INVESTMENT BRIEF

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Strategic Investment Group®

Structuring Hedge Funds for Success

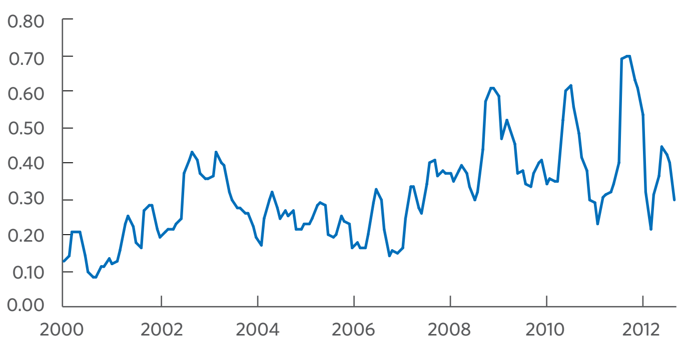
Although in recent years Strategic's hedge fund investments have performed well in both absolute and relative terms, broad hedge fund indices have produced disappointing returns. Portfolio structure explains much of the difference in results, and offers a useful example of how structure can help overcome an unfavorable investment climate.

Lately, markets have been subject to wide swings in sentiment, driven primarily by macroeconomic factors and varying views of financial fragility, rather than fundamental valuations. The risk-on/risk-off environment has produced highly correlated and choppy markets (Exhibit 1), constraining opportunity for certain hedge fund strategies such as sector selection, market timing, and trend-following.

EXHIBIT 1:

Average S&P 500 Correlation

Sources: Strategic, Compustat.



Moreover, disruption in the credit markets has dampened corporate activity. In addition to credit constraints, companies lack confidence to engage in mergers and acquisitions. As a result, strategies seeking to exploit merger arbitrage opportunities have not generally prospered. At the same time, corporate default rates have been low, hurting strategies targeting distressed credit opportunities.

Despite this adversity, Strategic's hedge fund portfolios have delivered risk-adjusted returns in line with expectations, while providing diversification to traditional asset classes. In this environment, it has been especially important to avoid directional strategies with a high-beta exposure, as these strategies have suffered the most from risk-on/risk-off trading and highly correlated market reversals.

In contrast, we aim to focus Strategic's hedge fund portfolios on risk-controlled strategies that minimize beta and seek instead to generate alpha by exploiting fundamental valuation anomalies. Such strategies have performed relatively well. Focusing on low-beta strategies reduces the problems that have plagued market timers, sector rotators, and trend followers. It has also been especially important to design portfolios to include managers with diverse insights who can be expected to generate uncorrelated alpha streams. In cases where we have invested in more challenged styles, we have focused on managers we deem to be more likely to have either better skill in identifying opportunities or superior methods of risk management. Taken together, these characteristics have resulted in broadbased manager outperformance.

Notwithstanding recent experience, signs point to an improving environment for hedge funds. Valuation spreads remain wide, suggesting that the opportunity set for fundamental security selection is attractive. Volatility and dispersion are ample, providing skilled managers opportunities to outperform. A trend toward a more normal, fundamentally driven market would give active strategies the chance to perform well as valuation fundamentals reassert themselves.

Hedge funds may also benefit from an increase in mergers and acquisitions activity, creating opportunity for arbitrage strategies. U.S. corporations have relatively healthy balance sheets and significant amounts of cash, and valuations are reasonable. In the case of European corporate bonds, the opportunity for distressed investing is likely to expand, as deleveraging European banks withdraw credit and contribute to rising default rates. Hedge funds will face less competition for investment opportunities from bank prop desks, which have been scaled back in the wake of the global credit crisis.

The lackluster performance of the broad hedge fund universe in the recent tough environment has highlighted the importance of carefully structuring hedge fund portfolios so as to focus on a diversified set of uncorrelated streams of added value while minimizing market exposure. Such structuring also furthers the aim of portfolio diversification – a key rationale for including hedge funds in the asset mix. As the last few years have shown, a strategically structured set of hedge funds can thrive in many market environments.

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