

Hedge Fund Industry Commentary: Fourth Quarter 2003

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General market environment in the fourth quarter of 2003

Major equity markets posted their third winning quarter in a row to end the year in positive territory. The fourth quarter confirmed what had already been partly anticipated by markets in the prior months: the economic situation in the US and around the world is improving.

Among the highlights for the quarter was the Q3 GDP number in the US that showed tremendous strength and was much above expectations. Lower unemployment claims also provided some positive news on the labor front. At the same time, the interest rate environment remained tame and the Fed indicated that tightening was not in the pipeline yet. In October and November, equities followed the same path as the previous six months, with cyclical sectors outperforming more defensive ones. This trend changed in December when defensive sectors, especially energy, came to the forefront. Small cap stocks fared much better than large caps; with a 2 to 1 outperformance in many cases. Another marking attribute was the outperformance of low quality stocks (as measured by financial strength) versus high quality ones. As one would expect from the beginning of a cyclical upturn, economically sensitive stocks had the best performance. Q4 performance was strong across the board with +13.92% for the MSCI World, +11.32% for the S&P 500, +12.11% for the NASDAQ, +10.86% for MSCI Europe and +4.47% for the Nikkei.

Following July's substantial USD yield curve reversal, which materially widened generic option adjusted spreads (OAS) and volatilities across most interest rate product classes, the prevailing theme of the fixed income markets in the last quarter of year 2003 was a «reversion» of spreads back to pre-July levels. The USD yield curve steepened slightly: the USD 3-month interest rates decreased slightly to 0.89%, while the USD 2-year rates increased from 1.58% to 1.86% and the 10-year long end of the curve from 3.96% to 4.26%. The US Fed Funds rate remained at 100 bps. In Europe, short term rates stayed around 2.03% while 10-year rates increased from 4.04% to 4.30%. Overall, the JP Morgan

Global Bond Index gained +5.03% in the fourth quarter which was partly due to currency gains. The Pictet Swiss Bond Index was up an insignificant +0.62%. The high yield markets continued to deliver tremendous performance in a year that saw a gradual recovery in economic fundamentals. The Lehman Brothers High Yield appreciated by +6.66% in Q4 on the back of the continued tightening of credit spreads, and ended the year up with a tremendous +32.42%. On the currency front, the US Dollar continued its weakening against the Euro to end the quarter at 1.25 (up 8 Cents). The JPY strengthened slightly to 106, whereas the CHF strengthened to 1.25 from 1.42. Gold continued its rally to USD 416 per ounce (up from USD 385), while Brent Crude Oil prices increased slightly to USD 30.

Performance of hedge funds in Q4 2003

Apart from short-sellers, all hedge fund strategies ended the quarter with a positive performance. Q4 was led by the long/short equity and credit strategies, followed by the CTAs and relative value fixed income strategies. Overall, from October to December 2003, the equal-weighted HFR Composite Index was up +5.81% and the asset-weighted CSFB/Tremont Index up +4.47%. The performance of the HFR Funds of Funds Index was up +3.48%, which was below the single manager indices, explained by a much lower long-equity bias, as well as the additional fee layer and lower survivorship bias of the Funds of Funds Index.

Directional Equity Strategies: In Q4, long/short equity managers caught only part of the upside of the equity markets and delivered +6.68%. They started the quarter by leveling off the October rally end even outperformed markets in November. December, however, was a more difficult month. This is explained by a violent sector rotation towards defensive stocks, and in particular the energy sector. Another reason is that directional equity managers have been more exposed to small caps over the last couple of years while markets in December favored large caps. When looking on a regional level, emerging markets hedge funds had the best performance for the quarter as well as the year with +10.82% and +40.57% respectively. They caught 80% of the upside offered by their index. US focused managers were up +6.39% for the quarter and +16.74% for the year. They were less talented in getting the upside of which they

Hedge Fund Strategy	Ret Q4 2003
HFR Funds of Funds	3.48%
HFR Hedge Funds	5.81%
CSFB/Tremont Hedge Funds	4.47%
Emerging markets	10.82%
Long/short equity	6.68%
Distressed securities	6.59%
Macro	6.19%
Sector specialists	5.97%
High yield	4.46%
CTAs	3.49%
MBS arbitrage	2.65%
Fixed income arbitrage	2.54%
Merger arbitrage	2.32%
Convertible arbitrage	2.20%
Market neutral equity	0.99%
Statistical arbitrage	0.57%
Short-selling	-8.29%
MSCI World	13.92%
JPM Global Bonds	5.03%

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

captured «only» +65%. European long/short managers delivered +2.07% for the quarter and +6.56% for the year. Their capture ratio for the year was at 55%. Japanese managers were up +2.88% for the quarter and +15.77% for the year, equating to a 66% capture ratio. Emerging market managers tend to have a longer bias than their developed world counterparts which in part explains the above ratios.

Relative Value Equity Strategies: Convertible arbitrageurs were up +2.20% in the fourth quarter. Managers benefited from a continuation in the powerful credit spread rally which brought both investment grade and sub-investment grade indices substantially higher. Compressing levels in both realized and implied volatility levels, as well as the Parmalat fraud, provided a number of challenges to managers and detracted returns. Many hedge funds got caught off guard by the extent of the Parmalat fraud, which not only caused the bonds of the company to trade down from 80 to 8 but caused ripples throughout the Italian market and across the European market. Over the period, the S&P investment grade index tightened from 188 to 164 bps and the S&P speculative grade index tightened from 980 to 767 bps. The actual volatility of the S&P 500 index continued its fall, compressing from 12.5% to 10.5% which was putting pressure on implied volatility levels, with the US index falling from 29.5% to 28.5% and the European index contracting from 33% to 32%. Primary issuance over the quarter was sufficient to bring aggregate 2003 issuance to its second

highest level in history after 2001, with a total notional value of USD 169.9b! October and November saw moderate issuance, with December providing most paper notably with a number of billion euro deals, including those by KfW/Deutsche Post, Repsol, Swisscom and Generali. The most significant US deal was a USD 2b convertible issued by American Express.

Merger arbitrageurs were up +2.09% for the quarter. Deal activity has seen only a moderate pickup in activity despite low equity market volatility, firm equity prices and a positive economic environment. The month of October provided for strong anticipations with over USD 70b in transactions announced in a single day, to include the USD 47b deal between Fleet Boston and Bank of America, the USD 16b combination between WellPoint and Anthem, and GE's USD 9.5b bid for medical imaging company Amersham. The months of November and December provided a return to a more moderate pace of activity. Europe saw activity principally in the small to mid-capitalization area with deals such as GE's property unit acquisition of French Sophia SA. In aggregate, merger arbitrage spreads remain tight, but the outlook for 2004 is distinctly more encouraging with the high levels of free cash flow generation by corporations in otherwise generally mature markets pointing to additional deal activity. Statistical arbitrageurs were up +0.57% for the quarter. While traded volumes did remain supportive up to the end of the year slowdown, a lack of individual stock volatility substantially dampened trading opportunities. The pattern was observed broadly across geographical zones and meant that only managers with sufficient systems sophistication did manage to significantly demark themselves. Market neutral equity managers were up +0.99%. The market continued to favor companies with low earnings to price, low dividends, low momentum characteristics, low USD prices and attractive betas in contrast to usual long term investment rationales. December appears to have marked a potential inflexion point with defensive stocks gaining some momentum.

Relative Value Fixed Income Strategies: In a background of gradually improving economic news, managers across most fixed income product classes took the opportunity presented by the previous quarter's widening of spreads to set up relative value positions which would ultimately benefit from a reversion to «fair» market pricing levels. This activity contributed to help swap spreads contract and revert back to tighter than pre-July-stress levels, providing a good environment for managers to perform. Notwithstanding this benign relative-value environment, performance was not as

good as it could have been, since most managers remained cautious and underexposed after having been hurt by draw-downs in Q2, fearing an eventual reverberating second wave of widening. In directional terms, the curve started developing an expected and moderately bearish trend for bonds as the economic recovery continues to gather pace. This in turn enticed front-end traders (<2 years) to bid up the likelihood of FED hikes which quickly reverted back as the FED continued to signal that rates would remain low until the output gap is closed and the threat of inflation becomes real. This recovery environment helped fixed income arbitrageurs who benefited from sustained volatility reduction and OAS compression stemming from risk-premia reduction. Funds delivered a solid performance (HFR FIA +2.54%) on average, capping a year of solid mid-range returns despite violent market surprises in March and July. The curve remains steep and managers started positioning their books short anticipating sustained recovery. In the absence of macro economic surprises (terror, Freddie Mac) we expect managers to generate stable but moderate returns in an orderly bear, range-trading bond environment. MBS arbitrageurs delivered moderate returns (HFR MBS +2.65%) in spite of strong trading fundamentals of low financing rates and a steep yield curve. They ended a long year full of market surprises, including July's market dislocation and the debate on the financial viability and status of the agencies. As the economy recovers, the fundamentals should continue to be eroded, partially reducing the set of opportunities. However, the agency guarantee debate should remain in the sidelines entering into an election year. We anticipate continued moderate performance.

Directional Fixed Income Strategies: The dominant theme of the fourth quarter continued to be the «search for yield». Q4 provided an extremely interesting insight into the contrast between fundamentally and technically driven trading styles. Although fundamental analysis suggested widespread and historical richness – or tightness – and therefore no intrinsic value across most credit sensitive segments, investors continued pouring money into increasingly risky assets in the search for yield. Long/short high yield hedge fund managers took advantage of this technical flow factor despite fundamental tightness signals and managed to deliver very solid returns as a group (HFR HY +4.46%), even as credit spread compression started to slow down by year end. As the search for yield rush slows down, professionals expect opportunities to become less abundant and high yield performance to remain moderate driven by relative value opportunities stemming from fundamental analysis

rather than directional long bias. Tightening credit spreads, rallying stock markets and improved economic fundamentals also supplemented the performance of distressed securities managers, who concluded a stellar year with a very strong quarter (HFR Dist +6.59%), thereby capping a cycle characterized by abundance of opportunities driven by the massive corporate collapses and scandals of 2002. American based opportunities should become less abundant in 2004, perhaps ceding the limelight to European opportunities lead by Parmalat. Nevertheless, continued economic recovery should provide further support for mid-range sector performance. Strong US recovery, sustained inflows and positive news continued to foster emerging market debt performance this quarter, helping emerging market debt managers deliver an outstanding performance. Despite improving fundamentals, the most seasoned market professionals advise caution as the market appears extremely rich.

CTA and Macro Strategies: CTAs achieved a good +3.49% return in the last quarter of 2004. Overall, currencies were the best sector followed by metals and stock indices. In October, most of the performance came from the commodity sector, particularly the metals as platinum reached a 23-year high and copper rallied over 10%. Currencies and stock indices also produced good returns, and so did agricultural markets, with soybeans reaching a six-year high. Only the volatile energy markets produced negative results. In November, most CTAs ended the month with a slightly negative performance. Geopolitical tensions and terrorist attacks in Turkey caused stock prices to fall mid-month, hurting the managers' long positions. At the same time, the USD continued its decline, reaching ten and five year lows against the Canadian dollar and the Sterling respectively. Energy trading continued its volatile path as oil prices rose initially to above USD32 a barrel, but then plunged again when the OPEC released higher output figures. CTAs were positive again in December. Strong economic figures confirmed the health of the US economic recovery and sent stock index prices higher generating profits for the long positions. Currency trading was also very profitable due to the steady fall in the USD. Long positions in major currencies like the EUR, CHF and JPY all benefited. The improved global economic outlook and the weaker USD helped metals which continued their strong rally. Energies were volatile throughout the month on concerns of supply and cold weather. Livestock markets were particularly volatile due to the first case of mad cow disease found in the US. Macro hedge funds recorded an even stronger performance over the quarter, up +6.19%.

Hedge Fund Strategy	Ret 2003	Ret 2002	Ret 2001	Ret pa 1994-2003	Stdev pa	Corr MSCI
HFR Funds of Funds	11.30%	1.09%	2.76%	7.48%	6.15%	0.56
HFR Hedge Funds	19.94%	-1.18%	4.62%	11.93%	7.45%	0.74
CSFB/Tremont Hedge Funds	15.42%	3.05%	4.41%	11.11%	8.48%	0.48
Emerging markets	40.57%	4.59%	10.49%	8.76%	15.45%	0.64
Distressed securities	29.74%	5.39%	13.13%	11.93%	5.69%	0.50
Sector specialists	27.34%	-12.33%	-4.90%	14.63%	15.53%	0.66
Macro	22.22%	8.26%	6.89%	11.13%	7.71%	0.41
Long/short equities	20.91%	-4.38%	0.46%	15.61%	9.47%	0.70
High yield	20.78%	7.46%	5.34%	7.33%	4.81%	0.48
Fixed income arbitrage	9.17%	8.78%	4.74%	5.97%	4.21%	-0.04
Convertible arbitrage	8.97%	9.11%	13.34%	10.94%	3.54%	0.27
Merger arbitrage	8.13%	-0.81%	2.77%	10.76%	3.70%	0.48
CTAs	7.97%	11.80%	0.83%	6.45%	8.50%	-0.15
MBS	6.80%	8.85%	21.37%	9.61%	4.89%	0.01
Market neutral equity	2.45%	1.80%	6.69%	8.55%	3.28%	0.14
Statistical arbitrage	2.25%	-2.31%	1.67%	7.48%	3.98%	0.51
Short-selling	-21.66%	25.06%	8.79%	0.89%	23.21%	-0.69
MSCI World	30.82%	-21.05%	-17.84%	6.81%	14.82%	1.00
JPM Global Bonds	14.53%	19.36%	-0.78%	7.21%	6.30%	0.03

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.

supported by the rally in the global equity markets and the fall of the USD against other major currencies. Macro managers in general also benefited from their long exposure in treasuries.

Going forward, we remain bullish on long/short equity and macro funds. We are slightly bullish on convertible arbitrage and distressed in the short term, but neutral in the more medium term. Furthermore, our outlook is neutral on CTAs, merger arbitrage, statistical equity arbitrage, MBS arbitrage and fixed income arbitrage. Long/short high yield is currently over-exposed to a widening of credit spreads, hence underweighting is recommended for cautious investors. We are also negative on short-sellers.

Hedge fund performance in 2003

After the difficult 2001 and 2002 period, 2003 was a nice relief not only for equity and bond investors but also for the hedge fund industry. The positive hedge fund performance was driven by bullish global stock markets, a drastic contraction of credit spreads, and clear trends in currencies, interest rates and commodities. With the exception of short-sellers, all hedge fund strategies were positive. Many funds ended the year up with double digit returns, led by distressed, macro and long/short equities strategies. Overall, net inflows into hedge funds accelerated in the second half of the year.

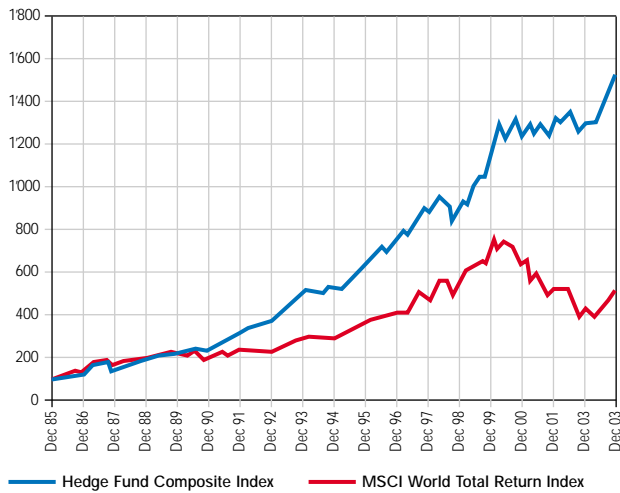
Long term hedge fund performance

In the last twenty years, hedge funds have held up very well in a variety of different market environments for both stocks and bonds. On average, hedge funds managed to capture a good part of the upside in bullish environments and preserved capital when markets were tough. Over the last ten years, ie during the period of 1994-2003, all hedge fund strategies with the exception of short-sellers, fixed income arbitrageurs and CTAs outperformed stocks, particularly on a risk-adjusted basis. Over the same period, funds of hedge funds outperformed stocks and bonds, but with a lower volatility and uncorrelated returns.

How much should a risk adverse investor allocate to hedge funds?

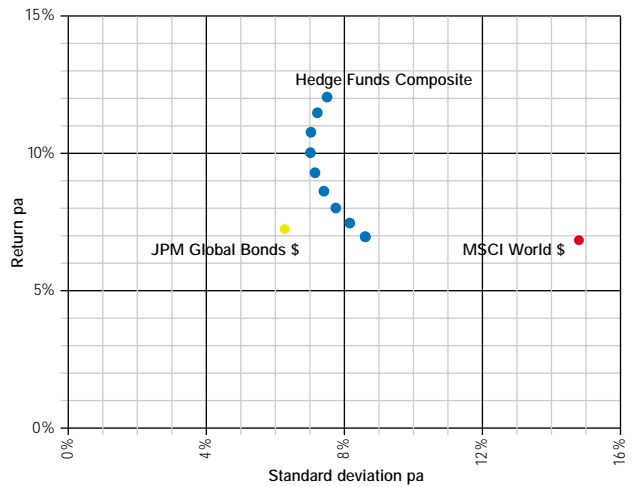
The efficient frontier chart below is based on data for the period of 1994-2003 and shows the impact of adding hedge funds to a traditional stock/bond portfolio. The lowest dot on the blue curve is the starting point for the investor: we assume that our global, USD based investor owns 50% global bonds and 50% global stocks. Now hedge funds are added incrementally in 5% steps all the way up the blue curve to its top where our investor holds 100% hedge funds in his portfolio. As can be seen, when allocating to hedge funds, the risk decreases while the return increases. The

Chart 1 | Long term performance comparison



Source: MSCI; TASS; Hedge Fund Research Inc.

Chart 2 | Portfolio impact of hedge funds



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

chart actually leads to a very controversial conclusion: Projecting historic return, risk and correlation characteristics forward, a risk adverse investor should hold 65% hedge funds in his portfolio, since this is the ‘minimum risk portfolio’ according to modern portfolio theory. Along similar lines, a risk neutral investor who simply wants to hold the «optimal» portfolio, should borrow 10% and invest 110% in hedge funds.

Obviously, Harcourt is not recommending that investors put all their money into hedge funds. First of all, there are certain caveats with the data of the composite hedge fund index such as survivorship bias, selection bias, long equity bias and fees, as evidenced by the lower returns of the HFR Funds of Funds Index compared to the HFR Composite Index. Secondly, standard deviation as a measure of risk is based on the assumption of normal distribution. Hedge fund returns are not entirely normally distributed and have a fat tail similar to that of stock market index returns. Thirdly, the time frame of the data is quite short. Finally and as a matter of principle, one never put all eggs in the same basket.

Having said all that, modern portfolio theory is not alone in suggesting that investors allocate a part of their assets in hedge funds. Interestingly, these allocations vary greatly by country and investor segment: We see allocations ranging from 1% for certain large european institutional investors who make their first step into the area; to 10-20% for many swiss private banks; all the way to 50% for certain sophisticated US university endowment funds and family offices. Harcourt believes the optimal number to be somewhere in between these extremes. We recommend to allocate at

least 10% (otherwise it is not worth the effort) and all the way up to 35%. The optimal figure will depend on: a) the degree of sophistication of the investor; b) the risk appetite of the investor - contrary to intuition, conservative investors should allocate more to hedge funds than aggressive investors; 3) liquidity constraints and legal restrictions, for example in the case of various pension funds and public institutions.

