Hedge Fund Market Commentary – December 2009

Markets extended their gains in December, with the S&P 500 Index returning a relatively modest 1.9% for the month and the high yield bond market rising 3.3%. Equity markets exhibited high intra-stock dispersion, with small-cap stocks surging over 8%, closing the performance gap which had persisted for most of the year. Mortgage-backed securities had a particularly strong month, as exemplified by an over 20% return to the ABX. A broader overview of recent performance across markets is shown in Exhibit 1.

Exhibit 1: 2009 Market Performance

Index	December	YTD 2009	FYTD*	Calendar 2008
Equity				
Dow Jones 5000	2.8%	28.6%	23.1%	-37.2%
S&P 500	1.9%	26.5%	22.6%	-37.0%
Russell 2000	8.1%	27.2%	23.9%	-33.8%
MSCI EAFE	1.5%	32.5%	22.2%	-43.1%
MSCI Emerging Mkts	4.0%	78.3%	31.4%	-53.5%
DJ REIT	7.0%	28.5%	47.9%	-39.2%
S&P 500 Financials	-1.5%	17.2%	21.4%	-56.6%
Fixed Income				
Barclays Aggregate	-1.6%	5.9%	4.0%	5.2%
Barclays Treasuries	-2.6%	-3.6%	0.8%	20.1%
Barclays TIPS	-2.2%	11.4%	4.9%	-2.4%
Barclays High Yield	3.3%	58.2%	21.3%	-26.2%
Barclays Bank Loan	3.1%	53.8%	14.3%	-29.5%
AAA ABX (Subprime)	23.3%	-0.6%	48.6%	-43.2%
Barclays Municipals	0.3%	12.9%	6.1%	-2.5%
3 mo.Libor	0.1%	1.1%	0.5%	3.1%
Alternative				
DJ UBS Commodity	2.0%	18.9%	13.7%	-35.7%
Hedge Funds				
HFRI Fund of Funds**	0.9%	11.6%	6.0%	-21.4%
HFRI Fund Weighted**	1.3%	20.1%	9.6%	-19.0%
CS/Tremont	0.9%	18.6%	10.6%	-19.1%

* Fiscal YTD from June 30, 2009
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Hedge funds once again performed well in December. The HFRI Fund Weighted Index was up 1.3%, while the HFRI Fund-of-Funds Index was up 0.9%. For 2009, the HFRI Fund Weighted Index gained 20.1% and the HFRI Fund-of-Funds Index returned 11.6%.

Exhibit 2 shows the performance of different hedge fund strategies, as defined by HFRI and CS/Tremont. All major strategies with the exception of global macro enjoyed positive returns for December. Macro funds, which outperformed last month, were hurt in December by falling gold prices and a large jump in long-term interest rates.

Exhibit 2: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	December	YTD 2009	FYTD*	Calendar 2008
Arbitrage/Relative Value				
HFRI**	2.1%	26.0%	11.7%	-18.0%
CS/Tremont-Convert	2.2%	47.3%	18.9%	-31.6%
CS/Tremont-Fixed Income	0.8%	27.4%	13.9%	-28.8%
Event Driven				
HFRI	3.0%	25.9%	14.5%	-21.8%
CS/Tremont	2.3%	20.4%	12.9%	-17.7%
Equity Long/Short				
HFRI	2.3%	25.0%	11.5%	-26.7%
CS/Tremont	1.7%	19.5%	10.4%	-19.8%
Global Macro/CTA				
HFRI	-1.4%	4.2%	2.8%	4.8%
CS/Tremont-Macro	-1.4%	11.6%	7.9%	-4.6%
CS/Tremont-Managed Future	-5.0%	-6.6%	0.9%	18.3%
Multi-Strategy				
HFRI	2.0%	24.4%	10.9%	-20.3%
CS/Tremont	1.2%	24.6%	11.0%	-23.6%

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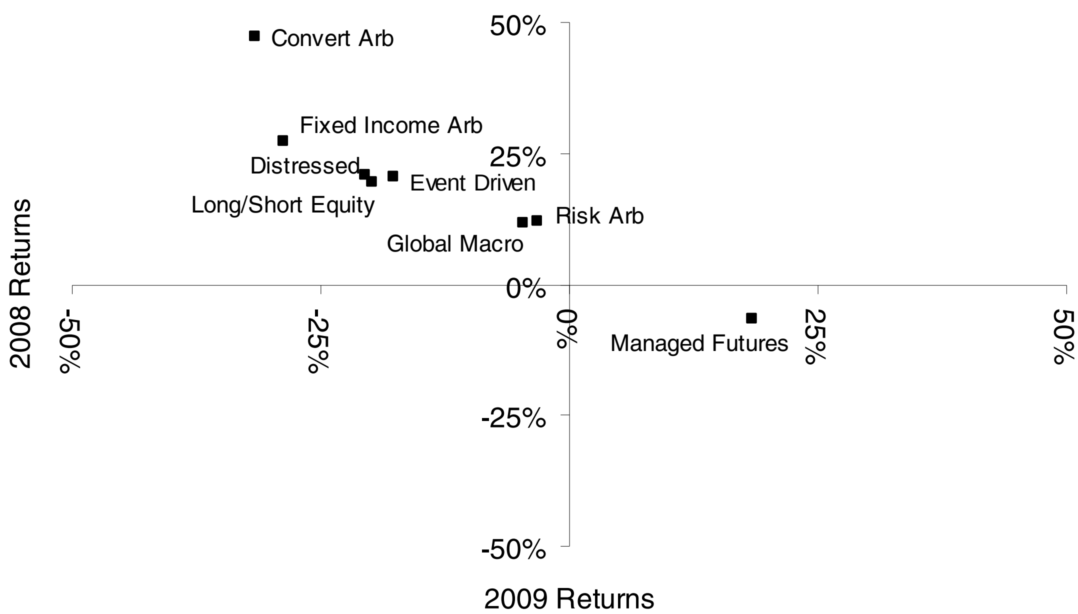
Looking back over the last two years, a clear pattern has emerged which underscores the importance of a long-term perspective in managing portfolios of hedge funds. Specifically, any adjustments to strategy weightings after 2008 which favored the best performers over that year would have been detrimental to overall portfolio returns. As shown in Exhibit 3, the worst performing hedge fund strategies in 2008 were the best performers strategies in 2009, and vice versa.

Exhibit 3: 2008 vs. 2009 Hedge Fund Performance by Strategy



Source: Credit Suisse/Tremont

This is a pattern which investors are perhaps used to seeing in public market returns – riskier markets underperform in downturns and outperform in recoveries. Yet this explanation seems somewhat counterintuitive when discussing hedge funds, which are designed to provide alpha. However, as demonstrated in academic literature even before the 2008 credit crisis, each hedge fund strategy has unique sensitivities to a unique set of markets/factors. In a period like 2008-2009, when lines between different markets blurred as correlations tended towards one, the equation governing hedge fund returns simplified, and the number of relevant factors declined. In the most oversimplified model, strategies that by their nature were more exposed to a liquidity crisis underperformed in 2008, and outperformed in 2009 when liquidity flowed back into the markets. Were the liquidity crisis to have deepened in 2009, a strategy rotation into, for example, global macro and managed futures may have proven smart, but only in retrospect.

One should not be surprised to see a similar pattern when applying the same analysis to the universe of individual hedge funds, at least those which survived the entire two-year period. Just as each strategy has unique exposures to common market factors, so does each hedge fund, ideally with an alpha component attached. Investors should balance their portfolios among funds which underperform in certain conditions and those which outperform in similar conditions, always striving for the greatest alpha, not the greatest return.

Eli Sokolov
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