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General Market Environment in Q4 2008

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The fourth quarter was full with superlatives as almost every index and economic indicator showed new lows for the year, the decade, several decades, or since inception. The negative sentiment that was prevalent at the start of the year only gained in strength and momentum in the final months. One of the big negatives in the first half was inflation; the main threat came from soaring commodity prices. As the global slowdown gripped the world with accelerating reality, commodity prices along with other assets (except government bonds) plunged and the world woke up instead to fears of debt-deflation.

One of the outstanding features of the last quarter was the unprecedented policy measures taken across the globe. While tergiversation at the government level in the US was strongly punished by markets, once it had become clear that every method possible would be deployed to put a brake on any debt-deflation spiral, markets saw some stabilisation. The USD700b TARP plan, initially designed to buy toxic assets, later turned into a facility to recapitalise ailing financial institutions. In addition, the Fed provided unlimited liquidity to financial institutions, created money market facilities and guaranteed credit lines to corporations. In one of its latest

stabs, the Fed has started to buy FNMA and FRE mortgages outright. With these measures, the lender of last resort has gone into uncharted territory.

Monetary easing was also on the agenda as central banks around the world have cut rates aggressively or are expected to do so. Most of these measures have served to stabilise the financial system. Now, all eyes are on various spending programs to stimulate the economy through tax cuts and infrastructure spending.

Performance of hedge funds in Q4 2008

Although a disappointing quarter for hedge funds altogether, some strategies delivered positive to flat returns. It should come as no surprise that short biased managers were on top of the league table both for the quarter and the full year. The quarterly number only captures half the equity market declines because many short biased funds tend to be underinvested due to the inherent volatility in the strategy. CTAs also delivered a strong quarter and year as both long term and short term trends provided ample opportunities. The current environment has obviously also been constructive for Marco managers.

Directional equity: The demise of Lehman Brothers in September accelerated the negative spiral for equities and most other assets classes into the year end. The MSCI World Index posted its worst quarter in over two decades at -22.2%. The most extreme downward moves came early in the quarter

as Lehman's default lead to a complete breakdown in inter-bank lending. In parallel, at a time when markets were looking for confidence, policy actions in Washington were stalling, driving markets to their worst month in 2008 with the MSCI World down -19.0%. By mid November, markets stabilized as globally coordinated action saw some of the most aggressive and creative policy measures ever. November ended at -6.7% but was down as much as -19.0% intra-month and December even managed to post a gain of 3.3% (though only 0.88% in local currencies). The actual economic situation however continued to deteriorate rapidly as seen by economic numbers and some corporate profit warnings.

While the epicentre of this crisis is the US, the contagion spread like wild fire and when all was said and done, most major indices lost over -20% for the quarter. The outliers to the downside were Russia which lost almost -50% and Dubai around -60%. The relative winner was the FTSE100, down only -9.6% for the quarter. Not surprisingly, in the context of a credit crunch and with prospects of a global recession, it was the Financial sector and cyclical names that fared the worst. Telecoms and Healthcare played their defensive roles as relative safe havens.

Although the absolute losses delivered by Directional Equity managers were higher in the fourth quarter than the preceding one, their role as a hedged equity strategy became much more apparent. This was true even though regulators took away part of L/S equity manager's tool boxes by enacting selective short banning regulation on very short notice. Regulations were more or less stringent and varying in time frame depending on the country. Nonetheless, when one considers that the worst performing sector for the quarter was Financials and this is where the bulk of restrictions took place, it is evident that performance could have been better for this group had these measures been reversed earlier. Unlike the previous quarter, Q4 saw declines that were continuous and across the board. The impact of hedge fund specific liquidation which had taken place over the summer, and had been extremely painful for this asset class as all positions long or short went against them, was no longer an issue in the fourth quarter. While this was not necessarily a time when much alpha was delivered, strategic positioning on the other hand was of utmost importance. Funds that were net short and or extremely nimble in changing exposures fared the best. Buy-and-hold, long biased strategies were hit the hardest.

On an absolute basis, the fourth quarter was a dismal one for Directional Equity strategies, losing an average of -12.4% for the period. While it is the worst quarter on record for this strategy, in a way it was more rewarding than the previous one

as L/S Equity managers did limit the downside. Global, US and European managers returned between -8% and -10% on average according to Eurakehedge estimates, protecting more than half the downside. Using the same source, Japanese managers seemed to have delivered a flat to slightly positive return, quite an achievement for such market conditions. What may be more of a surprise is that Emerging Market managers, usually attacked for being long only beta plays, did overall manage to protect the downside by losing -16.8% which represents a relative outperformance to the relevant MSCI Index. Not all Emerging Markets were equal however, and Russian managers lost close to -30%.

Relative value equity: The fourth quarter of 2008 will be remembered on many fronts including the massive de-leveraging of hedge funds, dislocations in credit markets, increased market volatility and significant redemption pressures on hedge funds. The HFR Event-Driven Index was down -11.5% in the fourth quarter and -21.3% for the year. The HFR Convertible Arbitrage Index finished the quarter down -19.1% and was down an astonishing -34.6% for the year while the HFRX Equity Market Neutral Index finished down -2.9% for the quarter and -6.1% in 2008.

Event Driven funds had a difficult start to the fourth quarter following a disappointing September. Slowing global deal volume remained active in select industries with roughly USD256b in announced deals of which only USD71b came from the US. As credit markets seized up there was increased pressure on most spread based strategies. Merger Arbitrage was no different with high quality strategic corporate deals trading at annualized spreads from the mid-teens to over 60%. Deals where there may have been the faintest concern with financing blew-out in October. November was another negative month for managers although improved over the prior two months. Global deal volume continued to decline with little ability to finance transactions. Spreads remained attractive following the failed hostile bid between Rio Tinto and BHP. A positive during the month was the successful closing of the Anheuser Busch-Inbev strategic deal. Global deal volume picked up a bit in December with spreads tightening as markets improved a bit to close the year. However, gains for some Event Driven managers on deal spreads tightening were not enough to offset losses on credit situations and select deal breaks. Of particular pain in December was the termination of two prominent deals. Ontario Teacher Pension walked away from their CAD52b leveraged buyout of BCE. Another termination occurred with Huntsman accepting a USD1b settlement from Apollo's Hexion. A couple of widely held strategic deals were completed in December, including

Republic Services merger with Allied Waste as well as Teva Pharmaceuticals' acquisition of Barr Pharmaceuticals.

The fourth quarter started as the third quarter ended for Convertible Arbitrage with the HFRI Convertible Index down -11.97% and -17.07% in September and October respectively. The strategy has faced a number of headwinds including pressure from counterparties to reduce leverage, forced selling by proprietary desks and even selling by outright buyers and mutual funds. Within the Volatility Arbitrage universe, the dispersion among managers has been fairly broad with a number of funds benefiting by single stock and index volatility while some managers suffered from being too early in getting short volatility. The VIX finished October at 60 up from 39 at the end of September. November saw convertible managers continue to lose money, as markets firmed up as the month progressed. The pace of hedge fund liquidations slowed during the month with crossover buyers providing some support to the strategy. November performance among Volatility Arbitrage funds was mixed with gains achieved early in the month given back as volatility came in during in the last week as markets firmed up. The VIX started the month at 60 and peaked intra-day on November 20th above 80 only to finish the month at 55. December saw some firming in convertibles with US investment grade convertibles enjoying an improvement as markets came back.

Structured Equity Linked Funds had a difficult October in line with the general stress in global equity markets and the particular stress among smaller capitalization companies. The Russell 2000 Index was off -20.9% in October. Exposure to listed equities proved painful with managers also stressed by credit deterioration as their portfolio companies have found it difficult to refinance their obligations at the same time as their businesses have slowed. November was similar to October, which saw the Russell 2000 Index off by 12%. Smaller cap companies are finding it difficult to refinance existing debt and managers have been unable to provide support as they face their own redemption pressures and lack of cash. While the year ended up, the overhang on the strategy remains as we enter 2009 with managers facing pressure from redemptions while portfolio companies face continued pressure from the deepening slowdown in global markets.

Directional fixed income: The main driver of credit markets in the final quarter of the year was the draining of liquidity from the market. The aftershocks of the Lehman bankruptcy had far-reaching consequences for many asset classes. In this environment, credit managers were challenged to generate returns. Those with a long-biased buy-and-hold strategy got tagged by lower and lower marks, those with active trading

strategies were not able to execute in an illiquid market. During the quarter, the CDX HY hit a fresh new high of 1550 bps, although the market saw a late rally in the last 2 weeks of December. While one can argue that investors get compensated for taking default risk at these levels, economic indicators suggest a downturn worse than any recession witnessed in the last 25 years. From this perspective, taking a sanguine and defensive stance on the market makes sense.

Although there is plenty of distressed paper around, the issue for distressed debt managers in the fourth quarter has been that the majority of this paper continued to trade down. The end of 2008 was still too early in the credit cycle for distressed managers to take advantage of the opportunities presented. As long as the economic outlook continues to deteriorate and actual default levels remain subdued, distressed debt managers will continue to be challenged. By the end of the quarter, defaults started to pick up noticeably, with several high profile Chapter 11 filings. We expect the pace of defaults to pick up markedly into 2009, ultimately leading to attractive return opportunities for the strategy. High yield defaults reached 2.5% in 2008, compared to a rate of over 10% in past credit cycles.

Returns for Fixed Income Emerging Market managers were still weak in October, as funds suffered from the withdrawal of liquidity from these markets resulting from the Lehman bankruptcy. Sharp down-moves in currencies negatively exposed many corporates in Mexico and Brazil to speculative positions they had entered under the cover of calling it a hedge. The following unwind of these positions not only exacerbated the moves in FX, but also led to a huge spike in implied volatility. Markets normalised in November and December and funds were able to take advantage of a sharp drop in yields across many countries as the view of a low-inflation world is taking hold.

Relative value fixed income: Fourth quarter performance in relative value strategies was not driven by fundamentals but were much more a function of technicals dominating the market. In such an environment, relative value managers continued to be challenged in their performance. Many distorted relationships moved even further away from equilibrium leading to increased losses. For example, the long end of the US swap curve experienced one of its sharpest rallies with 30 year yields declining by close to 140 bps during the month and trading through Treasuries; the bulk of the move was experienced in a single day. The US 2/10 slope flattened by close to 60 bps supposedly led by technical factors. One positive sign is that the interbank market continued to show signs of normalisation, a clear indication that government policy is

starting to make an impact. US government officials continue to use aggressive measures and moved towards quantitative easing with the effective fed rate staying way below the target rate during the entire month.

ABS & MBS markets were volatile during the quarter, in particular in light of changing focus of certain government programs like TARP. The going back-and-forth of the US Treasury with respect to the use of TARP funds had a pronounced effect on securitised credit markets such as CMBS and Alt-A RMBS. The announcement of a direct purchase program for FNMA and FRE bonds lead to a significant narrowing of the mortgage basis and lower absolute yields on these securities. This will be positive for homeowners going forward as they would be able to refinance their mortgages at lower rates. An indirect effect of this would be a pickup in pre-payment speeds, which have been anaemic for the last 18 months.

Commodity strategies: The commodity markets fell back sharply during the second half of 2008 under the weight of a rapidly deteriorating outlook for global growth spurred by the financial crisis that led to risk reduction and an extreme contraction of liquidity. Commodity demand weakness was further exacerbated by the inability of some trading companies to renew long standing letters of credit. As such, in the space of a few months, the global commodity markets have seen a complete reshaping of the demand landscape that has led to extreme weakness at the front end of forward price curves, which in turn led to a greater-than-expected dislocation in time spreads. The focus on demand, or the lack of it, has eroded sentiment to very low levels that have not been seen since the start of this decade.

Yet, it is not only the demand side of the equation that has been impacted by the crisis witnessed in the financial markets. The steep contraction in credit is doing rapid damage to the supply side. Depending on the commodity and location, existing output has been unable to cover cash costs due to the very low commodity prices whilst input costs have remained at elevated levels. This has led to the enactment of output cuts and the cancellation of large numbers of new projects that are difficult to finance in this environment.

Despite the very turbulent period, commodity fund managers have fared well with some even being able to exploit the weakness by adopting very nimble trading strategies, implementing short-biased trading tactics and trading the market technically and not fundamentally. The strongest performances came from managers focused on niche commodity strategies within base metals, energy and agriculture as well as via directional and relative value based trading tactics. There

was a distinct split between managers with a broader commodity trading approach with some faring less well, especially those with directionally biased strategies and a strong focus on fundamentals. Nevertheless, there are always exceptions and in this case there were some managers able to adapt to the different trading environment and generate very good returns.

Shifting our focus to the separate commodity complexes and firstly with energy, WTI Crude Oil prices bottomed during the fourth quarter at just above USD35 a barrel, but with the pace of decline slowing during December, which was much the same case for most commodities during that month. The flow of oil demand data, especially from the US and China, during the last quarter came much in line with bearish expectations and has also led to a significant shift in the crude oil contango term structure. While contracting supply is likely to help offset a large fall in demand from the non-OPEC producing regions, the rapid move by the OPEC cartel could help balance the global crude oil markets and keep inventory builds in check. Despite the link to oil prices, the US natural gas market looks likely to take longer to recover as demand factors felt the severe pressure of a soft economy whilst over-supply continues to dampen enthusiasm.

Industrial metals, the commodity most prone to economic cycles, felt the flood of grim economic data and eroded sentiment, especially in copper as it is seen as the most sensitive to industrial activity. Supply cutbacks have been most prevalent within the industrial metals with nickel, zinc and aluminium being the most impacted due to prices trading below average industry cash costs. Amongst the gloom for the industrial metals, the precious metals managed to outshine, holding up well against the broad commodity market. Nevertheless, the last quarter of 2008 saw significant shifts in precious metal volatility caused by de-leveraging across all asset classes and a break-out of the USD during October but a normalisation of trading during November and December.

Agriculture also struggled against the tide even though these markets have been historically less susceptible to economic cycles; especially for wheat and corn. Nevertheless, specific fundamental shifts that have occurred over the last 2-3 years have had greater negative impact on each of the individual agriculture commodities. For example, the decline in crude oil prices has weighed on corn, while the sharp fall in US gasoline demand has depressed US corn-ethanol demand, which has been one of the most dynamic drivers for the corn growth story.

Directional multi-asset classes: Managed Futures and Macro managers had a strong quarter, with the Barclay CTA, HFRX Macro and AlternativeEdge Short-Term Traders indi-

ces posting 6.1%, 4.1% and 2.9% respectively, compared to -9.3% for the Barclay Hedge Fund Index. Amongst the Barclay CTA sub-indices, Systematic traders outperformed Discretionary traders by about 3.8% over the quarter.

In October, extreme volatility across markets contributed to wide dispersion in hedge fund returns. Equity market volatility reached an all-time high, with the VIX reaching 89, as indices fell over the month before a sharp rebound in the last week. Trend-following programs saw significant reductions in position sizes from market volatility-based position management. Systems generally benefited from: long positions in short-term interest rates with major central banks cutting benchmark rates in the second week; short positions in equity indices; short positions in commodities which sold off by over 22% measured by the CRB index; and the strengthening of the USD with a 7% gain in the USD index. Short-term trading performed very well, especially in intra-day systems. However, some mean-reversion systems, including short-term revisionary components of trend-following systems, were hurt badly when they scaled into the series of equity market drops in the second week of the month. Emerging market currencies fell against the USD in a sell-off driven by increasing risk-aversion. The fall in the Mexican peso and Brazilian real was further fuelled by position unwinds by corporates betting on currency appreciation. Volatility in virtually all currencies exploded to levels near those seen in Asian currencies in 1997 or Latam currencies in 1994, especially USD/Mexico with rates going from a 10-handle to a 14-handle in just 2 hours. Global macro funds overall had a difficult month with positioning or timing, especially in global equities and emerging markets, with outliers mostly to the down-side. De-leveraging appeared to have taken a respite during the month, but market participants were apprehensive of further activity on that front through year-end.

In November, equity volatility spiked again during the month and the VIX peaked at 80 on the 20th before falling to 55 by month-end. Short index positions common amongst systematic programs were profitable as equity indices made fresh lows, although systematic exposures were significantly lower as a function of recent volatility. The fixed income sector accounted for a larger portion of risk allocation in longer-term systematic strategies and programs profited from long positions short-term interest rate futures and bonds driven primarily by the larger than expected rate cuts in Europe and Asia, especially the BoE's 150 bps cut. Treasuries saw the largest monthly gain since 1981 as risk aversion increased and equities fell. In currencies, the USD

strengthened over the month, especially against the GBP and the EUR. However, whipsawing moves in the first week made for difficult short-term trading of the USD against other majors. The yen rallied strongly as carry trades unwound on a flight to safety. Energy futures trading was profitable on the short side with falling demand expectations. Other sectors traded sideways after a period of weakness. Macro managers were mostly positive despite the high volatility, with managers benefiting largely from global monetary policy actions. Here again, the best profit opportunities came from being long the short end of interest rates in the Eurozone, UK and New Zealand, as well as from the continued strength in the dollar and decline in commodities.

In December, market volatility declined in stocks and bond markets. The VIX went from a high of 68 to a low of 38, and equity markets regrouped and ended the month nearly flat. But, the deflationary mood set by weak US employment data on the 5th followed by the Fed's 75 bps cut on the 16th drove strong rallies in short-term interest rate futures and long-dated bonds. Short-term systems however were caught offside in European and Asian bond markets which showed strong moves with no follow through, especially in JGBs. Currency markets saw a very volatile period, and currencies featured prominently in short-term trading returns as both gainers and losers. The Australian dollar, a predominant short position, strengthened. The USD further weakened into the third week driven by the rate cut before strengthening steadily through the latter part of the month as the global economic forecast worsened. Commodity prices trended lower in the front end on weaker demand and forecasts, with unexpected reshaping of the curves. Trend following programs benefited from generally short front exposures, despite oil, sugar and silver rallying later in the month. Macro managers were able to post positive returns during the month, mainly driven by short-term interest rate positions benefiting from central bank actions in developed countries. Weaker commodities made a positive contribution, and the low inflation theme in emerging markets performed well as local short-term interest rates in Brazil, Mexico, South Korea and other emerging markets continued their strong decline. High levels of volatility in G7 FX made it difficult to capitalise on the opportunities there.

Outlook

In the US, strong political leadership is expected to deliver unprecedented fiscal expansion. A central bank assuming primary responsibility for a recovery is likely to continue

bold and targeted policies. These powerful forces are expected to create significant global macro trading opportunities and set long-term trends, while the uncertainty in the effectiveness and timing of results will maintain elevated levels of market volatility.

Liquid strategies such as Directional Equity should benefit as cash on the sidelines searches for new opportunities. The tremendous dislocations that have occurred should throw up ample opportunities for those funds that have maneuverability.

A number of new fund launches are planned in the Convertible Arbitrage space as managers position themselves to pursue what is thought to be a historic opportunity set. One common theme is that an unlevered portfolio on an outright basis can now generate very attractive returns with the only caveat being able to withstand some near-term mark-to-market volatility.

The dislocation in the credit space should show some improvement and that could lead to better returns in the Fixed Income strategies; progress could be hindered by illiquid legacy positions present in some funds.

The supply and demand dynamics discussed earlier will provide trading opportunities in the commodities space. In the short term, the uncertainty of the demand picture will make it more difficult for long biased buy-and-hold equity strategies, but should be conducive for trading oriented managers.

While the Madoff scandal will probably put pressure on redemptions and negatively affect some illiquid funds over the first quarter, the regulatory consequences that will likely ensue should be viewed as positive. Higher transparency and disclosure to serve an increasingly institutional investor base has been at the core of Harcourt's strategy since inception, and we look forward to investing in a world which should emerge with higher standards.

Table 2 | Hedge fund returns Q4 2008

Hedge Fund Strategy	Ret Q4 2008
FTSEhx (investable, net)	-4.74%
HFRI Fund of Funds (non-investable, net)	-8.48%
HFRX Global HF Index (investable, gross)	-13.17%
CSFB/Tremont HFs (investable, gross)	-13.93%
Short-selling	12.40%
Macro	4.31%
CTAs	5.16%
MBS Arbitrage	-0.50%
Merger Arbitrage	-0.52%
Equity Market Neutral	-3.19%
Relative Value Arbitrage	-9.12%
Event Driven	-12.27%
Long/Short Equity	-12.40%
Fixed Income Corporate	-14.74%
Distressed / Restructuring	-16.04%
Emerging Markets	-16.83%
Convertible Arbitrage	-18.32%
JPM Global Bonds	4.48%
MSCI World	-22.18%

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

Table 1 | Hedge fund returns

Hedge Fund Strategy	Q4 2008	2008	2007	Ret pa 2000-2008	Ret pa 1994-2008	Stdev pa 2000-2008	Corr MSCI 2000-08
FTSEhx (investable, net)	-4.74%	-19.93%	0.62%	2.36%	n/a	4.37%	0.54
HFRI Fund of Funds (non-investable, net)	-8.48%	-19.97%	10.25%	3.39%	5.74%	5.76%	0.70
HFRX Global HF Index (investable, gross)	-13.17%	-23.25%	4.23%	3.58%	n/a	6.56%	0.60
CSFB/Tremont HFs (investable, gross)	-13.93%	-25.38%	7.42%	3.43%	n/a	5.79%	0.51
Short-selling	12.40%	28.25%	4.72%	8.00%	2.61%	19.32%	-0.69
CTAs	5.16%	13.67%	8.16%	6.70%	6.55%	7.27%	-0.15
Macro	4.31%	5.66%	11.11%	8.11%	9.77%	5.58%	0.25
MBS Arbitrage	-0.50%	0.77%	1.11%	7.20%	8.45%	3.64%	0.23
Merger Arbitrage	-0.52%	-4.74%	7.05%	5.83%	8.83%	3.78%	0.61
Equity Market Neutral	-3.19%	-6.10%	5.29%	4.49%	6.76%	3.19%	0.14
Relative Value Arbitrage	-9.12%	-16.44%	8.94%	5.62%	7.79%	4.41%	0.64
Event Driven	-12.27%	-21.29%	6.61%	6.18%	10.30%	6.94%	0.79
Fixed Income Corporate	-14.74%	-22.11%	-0.74%	3.01%	4.83%	5.84%	0.64
Distressed / Restructuring	-16.04%	-25.09%	5.08%	7.17%	8.96%	6.45%	0.63
Long/Short Equity	-12.40%	-26.40%	10.48%	3.48%	10.71%	9.04%	0.81
Convertible Arbitrage	-18.32%	-34.61%	5.33%	1.99%	5.37%	8.00%	0.53
Emerging Markets	-16.83%	-36.23%	24.92%	8.13%	8.19%	12.40%	0.82
MSCI World	-22.18%	-42.08%	7.09%	-4.64%	2.91%	15.34%	1.00

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