Hedge fund industry commentary: 2005

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Performance of hedge funds in 2005

2005 was not an easy year for the hedge fund industry. Although the year-end numbers were positive, this masks periods with significant downside volatility, such as the months of April and October which produced draw-downs in the magnitude of about -1.50% each. Nevertheless, the summer and especially the last two months of 2005 provided relief, driven by a broad rally in equities. The year was also marked by unusually high cross-correlations between the strategies, as well as high correlations of hedge funds to traditional market indices. Overall, the FTSE Hedge investable hedge fund index returned +2.72% for the year, roughly in line with other investable indices. Non-investable indices posted returns around 5-6% in 2005 (the difference can be explained by selection and survivorship biases in the non-investable indices).

While most hedge fund strategies ended up performing within their long term expected return ranges, albeit often at their lower end, convertible arbitrageurs had their toughest year since inception of the strategy in the early 90s. 2005 also proved to be very challenging for the CTAs, with the occurrence of numerous trend breaks.

Directional Equity Strategies: Equity markets enjoyed a relatively good year in 2005. As investors outside the US slowly shed their macro concerns, liquidity returned to world equity markets. The continued rise in input costs with the notable +40% rise in the oil price during 2005 did take centre stage. Energy stocks enjoyed the strongest gains throughout the year with oil services at the forefront following an intense hurricane season. The rising input costs did however cause some jitters in the markets, resulting in a sharp sell-off in April and October. The US markets, more heavily burdened by concerns about global imbalances saw the S&P500 rise a mere +3%. Outside the US, an easier macro environment allowed many investors to focus on company fundamentals, where corporate earnings generally came out above market expectations. As a consequence, Europe enjoyed a far stronger year than expected, with the MSCI Europe being up +22.77%. Investors also pushed up many emerging markets with strong performances in Korea, India and Taiwan, contributing to a rise of +30.31% in the MSCI Emerging Markets Free Index. Japan on the other hand took centre stage this year with the TOPIX up +43.50% and small caps enjoying strong outperformance, with the TSE2 up an even more staggering +71.43%. The recovery in corporate Japan made itself most pronounced in the banking and real estate sectors. On average, long/short equity managers ended the

Table 1 | Hedge fund returns

Hedge Fund Strategy	YTD	Ret pa 2000-2005	Ret pa 1994-2005	Stdev pa	Corr MSCI
FTSEhx	**2.72%**	**6.28%**	n/a%	2.28%	0.79
HFR Funds of Funds	**7.43%**	**5.58%**	7.45%	5.82%	0.58
HFR Composite	**9.16%**	**7.47%**	11.55%	7.05%	0.75
CSFB/Tremont HF	**7.60%**	**7.40%**	10.69%	7.88%	0.50
Emerging markets	**19.74%**	12.43%	10.34%	14.44%	0.64
Long/Short Equity	**10.67%**	6.98%	14.48%	8.97%	0.71
Sector specialists	**9.55%**	4.43%	41.03%	14.41%	0.67
Distressed securities	**8.93%**	12.78%	12.23%	5.40%	0.52
Short-selling	**8.42%**	6.95%	0.81%	21.42%	-0.70
MBS arbitrage	**7.89%**	9.13%	9.74%	4.49%	0.01
Event driven	**7.57%**	10.06%	13.37%	6.43%	0.69
Macro	**6.72%**	7.89%	10.08%	7.24%	0.42
Market neutral equity	**6.39%**	5.79%	8.00%	3.10%	0.17
Relative value arbitrage	**6.05%**	8.26%	9.69%	3.16%	0.44
Fixed income arbitrage	**5.54%**	6.53%	5.95%	3.86%	-0.03
Merger arbitrage	**5.38%**	5.98%	9.67%	3.64%	0.49
Statistical arbitrage	**5.10%**	3.24%	7.08%	3.85%	0.53
High yield	**4.60%**	7.17%	7.40%	4.49%	0.49
CTAs	**1.90%**	5.74%	5.85%	8.20%	-0.10
Convertible arbitrage	**-1.62%**	7.57%	9.11%	3.70%	0.26
MSCI World	**7.56%**	**-2.01%**	7.36%	13.90%	1.00
JPM Global Bonds	**-6.53%**	**6.55%**	6.23%	6.30%	0.06

Source: FTSE; HFR; CSFB; Barclay Trading Group Ltd.; MSCI; JP Morgan

year at +10.67%, capturing most of the upside of world equity markets for the year. The two main themes global managers benefited from were exposures to Japan and to the energy sector. US managers overall had lower exposures and were able to extract enough alpha to outperform the market. European managers held on to generally higher net exposures with bottom up stock pickers utilizing their balance sheet to make strong returns, especially in the large cap arena. Japanese managers, who played the so-called reflation story and used their balance sheet well in the second half, fared well with strong returns across the board. Emerging markets managers did well overall with those implementing the right country selection enjoying the highest returns.

Relative Value Equity Strategies: 2005 was the second consecutive highly disappointing year for the convertible arbitrage strategy with a return of -1.62%. This number does not reflect the perfect storm that funds were facing, especially in the second quarter, when bond prices cheapened dramatically due to large redemptions from investors. It is estimated that 40% of the capital allocated to convertible funds was withdrawn during the year. A difficulty for the strategy was a continuation of declining volatilities in the US. Implied volatility in US convertible bonds decreased from 28.9% to 22.9%. European bonds' implied volatility rose over the year from 24.6% to 27.5%, however during the year it touched lows close to 21%, forcing funds to close positions. Japanese bonds' volatility had a sharp rally after the election in September. The rally in equity markets also provided tailwind for Asian convertibles as long-only investors were buying heavily. Both Japanese and Asian bonds are trading at expensive volatility levels now. New issuance in 2005 was at low levels across the region and could not compensate for the notional of maturing bonds.

Merger arbitrage funds performed +5.38% in 2005, which was a strong year for M&A transactions. Deal volumes continued to improve from their sharp drop in 2001. The opportunities for funds were spread across regions, allowing diversification of risks. Private equity was an important force in the market with transactions like TDC (USD12b), Sungard (USD10b), and Neiman-Marcus (USD5b). Funds faced difficulties in April, as concerns in the credit market over the US auto industry caused merger spreads to widen and as prominent deals like Woolworth broke. Another negative month was October, when negative equity markets and a number of deal specific negative news hit funds. Statistical arbitrageurs were up +5.1% for the year. Reasonable volumes and market breadth were supportive to the strategy. Higher volatility levels would be conducive to further opportunities going forward. Market neutral equity managers were up +6.39%. The strategy had a reasonable year with all geographical zones adding returns. Market neutral equity managers focused on Japan initially showed large outperformance but gave back some of the gains in the last quarter. Value and momentum type signals provided good returns. Earnings revision and earnings

quality related signals were more mixed.

Relative Value Fixed Income Strategies: The Treasury markets were characterized by a difficult trading environment throughout the year, as the market weighed the possibility of a slowdown in the US economy and fears over a pickup in inflation. Fixed income arbitrage managers generated steady but moderate returns (+5.54%). The compression in swap spreads, the flattening of the yield curve and higher Libor rates in the US all contributed to a more difficult trading environment. The ABS markets experienced record new issuance in 2005, putting upward pressure on spread levels, in particular in the second half of the year as the market had trouble digesting the new supply. Within the mortgage sector, OAS have been trading in narrow ranges for the whole year and volatility has remained relatively steady. Overall, MBS arbitrage managers posted solid and steady returns for the year (+7.89%), albeit at lower levels than the previous years, as the flattening of the yield curve, higher libor and slower prepayments all limited the number of trading opportunities.

Directional Fixed Income Strategies: After two years of spread compression, 2005 turned out to be a lot more challenging for long/short credit managers (+4.60%). Spring in particular was difficult, with the much discussed downgrade of GM causing turbulence across the credit markets. October saw another widening of credit spreads, this time sparked by inflation fears and higher libor rates in the US. Overall, however, spread levels have stabilized at levels roughly equal to where they were at the beginning of the year. Distressed managers faced an environment of fewer defaults and a decreasing opportunity set, respective to previous years. Despite this, they were still able to generate decent returns (+8.93%), as a number of companies finally came out of their restructuring. By the end of 2005, a number of high-profile defaults in the form of Delta, Northwest, Delphi and particularly Calpine provided ample new trading opportunities to capitalize on. Emerging markets was the best performing asset class for the second year around (+19.74%), supported by improving fundamentals across the different EM countries. Large trade surpluses, healthy fiscal balances, and relative political stability led to a substantial compression of spreads. Interest rates have been decreasing in most of the major emerging markets, and foreign currencies have appreciated significantly against the dollar. By the end of 2005, the long-awaited strengthening of Asian currencies finally started to take off.

Commodities Strategies: 2005 saw commodity markets return to the news and while it was little surprise that some of the best performing strategies were in the energy sector, this was also a strong year for many other commodities such as zinc, copper, sugar and silver. Inevitably, this also entailed markets experiencing sharply higher volatility, particularly during the summer events in the US. Relative value strategies had a strong start as crude and gas prices rose by 30% in the first quarter, followed by a period of muted returns with relatively decreased volatility in Q2. The third quarter was dominated by events in the US, where hurricanes Katrina, Rita and Wilma threw the markets into turmoil and spurred market highs in oil at USD70 and gas at USD15. Q4 began with a reversal of energy prices as oil fell 9% and gas fell 12% in October. Losses incurred in this hangover from the summer were recouped in a strong end to the year. The directional energy trading sector suffered at the beginning of the year as freezing weather gripped Europe and power prices spiked. Supply problems were more of an issue in the second quarter and sharp market moves caused further problems. The US performed well until the third quarter natural events, when managers took a hit. The problems continued into Q4 but as fundamentals became clearer the sector bounced back. The metal & agricultural sector benefited particularly from base metals, where tight supplies, ramping demand and low stock levels drove prices higher. April saw a correction in aluminium prices but was swiftly recovered. Agriculturals were less rewarding but sugar maintained a steady uptrend; and grains developed a more consistent downward trend after the summer, with signs of reversing at the close of the year. Insurance linked strategies had a difficult year as a result of the USD54b of insurable damages resulting from the summer hurricanes. As a consequence of erased insurer's capital, increasing capital requirements and alterations in catastrophe modeling, the market is looking forward to significantly higher premiums in 2006.

Directional Multi-Asset Class Strategies: The universe of macro managers as a whole posted moderate returns (+6.72%), with March, April and October being particularly difficult. This figure hides the dispersion of returns generated by the different managers, as some got their market calls a lot better than others. In the difficult months, most macro managers got caught out by sell-offs in the credit and equity markets, in addition to the unexpected strengthening of the USD. Themes that generally worked well were the rise in oil prices and commodities, as well as the run-up in equity prices in Japan and Europe. In addition, emerging markets were a profitable theme to play in 2005. The year proved very challenging for the CTAs, nevertheless they

managed to end the year slightly up (+1.90%). Early on strong trends that had started in the closing months of 2004 corrected sharply. The currency sector suffered most due to a rallying USD, hurting short positions which had been maintained during the dollar decline. CTAs subsequently built up long USD positions which were very profitable as the strong economy helped the USD surge against the major currencies. Equities were also profitable as they rallied across the board, and particular strength was seen in Japan. In the first half of the year, long positions in fixed income contracts provided for solid profits as long-term interest rates continued to fall. In the second half, the interest rate sector suffered as bonds declined after a series of strong economic data. Energy was one of top performing sectors for the year as crude oil rose to new all-time highs. The long positions benefited early on from a perceived increase in global demand and a tightening of supply. Metals also returned good profits as expanding economic development and supply shortages fuelled demand.

Performance of hedge funds in Q4 2005

The last quarter of 2005 started with something of a shock in October when equity markets corrected sharply followed by similar corrections in oil prices and bonds, triggering drawdowns of approximately -1.50% on average. Fortunately, November and especially December then provided relief, and hedge funds pulled back to see positive quarterly returns, driven by the year-end rally of the stock markets. The FTSE Hedge investable hedge fund index returned +1.54% for the quarter. This compared to a return of +2.13% for the non-investable HFR Funds of Funds Index. All strategies were positive in Q4 with the exception of short-sellers.

Directional Equity Strategies: Investors around the world enjoyed a healthy end to what proved to be a good

Table 2 | Q4 returns of hedge funds

Hedge Fund Strategy	Ret Q4 2005	Oct-05
FTSEhx	**1.54%**	**-1.49%**
HFR Funds of Funds	**2.13%**	**-1.38%**
HFR Hedge Funds	**1.95%**	**-1.43%**
CSFB/Tremont HF	**1.61%**	**-1.46%**
Emerging markets	3.24%	-2.50%
Relative value arbitrage	2.62%	-0.35%
Long/short equity	2.58%	-1.88%
CTAs	2.52%	-0.15%
Statistical arbitrage	2.28%	-0.29%
Sector specialists	2.24%	-2.11%
Distressed securities	2.05%	-0.35%
MBS arbitrage	1.42%	0.66%
Macro	1.36%	-0.71%
Event driven	1.26%	-1.83%
Convertible arbitrage	1.18%	-0.08%
Fixed income arbitrage	1.11%	0.34%
Market neutral equity	0.96%	-0.36%
Merger arbitrage	0.67%	-1.50%
High yield	0.27%	-0.48%
Short-selling	-0.29%	1.45%
MSCI World	**2.72%**	**-2.49%**
JPM Global Bonds	**-1.91%**	**-1.80%**

Source: HFR; CSFB; Barclay Trading Group Ltd; JP Morgan

year for equity markets. The MSCI world rose +2.73% in the fourth quarter with continued investor euphoria and increased risk appetite. October was a turbulent month where inflation concerns led to a sharp sell off in many markets. Europe and Emerging Markets rebounded strongly to end the quarter with respectable returns; MSCI Europe +3.86%, MSCI Emerging Markets Free +6.83%, and S&P500 +1.59%. A large part of the rally could be attributed to good corporate results, a more benign macro environment, and an abating oil price. This upsurge in performance was most pronounced in the large cap space whilst energy was the only sector to have fallen. Japan seemed to be drumming to its own beat, with re-elected Koizumi's postal reforms triggering a strong and steady rally seeing the TOPIX end the quarter up +16.82%. Small caps continued to outperform the market. This was a relatively good quarter for directional equity strategies with the relevant index rising +2.58% though masking a painful October. Managers in Europe fared well, catching much of the upside in equity markets, whilst US based managers focused on extracting some alpha on both sides of the balance sheet. Most funds had a very strong quarter in Japan where managers who concentrated positions on reflation type stocks and held a bias towards smaller caps fared best. Emerging markets managers had some fairly mixed results with those exposed to the Korean and Indian markets faring best.

Relative Value Equity Strategies: Convertible arbitrageurs finished the year with a positive performance of +1.18% in the last quarter. The main return drivers were Asia and Japan, where implied volatility continued to increase sharply, driven by demand of investors seeking outright exposure to the underlying equity. Implied volatilities in the US decreased from 24.3% to 22.9%. European bonds experienced an increase in implied volatility from 23.4% to 27.5%. Credit exposure had a minor negative impact on performance. High-yield US convertible bonds continued to be cheap compared to straight bonds. The primary market in the US had a significantly higher volume with USD16.4b issued. This compares to USD8.7b in the last quarter and to USD11.1b in the fourth quarter of 2004. It was driven by a strong November and December, both with positive net new issuance after eighteen consecutive months of negative organic growth. Europe also saw a strong increase of primary market volumes with an aggregated notional amount of USD4.9b. Issuance in Asia and Japan declined.

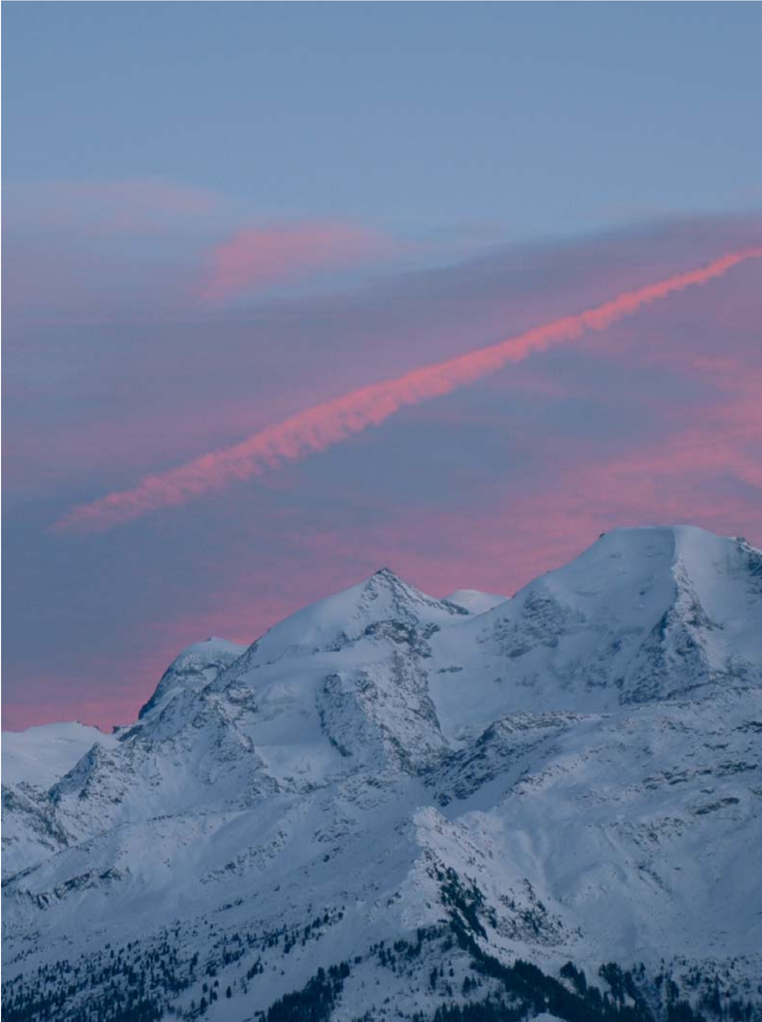
Merger arbitrage funds gained +0.67%. Returns would have been significantly higher had October not been a painful month in an otherwise conducive environment: US funds lost on the Guidant/Johnson&Johnson takeover that ran into serious trouble. Several other deals such as School Speciality and IMS/Health VNU broke. European funds were hit by their concentrated exposure to the Scandinavian oil sector, as shares fell sharply with declining oil prices. Additional insecurity arose due to volatile equity markets and the announcement of a closure of a USD2b event fund. Reduction in allocated risk capital caused spreads to widen across the deal universe. However, the month ended on a positive note with the announcement of the USD31b takeover of O2 by Telefonica. The Guidant deal experienced a turnaround mid November as Johnson&Johnson agreed to go ahead on revised terms and later Boston Scientific declared an unsolicited bid at a significant premium. Investment opportunities were not limited to the US and Europe: in Japan, event driven funds benefited from a short position in Sanyo Electric, as the company struggled to restructure, its CFO resigned and at first its bank did not appear to be willing to support it. Brambles announced a unification of its dual listing structure causing the spread between shares in London and Sydney to contract. Statistical arbitrageurs were up +2.28% for the quarter. Volumes and market breadth were supportive to the strategy. Market idiosyncrasies provided incremental trading opportunities. Market neutral equity managers were up +0.96%. The quarter showed some dispersion within the group as Europe and UK focused managers performed well, whereas US and in particular Japan oriented managers experienced performance give backs. Overall momentum factors performed well while value and earnings related signals were only moderate profit contributors.

Relative Value Fixed Income Strategies: Inflation fears suddenly took hold of the Treasury markets in October after the publication of the CPI number, leading to a sell-off across maturities. 10y Treasuries reached a high of 4.66% from a low of 4.01% at the end of August. As the market realized that economic data had been distorted by Katrina, the Treasury market rallied again to end the year at a level of 4.38% for the 10y Treasury. In this process the yield curve actually flattened further, where the 10y Treasury traded through the 2y Treasury at some point. Fixed income arbitrage managers held up quite well in difficult markets in October, but were not able to capitalize on any further gains during the rest of the quarter (+1.11%). Greenspan's successor was announced, and the market reacted reasonably well to the prospect of Bernanke as the new Fed chairman. ABS markets were affected by a technical

correction in November as hedge funds expressed a negative view on the US housing market though a short on the BBB segment of the market, leading to significant spread widening in this part of the credit curve. CMBS spreads also had a weak quarter selling off as a result of oversupply and weak demand in the markets. The performance of MBS arbitrage managers was relatively muted for the quarter (+1.42%), as the flat yield curve, higher Libor and slower prepayments created a difficult trading environment.

Directional Fixed Income Strategies: The markets were spooked in October by a higher than expected CPI reading, in addition to slower US consumer spending, high oil prices and higher rates. Credit spreads widened across the board, directly affecting returns for long/short credit managers. The bankruptcy filings of Refco and Delphi and the uncertainties surrounding GM further contributed to the spread widening. In November, the sentiment in the market remained very weak, but by the end of December the market had regained some of its optimism and spreads tightened. Distressed managers saw a slew of new supply in the fourth quarter of 2005 with the two aforementioned bankruptcies in addition to the high profile bankruptcy of Calpine with over USD14b of debt. While October was a weak month for the distressed managers, a number of companies finally came out of their restructurings by the end of the year, leading to solid gains for the strategy (+2.05%). Emerging markets continued their strong run for the year, supported by improving fundamentals across the different countries, the most noteworthy being Mexico, Brazil and Turkey. By the end of the quarter, the long-awaited strengthening of Asian currencies finally took off, led by the Korean Won. Credit spreads in Emerging Markets experienced a spike in October, but fully recovered in November and December.

Commodities Strategies: Relative value commodity managers were positive over the quarter. October saw continuing volatility following the hurricanes of the summer and the end of the month saw a swift drop in oil and gas prices. Managers as a group were flat over the month as exposures to different markets, notably power and natural gas, essentially cancelled each other out. November saw some mixed signals from weather and storage indicators but long volatility positions fared well. More discernible trends in oil through December also brought good performance. Directional energy trading strategies also suffered in October due to the steep decline in crude prices but quickly rebounded in the following two months as sentiment reversed. Metals & agriculturals trading funds were positive in the quarter with base metals a key driver of performance as prices rose in response to good physical demand, low stock levels and market stories of a large short position held by a Chinese agency. Agricultural positions were largely a disappointment, although coffee and sugar contributed towards the end of the year. Insurance linked strategies continued their payouts on the summer's US hurricanes, while no additional claims were reported.



Directional Multi-Asset Class Strategies: Macro managers also experienced a dip in October, but rebounded well in November and December (+1.36%). Some of the main themes in the fourth quarter were the run-up in the gold price, the retracement of oil prices, and the strength of the Japanese and European equity markets. That said, the markets experienced a decent amount of interim volatility, which led to a wide dispersion of investment returns across the different managers. The CTAs closed the year with a strongly positive quarter (+2.52%). Equity markets fell sharply on inflation concerns, resulting in losses across global stock index contracts. Good profits were made in currencies where the managers benefited from the strengthening USD and the weakening JPY. The fixed income sector was profitable as inflation fears fuelled the sell-off in bonds and interest rates moved higher across the whole yield curve. Energies developed a downward trend as warmer-than-expected temperatures in the US led to a lack of demand. In November, CTAs produced a solid positive return. Currencies were the most profitable sector as the USD continued to strengthen against European and Asian currencies. The JPY lost nearly 9% of its value in the previous three months. Long positions in metals were profitable, led by gold, which surged to nearly USD500. Energy prices continued their slide as the US weather remained temperate. In the last part of the quarter sharp reversals in the currencies and fixed income sectors resulted in losses. In contrast, the European and Asian equities continued to rally strongly into the year-end. Base metals also continued to rally as reports emerged confirming the sustainability of demand from China.

Outlook for 2006

Overall for 2006 we expect returns from diversified funds of hedge funds in the range of Libor + 400 to 600 bps with moderate volatility. The hedge fund strategies that, in our view, have the most favorable outlook for the next six to twelve months certainly include the event driven equity space, as well as energy, commodities, distressed securities, long/short Asian equity markets (incl. Japan), global macro, sovereign fixed income strategies, and multi-strategy arbitrage (at least the more flexible, proactive breed). We remain neutral on long/short credit, long/short US and European equities, CTAs, asset-based lending, insurance-linked risk trading, and statistical equity arbitrage. We are underweight MBS arbitrage, fixed income arbitrage and convertible arbitrage.

Fortunately, asset inflows into the hedge fund industry have slowed down. This should be good for the industry in the sense that some trades had started to become very crowded last year. Furthermore, some hedge funds have started having «attitudes», being overwhelmed by heavy inflows from investors. Looking forward, the current macroeconomic environment seems to be stable with constant growth, low inflation and low interest rates. In a way, we are in an almost «perfect» market environment. This has resulted in high correlations across countries and regions, as well as between bonds and equity markets. However, many of the global macroeconomic imbalances have not subsided yet. For instance, the US consumer is still overleveraged with potential spillover effects for the US real estate market; the US government debt is still growing; Europe is not reforming; and there is increasing West-East competition at several levels. Furthermore, investors over the last two years have greatly increased their risk tolerance, which has resulted in low risk premia across most financial markets worldwide (low volatilities, low credit spreads, narrow swap spreads, low OAS spreads, emerging markets spreads, very bullish investor sentiment, etc). With that, the markets have become exposed to potential disruptions. Therefore, we do expect more volatility in the financial markets going forward. This will, as usual, provide both risks and opportunities to the hedge funds.

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