

27 August 2009

**JOHN MAULDIN'S ACCREDITED INVESTOR E-LETTER
HEDGE FUNDS IN A TIME OF VOLATILITY:
THE GREAT IMMODERATION**

This week's accredited investor e-letter by John Mauldin looks at hedge funds. To a large extent disappointment reigned in the hedge-fund arena in 2008. The idea that hedge funds could provide absolute returns even in very negative market conditions proved by and large not to be the case. Mauldin addresses the question as to why this occurred and also looks at opportunities going forward.

Enjoy the read.

It is time for some retrospective examination of hedge-fund performance over the last few years. To say that many have been disappointed is to be far too kind. Given their performance for the 15 years leading up to 2008, and given the large sums of money put into hedge funds by very sophisticated institutions, what happened? In this edition of the Accredited Investor E-Letter, we turn our attention towards the dramatic increase in volatility in the last year and how various hedge-fund strategies performed. What I am going to write might be considered controversial and might not be appreciated by some hedge funds, and much less so by some funds of funds; but if the hedge-fund community cannot learn from recent events, it will be doomed to repeat them. I would like to think that we can in fact learn a few lessons. I believe that an investor who learns from his mistakes is a better investor, so let's jump right in.

It would be an understatement to say that last year was a watershed moment for hedge funds. In the 1980s and 1990s, few people talked about hedge funds, except when George Soros famously "broke the Bank of England" or when LTCM blew up. However, in the past few years hedge funds have risen in acceptability to such an extent that almost every college endowment is now invested and most high-net-worth individuals have some of their assets in hedge funds. After years of low volatility and steady returns, 2008 finally put to the test the claim that hedge funds could provide alpha on the upside and protect an investor's capital in a down market.

So how did hedge funds fare? The statistics, as of June, speak for themselves. Investors voted with their feet and some abandoned strategies that worked well in the past. According to EurekaHedge, investors withdrew money almost every single month last year. Withdrawals reached a fever pitch in the quarter that followed the October crash, as hedge-fund investors withdrew \$315.6 billion. May of this year was the first month to reverse the trend, as hedge fund assets rose by \$30.3 billion to \$1.32 trillion. In fact, assets managed by hedge funds have almost halved in less than a year, according to TrimTabs Research.

Industry bigwigs are predicting the number of hedge funds will dwindle. Emmanuel Roman, who with Noam Gottesman co-runs GLG, a \$24-billion-dollar hedge fund, said that up to 30 percent of all hedge funds will disappear "in a Darwinian process," either going bust or simply closing down due to very low fees. "This will go down in the history books as one of the greatest fiascos of banking in 100 years." Some funds are shutting, and others are merging to reduce overhead and back-office costs. Will it end up being the 30% Roman predicts? Maybe. Two questions should immediately spring to the mind of the reader: (1) Are things in fact this bad for all hedge funds? And (2) were the problems last year concentrated in any particular sectors?

The downturn in hedge fund returns was bad, but it has to be kept in perspective. The Credit

Suisse/Tremont Index was down 19% in 2008. That compares with a 42% decline for the MSCI world (see an explanation of this index in the notes below). Being down 20% seems pretty bad, but the difference is enormous. To recover from a 19% decline requires a 23% gain. To recover from a 42% decline requires a gain of 72%. Hedge funds have not outperformed a risk-free rate, but they have on average managed to preserve an enormous amount of capital.

While overall performance of the hedge-fund industry was negative in 2008, not all strategies finished the year in negative territory. The best performers were Managed Futures and Dedicated Short Bias, which returned 18.3% and 14.9% respectively, and Global Macro was only slightly negative, while the top global macro funds posted some of the most impressive returns. (Past performance is not indicative of future results.)

2008 Hedge Fund Performance

	Cumulative Return	Monthly Standard Deviation	Maximum Drawdown	No. of Positive Funds	No. of Negative Funds	Best Performing Fund	Worst Performing Fund
Broad Index	(19.1%)	2.8%	(19.5%)	106	390	93%	(100%)
Convertible Arbitrage	(31.6%)	4.8%	(31.6%)	1	21	12%	(61%)
Dedicated Short	14.9%	5.6%	(10.3%)	7	2	68%	(49%)
Emerging Markets	(30.4%)	4.5%	(30.6%)	2	67	27%	(78%)
Equity Market Neutral	(40.3%)	11.7%	(42.7%)	9	12	36%	(100%)
Event Driven	(17.7%)	2.3%	(17.7%)	9	67	33%	(75%)
Fixed Income Arbitrage	(28.6%)	4.6%	(29.0%)	8	24	14%	(65%)
Global Macro	(4.6%)	3.4%	(14.9%)	19	18	66%	(68%)
Equity Long Short	(19.8%)	3.5%	(21.3%)	19	147	47%	(77%)
Managed Futures	18.3%	3.4%	(7.1%)	28	3	93%	(4%)
Multi-Strategy	(23.6%)	2.8%	(23.6%)	4	29	26%	(93%)

Source: Credit Suisse/Tremont

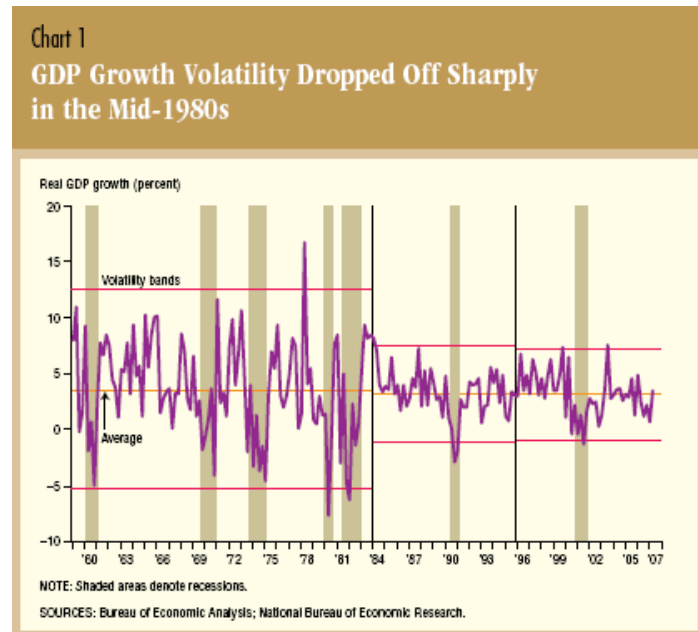
Some strategies are unlikely to perform well in unstable conditions, and last year even very good hedge funds that had never posted a down year got hit. These strategies are in effect “short-volatility” strategies: merger arbitrage, convertible arbitrage, and most interest-rate trading strategies. However, when the market becomes highly volatile you can observe unusually wide spreads between similar kinds of securities that typically shouldn’t trade at wide spreads (like the Long Term Capital Management crisis in 1998). When this happens, convergence strategies inevitably lose money. That is precisely what happened last year. Unsurprisingly, the worst-performing strategy of the year was convertible arbitrage, where supremely ridiculous things were happening in parts of the corporate finance structure of companies. Many of the anomalies from October and November’s crash have already corrected themselves; but as Keynes observed, “The market can stay irrational longer than you can stay solvent.”

Last year hedge-fund managers faced unprecedented uncertainty, much of it induced by the government. For example, the short selling ban and government intervention whipsawed the markets and moved the goalposts for many hedge funds, with little or no notice. Furthermore, the US government allowed Bear Stearns to be absorbed seamlessly into JP Morgan, but allowed Lehman to fail in a disorderly way. To put the Lehman Brothers bankruptcy in perspective, according to some estimates Lehman controlled approximately \$100 billion, or 5%, of the global prime brokerage business. This then had knock-on effects for Goldman Sachs and Morgan Stanley and other prime brokers and led to what can only be described as the mother of all margin calls.

So how did the hedge-fund industry and the world more generally get itself in this situation of poor returns and unpredictable volatility? In a back-handed way, in addition to general hubris, some of the blame can

paradoxically be put at the feet of central bankers and governments that managed to induce “The Great Moderation” (a phrase coined by Harvard economist James Stock, who described the decline in volatility in the mid-1980s of economic variables such as GDP, industrial production, monthly payroll employment, and the unemployment rate). As the following charts from the Federal Reserve Bank of Dallas show, the early 1980s in fact constituted a structural break in macroeconomic volatility. (Source: <http://www.dallasfed.org/research/eclett/2007/el0709.html>)

GDP became a lot less volatile...



As did employment...

Chart 3

Jobs Growth Volatility Declined Markedly in the Mid-1980s



It was not just hedge-fund managers who were seduced by low volatility; Journalists were too. Gerard Baker of the *Times* of London wrote in January 2007:

Welcome to 'the Great Moderation': Historians will marvel at the stability of our era

Economists are debating the causes of the Great Moderation enthusiastically and, unusually, they are in broad agreement. Good policy has played a part: central banks have got much better at timing interest rate moves to smooth out the curves of economic progress. But the really important reason tells us much more about the best way to manage economies.

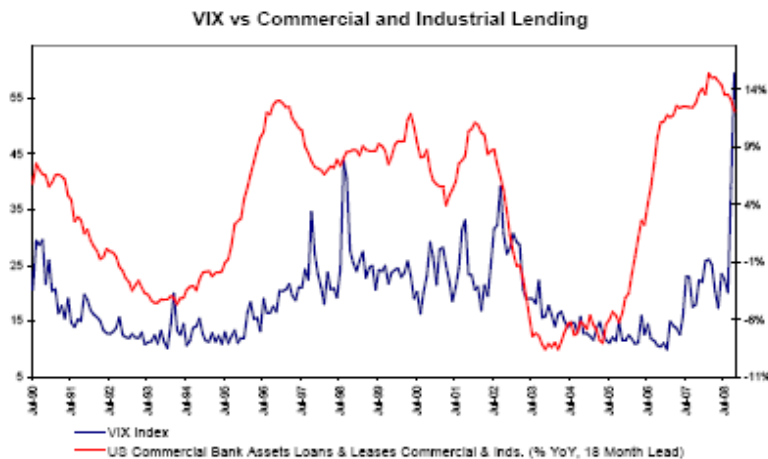
“It is the liberation of markets and the opening-up of choice that lie at the root of the transformation. The deregulation of financial markets over the Anglo-Saxon world in the 1980s had a damping effect on the fluctuations of the business cycle.... The economies that took the most aggressive measures to free their markets reaped the biggest rewards.

Source: http://www.timesonline.co.uk/tol/comment/columnists/gerard_baker/article1294376.ece

In retrospect, this line of thinking looks hopelessly optimistic, even deluded. I do not write this to pick on Gerard Baker (sadly, we could find hundreds of examples), but rather to point out that low volatility breeds complacency and increased risk taking. The greater predictability in economic and financial performance led hedge funds to hold less capital and to be less concerned about the liquidity of their positions.

Those heady days are now over, and we have now entered “The Great Immoderation.” One can confidently say that 2008 represents a structural break, moving back towards a period of greater volatility. Robert F. Engle, a finance professor at New York University who was the Nobel laureate in economics in 2003, has shown that the periods of greatest volatility are predictable. Market sessions with particularly good or bad returns don't occur randomly, but tend to be clustered together. The market's behavior illustrates this clustering. Volatility follows the credit cycle like night follows day, and periods following credit booms are marked by high volatility, for example 1989-90, 2000-03, and 2007-08 – all the tail end of credit cycles.

The following chart shows a very tight correlation, lagged by 18 months, between commercial and industrial lending and the VIX, a popular measure of equity volatility.



Source: www.variantperception.com

As you can see from the chart, if history is any guide to the future, volatility is likely to continue to be elevated for another year and a half at a minimum.

Will we ever return to periods of very low volatility? Of course, but not immediately. We are in the midst of a bust, and business cycles will always be with us. In fact, it appears that this is hardwired into our brains. Using MRIs, neuroscientists have shown that monetary gain excites the same parts of the brain as cocaine. Similarly, the threat of financial loss activates the same fight-or-flight circuitry as a physical attack. Some people seem capable of handling stress and thriving on it, but most people are driven by two things: Greed and Fear. Booms and busts reflect this. Given that these two powerful emotions control most of us, it should then come as no surprise that, according to the IMF, in the last 40 years over 35 countries have had banking crises. (See the following IMF paper: <http://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf>) Unsurprisingly, banking-related national crises were typically preceded by periods of rising real-estate and stock prices, large capital inflows, and financial liberalization – and, you guessed it, low volatility.

Simply put, low volatility breeds complacency. The following chart captures Greed and Fear by using volatility and returns of bonds and stocks as the main inputs. (The Greed & Fear methodology was created and popularized by Credit Suisse and Dresdner Kleinwort Wasserstein.)

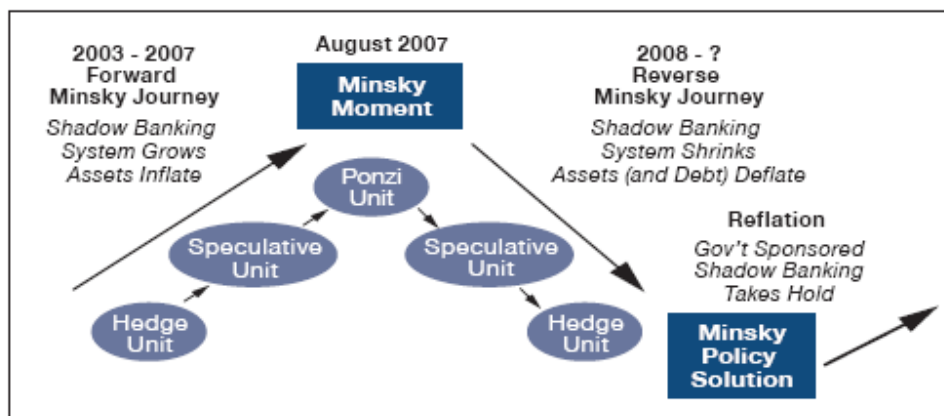


Source: www.variantperception.com

The Greed and Fear chart provides a demonstration that high returns and low volatility leads to complacency, and complacency eventually leads to blow-ups. Extremes in investor sentiment and “animal spirits” are highly correlated across countries and all asset classes, and changes in confidence can be captured by changes in the *relative* performance of risk-free investments like government bonds versus volatile assets like equities and emerging-country bonds. Major turning points in relative performance of risky and safe assets happen when investors are all lopsided in their biases in favor of one or the other. Why am I writing about The Great Moderation and volatility in the context of hedge funds? The secular decline in volatility led financial institutions to underestimate the amount of individual and systemic risk they faced and, consequently, overestimate the amount of leverage their investing could support. Paradoxically, low volatility was a prelude to a large measure of volatility in the market. This idea comes originally from Hyman Minsky. Minsky is chiefly remembered for his "Financial Instability Hypothesis" (FIH), which argues that stability is inherently destabilizing. "A fundamental characteristic of our economy, is that the financial system swings between robustness and fragility and these swings are an integral part of the process that generates business cycles."

My friend Paul McCulley has helpfully labeled the current environment a “Journey,” based on the writings of Minsky. Cycles begin with the Forward Minsky Journey, where stability begets ever riskier debt arrangements, until they have produced a bubble in asset prices. And then the bubble bursts, in something called a Minsky Moment, followed by a Reverse Minsky Journey, characterized by ever-tighter terms and conditions on the availability of credit, inducing asset price deflation and its fellow traveler, debt price deflation.

Journeying with Minsky



Source: PIMCO

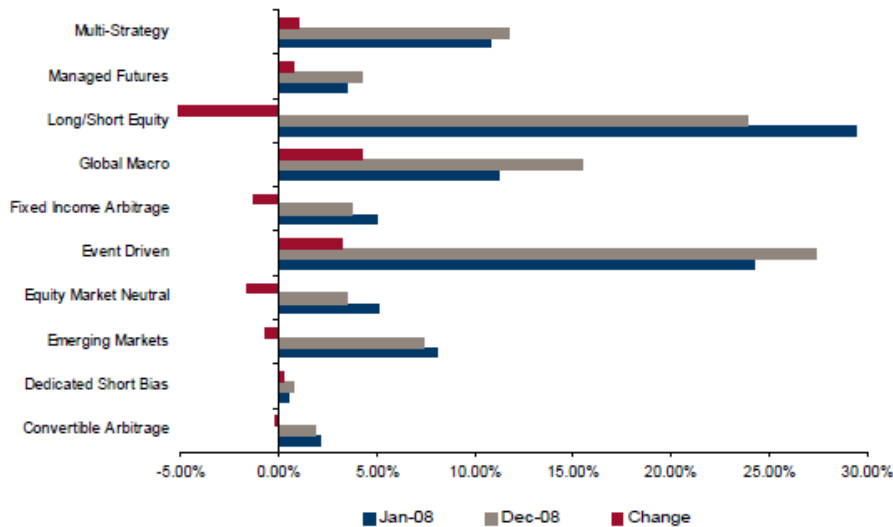
Source: PIMCO

Volatility was the great stumbling block for some hedge-fund strategies in 2008; but I would point out, gentle reader, that volatility can be your friend. Trades that make sense when the VIX is at all-time lows and credit spreads are at all-time lows make little sense in more risk-averse and volatile times.

Volatility itself is a major source of investment returns. Days of large gains and large losses account for most of the performance of any index fund. Someone who was fully invested in stocks from 1998 to 2008 – except for the market's 20 best days, during which he held cash – would have had a dismal record. Despite holding stocks more than 99 percent of the time, this investor would have lost 57 percent through the end of October 2008, as judged by the Dow Jones Wilshire 5000 index, a benchmark that represents the combined value of all domestic stocks. That is 70 percentage points worse than the 13 percent gain he would have achieved had he held stocks mimicking that index for the entire 10 years, including the market's 20 best days. (Source: Mark Hulbert writing in the New York Times, November 2, 2008.)

As I have written before, to put it bluntly, "Not all hedge funds are created equal, even if their returns appear to be similar." Not all funds have the tools and wherewithal to avoid market downturns and capture volatility. Furthermore, not all strategies are created equal. Convergence strategies have been crushed, but high market volatility is creating golden opportunities for global macro managers. Global macro funds can take advantage of volatility by actively trading futures, buying and selling currencies, and trading commodities. Managed futures managers, on the other hand, benefitted in 2008 from first rapidly rising commodity prices and then a commodity collapse late in the year. Accordingly, global macro has seen one of the largest increases in asset inflows, despite the overall decline in hedge-fund assets. (There is no guarantee such funds will continue to do well in the future.)

**Chart 6: Broad Index Sector Allocation Changes
(January 2008 – December 2008)**



Source: Credit Suisse / Tremont

As I have pointed out before, it is far more normal for funds to have negative alpha (i.e., they cost you something over a simple index) because of the extra burden of fees and transaction costs – and not forgetting the possibility of poor management. Achieving real alpha is difficult! That is why in a world of Great Immoderation choosing (1) the right strategy and (2) the right manager is a critical task.

Good opportunities are always present. Sometimes finding them simply requires more work.

An article from the *Wall Street Journal* recently quoted the manager of a billion-dollar volatility-hedge fund in New York as saying, "Massive global volatility events don't come along that often. The one we're experiencing right now is unprecedented. It's a good time for us." For every dark cloud, there is a silver lining. Dislocations can be painful, as 2008 showed us, but dislocations also create great opportunities. A recent survey of the hedge-fund community, titled *The Business of Hedge Funds: Results of the Alpha Search Advisory Partners 2008 Manager Survey*, found that over 75% of managers felt we were entering the greatest period of investment opportunity in our lifetime.

John Mauldin

Copyright 2006 John Mauldin. All Rights Reserved

Plexus. Independent Insight in an Uncertain World.

Tel: +27 (0) 21 970 2400 • Fax: +27 (0) 21 975 2248 • E-mail: info@plexus.co.za • Web: <http://www.plexus.co.za>

DISCLAIMER

This e-mail transmission contains confidential information that is the property of the sender and which is legally privileged. The information is intended only for the use of the addressee. If you are not the intended recipient, you are hereby notified that any disclosure, copying or distribution of the contents of this e-mail transmission, or the taking of any action in reliance thereon or pursuant thereto, is strictly prohibited. Should you have received this e-mail in error, please notify us immediately by telephone to arrange for the return of the documents comprising this transmission. In no event will Plexus Mauldin Alternative Investments (Pty) Limited, Plexus Asset Management (Pty) Limited or the sender of this e-mail be liable to any party for any direct, indirect, special or other consequential damages for any use of this e-mail, or on any other hyper-linked web site, including, without limitation, any lost profits, business interruption, loss of programs or other data on your information handling system or otherwise, even if we are expressly advised of the possibility of such damages.

