Man Investments

The merits of hedge fund investing

A straightforward guide to modern hedge funds

September 2003

Introduction to a growth industry

Hedge funds have gained wide acceptance as diversification tools within investment portfolios. In the early 1990s, they were taken seriously only by a small number of private and institutional investors. More recently, a wider range of investors have become convinced of their attractions. Part of this newfound popularity is due to a shift in culture – today's hedge funds offer greater choice than their predecessors, and managers are more willing to disclose performance attributions. There is also a growing awareness that hedge funds offer strong risk-adjusted performance. This has been emphasised by the way in which hedge funds have preserved, and in many instances grown, capital in the equity bear market that began in 2000.

The combination of strong performance and growing investor awareness of hedge funds has seen industry assets increase significantly. Much of the new money has come from old sources. Wealthy individuals became still wealthier in the 1990s, and had more money to invest either directly or through institutions such as private banks. Perhaps even more significant is that there have been a number of substantial investments by pension funds. This is an important milestone because pension funds are the largest and often considered the most conservative of institutional investors.

Against this backdrop, we believe it is worthwhile to address the following questions:

- What are hedge funds and how have they evolved?
- What are the merits of modern hedge funds?
- Is the current popularity of hedge funds justified?
- What are the controversial issues that surround hedge fund investing?

Our key observations are outlined below:

- **Superior performance**
  Independent studies show that an allocation to hedge funds has typically reduced the volatility of a portfolio of stocks and bonds while maintaining or enhancing the level of returns. Additionally, examination of aggregate hedge fund performance data indicates that they can offer superior risk-adjusted performance to traditional equity and fixed income funds on a stand-alone basis. The reputation of hedge funds has strengthened in the last few years when they have broadly succeeded in avoiding losses, and in certain instances produced strong returns, during a period that has seen some sharp falls in equity markets.

- **Investor friendly culture**
  Broadly speaking, the hedge fund industry has evolved into a universe that is appealing to a diverse range of investors. In earlier days hedge funds had a reputation for volatility, poor risk management and secrecy. While exceptions remain, hedge funds today offer investment styles, risk profiles and reporting practices that are increasingly attractive to a greater proportion of mainstream investors.

- **Diversity**
  The growth of the hedge fund universe has given rise to greater choice of investment opportunities. There are now many more talented hedge fund managers operating across the spectrum of styles.

- **Current concerns do not undermine the merits of hedge fund investing**
  The success of hedge funds has given rise to concerns. Some industry participants feel that, in a rush to gain access to hedge funds, some investors may fail to undertake adequate due diligence. Commentators also question whether capacity constraints particular to certain hedge fund styles may cause an erosion of returns. These concerns are justified, although we would contend that there will always be attractive investment opportunities for carefully selected and well managed hedge funds.

Defining hedge funds

There have been many attempts to define hedge funds, and most definitions differ in one way or another. However, the hallmark of hedge funds is the pursuit of ‘absolute’ returns - that is the quest to generate a positive return regardless of whether asset prices are rising or falling. This is the critical difference between hedge funds and traditional funds: while hedge funds seek positive returns through all market environments, traditional ‘long only’ mutual funds and pension funds typically aim to outperform a benchmark index. Even if asset prices fall, traditional fund managers continue to focus on beating a declining benchmark.

> The hallmark of hedge funds is the pursuit of absolute returns – success in this regard is highly dependent on the skill of the investment manager

The pursuit of ‘absolute’ returns is highly dependent on the skill of the investment manager. Most hedge fund managers seek to exploit market inefficiencies with identifiable and understandable causes and origins. They may take advantage of pricing anomalies between related securities, engage in ‘momentum’ investing to capture market trends, or utilise their expert knowledge of markets and industries to capture profit opportunities that arise from special situations.

Hedge fund managers are unencumbered by the sorts of regulatory and methodological restrictions that characterise traditional fund management. They have the flexibility to invest in a range of assets and instruments employing a variety of styles and investment techniques in diverse markets. The ability to use derivatives, arbitrage techniques and, importantly, short selling - selling assets that one borrows in the expectation of buying them back at a lower price – affords hedge fund managers rich possibilities to generate growth in falling, rising and volatile or range-bound markets.

The use of leverage is often cited as a defining feature of hedge funds, although this can be overstated. Leverage tends to be used to varying degrees by a variety of hedge fund managers to transform potential profit opportunities from relatively small price movements into more sizeable profits. Managers of macro and fixed income arbitrage funds are generally known to use more leverage than managers of other styles, such as equity hedged, which is now the single largest style segment in the hedge fund industry.

A key characteristic of hedge funds is that the interests of managers and investors are closely aligned. Given the confidence hedge fund managers must have in their strategy and investment process, they typically commit a significant portion of their net worth to the funds they manage. This means that hedge fund mangers and investors not only share similar risk and return objectives, but investors have the confidence of knowing that managers’ actual vested interests are aligned with their own.

Style categories

While hedge funds share many characteristics, the universe of strategies is vast, as is the range of risk-return profiles they offer. Portfolio construction and diversification opportunities are greatly enriched by the complementary strengths of different hedge fund strategies. Industry participants have tended to group hedge fund strategies that share similar investment methodologies and performance characteristics into style categories. As a result, hedge fund styles have become the dominant way to view and explain the investment activities that take place within the industry space.

There are no industry-standard or universally agreed definitions of different styles. Style classifications and descriptions tend to vary from manager to manager and among institutions. However, below we offer what we believe to be a broadly acceptable classification and description of the various hedge fund styles.

- **Equity hedged (long/short)**
  Equity hedged or equity long/short strategies represent the largest style segment of the hedge fund industry. Divergences in the performance of different stocks and sectors present a range of profit opportunities in developed and emerging markets around the world. Equity hedged managers aim to profit by taking long and short positions in primarily publicly traded equities they deem to be respectively under and over-valued in some respect. Strategies may be driven by a focus on growth or value stocks, market timing or industry sectors. Managers may have consistent or variable net long or short exposure - most have a variable hedge with a historical tendency to a long bias, but in difficult equity markets managers usually maintain a high hedge ratio.

  Equity hedged managers typically aim to achieve upside performance comparable to a diversified global equity portfolio, but for significantly lower levels of risk. Historically their returns have tended to show higher correlation to equity markets than other hedge fund styles. However, equity hedged funds can play a valuable role within a portfolio as they tend to deliver performance at the higher end of the return range during periods of equity market strength while protecting capital in weaker markets.

- **Event Driven**
  Event driven managers engage in the purchase and short sale of securities of companies experiencing or involved in substantial corporate changes. These events include the sale of assets/business lines, market entries and exits, capital structure changes, acquisitions, mergers, tender offers, exchange offers, liquidations and other corporate reorganisations. Profits derive from the difference between the purchase price and the value ultimately realised upon completion of the event. Typical event driven strategies include merger arbitrage (also known as risk arbitrage), distressed securities and special situations.

  Merger arbitrage managers generally aim to achieve low double digit returns with single digit volatility. Their performance tends to show relatively low correlation to traditional equity and bond markets, although these strategies can be vulnerable to market crashes. Distressed securities strategies generally outperform during times of economic recovery.

- **Funds of hedge funds**
  The funds of hedge funds category caters for any investment in a diversified portfolio of underlying hedge fund managers (usually around 30, but sometimes more than 100) and strategies. The basic principle behind the fund of hedge funds concept is to avoid over-exposure to any particular style of investing and prevent the risk of over-reliance on too few managers. Accordingly, a fund of hedge funds manager must employ a clear investment process and methodology to harness the competitive advantages offered by each underlying investment strategy and preserve capital in a wide variety of market conditions. Anticipating potential problems and capitalising on new opportunities as they develop requires expertise in manager due diligence, strategy selection, portfolio construction, and manager monitoring and risk management. The value-added role a fund of funds manager plays often hinges on being able to provide access to the capacity of exceptional hedge fund managers that are sometimes closed to investment.

  Funds of hedge funds generally strive to produce consistently attractive risk-adjusted returns - usually by combining double digit annualised growth with low (usually bond-like) volatility. An allocation to a fund of hedge funds within a broader portfolio helps to ensure an inherent level of strategic diversification and lends stability to the broader portfolio.

- **Global macro**

  Global macro managers implement opportunistic approaches in order to take advantage of shifts in macroeconomic trends. Strategies are applied to the spectrum of markets, asset classes (stocks, bonds, currencies, commodities) and financial instruments (cash, futures, derivatives etc.). Managers study changes or the rate of change in interest rates, inflation, economic cycles and political circumstances and reach investment decisions based on forecasts and assessments of how global macro economic developments will impact financial markets.

  The performance of global macro managers varies enormously according to the investment process and amount of leverage they employ. However, it is not unusual for leading global macro managers to deliver double digit returns at the higher end of the hedge fund performance range. Performance is most favourable when upward or downward price movements are pronounced or abundant across financial markets. Global macro strategies can play a valuable role in a portfolio as their returns are generally uncorrelated to traditional asset classes and other hedge fund styles.

- **Managed futures**

  Managed futures managers, also known as Commodity Trading Advisers (CTAs), trade futures and derivatives in government bond, stock index, currency, short-term interest rate and tangible commodities such as coffee, crude oil and gold. Systematic managed futures strategies include long-term trend-following and short-term active trading approaches that make use of historical price data to anticipate future price movements. Their managers rely heavily on computer generated trading signals to maintain a systematic and disciplined approach. Some managers may focus on trend reversal, contrarian (counter-trend), mean reversion and spread trading techniques. Discretionary managers apply opportunistic strategies drawing on both fundamental and technical market analysis. They rely less on computer generated signals and more on their experience and trading skills.

  Managed futures strategies tend to target relatively high (mid to high-teen) returns and, accordingly, managers tolerate greater volatility – double digit volatility is not uncommon. The majority of strategies thrive when markets exhibit clear upward or downward price movements. Managed futures strategies can provide valuable diversification benefits within a portfolio due to their low correlation to other hedge fund styles and traditional asset classes.

- **Relative value/arbitrage**

  Relative value managers apply arbitrage strategies and techniques to take advantage of perceived pricing discrepancies between similar or related securities. By establishing long positions in under-valued assets and short positions in overvalued assets, managers aim to capture profit opportunities that arise from the changing price relationship between the securities concerned. Most relative value managers are active in global equity and bond markets, although arbitrage strategies are executed across the spectrum of asset classes utilising a wide range of financial instruments. Typical relative value strategies include convertible bond arbitrage, fixed income arbitrage, mortgage-backed securities (MBS) arbitrage, derivatives arbitrage and equity market neutral and statistical arbitrage.

  Generally, relative value strategies aim for low double digit returns with single digit volatility in all market environments. Including these strategies in a portfolio can be highly advantageous because of their consistent performance capability even in unstable and volatile market conditions and their low correlation to traditional equity and bond markets.

A dynamic evolution

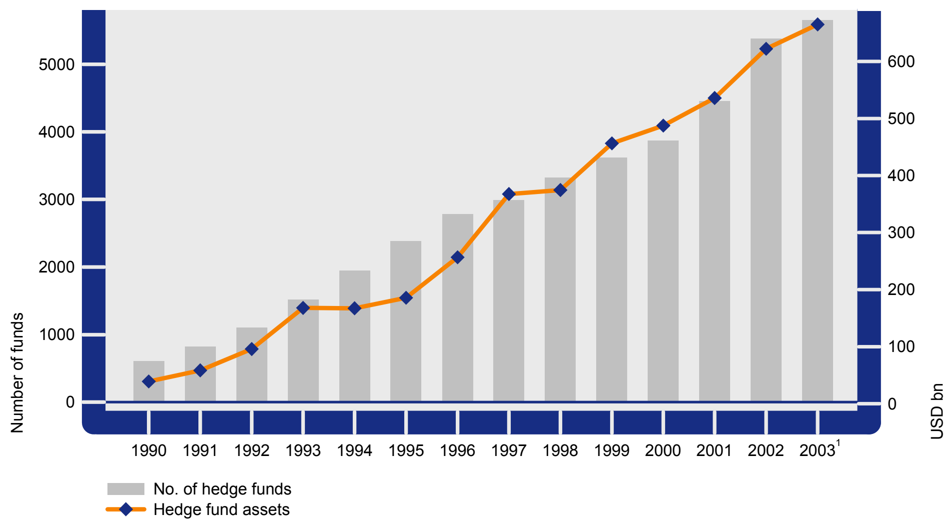
Hedge funds have evolved through a process of natural selection – survival of the fittest. In the 1980s and early 1990s, the hedge fund industry was dominated by a small number of so-called macro hedge funds. Typically headquartered in New York, the most successful of these generated exceptional (if volatile) returns and gathered substantial assets. The managers of these funds employed a variety of investment strategies, but their greatest coups came from executing large trades in G7 bond or currency markets.

> Over the last decade most money has flowed into the equity hedged style, but event driven and relative value styles have also come into prominence

Towards the end of the 1990s, the financial environment became less favourable for macro funds and equity hedged, relative value and event driven approaches became more popular. Wide divergences between the performance of different stocks and sectors have favoured equity hedged funds. Event driven investing prospered first with the merger boom, and then with increasing numbers of bankruptcies. Yet the popularity of these strategies is also a result of their conceptually straightforward strategies and relative lack of leverage.

Data collected by Hedge Fund Research Inc. (HFRI) charts this move away from leverage and complexity towards lower risk and greater simplicity. As hedge fund industry base assets have climbed from less than USD 50 billion at the beginning of 1990 to over USD 620 billion in 2003, so most of this new money has gone to styles like equity hedged, relative value and event driven.

Growth of the global hedge fund industry



Source: Hedge Fund Research Inc.
[1]As at 30 June 2003

A sophisticated return to simple origins

In some ways, this style shift represents a return to the hedge fund industry's roots, albeit in a more advanced form. Depending on whom you talk to, the first hedge funds appeared in the 1930s or 1940s. A.W. Jones, a United States-based investment manager who launched a fund in the late 1940s, is most commonly credited with setting up the first hedge fund. Jones's fund was an equity hedged fund, as were many of those that followed in the 1950s and 1960s.

Today's hedge funds are more highly evolved than their ancestors. Their managers have more tools and possibilities at their disposal. For a start, there is now a wide range of derivative contracts available in equity, fixed income, foreign exchange and commodity markets. Underlying financial markets have also become more liquid. Short selling is easier, as institutions have become more willing to lend stock. And, finally, the investment banks offer extensive facilities for hedge funds through their prime brokerage businesses.

In practical terms, these changes mean that hedge funds have far greater flexibility. They can operate across a wider range of markets, short sell a larger number of stocks, and hedge positions more easily. Further, the technology provided by leading prime brokers has vastly improved the ability of hedge fund managers to monitor performance and manage risk.

Investor relations

One other aspect of the dynamic evolution that has taken place in recent years is that these funds have become considerably more 'investor friendly'. As mentioned earlier in this paper, there is increasing transparency. Until the mid-1990s, hedge funds were notably reticent about performance attribution, with some justification: hedge fund managers do not wish to reveal their positions to competitors. While there remain exceptions, hedge funds are now generally prepared to disclose greater detail about their performance.

> The increasing openness of the hedge fund industry is happening in parallel with the changing nature of hedge fund management companies

Another illustration of the accessibility of hedge funds today is the move towards greater liquidity. A growing number of hedge funds now offer monthly liquidity, rather than the quarterly liquidity that was more typical in the early 1990s. Again, however, there are exceptions in the cases of particularly sought after funds and strategies that require longer-term commitment of capital.

The increasing openness of the hedge fund industry is happening in parallel with the changing nature of hedge fund management companies. As equity hedge funds have begun to dominate the industry, so a large number of hedge fund managers now come from an investment management background. Previously, perhaps the most common background was investment bank proprietary trading. Culturally, investment managers are far more open than investment bankers. In addition, the increasing involvement of mainstream institutional investors and investment management houses has pushed hedge funds towards improved investor relations.

Some types of institutional investors, like endowments, foundations, and insurance companies, have invested in hedge funds for many years, but are now doing so in increasing numbers. There is also a growing acceptance of hedge funds by pension funds, the most conservative of all their peers.

Performance characteristics

Examination of hedge fund data shows that investment across a spectrum of hedge fund styles would have achieved compelling results over the past decade or so. In the Appendix we show the performance of the Hedge Fund Research Inc. (HFRI) Composite index, a widely accepted industry benchmark, against world markets. The exhibits in the Appendix illustrate some of the advantages hedge funds have over traditional investments. Broadly speaking, studies on hedge fund performance have reached the following conclusions:

Performance provides the greatest justification for investment - hedge funds have considerable merits, both as diversification tools and as stand-alone investments

- Hedge funds have offered superior risk adjusted performance compared with competing equity investments. Their ability to produce returns in both rising and falling markets has highlighted the potential hedge funds have to enhance the risk-return profile of an investment portfolio (see Appendix, Exhibit 1).

- For institutional investors, like pension funds, which are already owners of portfolios of traditional securities, there is a clear argument for investing in portfolios of hedge funds. As diversification tools, hedge funds have proven ability to enhance an overall portfolio's risk-return characteristics. This is because hedge funds typically show low correlation with traditional markets (see Appendix, Exhibit 2), yet similar levels of percentage return. Most studies place the optimum allocation to hedge funds at 10-20% (see Appendix, Exhibit 3).

- The attractions of hedge funds increase in hostile market conditions. Hedge Funds Demystified, a study co-authored by Goldman, Sachs & Co. and Financial Risk Management Ltd. shows that in extreme market conditions, hedge funds have an even greater beneficial effect on the balance of return and risk. Statistics show, for example, that long/short equity hedge funds offer downside protection in periods when equity markets are falling.

In practical terms, these findings demonstrate that hedge funds have considerable merits - both as diversification tools and stand-alone investments. Care should be taken, however, when interpreting these studies. There are two caveats. The first is that while the broad hedge fund universe has done well, there is a wide variation in hedge fund performance, and a few have performed extremely badly. Secondly, hedge fund industry benchmark performance data tends to reflect a flattering 'survivorship bias' as hedge fund managers that disappoint may stop reporting to industry databases.

Controversial issues

Despite growing acceptance of hedge funds, some difficult issues remain.

Hedge funds have historically been criticised for excessive leverage, high fees, a lack of liquidity and a lack of transparency. Much of the reason for the success of modern hedge funds in attracting assets has been the fact that they have become less controversial in most of these areas. What follows is a summary of these issues, starting with the most topical, capacity.

- **Capacity**
  After the flood of money into hedge funds over recent years, there is talk of a 'bubble'. By this commentators mean that the returns of certain hedge fund types may be stifled by sheer weight of money. This is a legitimate anxiety. In particular, there are definite capacity constraints on both individual hedge fund groups and, at certain times, generic hedge fund styles. Merger arbitrage is an example of a style that has limited capacity, as the balance between the weight of assets chasing mergers and the number of mergers impacts the magnitude of returns. Should merger activity dwindle at a time of high investment in this strategy, then returns will logically suffer. Further, there is a fear that dwindling returns in some areas will lead to groups using more leverage and therefore introduce greater risk. While there is some merit to this concern, prudent hedge fund investors can avoid such difficulties. The key to successful hedge fund investment is not new: diversification across different investment styles implemented by strong managers with established track records.

- **Leverage**
  Leverage is often integral to the hedge fund investment process, although the degree to which it is used varies across and within different investment style segments. Many of the investment strategies that are currently most popular, such as equity hedge, employ relatively low leverage - similar to UK investment trusts. In other areas of hedge fund investment, however, greater leverage is required to magnify relatively small arbitrage opportunities. The greatest amount of leverage tends to be used by macro and fixed income arbitrage funds. While funds in these areas would not have been able to generate significant returns without leverage, this practice has caused a few notable failures. Best known is Long-Term Capital Management, the fixed income arbitrage fund that collapsed towards the end of 1998. In recent years, investors have tended to avoid highly leveraged funds.

- **Liquidity**
  A growing number of hedge funds now offer monthly liquidity, but there are examples of particularly sought after managers imposing far longer redemption periods or 'lock-ups'. This is also sometimes true of managers practising strategies that require long-term commitment of capital. In some cases, investors may only be able to redeem once a year.

- **Transparency**
  As the hedge fund industry has become more mainstream, so transparency has improved. Hedge funds generally offer more in-depth information about performance than was the norm five years ago. However, in some areas, instances of limited disclosure still occur. Some equity hedged funds still take currency positions, for example, yet are reluctant to reveal exactly what these are.

- **Fees**
  Fees in the hedge fund industry remain high compared with traditional investment management. Hedge fund management companies typically charge private investors a 1-3% annual management fee and a 15-20% performance fee. The performance fee is

charged only on profits that exceed the ‘high watermark’ of a fund’s net asset value and is sometimes levied on performance in excess of a benchmark such as monthly Treasury bill rates. Such fees are justified by the fact that hedge fund management companies strive for absolute performance and limit assets under management.

Conclusions

Following the expansion and evolution of the hedge fund industry over the past decade, hedge funds present a compelling investment opportunity for institutional and private investors alike. Performance must be at the core of any justification of hedge funds. But the increased size and diversity of the industry, and its growing awareness of basic investor relations issues, have made it far more acceptable to mainstream investors.

Of course, as with any type of investment, there remain some hazards to be aware of. The main one is that the increased popularity of hedge funds can compound capacity problems in some hedge fund styles at certain times. Also, it can be difficult to find skilled hedge fund managers that are still taking in new money. However, experience and an analytical approach (such as is practised by the best funds of funds) should counter these problems.

In summary, the following are the main merits of modern hedge funds:

- **Performance**
  Academic research suggests that portfolios of hedge funds can add value both as diversification tools and as stand-alone investments, presenting an opportunity to improve the overall risk-adjusted return of an investment portfolio.

- **Diversity**
  With in excess of USD 620 billion of base capital invested across more than 5,000 hedge funds (source: HFRI), the hedge fund industry has reached critical mass. There is now a sufficient number of serious hedge fund management groups for investors to be able to assemble portfolios of hedge funds diversified by both style and manager.

- **Maturity**
  Hedge funds have evolved. They now have characteristics of transparency, liquidity, and reduced leverage and volatility that are more appealing to mainstream investors. The majority of hedge funds have far more stable returns today and their management groups tend to disclose more detail about how performance has been achieved.

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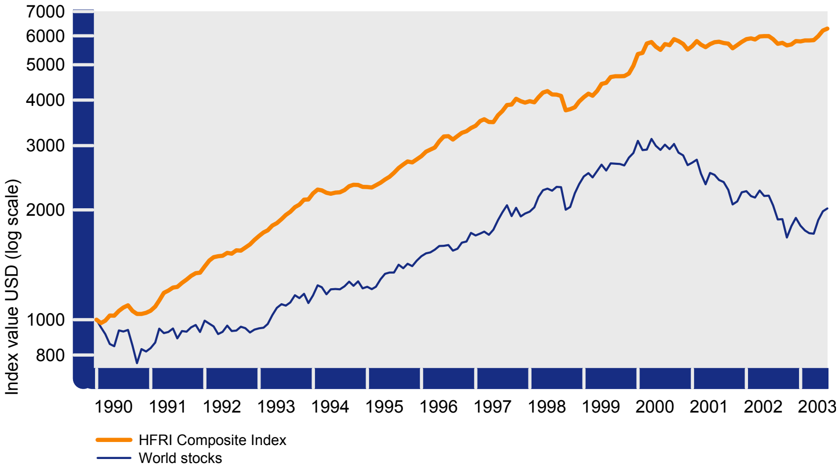
Appendix

Exhibit 1: Risk-adjusted returns

Hedge Fund Index vs. world stocks
1 January 1990 to 30 June 2003



	HFRI composite index	World stocks
Total return	528.1 %	101.7 %
Annualised return	14.6 %	5.3 %
Annualised volatility	7.2 %	15.1 %
Worst drawdown	-11.4 %	-46.3 %
Sharpe ratio	1.40	0.05

Source: Man Investments, Hedge Fund Research Inc. (HFRI) and Standard & Poor's Micropal. There is no guarantee of trading performance and past or projected performance is not necessarily a guide to future results.
Hedge fund composite index: represented by the HFRI Hedge Fund Weighted Composite Index.
World stocks: MSCI World Stock Index (Total Return).

Exhibit 2: Correlation matrix

Hedge fund Index vs. traditional investments
1 January 1990 to 30 June 2003

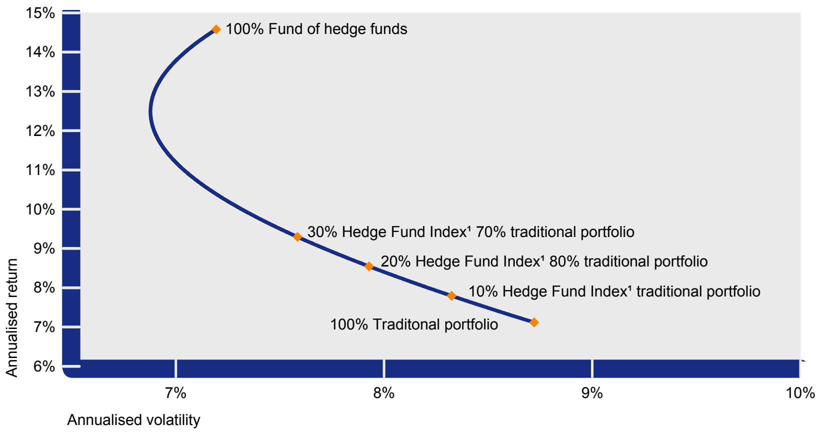
	US stocks	European stocks	World bonds	World stocks	Hedge Fund composite index
Hedge Fund composite index	0.69	0.60	-0.03	0.67	1.00
World stocks	0.86	0.58	0.22	1.00	
World bonds	0.06	-0.43	1.00		
European stocks	-0.43	1.00			
US stocks	1.00				

Source: Man Database, Hedge Fund Research Inc. (HFRI) and Standard and Poor's Micropal. There is no guarantee of trading performance and past or projected performance is not necessarily a guide to future results.
Hedge fund composite index: represented by the HFRI Hedge Fund Weighted Composite Index.
World stocks: MSCI World Stock Index (Total Return).
World bonds: Salomon World Government Index (Total Return).
European stocks: MSCI European Stock Index (Total Return).
US stocks: Russell 3000 Total Return Index (dividends reinvested).

Exhibit 3: Portfolio efficient frontier*

Impact of Hedge Fund Index on a Traditional Portfolio

1 January 1990 to 30 June 2003



* While this analysis suggests investors with portfolios of stocks and bonds should allocate more than 30% to hedge funds, 10-20% is likely to be a better yardstick. The current strength of relative hedge fund performance has flattered the data somewhat, while adoption of a high allocation by large numbers of institutional investors would cause capacity problems.

Source: Man database, Hedge Fund Research Inc. (HFRI) and Standard and Poor's Micropal.
[1]Hedge Fund Index: represented HFRI Hedge Fund Weighted Composite Index
Traditional Portfolio: 50% World stocks, 40% World bonds & 10% US cash.
World stocks: MSCI World Stock Index (Total Return).
World bonds: Salomon World Government Index (Total Return).
US cash: represented by the US Treasury Bill Index.
There is no guarantee of trading performance and past or projected performance is not necessarily a guide to future results.