surprisingly, they suffered from the October/November rebound) and CTAs. The leading performers were distressed securities, sector funds, emerging markets and convertible arbitrage.

Directional Equity Strategies: The HFR Equity Hedge index increased by +2.50% for the quarter. However, many directional equity managers continued to struggle: fundamental stock picking did not help them in the previous quarter when all stocks were being dumped across the board, and neither in October as companies with poor fundamentals had the strongest run. In November, things were a little easier to manage as the breadth of the rally increased (the Russell 2000 increased by only +3.1% in October, but by +8.8% in November). These sharp upward movements can be very damaging to directional equity managers, many of whom have a fundamental value approach. The US and Europe components of the MSCI Hedge Fund Security Selection Index performed +3.08% and +3.94%, respectively. Interestingly, the monthly breakdown shows that US managers perform better in increasing markets while their European counterparts do much better in declining markets, as was the case in December. The Nikkei was uncorrelated to the rest of the world for the quarter and the Asia Hedge index for Japan showed a decline of -0.68%. In this market context, it came as no surprise that short-sellers lost -7.76% for the quarter.

Hedge Fund Strategy	Return Q4 2002
HFR Funds of Funds	1,39%
HFR Hedge Funds	2,82%
CSFB/Tremont Hedge Funds	2,13%
Distressed securities	4,98%
Sector specialists	4,82%
Emerging markets	4,63%
Convertible arbitrage	4,75%
High yield	3,34%
Statistical arbitrage	2,91%
Macro	2,63%
Long/short equities	2,50%
Merger arbitrage	1,54%
Fund market timing	1,35%
Fixed income arbitrage	1,26%
Market neutral equity	1,03%
MBS arbitrage	0,21%
CTAs	-0,77%
Reg D arbitrage	-5,40%
Short-selling	-7.76%
MSCI World	7,32%
JPM Global Bonds	4,51%

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

Relative Value Equity Strategies: Convertible arbitrageurs were up +4.57% for the quarter. Returns were driven by credit tightening, healthy levels of volatility and catch-up buying by the convertible community. Over the period, the S&P investment grade index tightened by 30 bps and the S&P speculative grade index tightened 160 bps. These variations hide somewhat the huge movements observed in specific names such as bellwethers Vivendi Universal which tightened 1,565 bps, Tyco 290 bps and France Telecom 154 bps. Implied volatilities richened, particularly in the US, in spite of falling realized volatilities. This apparent contradiction is explained by expectations of higher realized volatilities in the first half of 2003, but also by the huge appetite of convertible players to put money to work. Primary issuance picked up slightly from Q3, yet remains well below levels observed in 2000 and 2001. The issue of two large European mandatory convertibles by Swiss Life and Credit Suisse was a significant development marking the first real acceptance of the structure in Europe. The outlook for 2003 is one of strong demand and uncertain supply.

Merger arbitrageurs were up +1.54% for the quarter. More stable equity markets and marginally firmer economic outlook underpinned a moderate increase in merger arbitrage activity, with new deals coming out at attractive spreads. Concurrently, decreased risk aversion drove spreads on existing positions tighter. No significant deal break affected the market over the period. The largest deals outstanding are a USD 55 bn deal by Pfizer for Pharmacia, the Crédit Agricole USD 19 bn acquisition of Crédit Lyonnais, and the HSBC USD 14 bn bid for Household International.

Statistical arbitrageurs were up +2.91% for the quarter. The stabilizing equity environment bode well for the strategy. Long term investors came back to the market while trading patterns reverted to more rationality. Even the month of December, which saw equities correcting to the downside, was very smooth given the movement came about with little volatility. The stabilizing equity environment drove long term investors back to market and stocks reverted to a more rational behavior. Market neutral equity managers were up +0.21% for the quarter. The month of October was difficult as it saw a strong inflection point for companies which the market had most favored and hence a poor performance for the momentum components of most managers. November and December were successful months and largely driven by the strength of valuations signals.

Relative Value Fixed Income Strategies experienced a testing quarter. The bond rally observed in the previous quarter gave way to a range trading environment in the fourth quarter where yields on US bonds across all maturity levels oscillated to end the quarter at slightly higher yields. Swap spreads tightened providing support for a good performance of pure relative value players. Volatility spiked supported by the lack of direction in terms of an economic recovery. Due to these market readjustments, the possibility of the re-hedging of FNMA's asset/liability gap has partially receded. Despite the reversal in trends in the markets, fixed-income arbitrageurs delivered positive returns, on average ending the quarter up +1.26%. Going forward, the outlook remains neutral until market-moving question-marks (Iraq and North Korea outcome, terrorist threats, Middle East instability, flagging economic recovery and direction of Fed policy) get resolved. The mortgage-backed securities markets remained well-bid. The Fed's ease in November combined with a steep yield curve and declining but solid mortgage refinancings provided abundant supply of opportunities, which helped mortgage arbitrageurs end the quarter up by +1.03% on average. The outlook for this segment going forward remains positive in the short term, since the fundamentals remain in place for the generation of substantial carry returns. In the medium term, the outlook will depend on the Fed's monetary policy, especially since an eventual tightening and therefore a partial flattening in the yield curve could negatively impact the richness of opportunities. The continued rumours on the impending discussions over the future of the «implied guaranteed» status of FNMA and FRMC remain. However, due to the economic uncertainties hanging over the recovery of the US economy, most market participants believe there will not be a rushed procedure to tackle such a challenging topic.

Directional Fixed Income Strategies: US credit spreads tightened during the second half of the quarter, providing a year-end boost in the performance of high yield funds that ended up +3.31%. A decrease in the downgrade speed, a stabilization of the recovery and default rates – all fundamental inputs in the determination of the term structure of credit spreads - provided the support for this tightening. The outlook for the sector remains neutral in the short term, since we attribute some of this contraction to the unsustainable levels which culminated in the record levels of spreads of the previous quarter and not to a fundamental improvement in the corporate outlook. Furthermore, the clearer spectre of war in Iraq and its potential ensuing credit-spread widening consequences could provide support for further instability and volatility. In this environment,

Picture: Montblanc mountain range taken from the top of Mont Fort 3330m | Verbier | Switzerland | Photographer: Christian Forrer

agile directional relative value players could outperform while long-bias or structural event-driven players could suffer. Progressing down on the credit quality range, distressed investors benefited from the same spread contraction and delivered a strong performance. The best performers benefited from the 'bottom fishing' of fallen angels which, upon balance sheet analysis offered assets with inherent value, provided them with bright prospective valuations post restructuration. The outlook for the segment remains selectively positive. In an eventual re-widening of spreads as the possibility of war strengthens conviction, investors holding mostly long positions could be affected while selective bottom fishers of fallen angel paper could still deliver outperformance. Emerging markets debt continued to suffer from the malaise hanging over G7 economies. The EMBI index surged at the end of the year to deliver a performance of +14.24% thanks to solid contributions by Mexico and Russia. However, on a risk adjusted basis, the segment remains far too volatile with continued regional risks. The left leaning policies of Lula in Brazil, the ongoing civil revolt in Venezuela and potential Middle Eastern unrest in case of war in Iraq contribute to our neutral stance for the region.

CTAs performed slightly negative (-0.77%) in Q4 2002. October and November were difficult months for managed futures strategies: Trends in the bonds and stock indices that had been profitable over the previous five months reversed and caused losses in most sectors. Only the agricultural sector performed flat to slightly positive. In December, the CTAs performed strongly again. Short USD positions were very profitable with the dollar hitting a three year low against major currencies. Long positions in bonds also contributed significantly to profits as interest rates continued to drop. Macro hedge funds were up +2.63% for the quarter, benefiting from the rally that followed the 50 basis point Fed Funds rate cut. Good profits were also achieved in the energy markets, which rallied on concerns of a war in Iraq and a strike in Venezuela.

Going forward, we are bullish on MBS arbitrage, distressed securities and CTAs, and neutral on most other strategies, including fixed income arbitrage, convertible arbitrage, market neutral equity, as well as long/short equity. The outlook for merger arbitrage continues to be negative.

Hedge fund performance in 2002

1994, 1998 and 2001 were difficult years for hedge funds in general but at least they ended with a slightly positive performance. Year 2002 on the other hand turned out to be

Hedge Fund Strategy	Return 2002	Return 2001	Ret pa 1994-02	Stdev pa	Sharpe Ratio pa	Corr MSCI
HFR Funds of Funds	1,09%	2,76%	7,07%	6,44%	3,32	0,56
HFR Hedge Funds	-1,18%	4,62%	11,28%	7,76%	0,81	0,74
CSFB/Tremont Hedge Funds	3,05%	4,41%	10,64%	8,90%	0,63	0,47
Long/short equities	-4,38,13%	0,46%	15,08%	9,84%	1,02	0,71
Reg D arbitrage	-9,14%	-1,79%	13,70%	7,88%	1,10	0,38
Sector specialists	-12,33%	-4,90%	13,37%	16,17%	0,52	0,65
Fund market timing	-2,20%	4,13%	11,63%	7,20%	0,92	0,70
Convertible arbitrage	9,11%	13,34%	11,17%	3,56%	1,73	0,31
Merger arbitrage	-0,81%	2,77%	11,06%	3,84%	1,58	0,49
Distressed securities	5,39%	13,13%	10,12%	5,70%	0,90	0,48
Macro	8,26%	6,89%	10,06%	7,86%	0,64	0,38
MBS arbitrage	8,85%	21,37%	9,96%	5,15%	0,96	0,01
Market neutral equity	1,80%	6,69%	9,35%	3,35%	1,30	0,17
Statistical arbitrage	-2,31%	1,67%	8,18%	4,14%	0,77	0,56
CTAs	11,80%	0,83%	6,46%	8,48%	0,17	-0,20
High yield	7,46%	5,34%	6,12%	4,89%	0,23	0,47
Emerging markets	4,59%	10,49%	5,80%	15,95%	0,05	0,62
Fixed income arbitrage	8,78%	4,74%	5,62%	4,39%	0,14	-0,06
Short-selling	25,06%	8,79%	3,40%	24,06%	-0,07	-0,69
MSCI World	-21,05%	-17,84%	4,43%	14,92%	-0,04	1,00
JPM Global Bonds	19,36%	-0,78%	6,33%	6,00%	0,22	0,00

Source: Hedge Fund Research Inc., Barclay Trading Group Ltd. Note: All data series start in 1994 because data on certain strategies was not available before that year.

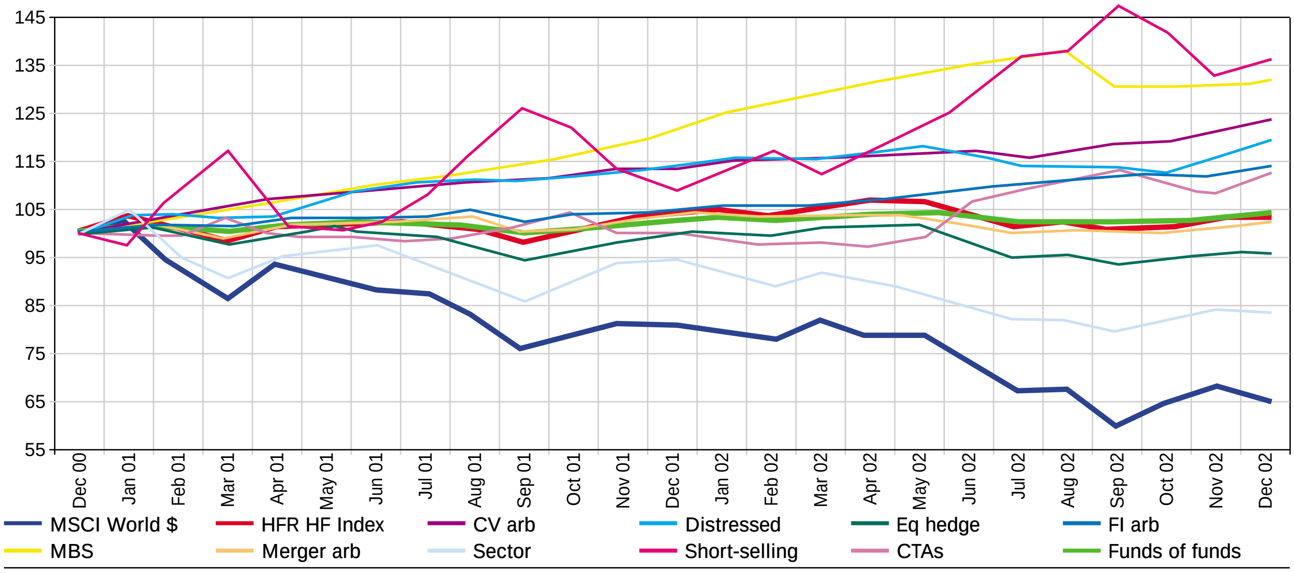
the first negative year for hedge funds in the last fourteen years! Long/short equity funds disappointed most, finding it difficult to cope with the ever changing market sentiment. Most other hedge fund strategies ended the year flat to slightly positive, including funds of funds. Short-sellers and CTAs were the only strategies with double digit positive returns. Year 2002 also featured a few highly publicized bankruptcies such as Lipper, Beacon Hill and Eifuku, plus the closure of some smaller hedge funds that had been operating below breakeven levels. Overall, net inflows into hedge funds continued, albeit at a slower growth rate than in the last three years. Essentially, 2002 was a continuation of year 2001, both in terms of dismal global stock markets, as well as the lack of consistent arbitrage opportunities. The line chart below shows the performance of different hedge fund strategies over the last two years. Only few strategies have done well over both years: short-sellers, MBS arbitrage, convertible arbitrage and distressed securities. Nevertheless, despite performing well below their long term return objective, hedge funds have outperformed the MSCI World Index by a wide margin.

Hedge fund performance since 1994

Obviously, the last two years have not been typical years for the hedge fund industry. When looking at hedge fund returns in a wider historic context, a few interesting conclusions can be drawn. The first take away is that, with the exception of short-sellers, all hedge fund strategies have managed to outperform stocks during the period of 1994-2002, not only on a risk-adjusted return basis but also on a return-only basis. The second interesting fact is the asymmetric return structure of hedge funds, as shown by the two charts below. While hedge funds have managed to perform similar to, or slightly below stocks in bull market years, they have added their real value by preserving capital in the bear market years. The pay-off structure of a diversified hedge fund portfolio could thus almost be thought of as a call option on the global stock market, with a negative premium ie the investor gets paid to hold the call option. Maybe the word «hedge» funds is not so wrong, after all?

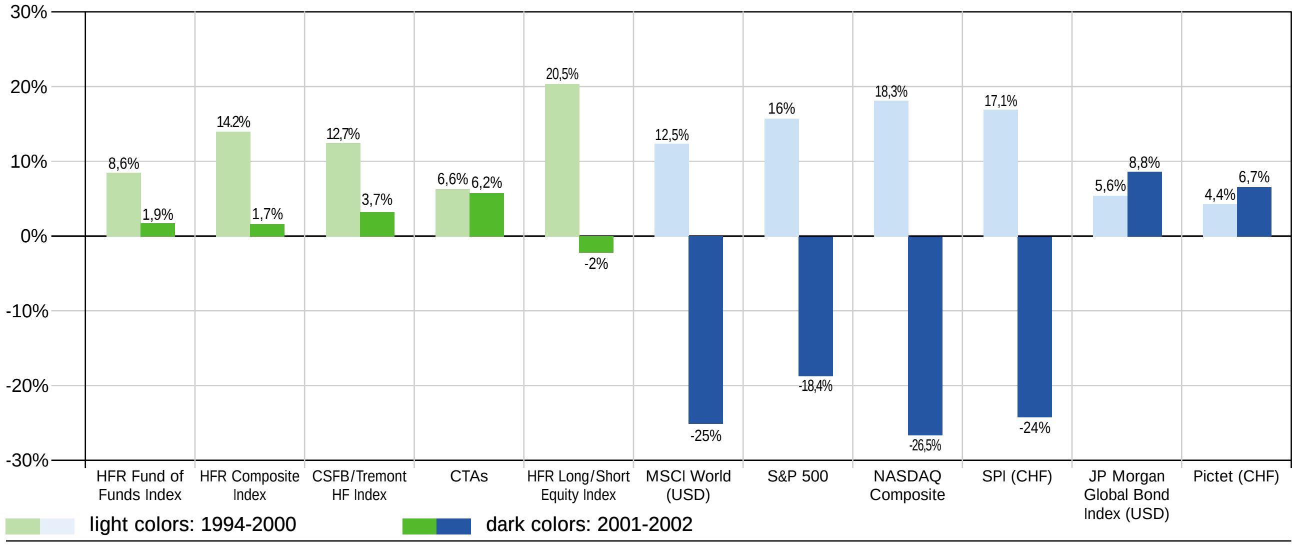
The third interesting fact is that funds of funds have underperformed the hedge fund indices by some 4% pa, as evidenced in the table above. We see the following possible explanations for this phenomenon: First of all, funds of funds still charge average fees of 2-3% pa. Secondly, the hedge fund indices contain a survivorship bias of roughly 1.5% pa which is not the case for the funds of funds figures. Thirdly, the hedge fund indices are dominated largely by long-biased long/ short equity hedge funds, representing

Hedge Fund Strategy Returns since December 2000



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

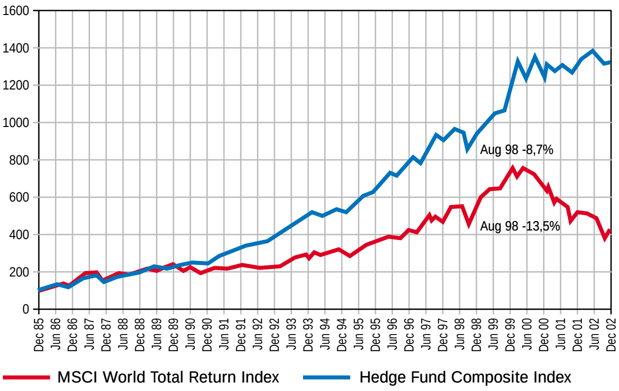
Comparing Hedge Fund Returns



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

the strategy that has been the top performer during the bull market years. The funds of funds on the other hand, have had much less of a «bull market» bias in their portfolio since they tend to be more diversified. All in all, funds of funds have probably on average «earned» a large part of their fees, but not all of their fees. In addition, the quality of funds of funds varies significantly – and we estimate the gap between sophisticated and less sophisticated funds of funds to widen further. This means that going forward, the selection of the right fund of funds will become even more important for investors seeking consistent positive returns in these tough markets.

Return Divergences



Source:Data source: Hedge Fund Research Inc., Barclay Trading Group Ltd.