



Editor's Note: The 2012 Nonprofit News Hedge Fund Outlook is part one of a three part series that will look at 2012 outlook of hedge funds, private equity and real assets. Part two, which will focus on private equity and venture capital outlooks, will be in next week's issue.

Volatility Notwithstanding, Outlook For Hedge Funds Positive In 2012

Hedge fund managers that deploy global macro and credit-related strategies could be positioned to have a solid 2012, while long/short managers will continue to struggle given the recent influx of market volatility, according to institutional investors.

In a series of interviews with plan sponsors, investment consulting firms and asset managers on what to expect of the hedge fund space in 2012, many experts believe that products such as global macro, credit and multi-strategy funds can take advantage of the market dislocations that have occurred over recent months. While others contend that hedge fund managers will not be able to weather the volatility storm until fiscal stability returns to the U.S. and Europe, both sides agree that hedge funds are still an essential part of an institutional portfolio.

Joe Gieger, managing director for the Americas at hedge fund manager GAM, said that investors have shown a great deal of interest in uncorrelated asset classes such as the firm's emerging markets rates and global rates hedge fund strategies, while also seeing increased interest in non-correlated strategies, such as the firm's catastrophe bond fund sub-advised by Fermat Capital Management.

"The general theme [for investors] is in the form of adding diversification to their portfolios, primarily focusing on diversifying from traditional asset classes, such as asset classes or strategies not correlated to their equity exposure or the Barclays Capital Aggregate Bond Index," Gieger said.

Gieger said that catastrophe bonds, which have historically been utilized as part of high-yield bond portfolios, can provide the uncorrelated returns clients are seeking in 2012 following an extremely volatile 2011. Gieger said that GAM anticipates the market cap for the strategy to increase to \$19 billion this year from \$12 billion last year.

For the calendar year 2012, 38% of investors said that they intend to increase their hedge fund allocation, while 53% intend to keep their allocation approximately the same and 9% intend to decrease it, according to a hedge fund investor outlook released by Preqin in December.

The survey also indicates that 49% of institutional investors will maintain their existing hedge fund relationships and add new managers, with 21% saying they will consider new managers on an opportunistic basis, 20% considering maintaining existing relationships only and 10% focusing on adding new managers.

Going into 2012, Christopher Long, president and co-portfolio manager of hedge fund-of-funds Palmer Square Capital management, said that he expects hedge fund commitments to continue, with one key level of activity in the sector being with funds that move within equity and credit, such as event-driven managers or firms that utilize a multi-strategy portfolio.

"Credit is much more attractive today and in 2012 than it has been in last 12-18 months," he said. "Essentially, there has been a huge disconnect in credit, and a lot of areas such as high yield bonds have spreads much wider than they have been historically."

Long said he believes that an emergence of new hedge fund startups—the most he has seen in five years—is an indication of growing interest in the sector.

"I think that this year is shaping up to be largest as far as new fund launches since 2007," Long said. "The reason for that is two-fold - there's been a loosening of what investors are seeking, and where there are the alpha-generating opportunities, they're seeing a lot of managers that can exploit that trend."

In the past 12 months, there were approximately 265 hedge fund mandates from U.S.-based defined benefit pension funds, foundations and endowments, 180 of which accounted for hundreds of billions of dollars being committed to the sector through strategies such as long/short, global macro and event-driven, according to reported search and hire activity in the finsearches database.

Jonathan Hook, cio of the Ohio State University endowment, said that institutional interest in certain hedge fund strategies can sometimes drive an increase in mandates, but will not always translate into successful long-term allocations.

"On the macro side is where I've heard people say they're going to add exposure. It does concern us that if you hear that from so many people you probably should go in another direction," he said. "A lot of firms are holding out their shingles saying they're global macro funds, and it makes sense to be with someone with an experience level rather than a brand new macro fund. Still, we have folks from the prop trading side starting new firms and there seems to be an awful lot of interest and capital flowing to that space, which is worth watching but may be not quite as good as what people think."

Volatility has been the story for long/short equity managers, Hook said, with good firms still attempting to make sense of the intense market swings the U.S. has experienced for multiple months.

"I think you've seen long/short guys have difficulty with volatility in the market," he said. "When you're up and down and up again, it is problematic for guys trying to trade equity and be nimble. I think that has pointed to a lot of folks having average to poor results on the long/short side."

"At some point we would hope to see good stock picking rewarded again and not have everything trade in bunches and have so much correlation between stocks," he added. "We still have a lot of macro events to deal with, and it may be some time before good, discrete stock picking is rewarded again."

Samuel "Q" Belk, director of diversifying investments at investment consultant Cambridge Associates, said that because of the muted performance of long/short equity, Jones models, and multi-strategy managers over the last decade, there is increasing demand for uncorrelated hedge fund strategies.

"These include global macro, from discretionary to systematic (CTAs), arbitrage strategies (fixed-income, convertibles, credit, capital structure), and emerging market strategies. Particularly in the case of emerging markets, there is demand for exposure to Asia ex-Japan managers," said Belk, former managing director of absolute return strategies for the Dartmouth College investment office. "There is also a growing realization that the distressed opportunity in Europe will be protracted; many managers are either opening European offices or increasing staffing in response to what is expected to be a multi-year opportunity. Many of the dislocations in the U.S. market in 2009 and 2010 have receded, but they may resurface if the European debt crisis remains unresolved for an extended period."

Bruce Guiot, director of investments and treasury services at the Miami (Ohio) University Foundation, said that while he is still optimistic for the continued success of the hedge fund sector, he is also concerned with the space becoming oversaturated as inflows from pension funds begin to crowd the sector.

"We still like the hedge fund space, but there's a lot of money flowing in there," he said. "The big state pension plans keep putting more and more in that space, and it is more crowded in terms of implementing ideas and volatility has wreaked havoc on strategies."

"I think it's hard to be a big pension plan or big university, when you have tens of billions to invest, the challenge is to not be the market yourself," he added.

Archstone Portfolio Solutions, an investment consulting firm based in Lutherville, Md., has seen a theme among its nonprofit clients to move into hedge funds not only in hopes to increase returns, but to also dampen volatility and provide lower correlations to the rest of the portfolio.

"The conversation is changing and the common theme now is attempting to dampen the volatility of the portfolio and introduce lower correlations," said Glenn Ross, a founder and managing director of Archstone. "When you say uncorrelated, that's a term that has gotten harder to achieve with elevated volatility."

Ross said that the firm's preference has been to shift into low volatility strategies as opposed to opportunistic strategies, 130/30 and long/short equity. Where the firm will invest in long/short equity is where they see larger economic themes, such as a firm that is focused on technology companies, as opposed to the greater market.

"With the world seemingly coming to an end every other day, clients are focused on liquidity and not locking up funds for a long period of time," Ross said.

Operations Improving Among Majority of Managers

Before even being considered for mandates, hedge fund managers must understand the importance of having its operations—including compliance, risk and back office functions—in place.

"If 2008 was good for anything, it was that pressure was put on managers to increase transparency and liquidity to improve operations, and this trend has continued at an increased pace," Long of Palmer Square said.

For investment consultants, transparency ranked next highest to performance (62%) in the Preqin survey at 12%.

Sherwood Yuen, a v.p. and consultant in Callan Associates' Alternatives Consulting Group, said that generally, operational due diligence has had a lot of changes over the past three to four years, with the onset of the Lehman Brothers collapse and Bernard Madoff's Ponzi scheme.

"When you invest in a hedge fund, you're not simply investing in a manager's investment ability, but you also need to understand the other operational aspects of the fund such as their prime brokerage(s), administrator, legal and accounting and risk management systems, he said.

"Risk management systems have a great deal to do with transparency," he added. "Transparency has undergone a 180 degree change since 2008. Before, fund-of-funds were only given manager names and qualitative information at best. Nowadays fund-of-funds are requiring gross and net exposures of underlying portfolios from individual managers and in some cases, providing an additional layer of transparency almost unheard of in 2005-06."

Archstone shared a similar sentiment, noting that many of the hedge fund-of-funds it works with have eliminated lock-ups and lowered fees.

"We have seen a number of the fund-of-funds managers beefing up operational due diligence," said Alex Fisher, a managing director and co-founder of Archstone. "Half of the failures [at hedge funds] are with operational problems and have nothing to do with investments or fraud. Whether it is not staying on top of the trading desk or back office functions, there's a higher level of scrutiny on everything our managers do, and that we must follow."

In GAM's experience as a hedge fund-of-funds manager, Gieger said that issues such as transparency are paramount to properly assessing managers.

"Transparency and best practices as it refers to operational mechanics and compliance, those are nec-

essary first step types of things," Gieger said. "You need those boxes checked before you can progress further in any sale. Maybe three or four years ago, maybe they were debatable, but those things are not up for debate today and are necessary to move on to the next step."

For Ohio State's Hook, transparency has varied on a case-by-case basis.

"It's still very much firm-specific. Some have done a nice job and tried to provide the things people have asked of them and some, I don't think they'll ever give you everything you might like," he said. "Each of us have to assess that issue. If you don't get everything do you choose not to invest in that firm? Is that issue big enough to tell you not to invest? We look at each one differently and have to factor that into the overall assessment."