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Hedge funds down; tough outlook ahead

By Darren Stubing on Sunday, August 24, 2008

Hedge funds had a difficult month in July, largely mirroring the performance of the broader market. World financial markets faced continued pressure during the month; the Morgan Stanley World Index was down by 2.5 per cent in July. Global hedge fund indexes such as the Eurekahedge Index declined by the same percentage. A major factor in the decline was the sharply weaker performance in commodities. The Dow Jones-AIG Commodity Index fell by a substantial 12 per cent in July. The oil price was lower due to weaker demand forecasts.

Other hedge fund indices were also down sharply in July. Hedge funds saw their worst monthly performance in the history of the Morningstar 1000 Hedge Fund Index, falling by 3.1 per cent. The Morningstar Global Equity Hedge Fund Index lost almost 8 per cent. Due to the fact that July saw big losses in commodities, the Morningstar Global Trend Hedge Fund Index halted its upward trend. In general, the strategy on long on commodities and shorting financials resulted in large losses.

Despite the problems, hedge funds still experienced good inflow in July. Multi-Strategy hedge funds had more than double the inflows of other categories, placing second only to Global Trend hedge funds. In a dynamic macro-economic environment, Multi-Strategy hedge funds can be more flexible and quicker acting than single-strategy hedge funds, allocating assets to strategies with a more positive outlook, while shifting away from strategies with weaker prospects.

July saw nearly all regional mandates finish in negative territory. Managers allocating to North America, Latin America, and Asia all fell between one per cent and two per cent, negatively affected by the sudden decline in commodity prices. Managers in Europe were also affected by the difference in market movements seen during the two halves of the month. Eastern Europe and Russia-investing funds were down a notable 10.6 per cent in July, largely because the region's equity markets (down by 10.8 per cent) were hit by the decline in oil prices. August will also prove to be weak for the region due to the conflict between Russia and Georgia.

Emerging market equities saw mixed returns. Brazil and Russia fell by 8.5 per cent and 13 per cent respectively. Chinese stocks rose by 1.5 per cent, aided by growing retail sales and a reasonable trade surplus in June. India saw a strong gain of 7.2 per cent. Fixed income and debt hedge funds saw some gains. The fixed income markets saw bond prices close higher on the month, as concerns on economic growth and falling energy prices worked towards curtailing inflationary pressures to some extent.

Other commodities, particularly agricultural, also saw price declines owing to increased inventories and production combined with lower demand. Some precious metals, such as platinum, were also down owing to a stronger dollar and slowing global economic growth.

All Eurekahedge hedge fund strategies were in negative territory in July, with large falls in commodity trading funds, long/short equities, and event driven funds.

Arbitrage and Relative Value indices were down 0.3 per cent and 0.6 per cent respectively. Managers of the strategies were negatively impacted by redemptions and increased margin requirements. In the US, arbitrage hedge funds finished the month down by 0.5 per cent. A significant portion of the month's losses for managers was due to the further deterioration in the convertible market. Participants in the market experienced liquidity-driven selling pressures, which resulted in further down-pricing of securities.

Long/Short Equities Hedge Fund Index declined by 2.6 per cent due to the sudden up-turn in global equity markets. After losing around six per cent at one point in the month, the MSCI World Index closed the month down 2.5 per cent. Inflationary pressures, commodity price volatility and continued distress across global financial markets negatively impacted stock markets.

Event-Driven Hedge Fund Index fell by 2.8 per cent, as event-driven managers were affected by volatility in the equity markets. The European Event Driven index shed 6.1 per cent. Managers were faced with difficult conditions in the underlying markets, with wide fluctuations in commodity prices and sudden shifts in investor sentiment.

Fixed Income Hedge Fund Index recorded a loss of 0.5 per cent in July, amid some volatility in the fixed income markets. The fall in commodity prices went some way in curtailing inflationary pressures and in turn favouring bond markets.

The yield on the 90-day Treasury bill was down 8 basis points, while that on the US 10-year Treasury note remained unchanged on a monthly basis. Distressed debt managers were down slightly amid wider credit spreads and further deterioration in the high yield markets.

Commodity Trading Advisors and Managed Futures hedge funds fell by 4.2 per cent. Crude oil prices saw the biggest daily drop in 17 years amid concerns on the demand for the commodity. Sudden movements in the currency markets also went some way in impacting the performance of managers of the strategy. The US dollar rebounded from its record low against the euro, on the back of lower commodity prices and signs of a slowdown in Europe. Multi-Strategy Hedge Funds recorded a loss of 1.9 per cent. US and European managers recorded losses of 3 per cent.

Final August performance for hedge funds will likely be mixed, reflecting difficult trading conditions. Markets remain volatile and sensitive to negative events. The notable correction in commodity prices has provided some positive news but the oil price is still subject to an upward revision on any supply concerns or political event. There also remain worries about financial stocks and further credit issues related to the sub-prime crisis and credit squeeze.