The Truth About Hedge Funds

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Alternative INVESTMENT MANAGERS

What was once regarded as wild investing by high-rolling cowboys, hedge funds have evolved into a widely-accepted, investment vehicle that is adding value to affluent investors and institutional portfolios.

There are more than 8,000 hedge funds worldwide, managing in excess of $1 trillion. This has roughly doubled in the past five years. Canada has helped contribute to this growth. There are more than 200 hedge funds in Canada with more than $15 billion in assets under management. Moreover, Canada's biggest pension plans, such as the Ontario Teachers' Pension Plan and the Caisse de dépôt et placement du Québec, have sizeable allocations to hedge funds.

Yet, despite the fact that hedge funds have become a staple part of many of the world's best pensions and endowments, much misconception still exists about these investment strategies.

Essentially, a hedge fund is a private investment program where the manager seeks positive returns by exploiting investment opportunities. This broad definition means that there are several different kinds of hedge funds with many different types of trading strategies across a wide range of instruments.

Incidentally, the word 'hedge' in hedge funds is, in general, misleading, since a hedge fund need not be hedged. Some hedge risks, others don't.

The playing ground has become vast for hedge funds. Hedge funds seem to be nosing their way into everything – equity, fixed income, currency, commodities, energy, loans, distressed debt, receivables, structured finance, and reinsurance. There are hedge funds that are run by one or two people and hedge funds that are as large as investment banks. Hedge funds are trading everywhere – North America, Europe, Asia, Middle East, Australia, Africa, and

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South America. Thus, hedge funds pretty much come in all sizes and shapes and, most importantly, all risk levels. This means that while there are hedge funds that are very risky, there are also hedge funds that have very little risk.

Hedge Fund Blow-ups

Hedge funds have long had a shroud of mystery and intrigue around them. Part of the image of many hedge funds is to be secretive and to fly under the radar. Unlike equities, which regularly have news conferences or press releases, the media does not get as much access to hedge funds. Consequently, when there is news, it's often BIG news such as Long Term Capital. This was a hedge fund that had an all-star team which included a couple of Nobel Laureates. Its sensational blow-up required the U.S. government to intervene in order to avoid a global financial catastrophe. The many hedge funds that quietly generate solid returns in a risk-controlled way, do not generate headlines.

Hedge fund managers face fewer constraints (both regulatory and in their investing domain) than mutual fund managers. Since the domain of investment possibilities for hedge funds is much larger, and the regulatory costs and constraints are less, it makes sense that a smart hedge fund manager who has a good risk management framework in place, should be able to add value.

However, the biggest strength is also the biggest weakness. Due to the fact that the investing space is so open and that there are not as many regulatory safety checks in place for hedge funds, the safety net is a lot thinner. Consequently, there is a lot less protection for hedge fund managers who do not have a good risk management infrastructure or who mistakenly believe that they have a winning strategy. These hedge funds are vulnerable to losses.

Is this reason enough to avoid the hedge funds space altogether? Only if one reasons that equities and bonds should be avoided altogether as well. After all, blue-chip stocks such as Enron went out of business. And the tech meltdown at the start of this millennium saw Nortel's stock go from well above $100 to flirting with penny stock status. Even fixed income has not been immune from the blow-ups. Corporate bond defaults helped initiate the creation of credit derivatives. Governments such as Russia and Argentina have defaulted on sovereign bonds and this was considered an impossibility before it occurred. Finally, when a hedge fund blows up, often there are winners on the other side since most hedge funds are playing in zero-sum games (what a hedge fund loses, another party wins).

The fact that there are so many new hedge funds forming means, just like any business, that many of them will not survive.

Alpha – The Hedge Fund Word For 'Value-add'

There are different definitions for 'Alpha' in the hedge fund world. Without getting too theoretical, Alpha can be defined as value-added by a hedge fund manager through skill as opposed to pure random chance. 'Beta,' very loosely speaking, refers to the broad markets.

Some hedge funds do not promise to be uncorrelated with the markets, but rather are trying to beat the market. The Alpha, in this case, is defined to be the amount of return above beta, or the fund's outperformance of the appropriate index. Those that do beat the market consistently, and do so because of skill rather than chance, are adding Alpha.

Market-neutral hedge fund strategies are non-correlated to the broad indices. These hedge funds are striving to deliver an absolute return, regardless of how the markets perform or what the market conditions are. This pure uncorrelated return can be thought of as Alpha. The amount of Alpha that these hedge funds are targeting will vary from fund to fund.

There also exist hedge funds that are hybrids. There are hedge funds that try to offer a 'bleeding' strategy – one that will be negatively correlated to the markets and produce mostly negative returns, with the goal of providing a good 'hedge' when the markets turn.

Ultimately, though, one has to determine if the hedge fund is adding value in terms of risk and return.

Returns – The Gretzky Rule

Wayne Gretzky, when asked to comment on his extraordinary success as a hockey player, stated that, as a child, his father instructed him to "skate to where the puck is going, not to where it is." Smart investors realize fairly early on that it is not a winning strategy to simply chase the returns puck and, in the hedge fund space, this is particularly dangerous. Last year's winner is often the next year's loser.

Even comparing the returns of two hedge funds is like comparing apples to oranges. From a purely statistical point of view, hedge funds often exhibit characteristics that require a deeper analysis than just the return and volatility. The return of a fund that had the higher return might have had much more Beta, so it is the Alpha return that should be compared.

Hotel California And Other Risks

In evaluating a hedge fund, one is not only determining if the trading strategy is a viable way to make money, but also examining the business structure. This means that all risks have to be examined. For instance, is a reputable, independent administrator calculating the net asset value of the hedge fund? If not, then that is a show-stopper and you should stay away. It is wise to be very risk averse when it comes to validation and accounting issues.

Proper operational due diligence and risk management controls are of the utmost importance. Many hedge funds realize that the deepest pockets will stay away if these areas are not satisfactory, and hence are striving to improve. This is 'the institutionalization of hedge funds.'

Proprietary is one of the favourite words used in this space. Everybody has something proprietary and they want you to think that their secret process is the most intelligent and best process available. Naturally, it is wise for managers to be discreet and it is unrealistic to expect too many details. Still, one should understand how they are generating their returns. If they don't give you enough transparency, do not invest.

Liquidity risk should not be neglected. If you do decide to invest in a hedge fund, what is the lock-up? The Eagles song 'Hotel California' is applicable in the hedge fund world. You may be able to "check out anytime you like, but you can never leave." One must understand exactly how onerous the redemption clauses are.

How Do I Get Me Some?

There are numerous avenues to gain hedge fund exposure. As can be guessed there is no one right universal answer. Each investor's needs are unique and care must be taken to craft what is best on a case-by-case basis.

A direct investment into a single hedge fund requires proper due diligence and monitoring. Investing into several hedge funds adds diversity to a portfolio, but, as can be guessed, requires more capital and more resources in conducting due diligence and monitoring. Large pensions and endowments often have the infrastructure to do this, but it is difficult for smaller shops to do effectively. A single multi-strategy hedge fund offers more diversification than a single-strategy hedge fund. However, it is often a challenge for the multi-strategy shop to keep their good traders from spinning off on their own.

Funds of hedge funds might be the easiest way to enter the hedge funds arena, largely because a good fund of hedge funds is doing the work – combing the hedge fund universe, selecting good hedge funds, conducting due diligence, constructing the portfolio, monitoring it, and then repeating this cycle. However, it is important to do proper due diligence on the fund of hedge funds. Make sure that they are really working hard in scouting different hedge fund opportunities and conducting proper due diligence. As well, beware of shops that are style over substance.

The newest way to get hedge fund exposure is via hedge fund indices that are investable. However, usually the best hedge funds are not part of a hedge fund index. There is much research currently being done, both academic and industrial, on hedge fund indices.

All of this might seem rather overwhelming, but the truth is that to get started in hedge funds, one does not need to get fluent with portable alpha or risk budgeting. There are numerous studies which prove that adding hedge funds to a portfolio greatly increases the risk-return performance and many of the world's finest pensions have been using hedge funds to add value for years. Hedge fund products that are uncorrelated to traditional assets offer diversification and can improve the risk-return profile when injected in a traditional-only portfolio. Diversification is the only free lunch in finance. ■

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Who's Buying Alternatives?

When it comes to alternative investments, size means a great deal.

Statistics from Integrated Asset Management show that, as of the end of December 2006, the four largest Canadian plans all had at least 20 per cent of their assets in alternatives.

For example, the $143 billion Caisse de dépôt et placement du Québec fund has about 30.4 per cent of its assets in alternatives, down a bit from the 33 per cent it had at the end of 2005. However, that slip may be due in part to the fact its assets rose from $122 billion to $143 billion, a 17 per cent increase. On a total assets committed to alternatives basis, it saw these assets grow from $40.7 billion to $43.8 billion.

The Canada Pension Plan Investment Board (CPPIB) had a similar experience. It has held its allocation to alternatives at 30 per cent over the two years. However, this means its assets in alternatives moved to $33 billion out of its $110 billion in total assets, from $27.8 billion of its $92.5 billion as of the end of 2005.

However, there are smaller players who also like alternative investments. The Local Authorities Pension Plan (Alberta), a $14.7 billion fund, has 27 per cent of its assets invested in alternatives including real estate, private equity, private debt, absolute return strategies, and timberland.

The Nova Scotia Association of Health Organization's (NSAHO) plan is another. This $2.3 billion fund is 32.2 per cent invested in alternatives, including a 20 per cent allocation to commodities. It has also seen its assets grow 33.5 per cent in the last 12 months.

Most allocations are in the single digits. However, the Caisse does have a 16.2 per cent allocation to real estate, followed by Teachers' at 13.3 per cent and the Ontario Pension Board with a 10.8 per cent allocation. For private equity, the CPPIB has the greatest commitment at 10 per cent while, surprisingly, the $700 million UBC Staff Pension has the greatest allocation to hedge funds, 10.8 per cent.

In the pages that follow, readers will find the *'Directory of Alternative Investment Managers.'* It starts on *Page 29* and features contact information and reports the alternative assets and strategies offered by Canadian, U.S., and international money managers to Canadian pension funds. Please be advised that it continues from *Page 29* to *Page 31* which is found inside the gatefold advertisement. ■

Allocations To Alternative Investments

as of December 2006	Assets $Billion	Real Estate % of Fund	Private Equity % of Fund	Private Debt % of Fund	Hedge Funds % of Fund	Infrastructure % of Fund	Commodities % of Fund	Other* % of Fund
CDP	143	16.2	6.4		4.6	2	1.2	
CPPIB	110	10	10			10		
Ontario Teachers'	96.1	13.3	6.4		6.6	5.2	2.8	3.5
Alberta Investment Management	69.4							4.5
OMERS	41.1	8.1	6			15		
PSP Investment Board	28	6.9	1.1					2.1
HOOPP	27.9	9.3	3.8					
BC Municipal Employees	18.2	9.4	2.5			0.2		
Local Authorities Pension Plan (Alberta)	14.7	10						17
BC Public Service	13.8	9.4	2.5			0.2		
Ontario Pension Board	13	10.8						
Montreal Police	3.5	5.2	5					
Manitoba Civil Service	3.4	8.4	5.6					0.3
TRAF Manitoba Teachers	3	11	3	3				
MUC Transit	2.9	7.7	4.9					
I.W.A. Forest Industry	2.8	4.7						

*Other may include Timberland, Private Equity, Private Debt, Absolute Return Strategies, Venture Capital, High Yield Bonds Source: Integrated Asset Management