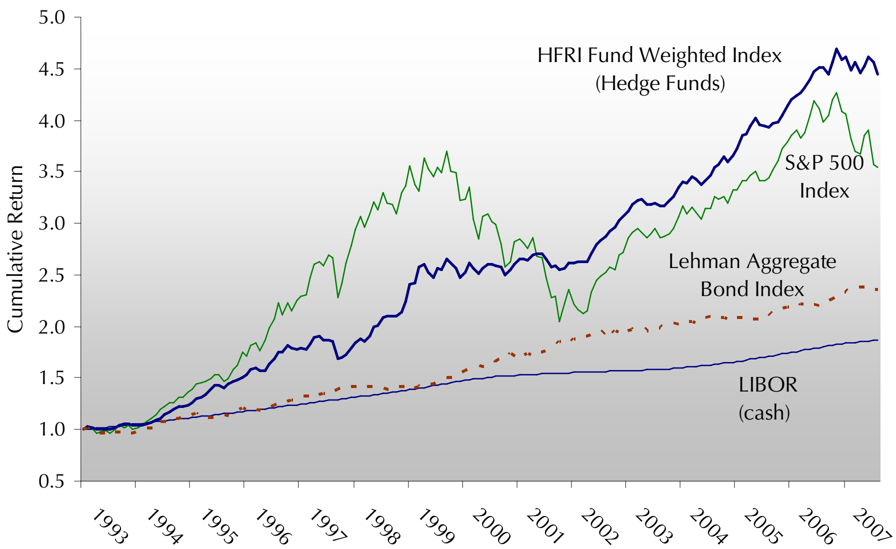
Are Hedge Funds Living Up to Their Promise to Preserve Capital?

Hedge funds' promise to preserve capital during bear markets is being put to the test by the current credit crisis. Year-to-date, through August 31, the most common measure of hedge fund performance, the HFRI Fund Weighted Index, is down 4%, creating concern among investors that perhaps they miscalculated the protections promised by hedge funds. Furthermore, an increasing number of individual hedge funds are experiencing large losses, and liquidating. This report compares current hedge fund performance with past periods of market distress to understand if there is reason for concern. Our conclusion is that recent hedge fund performance is consistent with performance during past periods of market crisis. However, we also show that hedge funds are sometimes unsuccessful in protecting against losses during market declines, and investors should adjust their expectations accordingly.

Introduction

The performance chart in Exhibit 1 below demonstrates why institutional investors have shifted hundreds of billions of dollars to hedge funds over the past several years.

Exhibit 1: Hedge Fund and Market Index Returns, January 1994 to August 2008



The rationale goes like this:

- Bonds (Lehman Aggregate Bond Index) provide a stable return and loss protection but past returns and prospective future returns fall well below an 8% return target (the actuarial rate for most pension plans; the sum of 5% spending plus 3% inflation for an endowment).
- Stocks (S&P 500 Index) might meet the 8% long term return objective, but at high allocations their volatility could jeopardize the ability to meet obligations.
- Hedge funds (HFRI Fund Weighted Index) appear to offer the best of both worlds, higher equity like returns over long time periods and protection against severe drawdowns[1], as occurred during 2000-2002 when stocks fell 40%.

Historical index return and risk, as reported in Exhibit 2, lend support to this thinking.

Exhibit 2: Hedge Fund and Market Index Returns, January 1994 to August 2008

Index	Annual Return	Risk
HFRI Fund Weighted	10.61%	6.84%
S&P 500	9.12%	14.08%
Lehman Aggregate Bond	6.09%	3.70%
LIBOR (Cash)	4.35%	0.49%

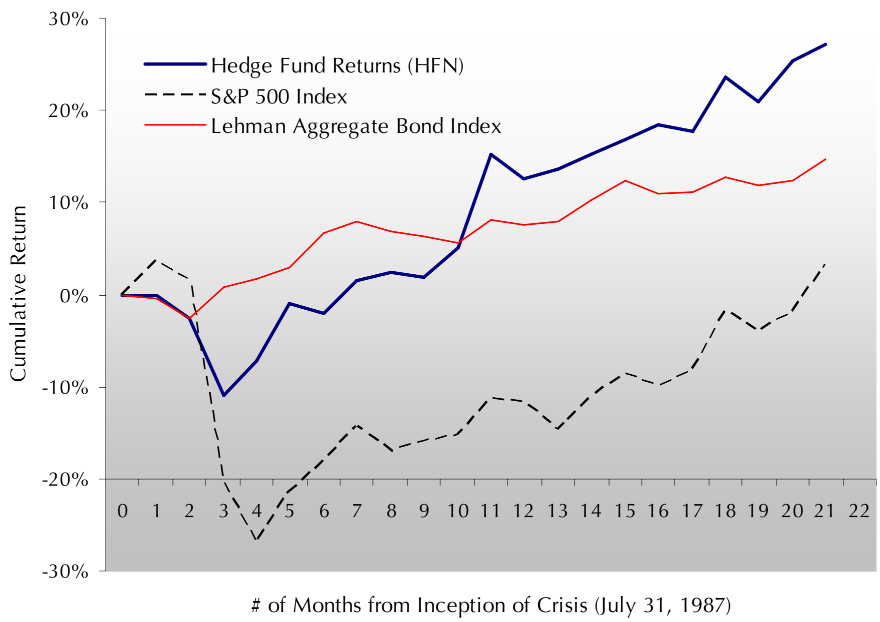
Over the almost 15 year history shown above, hedge funds earned the highest return with a level of risk much closer to bonds than to stocks. However, the negative hedge fund returns experienced so far this year are causing investors to question the level of capital protection hedge funds really provide. To address this concern, we examine hedge fund performance in past periods of market disruption to see if somehow this time is different.

Findings

There have been six periods of major market distress over the past 25 years, including the current credit crisis:

1. *1987 Stock Market Crash*. On Monday, October 19th, known as Black Monday, U.S. stocks fell 23% in just one day. The cause of the crash was a combination of a prior run-up in prices and the prevalence of "portfolio insurance" trading strategies that generated greater selling as prices fell. Exhibit 3 depicts cumulative monthly returns for the S&P 500 Index, the Lehman Aggregate Bond Index, and the HFN Hedge Fund Aggregate Index[2] from July 31, 1987, when markets first began to weaken, through April 30, 1989 when stocks fully recovered their pre-crash values.

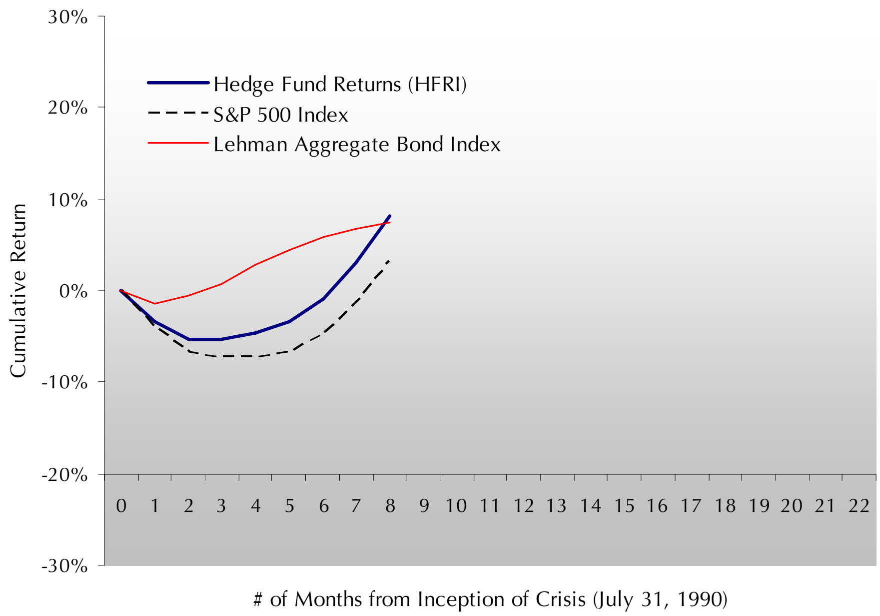
Exhibit 3: Hedge Fund Performance during 1987 Stock Market Crash



Stocks quickly lost 27.0% of their value during the 1987 Crash, most of it in October (month 3 in Exhibit 3), and took another 16 months to recover. Like most periods of market crisis, bonds performed well in a "flight to safety." Hedge funds experienced a serious drawdown (cumulative loss) of 11.0%, contrary to the notion that they don't lose value. However, they recovered as quickly as they fell, taking just four months to recoup earlier losses.

2. *1990 S&L Crisis & Recession.* A commercial real estate bubble during the late 1980s eventually burst and helped precipitate the 1990-1991 recession. Most of the impact of the crisis was felt in the real estate markets and among savings & loans that had invested heavily in the sector. The U.S. government established the RTC (Resolution Trust Company) to help bail out S&Ls, which subsequently created distressed real estate opportunities for investors.

Exhibit 4: Hedge Fund Performance during 1990 S&L Crisis

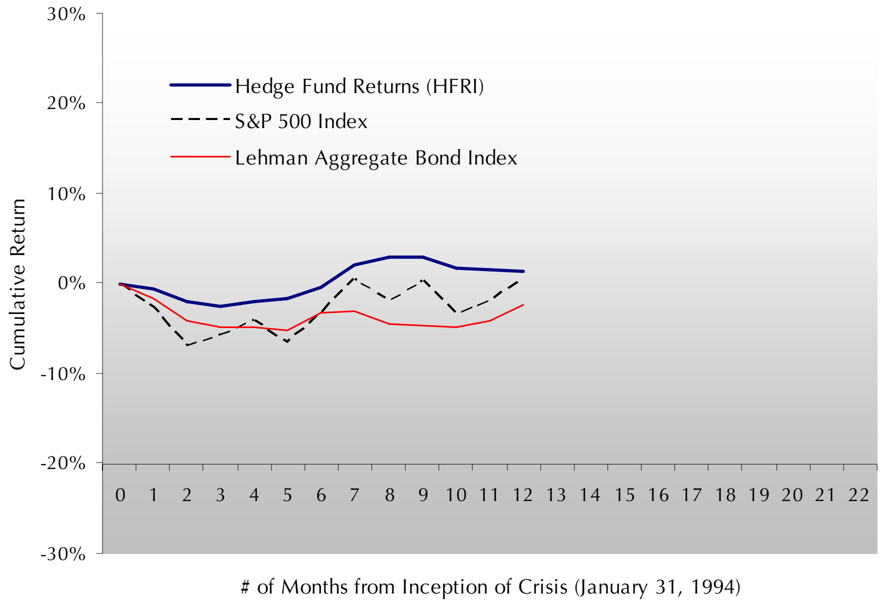


Stocks fell 7.4% over a short three month period in reaction to the recession. Hedge funds experienced a 5.4% drawdown over the same period, a disappointing outcome for those investors expecting immediate protection. However, like the 1987 Crash, hedge funds took just four months to recover their value. Only bonds held their value through this relatively short crisis period.

3. *1994 Federal Reserve Rate Hike.* The Fed surprised the market in 1994 by continuing to hike interest rates throughout the year in an effort to cool off the economy. The unexpected rate hikes caused investors with mismatched assets and liabilities to suffer losses, or even fail as was the case with at least one hedge fund (Granite Capital) and one municipality (Orange County, CA).

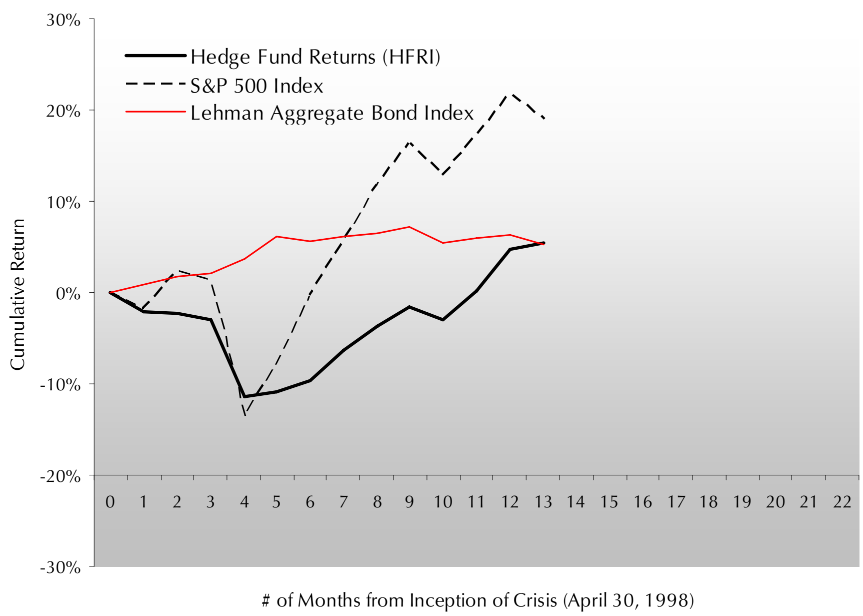
Overall, hedge funds pretty much lived up to their promise, and declined a modest 2.6%. Stocks suffered a 7.0% drawdown. Bonds experienced a 5.2% drawdown during this crisis, reacting to interest rate increases that are not typical during crisis periods. The time from drawdown to recovery was a relatively short 12 months.

Exhibit 5: Hedge Fund Performance during the 1994 Federal Reserve Rate Hike



4. *1998 Russian Debt Crisis*. The crisis began July 1998 in South Asia when the International Monetary Fund stepped in to bail out several emerging markets, principally Thailand, whose debt levels became unsupportable. Too much debt combined with falling oil prices created problems elsewhere among commodity exporting nations. Russia was forced to devalue its currency and defaulted on its debt in August 1998. The disruption in emerging market debt caused emerging market stocks to fall 44% over just a five month period. Many hedge funds were caught by surprise, and a rescue of the hedge fund Long Term Capital Management was engineered by the Federal Reserve.

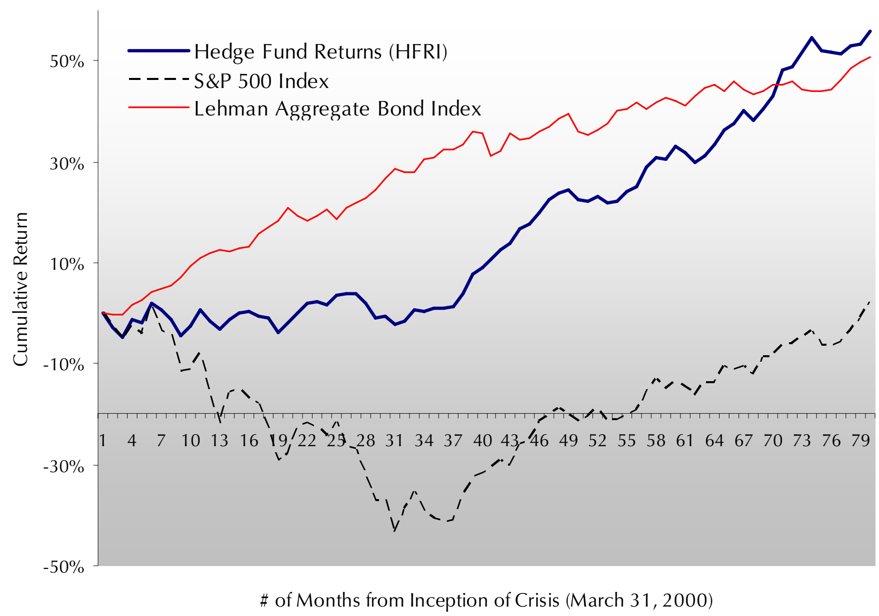
Exhibit 6: Hedge Fund Performance during 1998 Russian Debt Crisis



This was the first crisis where hedge funds performed almost as badly as stocks. The cumulative drawdown on hedge funds was 11.4% in just four months, only slightly better than the 13.5% drawdown on the S&P 500 Index. Consistent with other crises, except for 1994, a flight to safety created gains for the Lehman Aggregate Bond Index, which was up 6.1% over the same period. Again, the crisis was fairly short lived. The S&P 500 Index had recovered from its August lows by November 1998 but it took hedge funds until March 1999 to recover their losses. As you will see, the 1998 Russian Debt Crisis was the worst period for hedge fund performance.

5. *2000 Internet Bubble*. This crisis lasted almost three years and took another three years to fully recover. The initial cause was a bubble in technology/internet stocks that burst in March 2000. A subsequent recession, the 9-11 attack, and a corporate accounting scandal (WorldCom, Enron) exacerbated the crisis. The length and depth of the bear market in stocks during this crisis was a major factor in generating institutional interest in hedge funds.

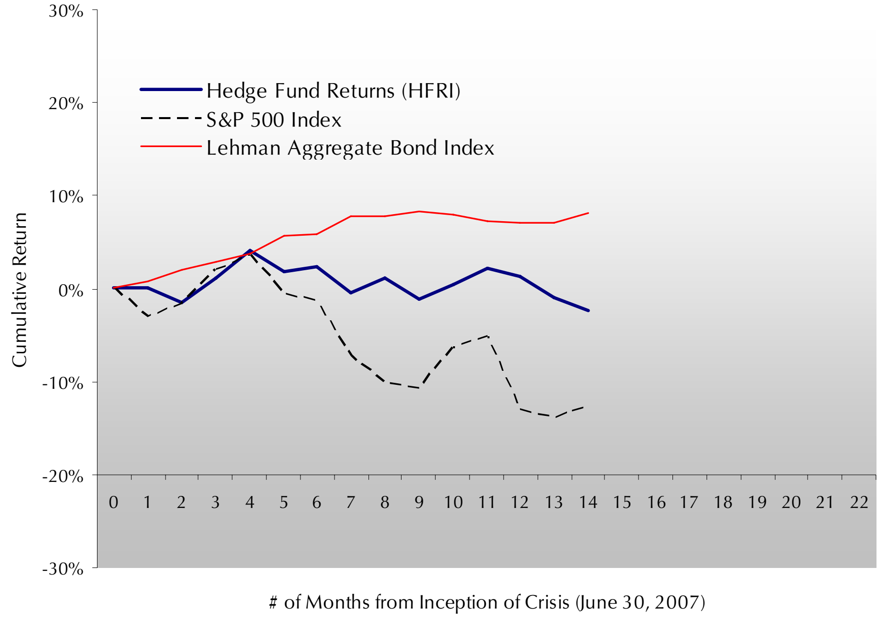
Exhibit 7: Hedge Fund Performance during the 2000 Internet Bubble



Though hedge funds may have been at their worst in 1998, they were at their best from 2000 through 2002, preserving value while the S&P 500 Index drawdown totaled 43.8%. When the S&P 500 recovered, hedge fund performance followed, surpassing the Lehman Aggregate Bond Index by the end of 2005.

6. *2007 Credit Crisis*. This crisis, precipitated by the collapse of the subprime mortgage market, started in July 2007 and is now into its second year. The crisis has spread to involve most of the credit markets globally and will likely lead to recession. Exhibit 8 details the current performance of hedge funds, stocks, and bonds from June 30, 2007 through August 30, 2008. The end of the crisis is not known at this time.

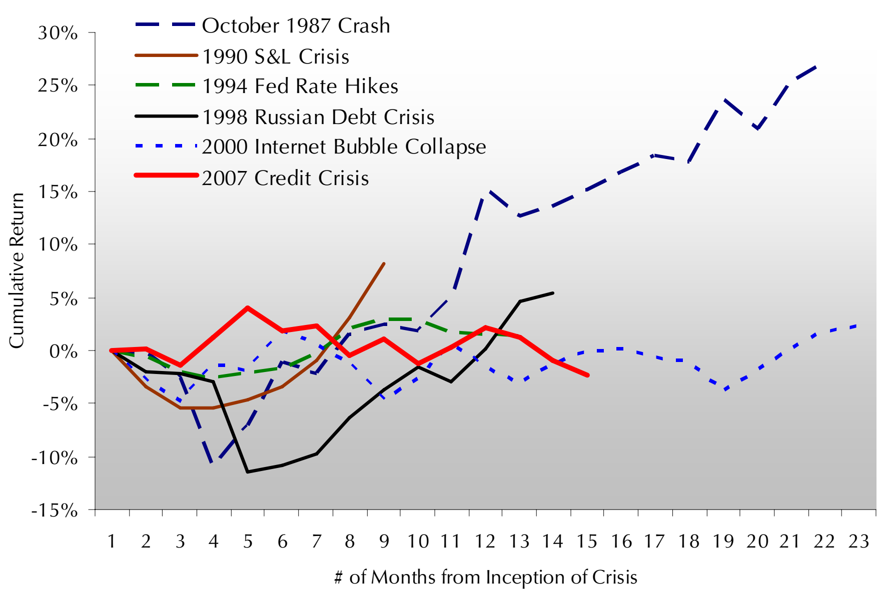
Exhibit 8: Hedge Fund Performance during the 2007 Credit Crisis



The current crisis has taken on the general characteristics of past crises. Stocks have performed poorly, with a drawdown of 13.9% through the end of July 2008, before recovering slightly in August. Hedge funds are down 2.3% from the crisis inception, though calendar year-to-date they are down 4.4%. As in most past crises, the Lehman Aggregate Bond Index has benefited from a flight to safety and is up 8.1% through August 2008.

Exhibit 9 combines in one graph hedge fund index performance during each of the six crisis periods (Exhibits 3 through 9). The origin for each line corresponds to the first month of each crisis.

Exhibit 9: Hedge Fund Performance during Six Financial Crises



Hedge fund performance during the current credit crisis appears consistent with past crisis episodes. The small single digit losses witnessed in recent months compares to the 1990, 1994, and 2000 crises and are thus far less than hedge fund losses during the 1987 and 1998 crises. However, the length of the current credit crisis (14 months) now exceeds all past crises except for the 2000 Internet Bubble, which took 31 months from inception before hedge funds and stocks again produced consistent positive returns.[3]

Conclusion

The Platonic ideal that hedge funds perform like stocks in up markets and avoid losses in down markets has never been true in practice. Our analysis of six historical crisis periods confirms that hedge fund investments provide no guarantee against losses. During periods of market crisis, it is not unusual for hedge fund returns to experience losses, though the losses are generally limited to low single digit declines as they have been in four of the six crisis periods. However, exceptions occur, as they did in 1987 and in 1998 when hedge funds as a group suffered double digit declines. The length of time crises last varies considerably, from three months to three years.

Our findings are based upon the behavior of hedge fund indices, which represent an average return of a large population of individual hedge funds. Individual investor experience will also depend upon hedge fund selection and diversification.

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[1] "Drawdown" is a common measure of risk used by hedge fund investors. It is the cumulative percentage loss from the prior highest valuation point to the lowest valuation point.

[2] The HFN Hedge Fund Aggregate Index is an equal weighted index of all hedge funds that report to HFN. The more familiar HFRI Fund Weighted Index is used elsewhere in the report but because its inception is 1990, the HFN Index is used to represent hedge fund performance during the 1987 Crash.

[3] As of this writing in mid September, equities and hedge funds continue to show negative returns for the month, much of it surrounding the collapse of Lehman.