Divergent world views good for hedge funds

- *Favourable scenario for hedge funds as an asset class*
- *Increased number of mergers and acquisitions will benefit several strategies*
- *Chances for good returns at reasonable risk*

With their different strategies, hedge fund managers have the potential to generate good returns in virtually all market situations, but generally speaking they thrive the very most when market assessments of future world developments diverge. They also benefit from the fact that the world is not so static, for example when key interest rates vary greatly around the world. Spreads in other interest rates and yields, as well as in estimates of which way these variables will move, also provide an excellent breeding ground for many hedge fund strategies. Falling or lower correlations, which we are also seeing at present, contribute positively to the good hedge fund climate.

In an environment where large portions of the emerging market (EM) sphere are fighting inflationary tendencies by hiking key interest rates, and the developed world is largely retaining low interest rates, hedge funds have good potential to generate returns. When certain developed market (DM) economies have performed so well that they have started their interest rate hiking phase (for example Australia and Sweden, as well as the European Central Bank, which has also begun raising its refi rate), such potential increases further. This should mean that strategies like Fixed Income Relative Value will be able to deliver good returns at reasonable risk. These strategies are relatively liquid, and it is thus possible to gain access to good hedge funds that are traded daily if an investor wants short trading cycles. It is not necessary to move further out on the liquidity curve than monthly trading to invest in good Global Macro or Fixed Income Relative Value funds.

At present, Relative Value managers are quite naturally focusing on the Fed's expected termination of its quantitative easing programme (QE2). This is expected to occur shortly, and there are divergent views in the markets as to what this will mean to the price of loans, regardless of whether they are corporate loans or government loans. Fixed Income Relative Value and Credit Long/Short can benefit from such divergent views. These strategies can also take advantage of a projected further normalisation of credit markets, meaning that some loans are perceived as having become expensive. Risk premiums have decreased, new loans may be of poorer quality again and many observers will shift part of their attention to inflation. There will thus probably be an increase in the differences between loans perceived as safer compared to those perceived as carrying higher risk. This is good news for Credit Long/Short, for example, which can thus make even greater use of both its long book and short book.

One sign of normalisation is that the market is opening up for more corporate mergers and acquisitions. Companies that have weathered the financial crisis better than others and have gained strength from a favourable cyclical trend are more aggressive than they have been for years and are beginning to look around for ways of improving their market position. This may be a matter of merging with another aggressive company, buying up a fledgling company that can contribute some good qualities, or simply buying up a competitor in order to have the market more to themselves. This may also involve pure restructurings or other types of special situations. Overall, this indicates that a Merger Arbitrage or other Event Driven strategy should generate good future returns.

Mergers and acquisitions increasing

Mergers and acquisitions are likely to continue increasing, which benefits these strategies. It is also relatively easy and cheap to borrow capital for investments in the current market climate, thereby enabling hedge funds to take positions and generate value. The really big opportunities have probably already passed for hedge funds that focus on problem loans and companies, but there are still large enough opportunities to generate good returns, also at reasonable risk.

Over the past few years, the rally in the High Yield segment has led to this asset class being valued on the basis of generalisations. Assuming a normalising market and bankruptcy levels close to zero, the next movement will include the differ-

ences between better and worse High Yield instruments. This will also further improve the potential for Event Driven strategies, which will be able to take more constructive positions, further improving the quality of investment opportunities.

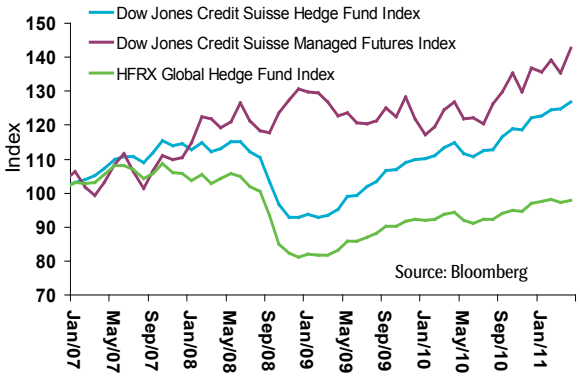
Equity Long/Short strategies are usually the easiest to understand and identify with. Buy shares you like and short those you don't like. Rather simple, actually, but this of course requires that both the analysis and positioning are correct and disciplined. The prevailing market climate should permit acceptable opportunities for this strategy as well, but we advocate some caution with Long Biased hedge funds, since most of the time these are invested in markets up to a high percentage of capital. There will be some ups and downs in this type of funds, but less than for ordinary equity funds in general.

Momentum is on the side of hedge funds

Although we are painting a very favourable scenario for hedge funds, the markets are of course not without some bumps in the road. A normalisation process takes time, and the pattern of movements tends to form plateaus, with large and small corrections along the way. Throughout the economic recovery, we have seen hedge funds as a group performing very well in some months, then losing a lot of value in other months. This has been repeated, with a correction about every four months. We believe that we can expect this pattern in the future as well. We saw this most recently in the first week of May, when we again experienced a genuine correction, which adversely affected many hedge funds. During the year, many hedge funds have built up positions based on a weaker USD and rising oil prices. The market situation changed dramatically when the dollar quickly began to appreciate and oil prices dropped by around 15 per cent in a short period. Such sharp, rapid movements obviously affect hedge funds, especially those that build up positions that follow market trends. Such hedge fund strategies as CTA (systematic multi-asset management), Global Macro and Long Biased Equity L/S took a real beating, with downturns of around 2.5-4 per cent on index levels for a week.

These movements thus have the potential to wipe out a third or more of a year's returns in as short a period as a week or so. This shows the importance of trying to keep track of such rapid shifts, if not otherwise as an indication of the performance of other asset classes. We nevertheless currently have a very positive view of hedge funds as an asset class. Momentum is on the side of hedge funds, and we expect the overall investment climate to improve even further. As always, quality plays an extra large role for hedge funds, but by way of summary, the investment climate is good.

KEY QUALITATIVE ASPECTS IN CHOOSING HEDGE FUNDS



The returns of recent years in the hedge fund field have shown divergent natures, depending on what strategy investors have chosen, and also depending on whether the index includes a very large number of hedge funds across a broad spectrum (HFRX) or whether the index has a more qualitative focus (DJCS Index). The chart shows the importance of trying to select hedge funds based on qualitative aspects. The table below shows what good characteristics CTA/Managed Futures had in the last crisis, but that this strategy has had a more difficult time since then.

Source: Dow Jones Credit Suisse

INDEX/STRATEGIES	YTD (April 2011)	2010	2009
Dow Jones Credit Suisse Core Hedge Fund Index	2.62%	8.10%	13.12%
Convertible Arbitrage	2.56%	11.16%	46.23%
Emerging Markets	3.50%	9.89%	26.86%
Event Driven	2.33%	7.15%	20.84%
Fixed Income Arbitrage	2.20%	4.46%	3.25%
Global Macro	1.61%	8.29%	5.81%
Long/Short Equity	3.47%	6.84%	19.08%
CTA/Managed Futures	2.97%	13.80%	-12.59%

SOME HEDGE FUND SUB-STRATEGIES

The table shows the performance of various common hedge fund strategies after the big 2008 downturn. Figures for 2011 are until the end of April and show good upturns, among other things due to fine figures during April itself.