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This Time Around, Hedge Funds ARE Hedging

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In early 2009 we wrote a white paper titled "[2008 Hedge Fund Year in Review](#)" because many investors experienced sharp declines in their hedge funds, a segment of their portfolio that was supposed to be insulated from the worst of the equity market's volatility. There were a few good performers, but the hedge fund industry as a whole did not protect client assets and many underperforming strategies were forced to close. According to hedge fund data provider Hedge Fund Research Inc., more than 1,400 hedge funds closed in 2008. Back then, we discussed the drivers of hedge fund performance and looked forward to better times ahead. But the headwinds to hedge fund performance did not stop blowing. Despite posting healthy absolute returns, hedge funds overall trailed the rebounding major equity indices from the 2+ year period from March 2009 through May 2011, leaving many investors asking the question, "Why do I even bother with hedge funds?"

What is the secret to investing in hedge funds that both hedge and provide exceptional long term results?

With the market's recent decline, it's worth revisiting that question. With the recent equity market sell-off, have hedge funds offered better protection better than they did in 2008? What is the secret to investing in hedge funds that both hedge and provide exceptional long term results?

Recent press coverage gives the impression that we are experiencing more of what we did in 2008 -- hedge funds failing to protect when the markets decline. On August 29th, *The Financial Times* published an article on their website entitled, "Market turmoil lands hedge funds with big losses," and on September 2nd, *Reuters* followed up with an article entitled, "August was rotten for many hedge managers." Both articles point anecdotally to several prominent hedge funds with big recent losses, such as Whitney Tilson's T2 Partners, which was down 22% year-to-date through the end of August, and John Paulson's Paulson Advantage Plus fund, which an October 10th *Wall Street Journal* article reported was down nearly 47% year-to-date.

These headlines, however, are not representative of the entire universe and do not reflect either our approach or our experience here at Federal Street.



*From May 1st
– Sept 30th, the
average hedge
fund suffered
only 60% of
the market's
decline. Our
experience has
been even
better than
that, as the
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the fund of
hedge funds
we oversee
have declined
only about half
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market.*

What we are seeing is that hedge funds are, in fact, hedging this time around. During the period from May 1st through September 30th, global equity markets declined almost 20% as measured by the MSCI World Index. Despite the individual exceptions highlighted by the media, the average hedge fund did hold up much better than the equity market as measured by a peer group of long/short equity hedge funds. The average hedge fund suffered only 60% of the market's decline. Our experience has been even better than that, as the managers in the fund of funds we oversee have declined only about half as much as the market. This may not seem like a substantial difference, but it is; a fund that is down 20% needs to return 25% to get back to even, while a fund that is down 10% only needs an 11% return to get back to even.

So how do you build a hedge fund portfolio that increases your chances of getting the hedge you need without giving up long term returns? There are a few basic steps involved:

- identify strategies that hedge
- build a robust due diligence process to identify the best hedge funds
- understand what hedging really means
- diversify your portfolio
- **Identify strategies that actually hedge**

While all "hedge" funds share this one label, the universe of hedge funds is actually quite broad. They range from funds that conduct heavy trading, relying on computer models to identify hundreds or thousands of mispriced securities, to funds that take majority stakes in a small number of companies and hold onto them (sometimes for years) while they push for big changes at the companies. You can also find pretty much everything else in between. Hedge funds can invest in all different types of securities, including stocks, indices, bonds, commodities, currencies, derivatives, other funds, private investments, and synthetic investments. With so much breadth and diversity among the group, it's no wonder why performance among hedge funds can diverge so much and why headlines can easily distort reality.

It is important to take a step back and ask what you want from your hedge fund portfolio. Some investors are purely interested in capital appreciation and are willing to ride through the tough times. There are funds that do just that. The role they play is return enhancement, not risk reduction, and there are managers who take big concentrated positions, use leverage and are capable of delivering on that return profile. While they are called hedge funds, they can have returns that look nothing like a hedged or protected investment.



Federal Street's "Equity Risk Reducers Portfolio" does not use significant leverage, does not take concentrated bets, does not have full exposure to the equity markets and does not hold illiquid securities.

Most investors are interested in both capital appreciation and risk reduction. They could be seeking a reduction in equity risk, interest rate risk or credit risk. Determining what type of risk reduction you are seeking will steer you toward the right vehicle. In fact, we here at Federal Street have determined that reducing risk in both bond and equity portfolios is important to our clients. For example, we recommend long/short equity managers where we expect equity-like returns over time, but with more consistency and smaller short term declines.

We have a segment of our clients' equity portfolio dedicated to this important role, and correspondingly call it the "Equity Risk Reducers Portfolio." The funds that make up this sub-portfolio tend to have several characteristics in common: they use only modest (if any) leverage; they maintain a disciplined process to include short positions in the portfolio at all times (to maintain downside protection irrespective of the environment), they generally have a modest "net" exposure to the market and they monitor risk and diversification. They look to make money in both their long stock positions and their short stock positions, with their long stock picks doing better than the stock universe over time, and with the stocks they are selling short (and making a bet against), underperforming the stock universe. Because of the risk reduction aspect of this part of our clients' portfolios, we make sure that the fund mix does not use significant leverage, does not take concentrated bets, does not have full exposure to the equity markets and does not hold illiquid securities.

- **Build a robust due diligence process to identify the best hedge funds**

Once you are fishing within the pond of hedge fund managers that actually hedge, it is still important to differentiate between managers who have generated their returns through skill from those who have simply been lucky. This distinction is not easily made, particularly during periods like the one we have just been through where the market has swung wildly over the past 3 years. For example, some funds have track records that are dominated by getting 2008 "right" by betting against housing or the market at large. Others put up a huge return in 2009 by increasing their exposure to the market (sometimes by using leverage to have more than 100% exposure to the market) at just the right time during the post March 2009 rally.

The question is, did they just get lucky or was there something about their process which would tell us that they could get that market call right again in the future? In general, for a manager to be eligible for inclusion as part of a risk reducing hedge fund portfolio, we look for managers whose outperformance came more consistently over time and was generated in multiple types of markets, as opposed to managers that got big returns all at once and could possibly be a one trick pony. Similarly, we look for managers that have derived returns from many different sources, rather than from related bets.



Hedge funds are intended to reduce equity risk but are not insurance policies. If they were insurance policies, they'd only work when the market fell and then when the market was going up, they would cost you money.

The fact that many hedge fund managers underperformed the broad equity market in 2009 doesn't mean that they were bad managers.

Dissecting returns is a key component of our due diligence process and can help us better understand whether a manager is truly skilled at picking stocks. As we mentioned earlier, many hedge fund managers underperformed the broad equity market in 2009. That doesn't mean that they were bad managers – in fact most short stock positions post March 2009 acted as a “brake” against an accelerating portfolio because of the market's quick recovery.

Rather than terminate our managers for underperforming the equity markets, we tested them to make sure that they hadn't lost their edge.

We did this by adjusting the benchmark returns to take into account the manager's hedge position and comparing that adjusted return to the manager's return. For example, if the market was up 10% but the manager was only 40% exposed to the market (because the rest of the portfolio was either in cash or had sold stocks “short”) we would want to see that the manager added value above the exposure-adjusted benchmark return of 4% (40% of the 10%).

If we saw a consistent pattern of underperformance against this exposure-adjusted benchmark, we would most likely question a manager's ability to generate good returns in the future. These perspectives, along with other data points, can help us better understand whether a manager is skilled and unlucky, or unskilled and lucky. It's only through a deep understanding of a manager's process that you can truly understand whether their past results are likely to be repeatable.

- **Understand what hedging really means**

Recognize and set expectations that hedging means that negative returns are likely to be softened, not eliminated, over short-term period.

During periods of market stress, it is important to remember that hedge funds are intended to reduce equity risk but are not insurance policies. If they were insurance policies, they'd only work when the market fell. Then when the market was going up, they would cost you money. We expect hedge fund managers to participate in the market's rise, and while good stock-picking and reduced market exposure can help buffer declines in a market sell-off, they don't avoid losses altogether. Setting this expectation from the outset is critical, since it can keep you from selling out of funds, and locking in losses, usually at just the wrong time.



For a manager to be included in our risk reducing hedge fund portfolio, we look for managers whose out-performance came more consistently over time and was generated in multiple types of markets, as opposed to managers that got big returns all at once and could possibly be a one trick pony.

- **Build a portfolio of funds**

Even skilled managers with processes designed to hedge can have periods when their style is out of favor and returns disappoint. For example, since the market's recent decline, managers who invest in companies with attractive valuations in beaten down industries have seen their stocks get overly punished because investors are simply unwilling to invest in companies that have had temporary earnings setbacks or are in industries facing any headwinds. In addition, the thesis for investing in a particular stock or theme can take longer to play out, so for managers who take more concentrated positions, returns can be somewhat more volatile. This is why building a portfolio of different hedge fund strategies is crucial.

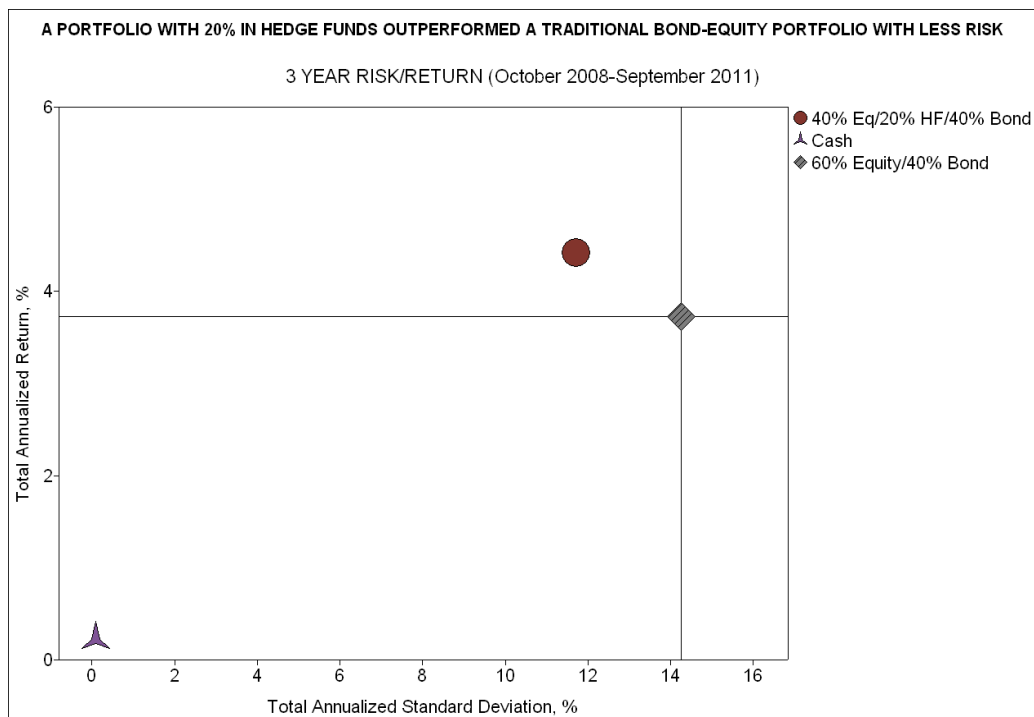
The fund of hedge funds that Federal Street oversees was down only half as much as the market in the recent downturn.

But not all nine of the underlying managers in that fund behaved the same way; they invest in different types of stocks, in different industries and geographic regions and have different exposures to the overall market. They all did hold up better than the market, but there was a wide range in that level of protection. Some managers participated in only about a quarter of the market decline, while others captured as high as 80% of the decline. Having a group of managers that invest with different styles can increase the chances that the group as a whole acts as intended.

This may seem like too much complexity – which brings us back to the question, “Why bother?” While the diversity of hedge funds can seem overwhelming, and the resources required to conduct appropriate due diligence seems out of reach, partnering with an advisor who is skilled at evaluating hedge funds managers is worth it.

In the chart on the next page, you can see the results for a traditional blended portfolio of stocks and bonds compared to the results for a portfolio that includes hedge funds.

When we dive into the broad universe of hedge funds, we find that, despite the exceptions playing out on the front pages of newspapers, hedge funds did hedge during the recent downturn.



The gray diamond represents a portfolio of 60% equities as measured by the MSCI World Index, and 40% bonds as measured by the Barclays Aggregate Bond Index, rebalanced quarterly. The red dot represents a portfolio that includes 20% in hedge funds, 40% in equities as measured by the MSCI World Index, and 40% in bonds as measured by the Barclay Aggregate Bond Index, rebalanced quarterly.

As you can see, diversifying some of the equity exposure with the fund of funds increased return and reduced volatility. It also decreased the biggest negative return for the full portfolio by more than 4%, reaffirming that adding hedge funds designed to reduce equity risk can work to protect capital in declining markets. Isn't this just what you want your hedge funds to do?

When we dive into the broad universe of hedge funds, we find that, despite the exceptions playing out on the front pages of newspapers, hedge funds did hedge during the recent downturn. We have found that by focusing on a certain profile of hedge fund, one that is well-suited to providing equity-like returns over time while protecting in negative markets, by conducting thoughtful due diligence to identify skillful managers, by setting realistic performance expectations, and by building portfolios of managers with various styles, you can increase your chances of getting the hedge you are looking for from your hedge funds. When you do that, you can add a lot of value to your portfolio.