



A Year of Crisis: Have Hedge Funds Kept Their Absolute Return Promises?

*Philippe Malaise, Professor of Finance
EDHEC Business School*

The financial crisis that began more than a year ago now, after the sudden fall in the prices of investments backed by subprime loans, sent shockwaves through the markets, with unprecedented write-downs of asset values continuing to undermine the foundations of the banking system and leading to a pronounced economic slowdown. The great increase in risk aversion ultimately led to great adjustments in the stock markets. Since the initial falls of June 2007, the major stock market indices have posted losses in the double digits. Volatility has increased abruptly; in the first quarter of 2008 it was twice its second quarter 2007 low. At the same time, credit spreads have widened greatly, throwing high-yield bond indices into a free fall, while, conversely, government bonds attracted renewed interest, despite inflationary threats. In this environment, one of instability, to say the least, analysis of the results posted by the major alternative strategies since the summer of 2007 takes on particular interest, all the more so in that many hedge fund managers play up their ability to withstand crises and to offer returns uncorrelated with those of conventional asset classes.

The results for the EDHEC alternative indices are mixed, but all in all they are, given the characteristics of each investment style, largely in line with expectations. Although some strategies have certainly profited from recent turbulence in the capital markets, easily outperforming the risk-free rate from July 2007 to June 2008, the majority post less spectacular results, closer to zero, and in some cases they are even slightly negative.

Of the beneficiaries of this period of turbulence, short sellers are by far the top performers (24.82% from July 2007 to June 2008). This performance is a result of their negative beta (stock markets were in the red two of every three months during these 12 months of activity). With a cumulative return of 17.73% for the period, CTAs have also done well. Short-term funds managed to take advantage of increased market volatility. For their part, trend followers, overall, benefited from the September/October 2007 rebound then, after having flipped their positions, from the bear markets of January 2008. In addition, they profited amply from the rise in commodity prices, the mid-February to mid-March fall of the dollar, and changes in interest rate trends.

A fair number of macro funds had something to celebrate as well (10.64% on average from July 2007 to June 2008), although results in this category range widely. Most managed to limit or avoid losses at the most critical moments (August and November 2007; January and March 2008), all while maximising gains during upturns (temporary) in the stock markets (September and October 2007 in particular). Many macro managers also profited from spikes in commodity prices and from the ups and downs on the money markets.

Equity market neutral strategies likewise managed to emerge from this volatile period with a positive score (5.94%). Despite their beta-neutral approaches and their profiles as pure generators of alpha that, as the assumption has it, offer persistent positive returns with low volatility, their performance should not mask the fact that they too can fall, as shown by their -1.12% January drawdown, when capital is transferred en masse to risk-free assets.

In the relative value category, fixed income arb funds managed to safeguard their capital, with a modest performance of 0.65% for the period. The toughest phase was undoubtedly the first quarter of 2008, which ended with significant losses (-3.65%), the worst since the Russian crisis and the implosion of LTCM in 1998. March, in particular, was catastrophic (-3.06%), serving as a reminder that these funds are particularly vulnerable to liquidity crises. The intervention of the Fed (opening of discount window to investment banks, increase in the range of assets accepted as collateral) led to a partial rebound in April and May.

Somewhat more surprisingly, merger arb funds also finished this first year of crisis on positive ground (1.54%). Although they suffered during the successive liquidity shocks, with an especially trying period from November 2007 to January 2008, during which spreads widened dangerously, wiping out the gains posted during the rally of September and October 2007, these funds rebounded in April/May 2008, as the intervention of the Fed in the wake of the collapse of Bear Stearns gave a boost to trading.



Largely as a result of widening credit spreads in November 2007, then in January 2008 (the largest monthly drawdown for distressed security funds, with a loss of -2.33%, and as much as -2.71% for multi-strategy event-driven funds), and finally in March 2008, the multi-strategy event-driven funds and distressed securities, by contrast, were less fortunate (-2.09% and -2.29% from July 2007 to June 2008).

Under the same influence, convertible arbitrage funds suffered from November to March, especially those that held on to their exposure to credit risk, while volatility arbitrage ended up faring somewhat better. Ultimately, this relative value segment lost -3.79% from July 2007 to June 2008.

Finally, long/short equity funds, which in both assets managed and number of funds account for the bulk of the alternative universe, limited their losses for the period to approximately -0.35%, thus appreciably outperforming stock market indices. All the same, the great peaks and valleys of the markets sometimes underscored the risks of portfolio concentration, as in July 2008 when financial stocks suddenly shot up (most funds were holding short positions in these stocks) and energy stocks dropped back down (here most funds were long).

In conclusion, turbulence in the financial markets has not, on the whole, led to substantial losses in the hedge fund industry. Some single hedge funds may well have succumbed as a result of excessive leverage or inappropriate positions, but the average results for each style show no unexpected poor performance and, for some strategies, they even reveal rather attractive returns on investment. It is worth noting, finally, that an investment diversified over the complete set of alternative styles would likely have made it possible, 12 months after the mid-2007 tack taken by the stock markets, to safeguard the principle (not deducting inflation), as suggested by the performance (0.01%) of the EDHEC FoF index from July 2007 to June 2008.