

# Hedge Funds Strategies for sourcing and evaluation of fund managers

**S**election of hedge fund managers does make a difference! With the announcement on 29th September 2006, that Amaranth Advisors, the \$9.2 billion hedge fund that lost \$6.5 billion in less than a month, is preparing to shut down, the importance of proper manager selection is further reinforced.

Nicholas Maounis, the founder of the hedge fund, sent a letter to investors informing them that the fund was suspending all redemptions for 30th September and 31st October to “enable the Amaranth Funds to generate liquidity for investors in an orderly fashion, with the goal of maximizing the proceeds of asset dispositions.”

Amaranth’s energy desk bet aggressively on Natural Gas, but when prices fell in September, the fund found itself in positions too big to liquidate and ultimately was forced to sell its energy holdings when some of its counterparties threatened to cut-off its credit.

The year 2006 has proved to be difficult for many other funds as well, including Madrid based Vega Select -14.45% YTD who after growing to \$13 billion was halved in 2005 after investors withdrew their money after heavy losses.

Moore Capital’s flagship \$3.2 billion Global Investment Fund is up less than 1% this year. But many large funds have posted double-digit returns this year like \$3.3 billion CQS Arbitrage Fund up 11% and \$1.9 billion Drake Global Opportunities Fixed Income Fund up over 35%.

However, many hedge fund managers



**John Bauer, Senior Vice-President, Asset Management, United Gulf Bank, examines the global scene for hedge funds and outlines the precautions investors need to take when selecting a fund manager for maximum security and returns**

will feel pressure to boost performance in the 4th Quarter as failure to generate performance above pre-defined hurdle rates means that they will not collect 20-30% profits, better known as performance fees.

## **Mixed returns**

Over the past 12-months, the top 20 hedge funds returned between 22% and 95% while the bottom 20 returned between 1.0% and -13.6%. There are over 9,000 hedge funds with assets totaling \$1,500 billion with managers located in the USA 56%, Europe 38%, Asia 3% and other regions 3%.

There are 12 strategies to choose from plus Fund-of-Hedge Funds. The HFRI Fund Weighted Composite Index reported performance for the first nine months 2006 of 7.10% and for the full year 2005 were 9.30% versus 9.03% in 2004. The strongest performing strategies for 9-months 2006 is Emerging Markets 12.06% and Merger Arbitrage 9.82%. Hedge Fund of Funds was 4.77%, one of the worst performers.

As of 29 September 2006 the three-

year annualized Hedge Fund Aggregate Sharpe ratio was 1.58 versus an average 1.85 since 1997. Manager sentiment shifted away from risky assets, which suffered a significant correction, particularly in equity markets after a sustained rise in the first quarter.

However, with approximately 9,000 Hedge Funds to select from (over 100 have assets of \$1.0 billion or more with the largest at over \$30 billion), what are the criteria an institutional investor should use when selecting a manager?

## **Clear definition of strategy**

Since hedge funds offer a wide variety of strategies and risk profiles, investors must first decide what they want to accomplish through this asset class. Factors often given priority are the availability of leverage from the manager, track record, volatility, liquidity and historic relationship that has evolved with the manager.

## **Strategy vs manager profiles**

Institutional investors are approached by numerous hedge fund managers from

**Outline Investor Objectives**

**Create Investor Strategy through the Objectives**

**Match the Investor's Strategy against the Appropriate Manager Profile**

all areas of the globe, all wanting them to invest in their fund(s). It is critical that institutions communicate their requirements in that first meeting so that it can be determined whether there is a possible fit and if it is worth any follow-up. Then focus can be placed on those few managers that really can best support the strategy. A more proactive approach and researching the universe can significantly narrow down the prospects to a small number of managers that best can support the institution in accomplishing the objective. For the best long-term results it is best to take an active rather than passive posture when screening managers. Some of the steps often taken when screening are:

- ▶ Desk research—screen a large universe (8,000+) via systems and desk research to reduce the target.
- ▶ Meetings—on site at managers' premises to reduce the target further.
- ▶ Monitoring—additional short-listing based on performance.
- ▶ Approved list of managers by the Investment Committee.
- ▶ Prioritize managers to invest in based on liquidity, opportunities in other asset classes, etc.

#### **Criteria for selection of manager**

The criteria to be used and the weight given to each when screening will depend on the investing institution's objectives. Below are some common ones used:

- ▶ Past performance relative to the investor's targeted return.
- ▶ Opportunity lost—there may be better investment opportunities than hedge funds.
- ▶ Volatility—appetite for volatility varies depending upon the investor's risk



tolerance. Investors often look for volatility below 4% p.a.

- ▶ Sharpe ratio—investors often target 1.5+
- ▶ Size of assets under management—managers with \$1.0 billion or more in assets under management tend to have the resources to do better at managing both investment and structural risks. However, smaller managers generally have the ability to make changes to their portfolios more quickly when adjusting to changes in market conditions.
- ▶ Transparency—not all managers disclose names and performance of underlying managers. This should be a requirement when selecting a manager.
- ▶ Availability of leverage from the manager (willingness of the manager to lend to the investor part of the amount invested using units of the fund as collateral).
- ▶ Relationship between the investor and manager.
- ▶ Past quality of risk management—this is often reflected by historic levels of volatility or with other problems.
- ▶ Investment process & style (active or passive, top down/bottom up, history of any style drift, ability to move quickly to take advantage of market opportunities, etc.)
- ▶ Non-investment issues and management of structural risk

#### **Post investment follow-up**

Evaluation of managers does not stop once the investment is made. Monitoring must be done continuously afterwards against the criteria above. Monthly reporting and annual meetings are minimum requirements.

#### **Shariah-compliant Hedge Funds**

The development of Shariah-compliant hedge funds had been earlier constrained by the strict rules of Islamic law, which prevent the use of those forms of derivatives where one is transferring risk for payment of something to another person. Now the hedge fund managers can still adopt some of the accepted Islamic finance practices to work with conventional hedge fund strategies.

For instance, the fund that is permitted within Islamic finance by creating "stipulating options," namely options where a buyer makes an advanced partial payment for a good at a later date. If the buyer later decides not to complete the deal, the seller keeps the advance and this is the closest analogy in Islamic finance to an option.

A further development of the hedge fund principle is the 'Salam Sale', where one sells a commodity to a buyer against full up-front payment for delivery at a future date. An investor can hedge downside risk by selling stocks as a Salam Sale, with the same economic result as short-selling, but without the involvement of a borrowing element.

The Salam Sale price includes the time value of money, but early delivery will not cause a fall in price and no refund is allowed. The macro-economic picture for Islamic finance is healthy, with an average of 15 per cent yearly growth in deposits.

#### **Other issues**

Other issues that have surfaced in recent years include the evolving role of prime

brokers, hedge fund failures and Shariah compliant hedge funds:

## Prime Broker

A Prime Broker is a large bank or securities firm that provides various administrative, back-office and financing services to hedge funds and other professional investors. Prime brokers can provide a wide variety of services, including trade reconciliation (clearing and settlement), custody services, risk management, margin financing, securities lending for the purpose of carrying out short sales, record keeping, and investor reporting.

Typically, the prime broker finances the investments and, therefore, they are often the fund's largest financial stakeholder. Most Prime Brokers earn their revenue in two areas: cash lending to support leverage and stock lending to facilitate short selling. In the stock lending business, Prime Brokers act as an intermediary between institutional lenders and hedge fund (and other) borrowers. Most institutional lenders will not accept the credit risk of dealing directly with hedge funds, which are generally, domiciled off-shore, whereas they are more than happy to take exposure to the Prime Broker.

## Hedge fund liquidations

The recent round of hedge fund implosions is not a new phenomenon. Beyond Aramant discussed above, hedge funds have always had a significant failure rate. Some strategies, such as managed futures, had an attrition rate as high as 14.4% per year between 1994 and 2003, according to a study recently released by the European Central Bank ("Hedge Funds and Their Implications for Financial Stability", Aug 2005). Most of the hedge fund fatalities discussed below occurred in 2005 and were related to a strategy that involves the use of leverage and derivatives to trade securities that the trader does not actually own. Here are some examples of hedge fund liquidations that further reinforce the importance of proper selection:

**Bailey Coates Cromwell Fund** This event-driven, multi-strategy fund was laid low by a series of bad bets on the movements of U.S. stocks in 2005.

## HFRI MONTHLY INDICES September 2006

HFRI Index	Total Return				1 Year		3 Year Annualized		
	AUGUST	YTD	1 YR	3 YR	Volatility	Sharpe	ROF	Volatility	Sharpe
HFRI Fund Weighted Composite Index	1.04%	6.92%	11.13%	36.94%	5.27%	1.16	11.04%	4.56%	1.75
HFRI Fund of Funds Composite Index	0.77%	4.74%	8.71%	26.42%	5.13%	0.8	8.12%	4.01%	1.31

## Hedge funds offer investors an additional tool to enhance investment performance, but success depends on how they are integrated into the portfolio and managed as a unique asset class

**Marin Capital** This \$1.7 billion fund using credit arbitrage and convertible arbitrage to make a large bet on General Motors. When General Motors' bonds were downgraded to junk status, the fund was crushed.

**Aman Capital** Aman Capital was set up in 2003 and leveraged trades in credit derivatives resulting in an estimated loss of hundreds of millions of dollars and ended up closing its doors in June 2005.

**Tiger Funds** In 2000, Julian Robertson's Tiger Management failed despite raising \$6 billion in assets, by short selling what he viewed as the worst stocks. This strategy hit a brick wall during the bull market in technology and Tiger Management suffered massive losses.

Long-Term Capital Management (LTCM)

LTCM made a big bet on Russian bonds and Russia defaulted on its debt in August 1998. The federal government of the United States feared that the imminent collapse of LTCM would precipitate a larger financial crisis and orchestrated a bailout to calm the markets which enabled LTCM to survive the market volatility and liquidate in an orderly manner in early 2000.

**Acceptable Exposure Levels** Selection a managers must be taken in context of the overall allocation of hedge funds in a portfolio. Commercial banks traditionally have low allocations due to fact that their liquidity is derived from depositors

and cannot take the risk of a high allocation. Investment banks can be more aggressive since their liquidity is derived from shareholders and reflect the risk tolerance from them. The allocation by other institutions and individuals will vary depending upon their risk tolerance and other objectives.

Factors that will determine an acceptable exposure level for an institution are:

- ▶ Opportunity cost—even though hedge funds may offer attractive returns on an absolute basis, other opportunities may even be better on a risk adjusted basis.

- ▶ Asset allocation—each institution normally will set guidelines as to how much should be allocated to hedge funds, depending on their investment strategy. In cases where an institution is at or above the limit, addition exposure to hedge funds may not be possible.

- ▶ Liquidity—an institution's ability to fund new investments may limit exposure.

- ▶ Time horizon—if daily liquidity is needed by the investor, then hedge funds may not be an option.

- ▶ Risk tolerance of the portfolio will help to define the overall exposure level.

Overall, hedge funds have offered investors an additional tool to enhance investment performance. The success, however, will depend on how they are integrated into the portfolio and managed as a unique asset class.

*John Bauer is Senior Vice-President, Asset Management, United Gulf Bank.*