

Hedge Fund Market Commentary – April 2009

The March rally continued through April, helping equity markets recover nearly all their earlier year losses. Emerging markets surged and now have the highest year-to-date return of 17%. Credit markets once again rose significantly in April, with high yield bonds and bank loans up 12% and 10%, respectively, outperforming large-cap equities. A steady inflow into high yield mutual funds helped to drive up prices, particularly in the higher rated segments of the high yield market. Financials outperformed the market again as investors perceived a reduction in systemic risk. REITs too recovered strongly, rising 33% on hopes that an extension of the TALF program to CMBS securities would ease the refinancing risks faced by leveraged real estate holders. Exhibit 1 presents an overview of major market indices.

Exhibit 1: 2009 Market Performance

Index	April	YTD 2009	FYTD*	Calendar 2008
Equity				
DJ Wilshire 5000	10.5%	-1.2%	-30.3%	-37.2%
S&P 500	9.6%	-2.5%	-30.3%	-37.0%
Russell 2000	15.5%	-1.8%	-28.3%	-33.8%
MSCI EAFE	13.0%	-2.7%	-38.3%	-43.1%
MSCI Emerging Mkts	16.6%	17.4%	-38.1%	-53.5%
DJ Wilshire REIT	32.8%	-12.2%	-37.0%	-39.2%
S&P 500 Financials	22.4%	-12.9%	-46.2%	-56.6%
Fixed Income				
Barclays Aggregate	0.5%	0.6%	4.7%	5.2%
Barclays Treasuries	-1.8%	-3.1%	13.8%	20.1%
Barclays TIPS	-1.9%	3.5%	-3.6%	-2.4%
Barclays High Yield	12.1%	17.6%	-12.0%	-26.2%
Barclays Bank Loan	9.8%	20.3%	-14.7%	-29.5%
AAA ABX (Subprime)	11.7%	-16.8%	-53.0%	-43.2%
Barclays Municipals	2.0%	6.3%	3.7%	-2.5%
3 mo.Libor	0.1%	0.4%	1.9%	3.1%
Alternative				
DJ AIG Commodity	0.7%	-5.6%	-52.6%	-35.7%
HFRI Fund of Funds**	0.7%	1.1%	-18.5%	-21.4%
HFRI Fund Weighted**	3.8%	4.2%	-14.5%	-19.0%

* Fiscal YTD from June 30, 2008

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Hedge funds performed modestly well in April though estimated returns for several of the more popular indices vary considerably. The HFRI Fund of Funds Index, which is viewed as representative of institutional portfolios, rose an estimated 0.7% for the month, while the HFRI Fund Weighted Index estimated return was a much higher 3.8%. Another popular hedge fund index is the Credit Suisse/Tremont Hedge Fund Index (not shown). This index is asset weighted unlike the equal weighted HFRI indices, and is also viewed as more representative of institutional portfolios. CS/Tremont estimates that its index will return 1.29% for April.

A partial explanation for the difference in returns is the equal weighting of hedge funds in the HFRI Fund Weighted Index. Equity long/short hedge funds represent, by number, almost one-half of the population in the HFRI Fund Weighted Index and therefore the monthly equity long/short strategy return will represent one-half of the monthly HFRI Fund Weighted Index return. The HFRI Fund of Funds Index equal weights individual fund of funds returns, but because funds of funds' portfolio strategy weightings tend more toward dollar asset weighting, the monthly equity long/short return will more likely have an approximate 30% weight in the HFRI Fund of Funds Index. The estimated HFRI equity long/short strategy return was 6.4% for April versus an average return of 1.0% for the other strategies, a difference that could account for most of the return discrepancies among the major hedge fund indices. We continue to examine closely the imperfect construction methodologies used by the index providers and are in the process of preparing a more detailed research report on the subject. In the meantime we continue to recommend to clients that they use the HFRI Fund of Funds Index for benchmarking purposes.

The hedge fund industry has settled down after a tumultuous fourth quarter.¹ Hedge fund outflows were a modest \$103 billion during the first quarter, down from \$154 billion during the fourth quarter of 2008. Hedge fund assets now total \$1.3 trillion, down from a high of \$1.9 trillion at the end of 2007. Hedge fund gates created a backlog of outflows but our sense is that the worst is over and we would not be surprised to see net hedge fund inflows by the end of the year or sooner.

A slowdown in fund redemptions and improved performance does not mean that the operational pressures facing hedge funds have eased. The vast majority of hedge funds, including 92% of funds in the HFRI database, collect incentive fees only on gains above an investor's initial account value. The mechanism which enforces this rule is referred to as a "high water mark." Since hedge funds typically collect incentive fees annually, the high water mark protects investors from paying incentive fees twice on the same gains. Hedge funds have historically relied on incentive fees as the primary source of compensation, and the primary currency with which to attract talent. Thus, a poor performance year for any individual hedge fund, in addition to leading to a loss of capital, can cause personnel turnover and other longer-term organizational problems. This is particularly true if the industry as a whole is doing well. In 2008, a large proportion of funds experienced steep losses, creating fewer transition opportunities for hedge fund professionals, and thus greater organizational stability. However, the phenomenon of stability through collective distress will not be sustainable for many funds, particularly as asset flows improve and are directed toward stronger funds.

We estimate that even with continued good performance throughout 2009, over 55% of funds will be below their high water marks, and a substantial portion of funds will need to earn 20% or more before being able to charge incentive fees. Many funds have resorted to using management fees to buttress employee compensation, but with a sharp decline in assets, and increasing institutional pressures to reduce management fees, many fund managers are losing the needed flexibility.

Hedge fund survival is not just a numbers exercise. Intangible factors, including strong leadership, motivated and loyal employees, and a loyal investor base, will sustain many funds through difficult periods, so long as performance remains strong.

Eli Sokolov
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¹ Hedge fund industry data comes from HFR Global Hedge Fund Industry Report – First Quarter 2009.