## INTRODUCTION

# STILL IN FAVOUR BUT WITH ACCENT ON DIVERSITY

Hedge funds proved they were not immune to this summer's market turmoil. But while some investment chiefs have refocused their strategies, the sector has not lost its allure, as Elisa Trovato reports

Due to their absolute return nature, hedge funds are usually considered as a safe bet by private banks wanting to provide their high net worth clients with superior risk-adjusted returns. But the recent credit market crisis has stirred up the old doubts on the market neutrality of these instruments.

The filing for bankruptcy by two Bear Stearns hedge funds and one managed by Australia's Basis Capital – combined with problems at funds such as those managed by Sowood Capital Management – have prompted wealth managers to assume clear-cut positions with their clients toward the world of alternative investing. Under the spotlight are the quantitative hedge funds – such as those run by big investment banks Goldman Sachs and Morgan Stanley. These have not been immune to industry criticism, having incurred heavy losses.

Christophe Bernard, chief investment officer at Swiss private bank Union Bancaire Privée (UBP), says: "All things being equal, we do not like those hedge fund strategies, such as the quantitative equity market neutral strategies, that are really dependent upon leverage to amplify or to produce returns.

"Going forward this is going to be even truer, because the cost of borrowing, not only for corporates and individuals, but also for hedge funds is going to be higher."

### AVOIDING DIRECTIONALITY

He predicts the industry is entering an investment regime where it is necessary to be wary of pure directionality, of hedge funds that are long and "have forgotten their hedging skills". The added value of the asset allocators such as UBP lies in their ability to identify hedge fund managers with good experience in hedging. "It is very important that we pay attention and allocate more to long-short equity managers that have that skill set," Mr Bernard says.

Nevertheless, UBP's stance to hedge funds, which remain the preferred investment instruments in the alternative area, has not changed, he says. The target is to generate absolute returns for private clients, he says, and those hedge funds "run properly", can offer downside protection when markets are going down and give investors good participation in upward markets.

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In a typical balanced mandate, the ideal exposure of 20 per cent to hedge funds has even been increased to 30 per cent over the past 18 months ago, explains Mr Bernard. "The risk-adjusted returns of hedge funds are competitive versus equity and bonds," he says, stating that the traditional asset classes do not offer "outstanding value" at present.

The business of funds of hedge funds – favoured over

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the single strategy hedge funds at UBP because of their diversification property – has reached $45bn (€32bn), accounting for more than 40 per cent of the total $108bn of assets managed by the Swiss firm.

The credit market crisis has opened up new opportunities in the hedge fund space. Mr Bernard believes that distressed strategies will show their full buying potential during 2008. Italy’s UniCredit private banking recently launched a fund of hedge funds specialising in distressed securities, and aiming to leverage the burst of the subprime credit bubble. Manuela D’Onofrio, head of the global investments committee at UniCredit private banking, explains that the product, the restructuring fund, targets the ultra-high net worth investors, the minimum investment threshold being €5m. “These strategies require a duration commitment of three years from investors and we offer it only to those very wealthy and very sophisticated clients,” she adds.

The suite of funds of hedge funds accessible to the Italian firm’s private clients ranges from a volatility of 2.5 per cent up to 5 per cent. This is much less than the risk associated with the traditional equity indices, she says. The funds of hedge funds are selected and managed by Momentum, the London-based firm acquired by UniCredit group’s company Pioneer Alternative Investments in 2002.

“We have always embraced the multi-strategy funds of hedge funds route, as opposed to single strategy hedge fun,” says Ms D’Onofrio. All the main strategies, ranging from macro-strategies, long short equity, event-driven to distressed securities are represented in each of the firm’s funds of funds, each managed by 20 or 30 hedge fund managers on average. Thanks to this diversification of strategies, fund of hedge funds are less risky, and are suitable especially in market periods like the present one, characterised by growing volatility and reduced directionality of traditional markets, says Ms D’Onofrio,

This fits well with UniCredit clients’ risk profile. “Our clients tend to be risk averse and the alternative products to include in their portfolios must deliver net returns a bit higher of those offered government bonds, but with an associated risk lower than the equity risk.”

In the model portfolio developed by UniCredit private banking, 20 per cent of assets are allocated to fund of hedge funds, while the equity component was opportunistically reduced from 60 per cent to 52 per cent at the beginning of June, in order to take the profits realised in the first part of the year. The rest of the portfolio is allocated to monetary investments or low-duration Euro government bonds.

Some clients, the most important ones, are interested in investing in other types of alternatives such as private equity, says Ms D’Onofrio, but the typical high-net-worth investor, having €2m-€3m of assets invested with the bank, employs prevalently funds of hedge funds as an alternative instrument. She is confident that, if there are no other unforeseen market shocks, this year the funds of hedge fund products will deliver the expected returns within the associated risk, as they did last year.

## STILL POSITIVE

Christoph Hott, chief investment officer at Germany’s Sal Oppenheim private banking, says the negative returns registered by hedge funds have not affected his firm’s positive views on these instruments. On the contrary, it is going to increase the allocation to hedge funds from 10 per cent to 15 per cent in its average portfolio. But the credit market crisis has strengthened some of Sal Oppenheim’s perceptions on alternatives.

Like his peers at UBP and UniCredit Private Banking, Mr Hott has always favoured funds of hedge funds. “First of all, this crisis has confirmed our views on the importance of diversifying broadly, by employing fund of funds and not single hedge funds,” he says. “Second, it was the right decision not to invest in quantitatively managed hedge funds.”

Third, he adds, the credit market crunch has endorsed his firm’s theory that that typically 80 per cent of hedge fund performance derives from market exposure (beta) and that only 20 per cent is the additional return (alpha) that the hedge fund manager is able to deliver.

But this backed up the firm’s idea of employing hedge fund clones in clients’ portfolios. Tradable on a daily basis and supposedly delivering hedge fund performance at a fraction of the cost, cloned hedge funds are the future that will affect the whole hedge fund industry, as it will put pressure on costs, states Mr Hott.

Acknowledging that some strategies such as long-short are easy to replicate, while others such as event driven are more complicated, he says the biggest

impediment to the employment of these instruments in investors' portfolios comes from investors themselves.

"The toughest issue is to bring this idea to our clients. Hedge funds are still quite new, and clients still hold negative sentiments toward hedge funds. Investors are still a bit uncomfortable with the idea that a cloned hedge fund is simply some kind of regression and there is no active manager that can intervene if necessary." He foresees the German market will see cloned hedge fund in the next 12 months.

Sal Oppenheim is most llikely to employ Partners Group for the hedge fund cloning business, although leading investment banks such as Goldman Sachs or JPMorgan are also possible choices, says Mr Hott.

This idea of cloning hedge funds fits well with the concept of allocating actively to different hedge fund strategies. "More and more we allocate actively to different strategies," says Mr Hott. But today it is only possible to change exposure on a long-term basis, due to the relative illiquidity of hedge funds. For the future, he says: "The idea is that we have some exposure to strategic hedge fund investments, which can be changed typically every three months, and to have cloned hedge fund strategies that you can trade on a daily basis."

Being able to distinguish what share of performance derives from asset allocation and what part comes from the bottom up is a key skill in a hedge fund manager. Risk control and a clear-cut investment approach, together with access to hedge fund managers, is what Mr Hott appreciates most in the managers selected.

The one question that typically half all hedge fund managers cannot answer is: "What share of their fund performance is attributable to bottom-up selection, that is to underweighting or overweighting a particular strategy and what part to the top down selection, the selection of single hedge fund managers?" Mr Hott says whether the manager can respond or not to this "killer question" may mark out the good from the bad.

## CONSERVATIVE VIEW

Alternative investments represent between 5 to 15 per cent of total assets in Nordea's international private client portfolios. This places Nordea on the more conservative side in terms of asset allocation to alternatives, says Claus Jørgensen, head of European private banking at Nordea in Luxembourg.

Alternative investments include liability products, in addition to hedge funds, private equity and property. "There has been a long tradition for private investors, especially in the Nordic and Danish markets, for leveraging investments in mortgage bonds, because of the credit spread," says Mr Jørgensen. These kind of products, where the emphasis is on earnings that can be made, for example, on the spread between the government bonds and the mortgage bonds, are commonly offered to Nordea's wealthy clients. These types of alternatives, on the liability side, have not been used so much in the general private banking business, but are now developing, says Mr Jørgensen.

Gregory Perdon, head of alternatives at London based stockbroker ARjENT, a firm offering investment advice in the hedge fund market to primarily UK high net worth investors, says August was one of the most challenging month in the hedge fund market since 1998. Many of the strong gains that were generated at the beginning of the year, were reversed in August, says Mr Perdon, who criticised hedge fund indices' ability to represent the market fall. The HFRI (Hedge Fund Research, Inc) fund weighted composite index fell 1.5 per cent in August, down from +1.99 in May, +0.73 in June and +0.11 in July. "But a more representative snapshot of the market would be closer to minus 2 per cent or 2.5 per cent," estimates Mr Perdon.

There have been no fundamental changes in terms of how the UK firm recommends its clients to allocate to alternatives, typically hedge funds and managed futures. These products represent 20 to 30 per cent of their clients' investable assets. "The only thing we did differently is that for some of the aggressive investors we subscribed to some of the quant managers, who were badly hit by the August crisis," says Mr Perdon. "For our less aggressive client, the area where we tend to focus is the equity long-short, where we still believe that fundamentally there are opportunities going forward."

But perhaps not all that came out of this market turmoil is bad. Mr Perdon says: "This credit crunch got a lot of managers off guard and humbled them to a certain degree. It is a healthy experience once in while to give back some gains. It keeps your eye on the ball."

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