

The Future of Hedge Funds

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National Council on Teacher Retirement

87th Annual Convention

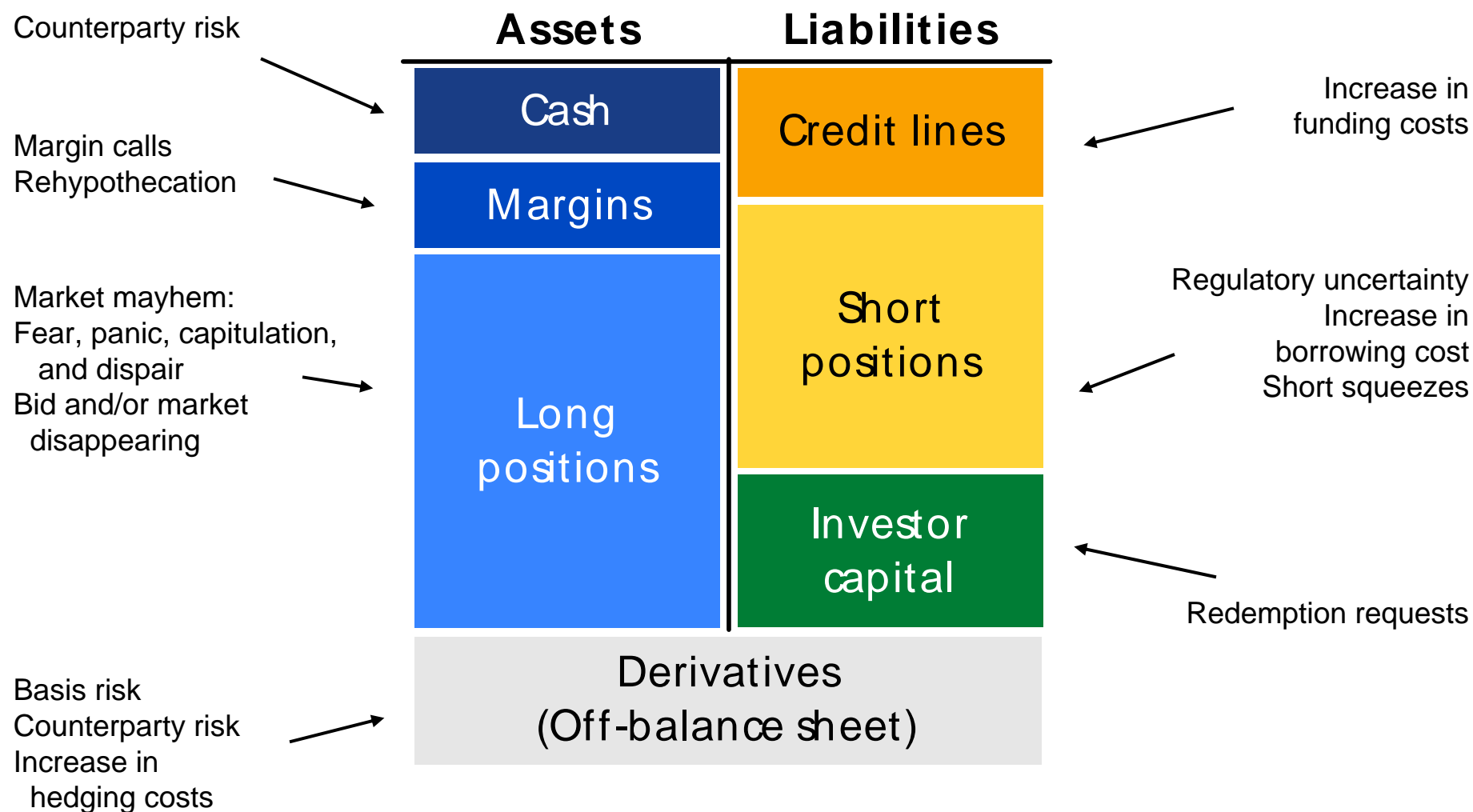
CHALLENGING TIMES

October 2009 • Renaissance Esmeralda • Indian Wells, California

“
Investment is by nature not an
exact science.
”
Benjamin Graham

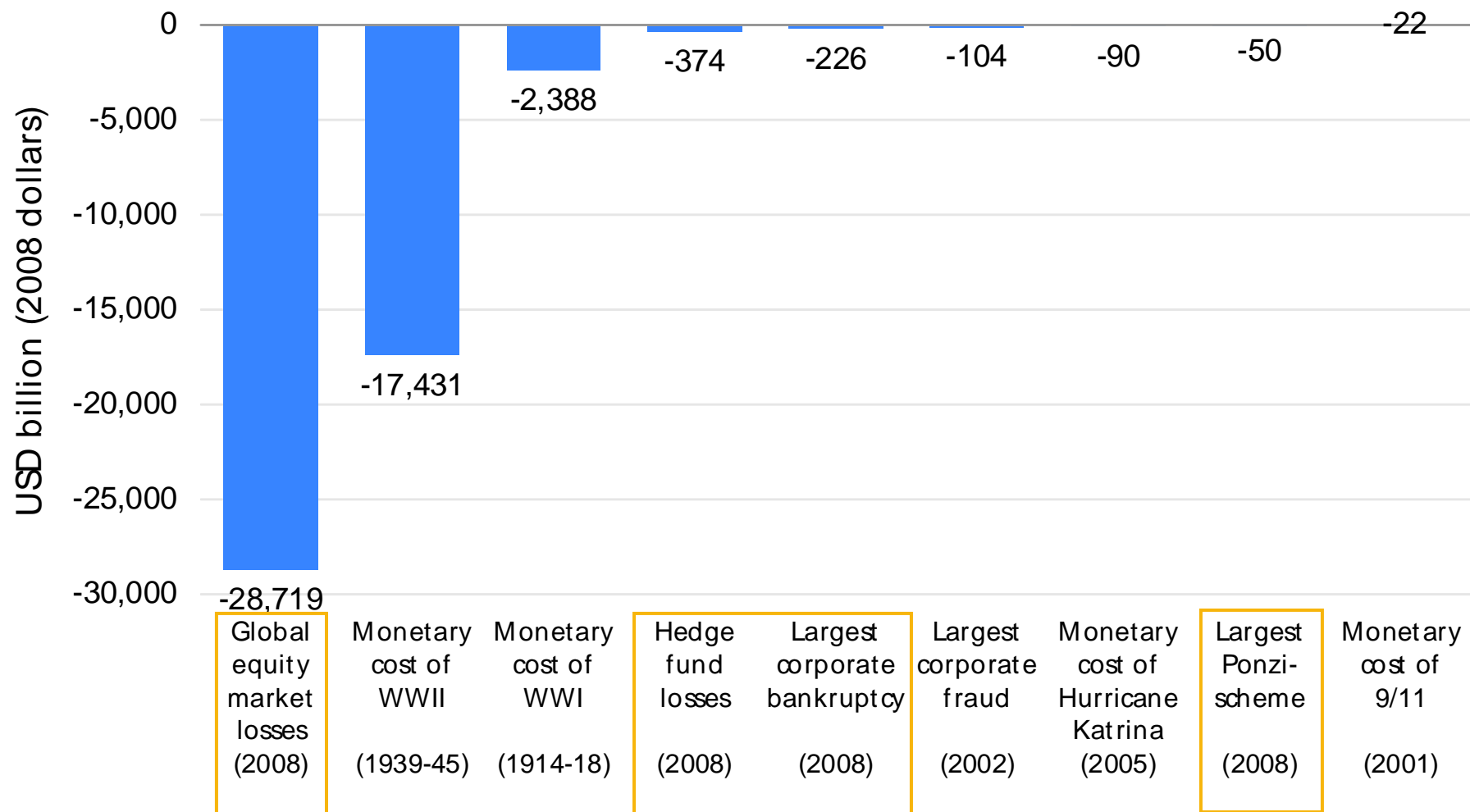
Annus Horribilis: Murphy's Law at work

Hedge funds needed to deal with systemic failure in 2008



Historical “accidents”

Active risk management is likely to become more important ...

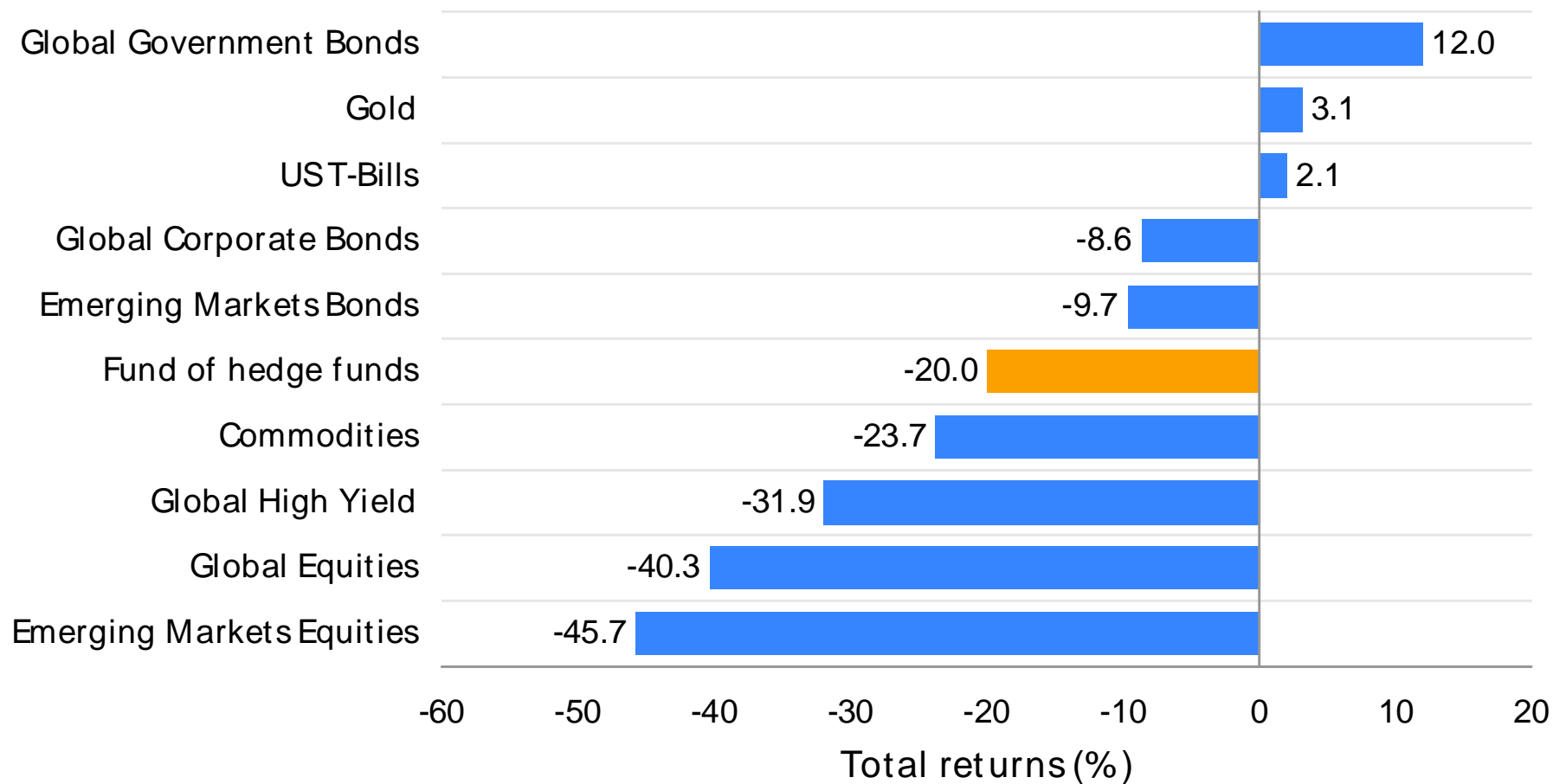


Source: A&Q Industry Research, data from Bloomberg, Swiss Re Sigma, wikipedia, Spartacus Educational

... rather than less important

2008 returns by asset class

Expectations of “absolute returns” were not met



Source: A&Q Industry Research, Thomson Financial

Based on USD total returns from January to December 2008. Global equities: MSCI World Index; EM Equities: MSCI EMF Index; Govt Bonds: JPM Global Govt Bond Index; Corp. Bonds: Barclays Capital Global Aggregate Corporates Index; EM Bonds: JPM EMBI+ Index; High Yield: Barclays Capital Corporate High Yield; T-Bills: Merrill Lynch US T-Bills 3M Index; Commodities: Reuters/Jefferies CRB Index; Hedge Funds: HFRI Fund of Funds Composite Index.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Absolute return value proposition still intact

Relative return focus

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2009	-8.7	-10.2	7.6	11.3	9.2	-0.4						
2008	-7.6	-0.5	-0.9	5.3	1.6	-7.9	-2.4	-1.4	-11.9	-18.9	-6.4	3.3
2007	1.2	-0.5	1.9	4.5	2.9	-0.7	-2.2	0.0	4.8	3.1	-4.0	-1.3
2006	4.5	-0.1	2.2	3.1	-3.3	0.0	0.6	2.6	1.2	3.7	2.5	2.1
2005	-2.2	3.2	-1.9	-2.1	1.9	0.9	3.5	0.8	2.6	-2.4	3.4	2.2
2004	1.6	1.7	-0.6	-2.0	1.0	2.1	-3.2	0.5	1.9	2.5	5.3	3.8
2003	-3.0	-1.7	-0.3	8.9	5.8	1.8	2.0	2.2	0.6	6.0	1.5	6.3
2002	-3.0	-0.8	4.4	-3.4	0.2	-6.0	-8.4	0.2	-11.0	7.4	5.4	-4.8
2001	1.9	-8.4	-6.5	7.4	-1.2	-3.1	-1.3	-4.8	-8.8	1.9	5.9	0.6
2000	-5.7	0.3	6.9	-4.2	-2.5	3.4	-2.8	3.3	-5.3	-1.7	-6.1	1.6
1999	2.2	-2.6	4.2	4.0	-3.6	4.7	-0.3	-0.2	-1.0	5.2	2.8	8.1
1998	2.8	6.8	4.2	1.0	-1.2	2.4	-0.1	-13.3	1.8	9.1	6.0	4.9
1997	1.2	1.2	-2.0	3.3	6.2	5.0	4.6	-6.7	5.4	-5.2	1.8	1.2
1996	1.8	0.6	1.7	2.4	0.1	0.5	-3.5	1.2	3.9	0.7	5.6	-1.6
1995	-1.5	1.5	4.8	3.5	0.9	0.0	5.0	-2.2	2.9	-1.6	3.5	2.9
1994	6.6	-1.3	-4.3	3.1	0.3	-0.3	1.9	3.0	-2.6	2.9	-4.3	1.0
1993	0.4	2.4	5.8	4.7	2.3	-0.8	2.1	4.6	-1.8	2.8	-5.6	4.9
1992	-1.8	-1.7	-4.7	1.4	4.0	-3.3	0.3	2.5	-0.9	-2.7	1.8	0.8
1991	3.7	9.3	-2.9	0.8	2.3	-6.2	4.7	-0.3	2.6	1.6	-4.3	7.3
1990	-4.7	-4.3	-6.0	-1.4	10.5	-0.7	0.9	-9.3	-10.5	9.4	-1.6	2.1

Return less than or equal to -4%

Absolute return focus

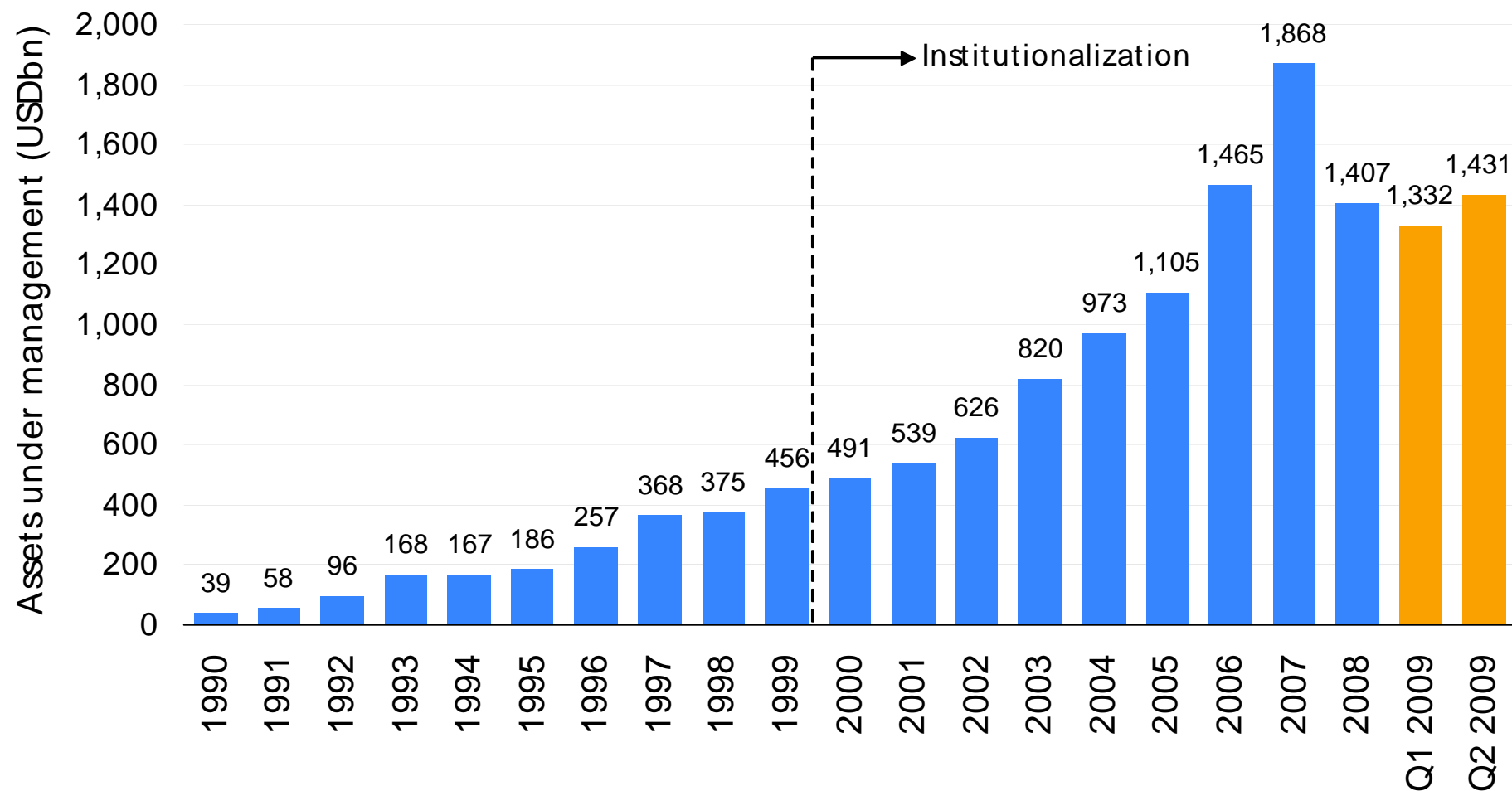
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2009	0.7	-0.4	0.0	1.1	3.4	0.5						
2008	-2.9	1.4	-2.7	1.0	1.7	-0.9	-2.7	-1.5	-6.5	-6.2	-2.6	-1.5
2007	1.3	0.8	1.0	1.7	2.1	0.7	0.3	-2.2	2.2	3.1	-1.5	0.5
2006	2.9	0.4	1.7	1.8	-1.9	-0.6	-0.2	0.8	0.0	1.7	1.9	1.8
2005	0.0	1.4	-0.6	-1.4	0.2	1.4	1.7	0.8	1.6	-1.5	1.7	2.0
2004	1.6	1.1	0.5	-0.9	-0.9	0.2	-0.6	0.0	0.9	0.8	2.6	1.5
2003	0.8	0.3	0.0	1.2	2.1	0.7	0.2	0.8	1.2	1.5	0.6	1.6
2002	0.5	-0.3	0.8	0.6	0.4	-0.9	-1.3	0.3	-0.5	-0.2	0.8	0.7
2001	1.9	-0.7	-0.4	0.7	0.9	-0.1	-0.4	0.2	-1.6	0.9	0.4	1.1
2000	1.5	5.2	0.2	-3.4	-1.6	2.8	-0.2	2.0	-1.2	-1.0	-1.5	1.4
1999	1.4	-0.2	2.1	3.3	0.8	2.8	0.7	0.1	-0.1	1.3	4.9	6.9
1998	-1.0	1.9	4.0	0.9	-0.9	-0.6	-0.2	-7.5	-2.6	-2.0	1.4	1.6
1997	3.6	1.7	-0.8	0.4	1.8	2.5	4.6	-0.3	2.8	-1.4	-0.5	1.1
1996	2.7	-0.6	1.0	3.1	1.5	0.4	-1.9	1.5	1.3	1.6	2.3	0.7
1995	-1.3	-0.1	1.4	1.5	0.9	0.6	1.7	2.3	0.8	-0.5	1.2	2.2
1994	1.3	-2.3	-2.3	-1.1	0.4	0.8	0.2	1.3	0.8	-1.0	-1.0	-0.5
1993	0.9	2.2	1.5	2.3	2.1	2.8	2.4	1.8	0.3	2.3	0.4	4.8
1992	1.3	1.2	0.8	0.1	0.3	0.4	0.8	0.5	2.5	1.7	0.3	1.8
1991	0.4	0.0	3.5	-0.8	0.8	1.2	0.5	1.3	1.8	0.6	0.1	4.5
1990	0.1	1.3	2.1	0.9	0.5	2.2	3.1	1.6	2.8	1.6	0.0	0.1

Source: A&Q, Bloomberg.

Relative return focus: MSCI World Total Return Index, Absolute Return Focus: HFRI Fund of Funds Composite Index. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

Growth of hedge fund industry

Assets under management could fall to 2005 levels



Source: A&Q, HFR (1990 through end of Q2 2009)

Volatility matters!

A friendly reminder that it is risk-adjusted returns that matter

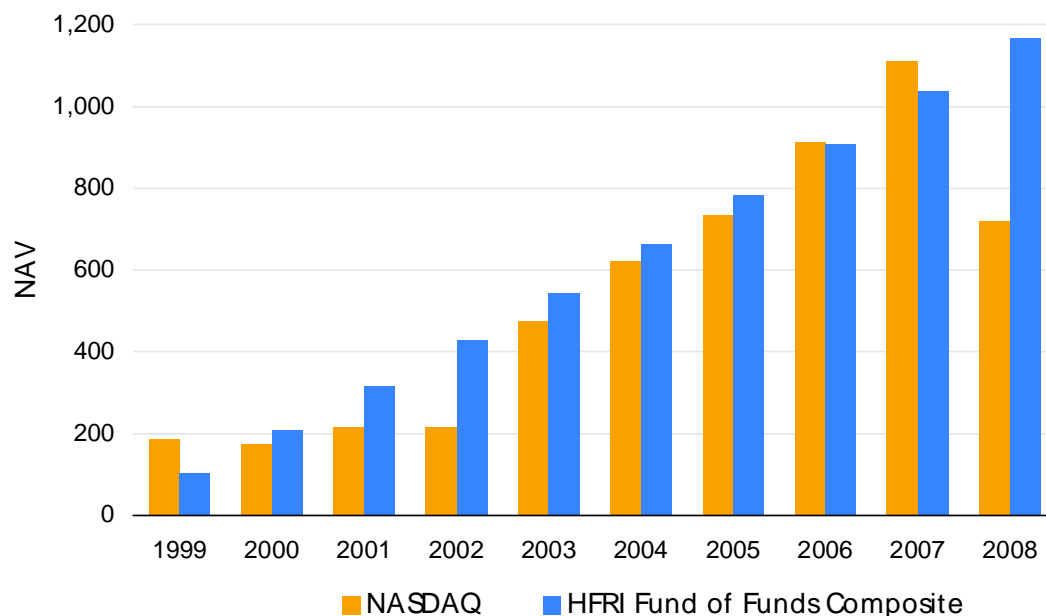
(%)	NASDAQ (USD)	FoHF (USD)
1999	85.6	26.5
2000	-39.3	4.1
2001	-21.1	2.8
2002	-31.5	1.0
2003	50.0	11.6
2004	8.6	6.9
2005	1.4	7.5
2006	9.5	10.4
2007	9.8	10.3
2008	-40.5	-20.0
Average	3.2	6.1
Volatility	28.9	6.7
IRR*	-6.0	2.8

Source: A&Q Industry Research, Thomson Financial

* IRR: Internal rate of return

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High versus low risk-adjusted returns



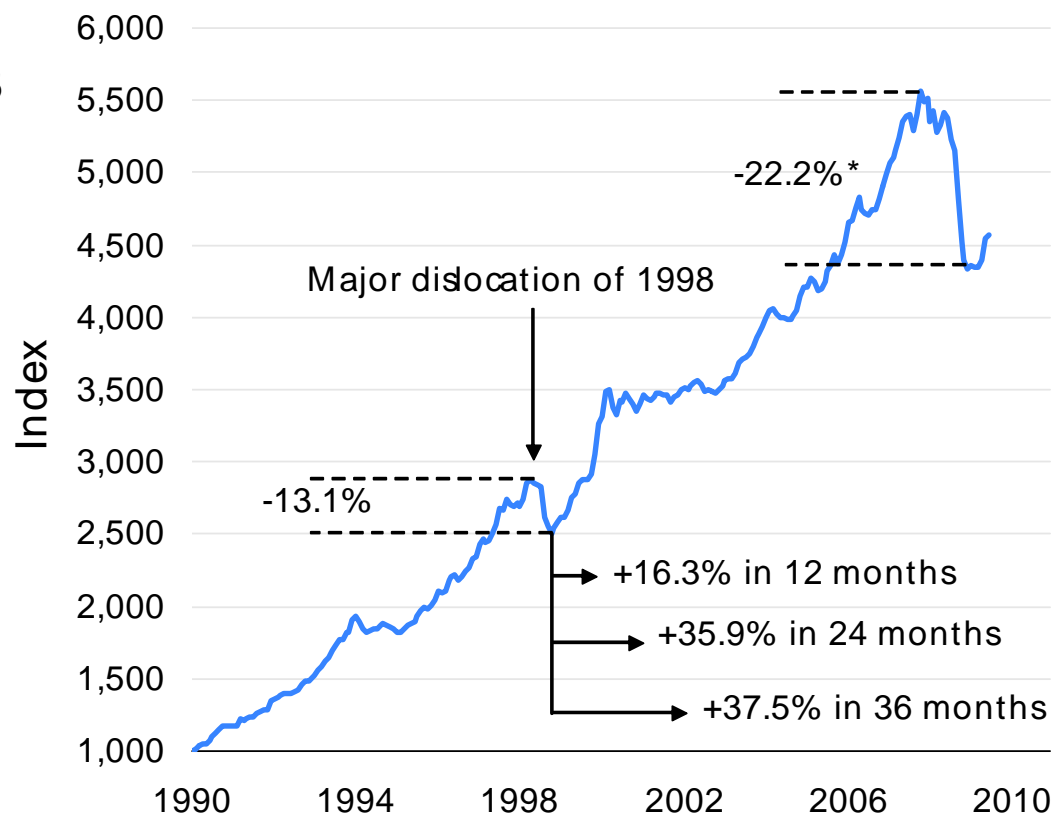
- ◆ Typically hedge funds underperform in equity bull markets, and
- ◆ lose money in equity bear markets
- ◆ However, it's risk-adjusted returns that matter

Retail flows as counter-indicator

Dislocation as an entry point

- ◆ There have been three years of outflow in US equity mutual funds since 1984: 1988, 2002, and 2008
 - Markets reversed sharply in 1989 and 2003
- ◆ Behavioral finance research suggests private investors “buy high and sell low”
- ◆ Historically, hedge fund dislocations have proven to be good entry points
- ◆ Market inefficiencies are largest after major dislocations

HFRI Fund of Funds Composite



Source: A&Q, Bloomberg.

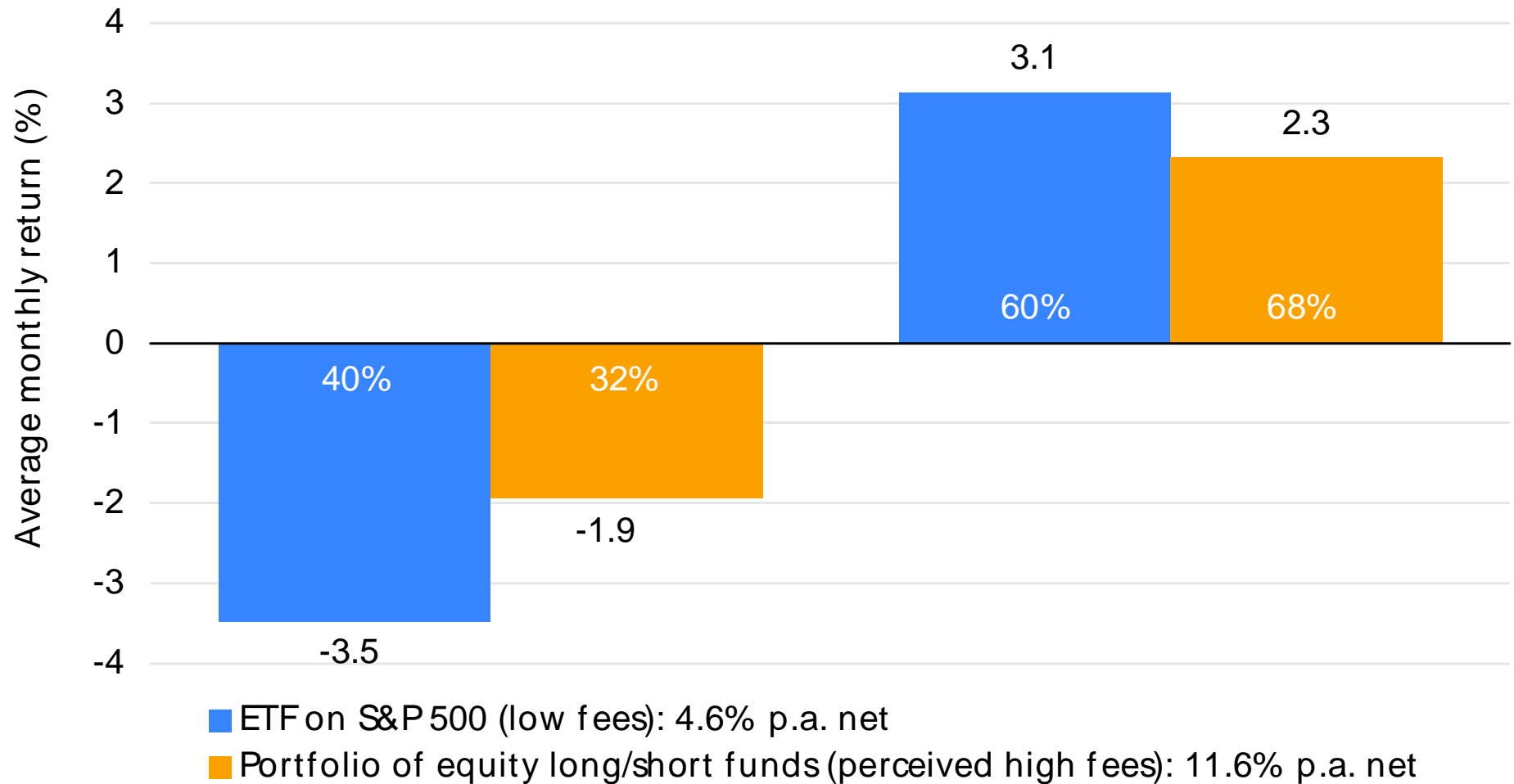
Note: Based on USD total returns from January 1990 through June 2009.

* Estimated drawdown from October 2007 through December 2008. Note that the estimated for the HFRI Fund Weighted Hedge Fund index was -20.4%.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Performance fee versus no performance fee

Fee structure as incentive to deliver asymmetric return profile



Source: A&Q Industry Research, Thomson Financial
USD returns from January 1993 to December 2008.
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Hedge fund industry: Conclusions

- Liquidity** ♦ Banks are still de-leveraging and only slowly resuming role of capital intermediary. Secured funding markets and term debt markets are not healthy and this will adversely affect any trading strategy that relies on leverage
- Fees** ♦ It is an investors' market. Almost all funds are open. Fees are negotiable
- Regulation** ♦ Banks will receive more stringent regulation and be expected to have more capital/less leverage. As a result, proprietary trading, asset backed warehousing, and high yield/levered loan underwriting will be de-emphasized
- Institutional-ization** ♦ Clients will demand greater transparency and show a preference for simple strategies. Managed Accounts will increase as clients will want to appoint custodian and control liquidation of their assets. Risk control will gain prominence. Hedge funds will need to spend more on operations and controls and this will lead to barriers to entry and a shakeout
- Reform** ♦ Like the National Venture Capital Association, hedge fund investors, banks, and hedge funds will agree best practice with respect to fee calculation and redemption practices. They will likely form a more meaningful dialogue with regulators and ultimately hedge funds may be asked to declare that they will conform with such practices
- Asset returns** ♦ While leverage may contain returns on Equity, the case for high asset returns in Hedge Funds can be made. Substantial risk capacity has been removed and trades are much less crowded. Many asset prices are arguably displaced

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- ◆ Jerome (Jay) Raffaldini is Global Head Product Specialists with Alternative and Quantitative Investments (A&Q), responsible for business development, post investment client servicing and investor education programs.
- ◆ Previously, Jay was a Senior Investment Officer and member of the Investment Committee of Alternative Investment Solutions (AIS), a key multi-manager provider within A&Q, where his responsibilities included manager due diligence, strategy research, portfolio allocations and investment monitoring.
- ◆ Jay joined UBS in 2000 as a Senior Investment Officer of the O'Connor Multi-Manager investment team, which became AIS in March 2004.
- ◆ Prior to joining UBS, Jay was Managing Director at Graham Capital Management, a global macro hedge fund where he was responsible for product development and risk management. Prior to that, he was founder, President and CIO of Fuji Alternative Asset Management Company, a wholly owned subsidiary of The Fuji Bank. Jay also founded Nippon Credit Asset Management, a wholly owned subsidiary of the Nippon Credit Bank, Ltd and functioned as the CIO of the fund of fund unit.
- ◆ Jay has been an adjunct lecturer on risk management and derivative topics for the US Federal Reserve.

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