INTRODUCTION

THE SPECTRE OF DIMINISHING RETURNS

With returns falling and correlations to equities rising, the knives are out for hedge funds. But, as Elisa Trovato reports, profit can still be derived through consideration of manager investment style and performance

During the last five years, portfolio managers at private banks have been recommending significant allocations to alternatives, pointing out to investors that these financial instruments have the desirable attribute of being uncorrelated with traditional assets. Gone are the days of the classic balanced 60/40 equity/bond portfolio, the emphasis is now on absolute return portfolios, which include a considerable percentage of alternative assets because of their diversification properties, their ability to optimise risk-return positions and stabilise volatility.

The substantial growth of hedge funds, the alternative asset class par excellence, is a clear signal of the trend. According to the latest report from specialised US firm Hedge Fund Research (HFR), the industry is now estimated to exceed $1400bn (€1030bn), a growth of 75 per cent in the last five years. The number of hedge funds has increased to an estimated 9462 globally, from 610 in 1990.

But increased correlation between asset classes, and in particular between hedge funds and equities, risks undermining modern portfolio construction theory. Considering the poor performance of hedge funds in recent market downturns, such as in May and June 2006, the question is can hedge funds really insulate investors from a falling stock market? And are portfolio managers and investment experts still recommending high allocation to hedge funds or has something changed?

The breakdown of HFR data conducted by the investment analysis and advice group at Citigroup shows a significant increase of the rolling three-year correlation between HFRI hedge fund strategy indices and the MSCI AC World equity since 1990. For example, the correlation coefficients for event-driven and equity hedge strategies have increased by 60 per cent and 76 per cent respectively. Correlation between equities and value and macro strategies have also sharply increased, with the latter rising just less than 150 per cent from 0.27 to 0.67 during 2006. Moreover, returns have dropped. Taking all sectors analysed by HFR, the average annualised return between 1990 and 1998 and 1999 to November 2006 has decreased by 4.7 per cent. Some strategies have been affected more than others. For example, in the first period the global macro strategy delivered on average an annual return of 20.8 per cent, which shrank to 9.2 in the second period, (-11.7 per cent).

Watson: key driver is the institutionalisation of the hedge fund business

Yet, there are compelling arguments for continuing to expect strong performance from good hedge fund managers. Philip Watson, head of investment analysis and advice group at Citigroup Private Bank Watson in London, points out that more than the diminishing returns it is interesting to analyse the movements of the sharpe ratio, which measures the amount of return for unit of risk. This has decreased very little, by just 0.22 over the last 16 years. The diagnosis is that "the industry is maturing", he says. There are many drivers that could change the face of the industry, including capacity constraints in strongly performing hedge funds that have experienced rapid growth and well publicised hedge fund failures such as Amaranth. "But the key driver is the institutionalisation of the business," explains Mr Watson. The rising of institutional demand for hedge funds is associated with declining appetite for risk, as institutional investors look for increased certainty of positive returns.

In addition, innovation creates scope for managers to produce attractive returns, says Mr Watson. In the analysis, all hedge fund strategies have performed worse in the past seven years, compared with the past, with the only exception being emerging markets (4.5 per cent). "That is interesting because it shows that there are lots of new avenues and growth opportunities in spaces previously uncatered to by many hedge fund managers."

Moreover, it should be noted that at times correlations have been higher than today's levels. There is always a reversion to the mean level that takes place when correlations are analysed over the longer term. "You have to make an assumption for building a portfolio for a given time period. Correlations may deviate but in the long term they will deviate to a mean level," says Mr Watson.

One of the crucial points in understanding the current high levels of today's correlation is the sheer amount of market liquidity. At times like this, consideration of managers' investment styles and strategy performances is essential, instead of a simple, short-sighted reduction in allocation to this type of alternative, says Mr Watson.

"We recommend that investors consider the different types of returns associated with different strategies," he says. And it is important to examine the variation of performance of different strategies at different stages in the investment cycle.

Bottom-up selection, being able to identify which managers perform best in stressed time periods, is also critical. For more than a year Citigroup has been recommending a credit/event-driven hedge fund, the Galaxite fund run by BlackRock, to its private investors which benefits from deterioration in the credit market, explains Mr Watson. "That is not to say that we anticipate a significant deterioration in the credit market. But the fund stabilises the portfolio when credit spreads widen, as they did recently." In addition, owning a fund like this among hedge funds assets ensures clients are protected and hedged against future volatility that may rise from credit spread widening, he says.

In a conservative portfolio, hedge funds generally represent 10-13 per cent of clients assets at Citigroup, explains Mr Watson.

FROM FUNDS OF FUNDS TO SINGLE STRATEGY

A clear trend among private banks is that they are shifting private clients' allocations from funds of funds to single strategy hedge funds.

Tim Harris, chief investment strategist EMEA at JPMorgan Private bank talks about the bank's evolution in managing hedge funds in clients' portfolios during the last three-four years. "We think it is more efficient to use a blend of active single strategy managers anchored around a core of single manager multi-strategy funds than to use funds of funds," he says.

"The issue with fund of funds, apart from layering fees, which are clearly a drag, is that they have become low volatility vehicles to the degree they were not getting us the return we were looking for," he says.

In this context, the purchase by JPMorgan of New York based Highbridge Capital Corporation three years ago has proved important, says Mr Harris. The fund, which now manages $8bn in assets last year, delivered returns "in the low twenties net of fees," he claims. "When you look at funds of hedge funds measuring 2-3 per cent risk and giving 5-6 per cent return, [Highbridge] makes it much easier for us, we are able to rotate money with greater confidence."

Having 15 per cent of a customer portfolio invested in hedge funds on a balanced fashion, and selecting six or seven active hedge fund managers, gives the team a duty of diligence and care that they have to resource properly, says Mr Harris.

"We are more resourcing intensive on hedge fund managers that we have been in the past," he says, partly because of assets under management growth, but also because of the increasing number of hedge funds, which means managers have to look for "best in class".

"One of the fastest growing areas in terms of resources within the private bank globally has been in the hedge fund space."

Other large private banks have decided to broaden the exposure to alternatives in some way at the expense of hedge funds.

Tim Gibbons and Simon Miles, senior portfolio managers at Merrill Lynch's Global Private Client group, say that historically hedge funds have made up most of the alternative assets in clients' portfolios. But in the last couple of years they have decided to broaden the exposure to alternatives by placing a greater emphasis on other alternative asset classes, such as property and infrastructure.

"Property is a very attractive asset class from the point of view of generating real returns and hedging your cost of living," says Mr Gibbons, and fundamentals in property remain attractive as they have in the past. While UK property look quite "well bid", they are looking to diversify overseas, at continental Europe where the market has not been as strong as in the UK, he says.

Infrastructure, a longer time contract with government or quasi-government organisations, delivering a defined level of return over a longer period of time, has recently established itself as a new asset class and Australia has been at the forefront for this sort of funds. "Infrastructure does not offer spectacular returns, perhaps 5-6 per cent yield, but [returns are] gently growing, which is not unattractive," says Mr Gibbons.

Hedge funds, however, still represent a substantial allocation in private clients' portfolios at Merrill Lynch, normally 11 or 12 per cent.

Like Mr Harris at JPMorgan, Mr Gibbons and Mr Miles express their disappointment in funds of hedge funds, particularly the "very diversified" ones and their decision to put a greater emphasis on single strategy hedge fund managers. The whole point is moving away from holding one or two mainstream diversified hedge funds and becoming more bespoke for every client, says Mr Gibbons. The other chosen option is to take "a very cheap tracker route".

Mr Gibbons also reveals that Merrill Lynch is studying the possibility of investing in hedge fund cloning products, aimed at replicating hedge funds performance at lower cost, such as the one recently launched by Merrill Lynch, the FX Clone, whose goal is replicate hedge funds' foreign exchange (FX) strategies.

Graham Duce, co-head of Credit Suisse Asset Management's (CSAM) UK multi-manager platform, talks of CSAM's recent decision to significantly reduce hedge fund allocations in private clients' portfolios. This is in favour of other alternative asset classes, which show lower correlation.

"Exposure to funds of hedge funds was 20 per cent and it has almost been halved, now being 11 per cent. We felt that hedge funds [were too correlated] to equity markets."

Aware of the disappointing performance of funds of hedge funds, Mr Duce explains the reason why CSAM has selected specialist funds of hedge funds managers such as Ken Kinsey-Quick at Thames River Capital. "Ken tends to avoid the big, dodgy hedge funds, feeling there is a life cycle with regard to some of these hedge funds. When managers get to a certain size it can be a case of wealth preservation rather than generating decent alpha in the portfolios," says Mr Duce.

There has also been an increasing need for some of CSAM's more sophisticated ultra-high net worth clients to move away from main plain vanilla funds of hedge funds, to get exposure to single managers. At Credit Suisse, due diligence of single managers' hedge funds is conducted by the hedge funds advisory service team headed by Eleanor Dachicourt, based in London. "The team puts together a list and we buy into [it] for getting exposure to whatever strategy we want to get some commitment to," explains Mr Duce.

Like Merrill Lynch, Credit Suisse has increased exposure to property in private clients' discretionary portfolio offerings at the expense of hedge funds, in particular focusing on the German residential and commercial market. "We have been very bullish on Germany as an economy and recovery play," says Mr Duce.

Duce: bullish on Germany

IN COMMODITIES WE TRUST

In addition, Credit Suisse's allocation to hedge funds has been partially replaced by the introduction of commodities. Unlike banks such as JPMorgan where allocation to commodities is tactical, commodities are seen as a long-term theme in private clients' portfolios at Credit Suisse. We like the big macro-stories on soft commodities," says Mr Duce, as they show lower correlation and are a big diversifier.

In particular, the portfolio management team has invested in a structured product investing in Goldman Sachs's agricultural index and in a long-only soft-commodities fund run by Schroders.

Total allocation to alternatives in the multi-asset portfolio at Credit Suisse is higher than many competitors, currently topping 30 per cent. Ten per cent of total assets are also represented by private equity, for which the bank has used a fund of private equity funds quoted on the Swiss Stock Exchange, in order to overcome issue of liquidity. The same fund is also in the tactical part of the portfolio (2.5 per cent). Infrastructure, a new entry in the alternative space at Credit Suisse, also represents 3 per cent.