Hedge fund industry commentary: Q4 2007

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The fourth quarter started on an upbeat note as markets continued their rise from the Fed rate cut in September, the first in 2007. But the party did not last as long as many expected. The last two months of the year turned out to be tricky to maneuver. The sell-off of risky assets was driven by continuous bad news surrounding bank balance sheets, monoline insurers and the US economy. The pain of the financial system has started to spread to the real economy. Central banks indicate further rate cuts in light of deteriorating economic indicators despite inflationary pressures.

For the first time in quite a few years, the goldilocks environment was challenged and stock volatility came back with a vengeance despite the Fed lowering rates. 2007 was anything but uneventful. The year was one of two halves and the adage to «sell in May and go away» could not have been better suited, at least in the developed world. Interestingly though, the discrepancy that could be found within different regions, sectors any styles was high. The Russell 2000 ended in slightly negative territory for the year, at -2.8%, hiding a strong trend of growth outperforming value throughout most of the year. As a result, the Russell 2000 Growth Index ended at +6.5%, while the Russell 2000 Value Index saw double digit declines of -11.5%. Another phenomenon that was unusual in the past years was large cap outperformance where the S&P 500 delivered a modest, albeit positive, return in 2007 versus similarly modest losses for the Russell 2000. While these cap and style performance results have not been present in developed equity markets for a while, they are often indicative of later stages of a bull market.

November was a slide with most major markets delivering their worst monthly declines for the year, and there was no respite in December which also saw red ink for all major indices. In the end, thanks to a great October, while Emerging Markets as a region posted positive results for the quarter the US, Europe and Japan ended in the red.

Fixed income markets saw renewed volatility going into year-end. While markets in October picked up their positive trends, November clearly saw a reversal of sentiment, reminiscent of the summer months. The spread between 3m Libor and 3m T-bills increased to 212 bps by mid-December, indicating severe stress in the interbank market. The Fed rate cut in December by 50 bps was not well-received, but the announcement the next day of the Term Auction Facility eased pressures across the global financial system. Negative technicals in the markets are now being augmented by a clearly worsening fundamental picture of the US economy.

Performance of hedge funds in Q4 2007

Despite the difficult environment in the last quarter of the year, hedge funds performed better than in Q3. Short-sellers posted the strongest returns, as declining markets benefited their short exposure. Emerging market, macro and trend-following funds were also strong. Despite the market sell-off in November and December, long/short equity funds generated gains during the quarter. High yield and event driven funds struggled again, but coped better than in Q3.

Table 1 | Hedge fund returns Q4 2007

Hedge Fund Strategy	Ret Q4 2007
HFRI Fund of Funds Composite Index (non-investable, net)	1.85%
CSFB/Tremont HFs (investable, gross)	1.68%
HFRX Global Hedge Fund Index (investable, gross)	0.20%
FTSEhx (investable, net)	-0.96%
Short-selling	5.94%
Emerging markets	3.89%
Macro	3.89%
CTAs	3.80%
Relative value arbitrage	2.32%
MBS arbitrage	1.54%
Statistical arbitrage	1.52%
Sector specialists	1.43%
Market neutral equity	1.22%
Long/short equity	0.82%
Convertible arbitrage	0.40%
Fixed income arbitrage	0.29%
Merger arbitrage	0.13%
Distressed securities	0.01%
High yield	-0.26%
Event driven	-0.26%
JPM Global Bonds	3.06%
MSCI World	-2.73%

Source: HFR, Credit Suisse, FTSE, JPM, MSCI

Directional equity: 2007 was a good year for directional equity strategies. Overall, the HFRI Equity hedge Index was up +10.7%, beating the MSCI Index which ended the year at +7.1%. The Eurekahedge indices are broken down by region and give us some insight as to where the returns and the alpha were generated. US Long/Short Equity managers seem to have been the most effective by delivering +9.45% for the year, substantially more than the Russell 2000 or the S&P 500. According to the same source, European Long/Short Equity managers also outperformed their long-only universe with a performance of +4.5% in a flat market. Japanese Long/Short Equity managers faced a tough environment and, while they added alpha, current estimates show them at -0.87% for the year, substantially better than the Topix at -12.2%. The best performance in absolute terms came from the Emerging Markets where L/S mangers made a whopping +30.4%, somewhat lower than the MSCI EM Free Index at 36.5%

During the fourth quarter, the HFRI Equity Hedge was in positive territory and it seems that it was the US Long/Short managers that were best able to beat the downside by posting slightly positive results (+0.63%) while European Long/Short managers (-0.67%) and Japanese Long/Short Managers (-1.87%) both posted negative results. In the US, managers who delivered positive numbers for the quarter were those who took a net short position in either Financials or Consumer Discretionary while being long more defensive sectors. The picture was somewhat different in Europe where a net short in Financials was beneficial but much less than one in Technology. Japan also went through quite a shift from the previous nine months with global cyclical positions underperforming domestic oriented themes. Emerging market managers were up around +3%, in line with the MSCI EM Free Index. This quarter however, China did not appear as the winner but it was India, Russia and the Middle East that were in the spotlight.

Relative value equity: 2007 was a disappointing year for relative value equity funds. While the first half of the year was very encouraging with good performance across all indices, the second half proved to be rather challenging. The HFRI Event-Driven Index was up 8.39% through the first half, only to finish the year up 6.94%. The HFRI Convertible Arbitrage Index finished up 5.11% for the year following returns of +4.64% in the first half. The HFRI Statistical Arbitrage Index finished the year up 8.96% after being up 5.72% through the first half.

October saw the closing of a number of high profile deals, thereby providing very nice profits to Event Driven funds who either maintained their exposures following the volatility over the summer, or who actively traded the spreads. Among the most significant deals to close were ABN Amro, Texas Utilities and Hilton Hotels Corp. The market also was buoyed by a number of announced deals. The increased risk aversion in November saw spreads widen out significantly, with LBO deals trading on average at annualized spreads of 60% above levels seen over the summer. Two LBO deals were abandoned in November, with Qatari-based Delta Two Fund walking away from Sainsbury and, more concerning the termination of Cerberus's acquisition of United Rentals despite a USD100m termination fee.

December was a continuation of the de-risking and LBO deals widened out to spreads of 70% while non-LBO deals saw average gross spreads of 30%. The market has seen improved deal flow (Ingersoll-Rand's acquisition of Trane, National Oilwell Varco's acquisition of Grant Prideco, and Philips buying Respironics) with a shift toward more strategic deals. However, a number of existing situations should provide managers with a tail-wind heading into 2008 including Harrah's, Clear Channel, Alliance Data Systems or Rio Tinto. For the quarter, the HFRI Merger Arbitrage Index was positive 0.13% and the HFRI Event Driven Index was -0.26%.

Convertible Arbitrage Fund's began the quarter with strong performance as realized, options implied and bond implied volatility all moved higher. The main drivers were implied volatility in the US driving valuations, while Asia benefited by increased volatility providing favorable gamma trading. These gains were short lived, with November and December proving very poor for the strategy. The hope that managers would provide protection in deteriorating markets did not materialize, with losses coming from the strong rally in Treasuries and the cheapening of the underlying bonds. These losses outweighed gains made on credit hedges and gamma trading in the US and Asia. A positive heading into the New Year was the fairly robust new issuance calendar and the re-rating of volatility. For the quarter, the HFRI Convertible Arbitrage Index was positive 0.40%.

Structured equity linked managers performed well in all regions in October with continued flow of deals coming to the market and the Asia IPO segment offering very interesting opportunities. Liquidity for new paper in the US declined in November as investors shunned certain issues causing pressure on pricing which continued into December. Asia saw a brief delay in the IPO market in November as the volatility in equity markets impacted certain situations only to continue in December, finishing the year on a positive note for Asia managers.

The fourth quarter saw very a very favorable trading environment for Quantitative Equity Managers who posted positive results primarily in short-term models. High volatility, exploitable trends and indiscriminate selling pressure on certain names offered a good environment. Fundamental strategies continued to find weakness in their value-signals throughout the quarter, continuing the trend from the summer. For the quarter, the HFRI Market Neutral Index was +1.22% and the HFRI Statistical Arbitrage Index was +1.52%.

Directional fixed income: Credit managers started the quarter well, taking advantage of the dislocations that happened during the summer. However, in November negative sentiment set in again and leveraged loans in particular came under heavy price pressure. Over the quarter, the HFRI High Yield Index was slightly down. Although returns held up for the month, this hides the significant volatility that was seen as well as the low levels of liquidity and high bid offer spreads. The market clearly values cash over anything, which explains the significant difference between cash and CDS spreads. Hedge funds have been starting to take positions to benefit from a normalisation of this negative basis in the future.

Distressed managers ended the quarter flat, with losses in November offsetting gains in October and December. In November, many managers got hit on positions initiated after the summer. In addition, ongoing restructurings hit issues as refinancing plans were either postponed or terminated. Overall, the number of defaults in the high yield universe remains at cyclical lows, with no defaults in November and December. Only 10 high yield companies defaulted in 2007, the smallest annual number since 1981. That said, credit availability tightened significantly during the quarter and if it continues this will ultimately lead to a dramatic pickup in the default rate. As an indicator of this, by the end of 2007 USD36bn of debt traded at or below 70% of par, up from USD3.5bn in May.

Emerging market managers performed as if the credit crunch did not exist. The quarter was strong, despite a negative November. The same themes that worked earlier in the year helped performance in the last quarter: long Brazilian currency and rates, long Turkish Lira, long Asian currencies. Countries with pegged currencies also came into play. The acceleration of Chinese Renminbi appreciation and the repegging of the Gulf country currencies were positive contibutors. Although returns continue being driven by strong economic fundamentals in many countries, the recent highs reached by a number of currencies and the pick up in inflation driven by higher food and commodity prices might dampen return potential going forward.

Relative value fixed income: Rising volatility in the fixed income markets and significant changes in expectations in regard to the future path of interest rates created an ideal environment for Fixed Income Arbitrage managers. The MOVE index - an indicator of fixed income volatility - jumped by 50% during the quarter. Further expected rate cuts by the Fed led the 2-year Treasury 100 bps lower from 4% at the beginning of the quarter. The continuation of the flight to quality caused the 10-year Treasury to rally by 67 bps from a 4.55% to a low of 3.85% in November. As a result, the yield curve steepened by more than 30 bps, on top of the 70 bps steepening already seen earlier in the year. The HFRI Fixed Income Arbitrage Index did not move much during the quarter, gaining only 29 bps. However, this return hides the good performance of pure fixed income arbitrage managers and is skewed by the negative performance of municipal arbitrage managers, who had a tough quarter, and managers exposed to sub-prime included in the index.

MBS Arbitrage managers had a positive quarter, driven by performance in October. Although the subprime markets continued to be under pressure – delinquency reports in November and December were extremely negative – this did not weigh much on the index (possibly because the worst performing funds have stopped reporting). With year-end approaching and continuing problems in the ABCP market, a number of banks decided to take their off-balance sheet exposures – also called SIVs – on to their balance sheets. Subsequently, they decided to hedge part of this exposure through the ABX AAA index, putting severe pressure on valuations. With most of the hedging activity out of the way, valuations should revert back to fundamentals in 2008. In classic MBS arbitrage strategies, managers capitalised on a significant slowing of prepayment speeds through IO pieces. Inverse floaters were also profitable as a result of lower future LIBOR rates in the US.

Commodities strategies: The commodity markets adopted a variable tone during the fourth quarter benefiting primarily directional strategies but also relative value. The US Federal Reserve reacted by lowering interest rates during the quarter, adding more downside pressure to the USD and inversely supporting some key commodities. Apart from the concerns about the tight global energy market and geopolitics, the strong rally in crude oil during the fourth quarter was also supported by the inverse relationship of the weaker USD. The momentum pushed crude oil to a new record high for 2007 of USD98 per barrel. Similarly, gold found strong support from the currency weakness, rallying briskly and breaking key resistance levels to make new highs in late December.

Another area of strong performance was in agriculture commodities, which continued to find support from an expanding appetite for bio fuels and Asian consumption. Soybeans, soybean oil and corn were the pick of the crop whilst wheat experienced a roller-coaster ride ending lower for the quarter. The rally in prices is fast becoming a vicious circle as buyers and importers try to gain access to available stocks in the fear that prices will rise further, which is accelerating the physical squeeze. Additionally, key consuming countries are now trying to secure contracts further ahead than they traditionally have. There appears to be no end to the growing demand for soybean, corn and wheat. Of the soft commodities, sugar benefited the most during the quarter given its strong link to the production of ethanol.

Unlike the above commodities, the industrial metals came up against strong economic headwinds during the fourth quarter. Zinc, copper and nickel were the worst performing commodities during the quarter as concerns grew about the potential impact that the sub-prime crisis could have on the global economy. Surprisingly, the fall in the copper price was despite only small increases to global copper inventories and falling inventories in China. Likewise, zinc inventories remained very tight through the quarter yet the metal was the worst performer.

Directional multi-asset classes: Macro and Managed Futures managers had a strong quarter, posting 3.9% and 3.8% respectively. October and December were positive months but returns were largely negative in November. Commodities produced the largest gains of the quarter. Sustained upward moves in oil, gold and agriculturals benefited macro managers as well as trend followers. Equity and fixed income markets were volatile over the course of the quarter with abrupt sell-offs and rallies, but generally directionless until evidence of US economic slowing became clear. Short-term systematic traders capitalized on high volatility across all asset classes and delivered strong performance capitalizing on moves in fixed income, equities and currencies against the dollar.

For macro managers, the volatile environment was very supportive for returns. While benefiting from strong rallies in commodity markets, specific long/short sector bets also contributed strongly. In fixed income, a lot of focus was on long positions both in the long and short end of the curve across the G7. With the flight to quality and rate cuts being priced in, these were profitable positions during the quarter. As a result of lower rates in the US,

Table 2 | Hedge fund returns in Q4 2007

Hedge Fund Strategy	Q4 2007	YTD 2007	Ret pa 2000-2007	Ret pa 1994-2007	Stdev pa 2000-2007	Corr MSCI 2000-07
HFRI Fund of Funds Composite Index	1.85%	10.12%	6.74%	7.85%	4.51%	0.59
CSFB/Tremont HFs (investable, gross)	1.68%	7.36%	7.72%	n/a	3.08%	0.31
HFRX Global Hedge Fund Index (investable, gross)	0.20%	4.15%	7.31%	n/a	4.91%	0.40
FTSEhx (investable, net)	-0.96%	1.22%	5.62%	n/a	3.22%	0.39
Emerging markets	3.89%	25.03%	15.52%	12.36%	10.40%	0.75
Macro	3.89%	11.73%	8.50%	10.12%	5.52%	0.31
Sector specialists	1.43%	11.34%	6.65%	13.96%	13.25%	0.66
Long/short equity	0.82%	10.65%	8.01%	14.00%	7.79%	0.74
Relative value arbitrage	2.32%	9.04%	8.78%	9.78%	2.26%	0.42
Statistical arbitrage	1.52%	8.96%	5.21%	7.68%	3.55%	0.59
CTAs	3.80%	8.17%	5.85%	5.90%	7.39%	-0.10
Merger arbitrage	0.13%	7.05%	7.23%	9.87%	3.36%	0.47
Event driven	-0.26%	6.94%	10.27%	13.02%	5.78%	0.71
Distressed securities	0.01%	5.70%	12.17%	11.96%	4.61%	0.50
Market neutral equity	1.22%	5.50%	5.92%	7.76%	2.71%	0.00
Convertible arbitrage	0.40%	5.11%	7.79%	9.02%	3.35%	0.13
Short-selling	5.94%	3.98%	5.62%	0.94%	19.99%	-0.71
MBS arbitrage	1.54%	3.54%	8.36%	9.21%	3.60%	0.11
Fixed income arbitrage	0.29%	2.92%	6.17%	5.83%	2.43%	0.09
High yield	-0.26%	-0.29%	6.73%	7.12%	3.85%	0.48
MSCI World	-2.73%	7.10%	1.41%	7.22%	13.37%	1.00
JPM Global Bonds	3.06%	6.94%	6.16%	7.13%	2.85%	-0.29

Source: HFR, Credit Suisse, FTSE, JPM, MSCI

the USD weakened concurrently. CAD finally capitulated on its strength against USD, as the market realized how dependent the Canadian economy is on US growth. The currency sold off more than 10% by quarter-end. Looking ahead, macro managers are positioned for a US downturn through long bonds, interest rate steepeners, short equities in credit-sensitive sectors such as regional banks and homebuilders, and short USD against major currencies. Similar exposures in the UK will capitalize on credit-related problems there.

Outlook

We expect a continuation of the volatile environment and hedge funds to outperform. US long/short equity managers will benefit from reduced exposures to equity markets and will show their true value added in more difficult markets. European managers are on average more long biased and may struggle. We are positive on Emerging Markets and expect funds exposed to these regions in long/short, credit, macro and structured equity linked strategies to continue to perform well. Distressed and credit funds active in developed markets will face short-term difficulties, but we expect positive returns over the full year, based on better supply of distressed paper and the cheap value of bonds after a likely continuation of spread widening in Q1. Macro funds and fixed income arbitrage managers are expected to perform strongly.