Hedge fund industry commentary: fourth quarter 2004

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General market environment in Q4 2004

Equity markets around the world enjoyed a healthy rally towards the end of the year. This led to a MSCI World Equity Index rise of +11.59% over the quarter. Following a summer mired with pessimism, and with the US elections out of the way, investors took comfort in an abating oil price, notwithstanding the declining US dollar. US and European small caps outperformed large caps, but there was no significant difference between value and growth. In Q4, the S&P 500 gained +8.73% and the MSCI Europe was up +5.6%, whilst the Russell 2000 powered ahead by +13.72%. Having suffered a poor October, Japanese indices enjoyed a less pronounced year-end rebound, with the TOPIX up +4.31%, whilst small caps underperformed; rising only +0.77%. Emerging markets continued their scorching pace with the MSCI Emerging Markets Free index rising +16.81%.

In Q4, as the USD fixed income bear market progressed, the USD yield curve experienced substantial flattening, driven predominantly by the front end. Two factors influenced investors: on the one hand the widely expected rate hiking of the Fed which, despite the lack of strong economic recovery signs, readjusted rates to higher levels since the economy was perceived to be out of recession. On the other hand the uneventful back-end of the curve which remained relatively stable due to the lack of decisive indicators, either on recovery or deterioration trends. Relative value spreads in sovereign markets remained inactive and partially tightened with respect to one another, maintaining their overall levels. Over the quarter, the JP Morgan Global Bond Index gained +8.17%, the Swiss Bond Index was up +1.89%, and the Lehman Brothers High Yield Index appreciated by +6.05%. The USD 3-month interest rate increased from 2.02% to 2.56%, while USD 2-year rates increased from 2.64% to 3.11% and the 10-year long end of the curve stayed flat around 4.20%. In Europe, short term rates increased from around 2.04% to 2.47%, whereas 10-year rates decreased from 4.02% to 3.65%. The currency markets were marked by low volatility and a continued weakening of the USD. The USD/EUR exchange rate increased to record highs, moving from 1.24 to 1.36. The JPY strengthened to 103, while the CHF strengthened to 1.14 from 1.24. The energy markets continued to make headlines with WTI Crude Oil increasing to record highs during the quarter, ending at USD43. Gold increased to USD438 per ounce, up from USD418.

Performance of hedge funds in Q4 2004

The fourth quarter of 2004 provided a welcome relief, after a rather difficult spring and summer period. The HFR Funds of Funds Index returned +4.68% over the whole quarter, +0.75%, +2.47% and +1.40% in October, November and December respectively. With the exception of short-sellers, all hedge fund strategies ended the quarter in positive territory. The winners of Q4 were emerging markets; distressed securities; long/short equity (including sector specialists); and CTAs.

Directional Equity Strategies: Q4 was a relatively good quarter for directional equity strategies with the relevant index rising +5.41%, catching much of the upside seen in

equity markets. Despite a lackluster October performance, November and December were among the strongest months this year. US and European managers focusing on smaller cap stocks enjoyed a healthy rebound whilst those fighting the rally and playing the energy sector in December got caught out. Conversely, Japanese managers had mixed results being generally exposed to small and mid cap stocks. Emerging markets managers posted excellent results overall so long as they steered clear of Russia in the latter half of the quarter.

Relative Value Equity Strategies: Convertible arbitrageurs were up +0.71% for the quarter. The market firmed over the period, rising out of the trough it had sunk into during October. Implied volatilities were mixed to negative and the bulk of the performance came from the strong rally in credit, which saw the Lehman HY index richening by +6.05%. Over the period, the realized volatility of the S&P 500 index fell from 9.2% to 9.1%. The convertible market US implied volatility index rose from 28.4% to 28.7% and the European index fell from 27% to 25.8%. Primary issuance was poor with USD11.1b in the US and EUR3.5b in Europe, in both cases insufficient to make up for bonds coming to maturity. The most significant issue of the period was a last minute USD2.5b convertible preferred issue by Fannie Mae at the end of December. Merger arbitrageurs were up +3.29% for the quarter. Deal activity picked up over the period with definite increases in both European and transatlantic deals. Increased confidence in the economy and financial markets is leading cash rich corporations to put their capital to work in acquisitions and reorganizations. The period saw several large deals coming to fruition such as the contested Wellpoint/Anthem situation and the simplification of the Telecom Italia share structure. Announcements of large new deals included LSE/Deutsche Börse – Euronext; Nextel/Sprint; Guidant/Johnson&Johnson; and Veritas/Symantec. Statistical arbitrageurs were up +3.11% for the quarter. Volumes and market breadth improved after the lows experienced over the summer. Market neutral equity managers were up +1.78%. Valuation based factors brought large returns, as did other behavioral factors such as those concentrating on analyst revisions.

Table 1 | Hedge fund strategies in Q4 2004

Hedge Fund Strategy	Ret Q4 2004
HFR Funds of Funds	4,68%
HFR Hedge Funds	5,30%
CSFB/Tremont HF	5,64%
Emerging markets	8,73%
Distressed securities	7,67%
MBS arbitrage	7,35%
Sector specialists	5,44%
High yield	5,41%
Long/short equity	4,89%
Fixed income arbitrage	3,96%
Statistical arbitrage	3,84%
Market neutral equity	3,29%
Macro	3,11%
Merger arbitrage	1,78%
CTAs	1,21%
Convertible arbitrage	0,71%
Short-selling	-5,93%
MSCI World	11,59%
JPM Global Bonds	8,17%

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

Relative Value Fixed Income Strategies: As the quarter recovered from erratic volatility in sovereign US rates, it offered clearer opportunities in the front end as traders anticipated continued Fed hiking. European sovereign markets experienced substantial activity as the back end of the curve priced in skepticism on economic health while the European central bank remained inactive. The Japanese yield curve remained basically static, disappointing investors betting on a stronger recovery. The stable spread environment helped fixed income arbitrageurs realize moderate relative value, leveraged-carry, returns but lacking capital gains contribution (up +1.21%). More directional sovereign managers benefited from the flattening trend, easily outperforming pure relative value sovereign players. Despite the yield curve's flattening and a substantial tightening of mortgage OAS, MBS arbitrageurs delivered very healthy returns at +4.89% (this return however remains somewhat misleading due to the presence of a substantially outperforming outlier in the HFR MBS index).

Directional Fixed Income Strategies: Credit markets experienced a dramatic tightening which brought spreads across all ratings to historically tight levels. This assisted long/short credit funds to deliver strong returns (up

+3.96%). High yield managers started building widening biased positions cautiously. These technical factors helped distressed securities managers to outperform and maintain a top tier return ranking for the quarter (up +7.67%) and the year. Emerging market debt managers closed the year with another run of tremendous performance as all credit sectors benefited from technical flows.

CTAs and macro funds: In Q4, CTAs benefited from the emergence of sustainable trends, and were up +5.44%. Profits were derived primarily from short USD positions: a weak US job market and the uncertainty surrounding the US presidential election put significant downward pressure on the USD against all major currencies. Global equity markets also trended strongly as the re-election of George W. Bush removed some of the uncertainty as to the future economic policy of the US government. Stock indices posted multi year highs but volatility remained low. Long bond positions were also profitable. The performance in the energy sector was flat as crude oil experienced big price swings. WTI crude hit a record high but then fell by more than 20%. Dramatic price moves were also observed in the base metals markets. In October, copper suffered its largest single-day decline in nearly 17 years, only to rebound strongly due to Asian demand. The environment for the short term systematic managers improved throughout the quarter due to the increase of volatility in the currency and bond markets. The macro managers also performed well in Q4, returning +3.84%. Again, the USD was at the centre of attention and its weakness contributed to significant gains. Furthermore, the fixed income markets provided good opportunities on the back of the flattening of the USD yield curve.

Performance of hedge funds in 2004

2004 turned out to be a difficult but interesting year for hedge funds. The year started on a very good note with all strategies booking above-average returns in Q1. In April however, the markets shifted direction after the announcement of the payroll number in the US that surprised market participants. The shift in market direction initiated a period of five difficult months in which funds of hedge funds essentially bled month by month due to low volatility; low volume; and trendless markets, resulting in an average drawdown of -2.09%. Fortunately, in September the performance turned around, and this positive trend continued until the end of the year. Over the whole of 2004, the HFR Hedge Fund Index was up +8.91% and the HFR Funds of Funds Index was up +6.67%. Both numbers are probably tilted upward due to significant selection and survivorship biases. The more conservative funds of funds that included allocations to CTAs generally underperformed their less conservative, less diversified counterparts.

Directional Equity Strategies: Stock markets had a tumultuous year in 2004. Nevertheless, all major stock markets ended the year in positive territory. Following a good start, equities spent most of the year range bound, suffering from low volatility, little volumes and high correlations. A variety of macro factors caused jitters in the markets: a changing interest rate environment; a slowing US economy; and a weakening US dollar contended for attention with the emerging impact of China; rising oil prices; and geopolitical tensions. After October, once the uncertainties surrounding the US elections disappeared and liquidity returned to the markets, a strong year-end rally made for decent 2004 returns. The MSCI World Equity Index was up +12.83% (MSCI World Local Currency Index up +8.17%), whilst the S&P 500 was up +8.99% and the MSCI Europe gained +9.67%. Japan saw a very strong first quarter before market participants took some profits and subsequently endured a trend-less market to end the year with the TOPIX up +10.15%. Emerging markets, and Eastern Europe in particular, were the clear winners this year having surged strongly after a sharp May correction to end the year up +22.45% and +32.10%, respectively. Long/short equity managers ended the year at +7.37%, capturing most of the upside of world equity markets for the year. While volatility dropped across most markets, the disparity of returns

Table 2 | Hedge fund strategy performance

Hedge Fund Strategy	Ret 2004	Ret pa 94-04	Stdev pa	Corr MSCI
HFR Funds of Funds	6,67%	7,43%	5,95%	0,57
HFR Hedge Funds	8,91%	11,76%	7,23%	0,75
CSFB/Tremont HF	9,64%	10,98%	8,15%	0,49
Emerging markets	18,96%	9,56%	14,91%	0,65
Distressed securities	18,64%	12,51%	5,57%	0,51
MBS arbitrage	13,94%	10,09%	4,70%	0,02
Sector specialists	11,59%	14,47%	14,92%	0,66
High yield	10,08%	7,62%	4,65%	0,48
Long/short equity	7,37%	14,80%	9,18%	0,71
Fixed income arbitrage	5,52%	5,95%	4,02%	-0,04
Statistical arbitrage	4,87%	7,34%	3,94%	0,52
Market neutral equity	4,22%	8,15%	3,20%	0,16
Macro	4,09%	10,40%	7,48%	0,41
Merger arbitrage	4,08%	10,07%	3,64%	0,49
CTAs	3,22%	6,22%	8,41%	-0,12
Convertible arbitrage	1,08%	10,13%	3,53%	0,25
Short-selling	-3,80%	0,15%	22,25%	-0,70
MSCI World	12,83%	7,34%	14,33%	1,00
JPM Global Bonds	10,11%	7,47%	6,33%	0,06

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.

amongst long/short managers seems to have increased. On both sides of the Atlantic, managers who were long in the lower range of market capitalizations had greater return potential. In general, managers who took on larger bets through stock specific risk or generous balance sheets were able to generate sufficient returns in the low volatility environment. Conversely, tight stop losses and rigorous risk management left many managers with sub-par returns. Most managers focused on Japan made their returns in the first quarter of the year on the back of an extremely strong small cap rally. Performance for the rest of the year was generally lackluster. Emerging markets managers enjoyed a strong year as their long bias helped them capture much of the liquidity fuelled market surges.

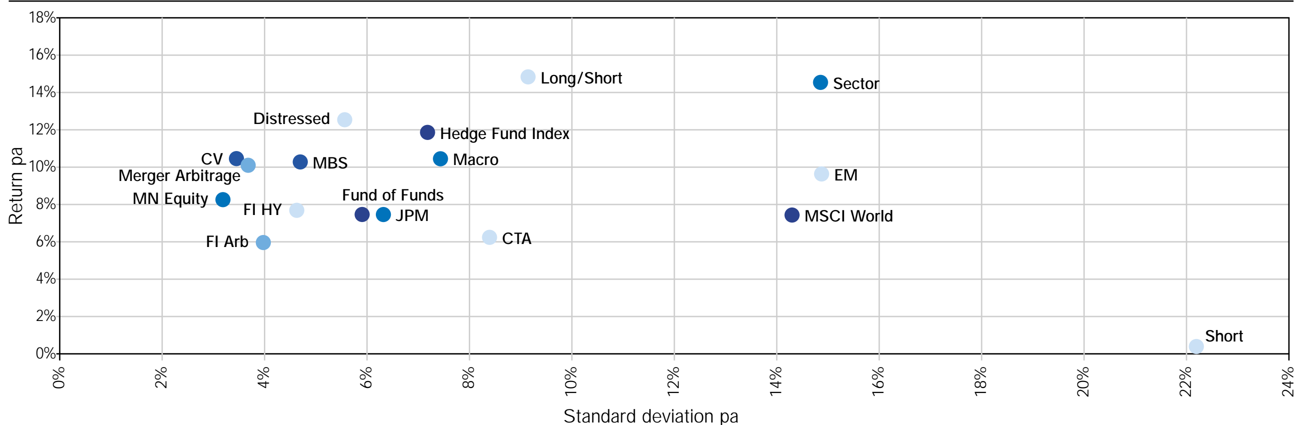
Relative Value Equity Strategies: Convertible arbitrageurs were up +1.08%. With volatility compressed to very low levels, manager performances for the year were largely a function of how much was held in directional sub-investment grade credit exposure, and to a minor extent to how much was held in the difficult European and Japanese markets. Credits rallied strongly with the Lehman High Yield Index US up a substantial +13.07%. Realized volatilities however remained low, with the S&P 500 30-day volatility hovering around the 10% mark. The US convertible market implied volatility index remained pretty flat at 28%. Other markets experienced more pain with the European convertible market implied volatility index falling from 32.0% to 25.5%. New issuance was disappointing in a year that saw a large amount of bonds coming to maturity. Total issuance in the US was USD47b, and only EUR20b in Europe. This led to a shrinking of the US market by USD17.4b, according to figures from Lehman Brothers, with similar effects in Europe. The larger issues of the year included Capitalia into Generali; Albertson; Deutsche Post into Post Bank; Swiss Government into Swisscom; Schering-Plough; France Telecom; and Fannie Mae. Merger arbitrageurs were up +4.08%. After a moderate start into the year and a summer which saw an unusual number of deals being postponed or broken, a notable increase in corporate confidence occurred towards the end of the year. Arbitrage spreads improved slightly over the period, in spite of large volumes of assets mechanically entering the more vanilla trades. The largest deals of the year included BancOne/JPMorgan; Aventis/Sanofi; ATT Wireless/Cingular; Santander/Abbey National; UFJ/Sumitomo; and Guidant/Johnson&Johnson. Statistical arbitrageurs were up +4.87%, as traded volumes experienced a lull over the summer months. Yet overall, sufficient opportunities for profitable trading were provided. Persistent low volatility and high correlation in the equity markets, however, put a limit on the returns achieved by the strategy. Market neutral equity managers were up +4.22% with only long term return factors performing well. In particular valuation factors, earning revision and measures of corporate leverage provided good explanatory power.

Relative Value Fixed Income Strategies: 2004 proved to be a difficult year for US sovereign fixed income strategies as multiple erratic unemployment numbers either contradicted or reinforced the recovery story of the US economy. Despite a clear hiking path in the front-end of the USD yield curve throughout the year, the uncertainty regarding the economy contributed to numerous reversals in the back end. These hurt the stability of returns of managers who remained cautious about their directional biases as the year progressed. European rates distinguished themselves by the inactivity of the European Central Bank, despite signs of economist pessimism in the back end. Japanese rates continued to display gradual signs of optimism but remained too tame for large hedge fund focus. Relative value spreads remained predominantly static with very few unsettling events to generate relative value mispricings. This drove fixed income arbitrageurs to generate very moderate carry based returns (up +5.52%) with only few capital gains opportunities. Despite deteriorating technicals for MBS arbitrageurs – yield curve flattening and OAS tightness – the strategy posted a return of +13.94%, one of the strong performers of the year.

Directional Fixed Income Strategies: The eventful and upside-biased pattern of the USD yield curve during the year provided numerous opportunities for trades. European markets allowed hedge funds to bet safely on economic deterioration paired with central bank inaction. While Japan continued to emerge from a long recession, raising hopes of new and diversifying opportunities for sovereign based trades. This helped directional sovereign traders deliver strong performance. The continued moderate credit spread compression helped long/short credit funds deliver fair returns (up +10.08%). The improvement in balance sheet restructuring, decreasing defaults, and increased recovery rates propelled distressed securities managers to outperform most strategies, ending 2004 up +18.64%. Emerging markets debt managers concluded the year as one of the strategies to beat, but caution is suggested as fundamentals have started to deteriorate.

CTAs and macro funds: 2004 was a very difficult year for long-term trend-following CTAs. Fortunately, they still managed to end the year up an average +3.22%. In Q1,

Graph 1: Risks and returns of hedge fund strategies



Source: Hedge Fund Research Inc., Barclay Trading Group Ltd. | Data period: January 1994 to December 2004

trend-followers performed very strongly on the back of a continuation of strong trends in financial futures that had emerged in the latter half of 2003. The top contributor was the weakening USD. In Q2, important trend reversals across practically all important sectors hurt CTAs significantly. Towards the end of Q2, many markets had become stuck in sideways trading ranges and CTAs were losing month after month, unable to position themselves in any meaningful trends. Directional trading remained difficult as the markets kept oscillating in relatively narrow ranges and the Barclay CTA Index reached its highest drawdown of the last ten years. Finally, in October, trends started strengthening again, driven by the currency sector. For short-term systematic CTAs, 2004 proved to be another challenging year due to the low volatility environment. Macro managers, on the other hand, performed at least moderately positively, and on average were up +4.09% for the year. They made money in the currency and fixed income markets in Q1 but subsequently lost money in yield curve flattening and other trades in Q2. Q3 turned out to be more difficult for macro funds again as global financial markets moved in tight ranges, making it difficult to express macroeconomic views. Furthermore, sharply rising oil prices undermined investor confidence. Finally, post the US elections, stock indices and currencies provided good trading opportunities again, enabling a generally satisfactory last quarter.

Outlook for 2005

Overall, we remain bullish on the hedge fund industry, and clearly expect asset inflows to continue – particularly from pension funds and insurance companies in the US, Japan, Continental Europe, and the UK. Our 2005 return expectation for diversified funds of funds is Libor +500 pa (net of all fees), with continued low volatility and only moderate correlation to stock and bond markets. However, we expect stock markets to become more difficult in 2005 and also assign a high probability of flat to slightly increasing long term interest rates. Therefore, the ride in 2005 could be rocky not only for traditional investors but also for hedge funds.

The hedge fund strategies that we are most positive on for 2005 are: energy; commodities; event driven; and macro. These are followed by: multi-strategy arbitrage; long/short credit; distressed; long/short Japanese equities; convertible arbitrage; and MBS arbitrage. We expect only flat to slightly positive returns from fixed income arbitrage; statistical equity arbitrage; long/short US equities; long/short European equities; and CTAs. The main hedge fund themes of 2005 – aside from whether stock markets and interest rates will go up or down – will focus on whether equity volatility will increase again, and whether the current credit spread levels are sustainable. Our in-house view on the latter leads us to believe that the return/risk profile of long-biased credit and high yield players has become significantly less attractive. While there are still many investment and trading opportunities in niche credit strategies (ABS; structured credit arbitrage; trade finance; unrated paper; European distressed), given the record tightness of current credit spread levels long-biased credit players may be penalized in 2005. We also expect the distressed securities restructuring pace to decrease over the next quarters.

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