FEDERAL STREET ADVISORS

2008 Hedge Fund Year in Review

2008 will go down as an unforgettable year in the capital markets where almost all investments posted negative returns. In contrast to the last bear market ending in 2002, hedge funds were not immune to the downturn in 2008. While generally declining less than the overall market, positive returns from hedge funds were the exception rather than the norm. Not only did hedge fund performance suffer, but hedge funds were blamed, in part, for the sudden market drop in the third and fourth quarters.

The purpose of this article is to discuss the drivers of 2008 performance and separate fact from fiction to answer a number of questions:

- Why did hedge funds not "hedge" as well as expected in 2008?
- Were hedge funds to blame in any way for the market's performance?
- What is the future of the hedge fund industry and what are the risks?

We will discuss how massive deleveraging in the markets offered nowhere for even hedge funds to hide, how short selling by hedge fund managers was not to blame for the market downturn, and how with a thorough due diligence program hedge funds can continue to play an important role in diversifying the risks inherent in an investment portfolio.

THE UNWINDING OF EXCESSIVE LEVERAGEWAS A KEY DRIVER OF NEGATIVE RETURNS IN 2008

Leverage can be useful in fueling growth across the economy as it allows institutional and individual investors to borrow for large purchases and/or amplify returns. Low interest rates throughout recent years helped to keep borrowing costs low, which gave companies access to an abundance of capital and individual's access to high levels of credit. But with excessive lending comes risk. Lending not only presents risk to the lender, it also increases risk for the borrower and, as we have seen recently, it increases the risk for the economy as a whole. As such, traditional risk management measures are imposed; banks enforce minimum standards when lending and regulatory bodies mandate and monitor institutional debt ratios.

Unfortunately, lending standards have diminished over the years. We have all read about negligent mortgage lending standards which allowed unqualified buyers to obtain mortgages they couldn't afford or couldn't understand. Even the Securities and Exchange Commission, one of the key regulatory bodies charged with maintaining market order, began to relax their regulations in recent years. Most notably in 2004, the SEC allowed five of the largest investment banks to increase their leverage from an already generous 12:1 leverage ratio to ratios of 30:1 or higher. This shift allowed banks to borrow $30 or more for every $1 in capital they held, compared with their ability to borrow only $12 for every $1 under the prior net capital rule.

By the end of 2006, excessive leverage became the norm, and the consequences were beginning to unfold. Most mortgages were packaged into mortgage backed securities, many of which were purchased using borrowed money. As mortgage delinquencies rose, the value of these widely held securities declined rapidly, resulting in a downward spiral of asset values across all areas of the economy. Highly levered financial institutions found it necessary to sell these mortgage-backed assets in order to maintain their liquidity ratios.

With the 30:1 leverage ratio mentioned above, it is easy to see how declines in asset prices decimated financial institutions' franchise value. Since the equity of each firm is the difference between their assets (for example, investments in mortgage backed securities) and their liabilities (money owed to other financial institutions) a decline of 3.34% or more in the value of the $30 in assets, with no change in the liabilities, could effectively wipe out the company's $1 in equity. In a normal environment an institution might be able to work through this type of problem over time, since the assets may eventually recover in value, or earnings from other business lines could be used to offset the shortfall.

As we know, however, the past two years have been anything but normal. Losses at two Bear Stearns hedge funds in 2007 brought to light the negative side of leverage as declines in their mortgage-backed securities portfolio triggered margin calls forcing them to sell assets at a loss. It was not until September of 2008, however, that the problems introduced by excessive leverage became more pervasive. Lehman Brothers, one of the most highly levered financial institutions, filed for bankruptcy protection, spreading fear throughout the marketplace. Trading in many types of securities ceased, and the capital markets fell precipitously. Selling continued as the deleveraging process spun out of control. Subsequent government intervention to save other highly levered financial institutions had minimal impact on the markets. The sell-off was indiscriminate and almost all types of securities fell in value, regardless of their quality. The ripple turned to a tidal wave, impacting the broad economy both here and abroad. The only type of security immune to the carnage was U.S. Treasuries; which investors sought out under the assumption that they were the safest of all investments.

HOW THE UNWINDING OF LEVERAGE IMPACTED HEDGE FUNDS

As a reminder, hedge funds are not, in and of themselves, an "asset class". They are an alternative way of investing in existing investment securities across a wide range of asset classes. Long/short hedge fund managers (the type that comprise the bulk of Federal Street's recommended list) are paid to identify and exploit mispriced securities and inefficiencies within the equity and bond markets. Long/short hedge fund managers accomplish this by buying and short-selling securities (short selling is an investment practice where the portfolio manager can earn profits when a stock falls in price).The ability to sell a security short should provide some downside protection in a market downturn, and for many funds, this did indeed occur in 2008. Many hedge fund managers who had a persistent short position were able to outperform the longonly benchmarks; however, few were able to post positive results.

As financial institutions unloaded assets to reduce leverage, the massive sell offs and deleveraging that occurred became indiscriminate in nature. This meant that all risk-bearing securities were sold off regardless of their fundamentals. In fact, the better the quality of the security, the more liquid it was; the more liquid the security was, the easier it was to sell and therefore the more susceptible it was to the impact of the sell-off. Compounding this indiscriminate selling was the fact that there were few buyers in the market, which drove prices down further.

In addition to pressure from selling higher quality securities, the redemptions and outflows required many proprietary trading desks at investment banks and hedge funds to buy back shares of lower quality companies that they had sold-short in the expectation of a price decline in the future. The adverse impact on active managers' returns came from two sides: "good" stocks getting sold off, and "bad" stocks going up in value.

As a result, hedge fund managers, especially long/short managers who held a net long position (where they owned more stocks than they shorted) were not able to post positive results; there were simply no areas outside of U.S. Treasuries that delivered positive returns.

HOW 2008 WAS DIFFERENT THAN THE LAST BEAR MARKET PERIOD FROM 2000-2002

In the bear market of 2000- 2002, many hedge funds outperformed the market and posted positive returns. Hedge funds were able to do this because, in contrast to 2008, there were actually areas of the market that were experiencing positive performance. For example, from 2000-2002, value stocks outperformed growth stocks by almost 70% and posted positive results. Bank loans outperformed high yield bonds by over 13%. Many a successful trade was made by simply buying stocks with a low price-to-earnings (P/E) ratio and shorting an overpriced technology stock with a higher P/E ratio. With all financial assets declining because of indiscriminate selling, this type of opportunity just did not exist in 2008.

SOME HEDGE FUNDSWERE MORE NEGATIVELY IMPACTED THAN OTHERS

Not all hedge funds are the same. Hedge fund managers' performance in 2008 had more to do with the type of strategy they employed rather than the successful execution of their particular strategy. For example, a manager who timed the market properly by carrying a net short position held up better than a manager who had a higher market exposure, regardless of the fundamentals of the underlying stock positions. In other words, historically successful stock pickers were not rewarded in 2008. It was market timers who properly guessed the downward direction of the market who were rewarded.

The hedge funds that performed the worst were those who used excessive leverage. By levering up their bets, sometimes in excess of 10:1, many of these leveraged funds had massive losses. Market value declines forced margin calls, which subsequently forced selling into the open market, further putting pressure on prices. This pressure was quick and severe, and some funds declined in excess of 90%, with much of those losses unrecoverable. To help stem the impact of forced selling from investors, many funds put up "gates" to restrict redemptions, requiring investors to seek liquidity in other parts of their portfolios.

Additionally, the unwinding of leverage caused unusual behavior in certain asset classes which contributed to additional negative performance surprises in 2008. For example, while we have seen equities drop in excess of 30% over a one year period, we had never seen a pull back in bank loans of the magnitude experienced last year. Until 2008, bank loans had historically delivered attractive returns with relatively low risk. A bank loan is simply a private loan to a company that sits at the top of its capital structure, providing investors with the first lien to the firm's assets if the issuing company cannot meet its obligations. In other words, if the company files for bankruptcy, assets go to the bank loan holders before they get distributed to the bond and stock holders. The problem in 2008 was not that the issuing companies were experiencing massive defaults; instead, it was that the loans were purchased by many investors using borrowed money which needed to be paid back as prices declined. As leveraged investors sold assets to cover margin calls, bank loans were hit particularly hard and their prices fell almost 30%. This price decline occurred despite the fact that most of the underlying loans were still in good standing. Hedge funds and mutual funds that invested in this relatively lower volatility asset class posted sudden and unexpected losses.

OTHER DRIVERS OF HEDGE FUND PERFORMANCE IN 2008

Outside of deleveraging, there were other factors which contributed to the decline in hedge fund returns. Government intervention, which prohibited managers from short selling over 900 securities, hindered hedge fund performance in September as many hedge fund managers were unable to execute on their negative outlook. As evidence of the impact of this government move, the CSFB All Hedge Short Biased Index posted a negative result for 2008. This is well outside of expectations given that short sellers are supposed to make their money on falling stocks. Finally, certain hedge funds and funds-of-funds were impacted by the write down of assets due to allegations of fraud discovered at the end of the year. In fact, the CSFB Market Neutral index declined over 40% in the month of November due to a complete write-down of two of its hedge fund components that were impacted by fraud.

SHORT SELLING BY HEDGE FUND MANAGERSWAS NOT THE REASON FOR THE MARKET DECLINE IN 2008

Hedge funds took a beating in both the press and in political circles, as short selling was blamed for the decline in the market, particularly the decline in financial services stocks. Ironically, these accusations came from the leaders of a number of financial services firms. Many these firms were using leverage to an extent that far outpaced even the most levered hedge fund. In addition, many of these firms had proprietary trading desks that were actively engaged in short selling as well. Short selling was not to blame for the decline in financial stocks or the market. Irresponsible lending and overleveraging were the causes. Forced selling by overleveraged hedge fund managers did contribute to the sell-off, however, short selling did not. We believe that hedge fund managers' ability to sell short aids in the discovery of information and helps keeps the market operating more efficiently. For example, many hedge fund managers had already seen the overleveraging and irresponsible lending that were infecting financial services companies and as such, they shorted their respective securities. One could argue that without short selling, the stock or bond prices of some of these highly levered financial institutions might have remained at unsustainably high levels, only to come crashing down at an even greater speed once the market discovered the extent of their overleveraging. In fact, the government-imposed short selling ban in September did nothing to stop the decline in financial sector stocks. Finally, unlike many institutional firms, hedge funds have very fluid investment mandates and are often the first to step in and buy distressed opportunities and bring liquidity back to the market after a downturn. Short sellers will often step in to buy back shares and cover their positions when there is little demand from other buyers. This can help stabilize prices after the market has over-sold.

THE MAJOR RISKS THAT REMAIN AND HOW FEDERAL STREET ADVISORS HELPS CLIENTS TO MITIGATE THESE RISKS

The major risks that still exist today, for not only hedge funds but all forms of investment vehicles, include: Disappointing performance, the crippling of firms, the investment manager's loss of confidence, restrictions on redemptions, government intervention, and fraud.

- *Disappointing Performance*: There are many risks that can lead to poor performance. Some of these risks are manageable while others are not. For example, we could experience another difficult market like 2008 where many of the factors influencing the markets, like massive deleveraging, were out of investors' control. We believe that many risks, however, can be measured and minimized. By focusing on investment managers who have a proven expertise in security selection, who have an understandable, repeatable, investment process, and who have stable personnel supporting their strategies, we believe we minimize the risk of underperformance.

- *Crippled Firms*: Many investment management firms are stressed by the decline in assets. Since revenues are tied to assets and performance, their top line is significantly lower than it was a year ago, necessitating budget cuts. We have gone through an extensive review of our recommended managers to make sure that they remain fiscally sound and that changes to their respective budgets are made with minimal disruption to the management of client assets.

- *Manager loss of confidence*: For many managers, this is the first time they have experienced such a dramatic market decline. As such, they are vulnerable to losing conviction in their approach and may change their investment process. We continue to test conviction in all of our recommended managers to make sure that they remain true to their time-tested strategies. If we detect that they are losing conviction, we are quick to recommend removing them from our clients' portfolios. On the flip-side, we also are on the lookout for managers that materially increase the risk profile of their investment approach beyond their normal bounds in order to make up for lost ground.

- *Restrictions on redemptions*: Restrictions on redemptions occurred in both mutual funds and hedge funds last year; particularly when the funds invested in less liquid asset classes. Shareholder redemptions can force a manager to sell securities, and when the market is down. These sales lock in losses and can exacerbate price declines. Add fund leverage into the equation, and a manager can be forced to recognize extreme losses from the combination of price declines and redemptions. While we cannot determine who will restrict redemptions in the future, the likelihood of redemption restrictions is minimized when a fund purchases relatively liquid securities and uses little to no leverage.

- *Government intervention vs. government regulation*: In 2008, the government intervened and was inconsistent in the way it acted. They placed undue restrictions on short selling and required short sellers to disclose their holdings. This type of government intervention risk still remains. Unfortunately, this is a risk that cannot be predicted or analyzed. Government regulation, on the other hand, where rules are set and then consistently enforced, can result in a more orderly market. Government regulation, per se, is not in itself a risk but instead enhances predictability and stability in the marketplace. It's the inconsistent and inadequate enforcement of rules that leads to risk.

- *Fraud*: Allegations of fraud once again surfaced at the end of 2008. The evaluation done to detect fraud is worthy of its own dissertation. As such, we will instead refer you to another paper written by Federal Street Advisor's senior hedge fund analyst, Ben Deschaine. In 2006, shortly after another fraud was uncovered, Mr. Deschaine wrote a paper titled "A Good Fraud is Hard to Find" which was published in the Journal of the Alternative Asset Management Association. That paper discusses in detail a situation where Federal Street Advisors was presented with a fraudulent opportunity and how basic adherence to our due diligence process steered us away from recommending it to our clients.

CONCLUSION

2008 was an extremely difficult year for investors as massive deleveraging dominated the marketplace and financial assets dropped in value without regard to the fundamentals. We believe that our clients were served well during this period by our dedication to thorough due diligence and by our resisting being caught up in the moment. Instead of running blindly from hedge funds, we've used this experience to take a closer look at both hedge funds as a category as well as our own due diligence process. This analysis has confirmed our belief that hedge funds continue to play an important role in a portfolio but only when accompanied by a robust due diligence process done by an experienced team that continually monitors the risks while simultaneously looking for the opportunities. While hedge funds have never been immune to market downturns, Federal Street's steadfast process is built to protect our clients from undue risks while seeking to deliver attractive long-term returns. Since December, the market has continued to fall but we have started to see it revert back toward a focus on fundamentals. With that shift, our hedge fund managers have been outperforming their benchmarks, with many posting positive results. We expect clients will once again be rewarded by the managers' proven strategies, and by Federal Street's continued commitment to hedge funds.