



Quarterly review

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Q2 2009 – special topic: hedge funds after the storm

- Hedge funds had their best quarter in nine years as risk appetite came back strongly. All styles except for managed futures made profits. Last year's laggards such as convertible bond arbitrage have been this year's biggest gainers and vice versa.
- Overall, hedge funds are back on track. The liquidity situation has improved considerably and many gated or suspended funds could liquidate their holdings in an orderly fashion and, in some cases, lift redemption restrictions earlier than expected.
- Transparency, liquidity and asset control are key points of the post-2008 world: our special topic covers these areas in more detail.

Performance review Q2 2009

Q2 reversed to the upside as risk appetite returned

What a difference a quarter makes. Q2 continued the alternating 'risk on; risk off' pattern for global markets. Stocks fell 10% in Q1 after a disastrous 2008 and the banking system as a whole was considered to be nearly insolvent. As a result the outlook had looked bleak going into Q2 2009. Markets defied expectations, however, and global equities rose by over 15% (YTD 3.21%)¹ in the quarter while emerging market equities jumped nearly 35% (YTD 36.01%).² Other risky assets like high yield bonds and leveraged loans also recovered strongly as did commodities, particularly crude oil which rose over 40% (YTD 56.70%).³

Government bonds struggled as yields rose

On the other end of the risk spectrum, safe-haven assets like government bonds struggled. The yield on 10-year US Treasuries, which fell sharply following the collapse of Lehman Brothers in September last year, rose from 2.05% at the end of 2008 to almost 4% in early June. This led to a massive steepening of the yield curve as the short end remained relatively unchanged. At the end of May, the US yield curve reached a record steepness of 275 bps.⁴ TIPS yields were fairly flat on the quarter. In Europe, the yield curve also steepened, but not as much. While this is good news for ailing banks⁵, it also points to concerns about a possible oversupply of government bonds and about the potential exit of central banks from various unorthodox programmes.

Figure 1: US yield curve steepened massively



Source: Bloomberg. Time period analysed: January 1980 to June 2009.

At the end of May the US yield curve reached record steepness

¹ MSCI World (in LC)

² MSCI Emerging Markets Index (in USD)

³ Bloomberg (generic oil future CL1).

⁴ 10-year UST – 2-year UST

⁵ Banks typically benefit from steep yield curves as they lend at longer maturities and take deposits on shorter maturities

The global economy has stabilised somewhat...

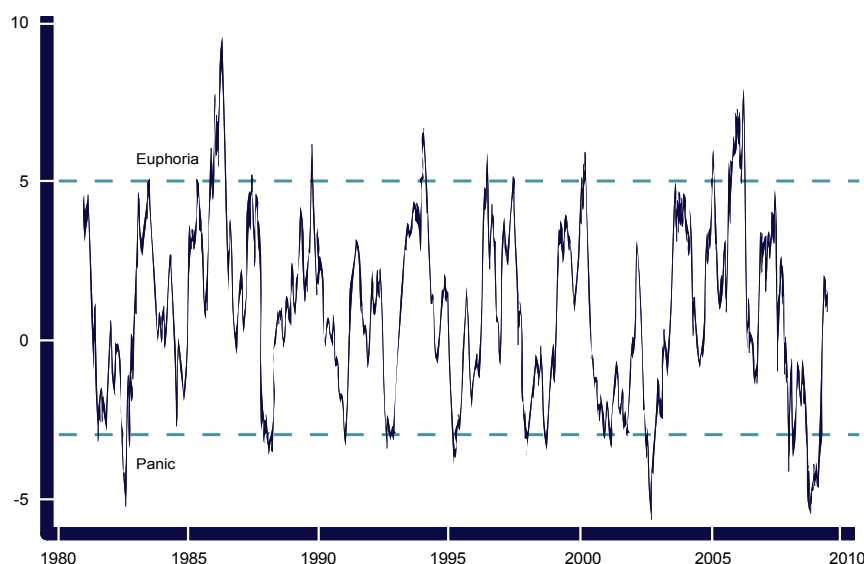
...thanks to massive stimulus

After contracting sharply in the three quarters ended March, there are indications that the global economic activity stabilised somewhat in Q2. While most of the news is still negative, leading indicators such as consumer confidence show signs of a slight rebound from ultra-depressed levels. That has stimulated talk of 'green shoots' or an improvement of the second derivative (i.e. things are still getting worse, but less quickly). Moreover, the large fiscal stimulus packages seem to be taking effect. This is most pronounced in China where the economy appears to have digested the collapse in the export sector surprisingly well. In the year to June, fixed investment surged by 35%, car sales rose by 48% and purchases of homes by more than 80%.⁶ This surge in domestic demand has been supported by direct stimulus spending as well as government encouragement of massive new lending by banks. Other large emerging markets such as India and Brazil have also displayed startling resilience. Whether this is sustainable remains to be seen, but so far it has helped to alleviate the freefall. Various other government policy measures have also helped as systemic risk in the banking sector has been reduced significantly. This is perhaps most evident in the quick narrowing of the TED spread which can be viewed as a 'fear barometer' in the interbank market.⁷

Hedge funds are back on track

Hedge funds are back on track. Broad hedge fund indices enjoyed its best quarterly returns since Q1 2000 in the wake of much improved liquidity, higher risk appetite (see chart) and tailwinds from credit, equity and commodity markets.

Figure 2: Risk appetite improved



Source: Credit Suisse. Time period analysed: January 1981 to 16 July 2009.

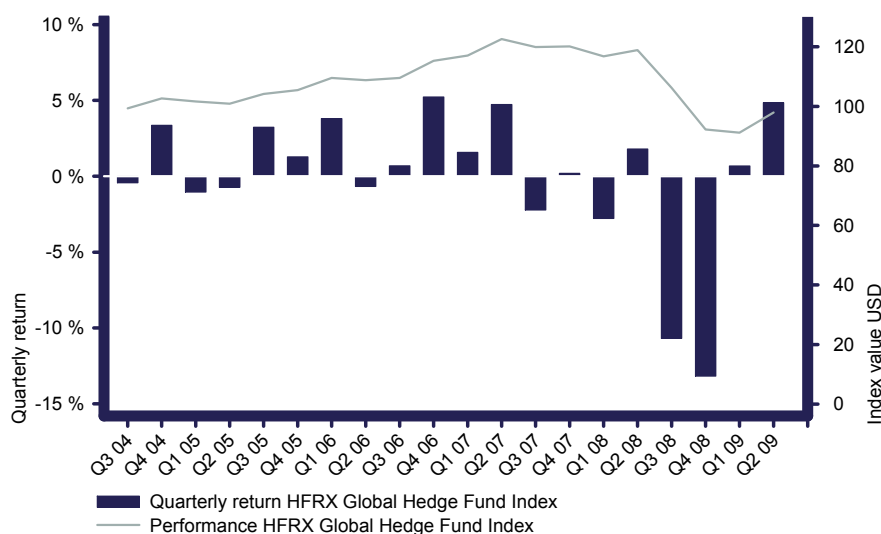
⁶ Bloomberg

⁷ The TED spread measures the difference between 3-month LIBOR and 3-month T-Bill

Last year's laggards are this year's gainers and vice versa

The HFRX Global Hedge Fund Index gained 4.85% (YTD 5.56%).⁸ Strong performance was recorded across all styles and strategies except for managed futures. Convertible bond arbitrage was the best performing strategy again, benefiting from further credit spread tightening and more normal liquidity. CTAs lagged due to frequent trend reversals in currencies and fixed income markets. Interestingly, the gains were led by strategies that have struggled in the recent past and vice versa.

Figure 3: Hedge funds are back on track



Source: Hedge Fund Research, Inc. Time period analysed: 1 July 2004 to 30 June 2009.

Liquidity has improved in most markets...

...and funds which imposed redemption restrictions have not been penalised

This quarter has confirmed that the hedge fund market has not only stabilised, but is now showing signs of real improvement. Figures from Hedge Fund Research, Inc. show redemptions slowed to USD 42.8 billion in the quarter, compared to USD 103.2 billion in Q1 and a whopping USD 154.4 billion in Q4 2008. Many funds are seeing net subscriptions for the first time since Q3 2008. Overall, industry assets under management rose by USD 98.9 billion, or 7.4%, to USD 1.4 trillion. For a variety of reasons, many hedge funds are now less constrained by the de-leveraging process and are able to redeploy risk. Those that still hold illiquid positions have been able to reduce their books in most cases and lift previously instituted gates or suspensions sooner than expected. The thawing of capital markets has been most evident in credit markets and convertible bonds where strong demand from long only and cross-over buyers induced some liquidity and lifted prices from extremely oversold levels. Interestingly, it appears that funds which have removed gates have not taken the pounding that people expected. When gating was in full swing the consensus was that gated money would melt away quickly when the gates were removed. In fact, this seems not to have happened.

⁸ Hedge Fund Research, Inc.

Equity hedge benefited from emerging markets

Equity hedge managers made good profits during Q2. The HFRX Equity Hedge Index gained 5.16% (YTD 5.97%).⁹ The broad rally in global equity markets in April and May that lifted most indices into positive territory for the year was clearly helpful. As in Q1, emerging markets strongly outperformed developed markets.¹⁰ The Indian stock market shot out the lights after a very favourable election outcome and rose almost 60% during Q2 (YTD 56.72%).¹¹ Hence, managers with (net) long exposures to EM benefited strongly. With the recent strong performance of EM stocks, developing countries' share of worldwide equity value climbed to a record 24%.¹²

There is now clear evidence of 'trading down' as consumer behaviour is shifting

In the US, the quarter began with a very strong continuation of the March relief rally whereby the most depressed stocks rallied the strongest. Toward the end of the quarter, markets became more subdued and leadership shifted to more fundamental stories. The NASDAQ powered ahead with a quarterly gain of 20% (YTD 16.36%), beating the S&P 500 which rose 15.22% (YTD 1.78%).¹³ This indicates that technology stocks were favoured in H1 2009 due to their solid balance sheets and high cash levels compared to the more indebted financial, retail and industrial stocks in the broader markets. The US consumer remains fundamentally weak, as reduced credit availability and continued job losses weigh on the willingness and ability to spend. Moreover, we can clearly see evidence of 'trading down' as high-end market sales decline considerably more than the rest.¹⁴ Some equity hedge managers were able to benefit from this. For the quarter, value stocks globally strongly outperformed the broader markets with a gain of 38% (versus 20%).¹⁵ Overall, equity hedge managers with a focus on emerging markets benefited most while funds that had low net exposure and/or were betting on more defensive names/sectors underperformed.

Relative value benefited hugely from the market environment in Q2

Relative value funds rose strongly. The HFRX Relative Value Arbitrage Index gained 14.59% (YTD 16.26%).¹⁶ The market environment in Q2 allowed managers to significantly lighten up liquidity seeking portfolios. Convertible bond arbitrage continued its recent strong streak and returned 10.06% (YTD 20.44%).¹⁷ Convertible bonds continued to benefit from improved liquidity as outright and cross-over buyers stepped in as bargain hunters. Tightening credit spreads and the revival of the primary market also helped performance. Many companies took advantage of the improved market sentiment to refinance themselves, with straight bonds and convertibles being their preferred route. In Europe, issuance during the first half of 2009 alone exceeded the level seen in 2008, while in the US the primary market was also very active. Most convertibles were issued with attractive terms, with measures such as cheapness in new issues reaching a 10-year high.

⁹ Hedge Fund Research, Inc.

¹⁰ MSCI World Index (in LC): Q2 15.47%, YTD 3.21% / MSCI Emerging Markets Index (in USD): Q2 34.73%, YTD 36.01%

¹¹ MSCI India

¹² MSCI Emerging Market Index as % of MSCI World Index

¹³ Bloomberg

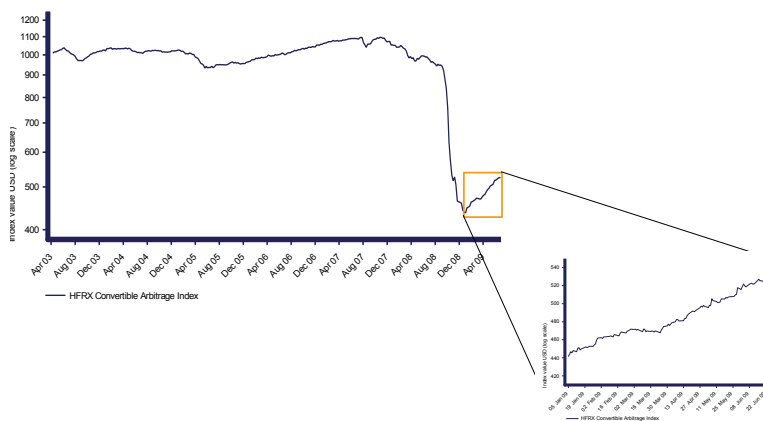
¹⁴ According to the International Council of Shopping Centers, US same store sales (excluding Wal-Mart) fell 5.1% y/y in May. Every retail sector posted weaker sales with the exception of drug stores, a classic staple, which saw sales increase 2.2% y/y. In a sign of how the US consumer is shunning the high end market, the declines were led by sales at luxury department stores, which posted a 12.2% y/y drop.

¹⁵ MSCI World Value Index versus MSCI World Index

¹⁶ Hedge Fund Research, Inc.

¹⁷ HFRX Convertible Arbitrage Index

Figure 4: HFRX Convertible Bond Arbitrage picked up again from a very low level



Source: Hedge Fund Research, Inc. Time period analysed: 1 April 2003 to 30 June 2009.

Convertibles are not nearly as cheap as earlier in the year

The market is no longer as theoretically cheap as it was earlier in the year and therefore less attractive for hedge funds. In June new issues were priced at average cheapness of only 3.9% which was the first month since September 2008 to dip below 4%. By comparison, YTD new issues had been priced between 4-5% cheapness. Another sign of caution is the narrowing spread between 90-day realised volatility and the implied volatility in convertibles. This spread was as high as 50 bps in Q4 2008 but fell to 26 bps in June from 30 bps in May.¹⁸

Credit RV and multi-strategy managers benefited from a general richening of underpriced assets

Relative value funds also benefited from the normalising CDS-bond basis relationships. While the basis is still wider than pre-crisis levels, a large portion of the price anomalies between cash bonds and CDS have been erased. A steep yield curve and improved access to leverage make negative basis trades cheaper to implement. At the same time, investors continue to pour money into cash bonds which further narrows the basis. GM's Chapter 11 filing was highly beneficial for basis traders as it served as a catalyst for the CDS/bond basis to collapse. Multi-strategy managers were mostly profitable as various mispricings converged and there was a general richening of underpriced assets. Key drivers were converts, CDS-basis trades, equity arbitrage and credit. The near universal positive performance suggests that recent results are more a reflection of asset reflation than any particular manager skill.

Event driven also benefited from 'Mr Market'

Event driven managers also benefited from 'Mr Market'. Stronger equity and corporate credit markets led to solid gains for most managers. Distressed managers enjoyed the continuation of the credit rally that began earlier in the year. Both high yield bonds and leveraged loans rose over 18% (YTD 27.22% and 27.10% respectively).¹⁹ There was a high volume of new issuances²⁰ in high yield as well as significant inflows.²¹ Credit spreads tightened by 517 bps (YTD 728 bps) to 978 bps. This is somewhat surprising

¹⁸ Man Investments relative value research

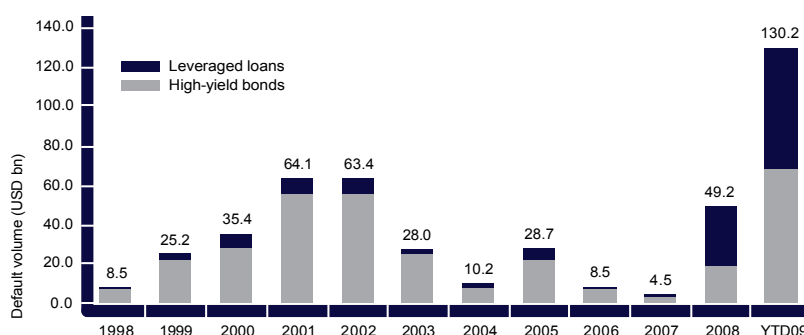
¹⁹ Credit Suisse High Yield Index and Credit Suisse Leveraged Loan Index

²⁰ New HY issuances Q2: USD 43.9 billion according to Credit Suisse

²¹ HY inflows Q2: USD 6.4 billion according to Credit Suisse

considering the rapidly rising default rate. Q2 included some high profile bankruptcies such as General Motors, Chrysler, RH Donnelley, Abitibi-Bowater and Six Flags. YTD 76 companies have defaulted for a record high USD 130.2 billion.²² For bonds, the par-weighted default rate rose to 8.63% and 11.02% for loans.²³ Recovery rates continue to come in lower than historical averages, as was broadly expected.

Figure 5: Default volume reached new high



Source: JP Morgan, S&P LCD. Note. Includes grace-period defaults. Time period analysed: January 1998 to 30 June 2009.

The distressed cycle is now in full swing

Most distressed managers were able to benefit from the large rally in credit but significantly underperformed long only high yield and leveraged loan indices. This can be explained by the rather cautious positioning, high cash levels and the impact of hedging. Moreover, several distressed funds still hold sizable illiquid legacy positions that did not participate in the rally. For distressed managers, the opportunity for H2 2009 and 2010 lies in mortgages, bankrupt corporate debt and capital restructurings. Many pundits consider securitisations of residential mortgages to be furthest advanced in the distressed cycle as they were the first to correct back in 2007. Commercial mortgages, on the other hand, are still in the early stages of the distressed cycle.

Merger arbitrage has been quiet as of late

Special situations and merger arbitrageurs had a rather quiet quarter. The YoY value of global M&A fell by 35% in H1 2009 to USD 1,140 billion, according to Dealogic. There have been a few interesting strategic M&A deals such as Wyeth/Pfizer, Schering Plough/Merck and Oracle/Sun Microsystems. A popular position for managers was in Liberty Media, as the company announced the restructuring of its complex holdings and the combination of some activities with one of its subsidiaries, DirecTV.

²² JPM Default Monitor, includes both bonds and loans

²³ JPM Default Monitor

Global macro managers shifted from recessionary to recovery trades

Global macro managers had good results. Increased speculation that the worst of the economic downturn may be over led many managers to shift from recessionary to recovery trades which generated good performance. However, most managers were positioned rather cautiously and big bets were rare. The opportunity was mostly in short-term tactical trading ideas. In fixed income, government bonds came under pressure as risk appetite returned and yields rose from extremely low levels. This led to a steepening yield curve, particularly in the US, as illustrated in figure 1. Many macro managers were anticipating a steepening and hence benefited.

Currency trading was difficult

Currencies proved to be the most difficult asset class to trade for global macro managers. Some managers lost money in options strategies as volatility declined. Others were hit by shorting the 'carry' currencies which outperformed. The weakening USD helped most managers throughout April and May but led to losses in June as the trend reversed. YTD, the US dollar is only marginally in the red.²⁴ Widely held EM currencies appreciated against the USD on the back of increasing risk appetite, rising commodity prices as well as the re-visited concept of a medium to long-term possible decoupling. Brazil is a good illustration here as the Brazilian real rose over 15% (YTD 15.67) against the USD.²⁵

Deflation or inflation that is the question

In keeping with the 'risk on' environment, reflation trades tended to perform in Q2. Although inflation has declined sharply in recent months and is now negative in some countries, inflation expectations, as measured by the difference between nominal and inflation-protected bond yields, rose close to pre-Lehman Brothers collapse levels. These rising inflation expectations may simply be a reflection of core inflation in the US that is still 1.9%, only slightly below its peak of 2.5% last summer. On the other hand, as major central banks have started to purchase assets with freshly-printed money in order to lower long-term interest rates and credit spreads for mortgages, markets may be registering concern over the inflationary implications of these strategies.²⁶ So far the net result on treasury rates has been somewhat negative, as rising inflation expectations have overwhelmed small declines in TIPS yields. How central banks navigate the inevitable dilemmas these policies create, including choosing the appropriate moment to exit these measures, will be key determinates of future market conditions. While this situation potentially creates large opportunities for macro traders, most managers are currently not taking a view in either direction.

²⁴ USD Trade-Weighted Index Q1: +4.81%, Q2: -6.64%, YTD -2.15%

²⁵ Bloomberg

²⁶ These policies are referred to as credit easing or quantitative easing and are currently employed by the US, UK, Euro zone, Japan, Sweden and Switzerland (list not mutually exclusive)

EM assets received a boost from the G20 summit...

...and even fundamentally weak countries rallied

There is no consensus on market direction

Commodities performed well, especially oil...

...but natural gas suffered...

...as did agricultural

Emerging markets delivered solid gains in equities, bonds and FX. The decision from the G20 summit in London at the beginning of April to substantially increase IMF resources provided a massive confidence boost in EM fundamentals and nearly all EM assets rallied substantially until mid-June. Emerging market bonds returned 9.95% (YTD 12.71%).²⁷ Some managers benefited from strong returns in the lower quality segment such as the Ukraine, Venezuela and Argentina which rallied strongly.²⁸ While most central banks in developed countries have exhausted their conventional monetary policies, EM central banks are still employing traditional monetary easing. This was anticipated by many managers which benefited from long bond positions. It is commonly believed that the EM easing cycle is drawing to a close and profits have been taken in most cases.

Overall, managers continue to focus on liquidity and maintain a cautious and tactical approach to risk as we enter the quiet and less liquid summer months. There is no consensus as to market direction and most global macro and emerging market managers are prepared to participate wherever there is opportunity and volatility.

Commodities also did well during Q2, most notably crude oil which rose over 40% (YTD 56.70%)²⁹ to around USD 70 per barrel. Oil prices have been trading in an unusually strong positive correlation with equity markets over the past few months on hopes that signs of an economic recovery could mean a boost for energy demand. Moreover, investor appetite has recovered strongly and the AUM of commodity ETFs now exceeds the highs of 2008 despite lower prices. Another driver of commodity prices was the global restocking and the Chinese stimulus package which particularly helped base metals. Equity focused managers took advantage of the strong rally in nearly all natural resource stocks. Managers that are more active in the futures and derivatives markets also made gains.

In contrast to oil, natural gas was very weak. This perhaps illustrates the main difference between oil and gas. While oil is a truly global commodity, natural gas is local, with the most heavily traded nat gas being Henry Hub in the US. Hence, the falling demand for gas in the US was not offset by other regions (like in the oil market).³⁰ Both electricity generation and industrial demand has been significantly lower due to the recession in the States.

The agricultural sector has been the worst performing complex during Q2. Corn was particularly weak and fell to an eight-month low at the end of June. Grain prices have been trending down as the market sheds its weather premium, given the favourable growing conditions in the US wheat and corn belts. The grain market was also dampened by a US congressional report recommending tighter restrictions on commodity index traders and excessive speculation.³¹ The best performers among softs were soybeans and sugar. While soybeans profited from Chinese stock building, sugar prices were lifted higher by dim prospects of the harvest in India.

²⁷ JPM EMBI+ Index in USD

²⁸ The single B segment rose 69.36% (YTD 68.26%)

²⁹ Bloomberg (generic oil future CL1)

³⁰ In the US, demand is expected to decline by 2% in 2009 and remain flat in 2010 while production continues to be strong despite lower prices, according to Deutsche Bank Commodity Quarterly. These estimates assume 'normal' weather.

³¹ The Commodity Futures Trading Commission will hold hearings during July and August 2009 to explore the need for government-imposed restrictions on speculative trading in oil, gas and other energy markets.

CTAs hurt by trend reversals and directionless moves

Managed futures struggled. The CS/Tremont Managed Futures Index lost -4.70% (YTD -6.47%).³² The main problems were directionless moves (see figure 6) or frequent trend reversals (see figure 7). The majority of the losses came from currencies and fixed income markets where a multitude of factors saw sustained periods of whipsawing movements and significant trend reversals.

Euro-Bunds illustrate the directionless moves

Trading in US Treasuries, Japanese government bonds and Euro-Bunds were the three largest detractors to performance in bond trading as prices shifted heavily, causing positions to whipsaw. The price swings were linked to a number of factors including central bank intervention, yo-yoing concerns between deflation and inflation and record government issuance. These gyrations developed with little directionality as can be seen in the next figure. The clearest example could be seen in Euro-Bunds (German government bonds) where long positions in the final quarter of 2008 proved highly profitable. Since then, prices have been trading sideways which has led to losses for CTAs.

Figure 6: Euro-Bund yields displayed directionless move in H1 2009



Source: Bloomberg. Time period analysed: 1 July 2008 to 30 June 2009.

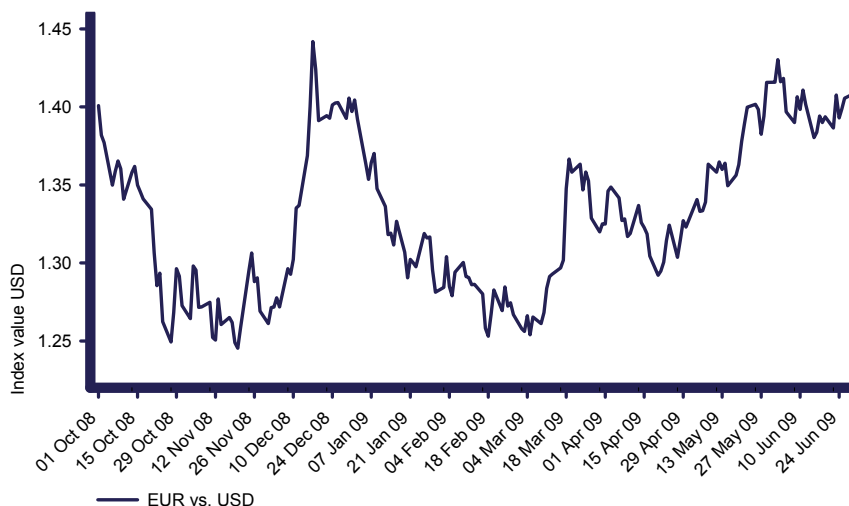
Currency markets have also been damaging as the USD weakened on the back of renewed risk appetite. This happened after a relative strengthening in Q1.³³ An example of frequent trend reversals is displayed in the next figure with the example of the EUR/USD exchange rate.

³² CS/Tremont

³³ The USD Trade-Weighted Index was up 4.81% in Q1 and down -6.64% in Q2 (Bloomberg: USTW\$ Index).

Figure 7: Frequent trend reversals (e.g. EUR/USD)

Frequent trends reversals like in EUR / USD have led to losses



Source: Bloomberg. Time period analysed: 1 October 2008 to 30 June 2009.

Taking whipsawing markets into consideration, it is not surprising that managed futures corrected. This drawdown has to be seen in the context of last year's gains. During most of 2008 financial markets presented an excellent environment for CTAs due to large directional moves and little counter moves or whipsaws. This year, however, has been a different story, as we described. On a positive note, the drawdown has been somewhat contained due to the relatively smaller position sizes, as CTAs tend to reduce positions during heightened volatility.

Special topic: hedge funds after the storm

Transparency, liquidity, security and control of assets are top concerns

Introduction

There is no doubt that hedge funds delivered disappointing numbers in 2008. The fact that hedge funds were neither the centre nor cause of the crisis and still outperformed equity markets by a wide margin offers little solace. Besides dismal performance, liquidity, or lack thereof, was a centre point over the last three quarters. Many hedge funds had to take unpopular measures such as gating, side-pocketing or suspending redemptions altogether. In most cases, this was justified by market developments and served the interest of investors. Nonetheless, it became clear just how many funds had piled up illiquid assets over the years. There are probably three key areas that investors insist on after their experiences last year: transparency, liquidity and asset control. In this special topic section we highlight the recent developments and current state of the hedge fund industry. We focus on liquidity, leverage, prime brokers, regulation, terms, and transparency/asset control through managed accounts.

Liquidity has many different faces...

The elusive liquidity premium³⁴

An extensive and still growing body of research³⁵ suggests that illiquidity constitutes an additional factor in determining expected returns. The common reasoning is that trading in illiquid markets involves additional risks and, as compensation for these risks, investors demand a liquidity discount on prices or, equivalently, a liquidity premium on expected returns. Consequently, in illiquid markets, expected returns do not only reflect the traditional risk premium (commonly referred to as beta) but also a liquidity premium (commonly referred to as alternative beta or sometimes alpha). Market liquidity is an elusive concept, however. Generally, it refers to the ease with which assets can be traded among investors. In detail, it covers several dimensions, such as depth, tightness and immediacy³⁶, and how these dimensions interact with each other and can be themselves a source of risk. The obvious question that comes to mind is: Why have so many hedge funds ventured into illiquid strategies and is there really a liquidity premium?

...e.g. it constitutes a non-traditional risk premium

Many hedge funds have gone 'off-piste' and piled up illiquid holding over the years

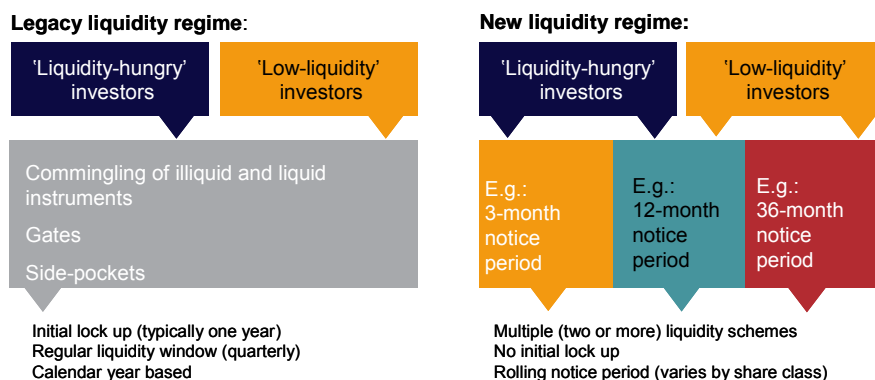
The private equity industry has capitalised on the liquidity premium for a long time. Over the last few years, some hedge funds have increasingly gone 'off piste' and purchased less liquid securities with the goal of reaping this liquidity premium and thus earn a higher risk-adjusted return. Others sought to diversify and/or exploit new opportunities in booming markets such as credit derivatives, asset-backed securities or non-public equities. This has stimulated talk about the increasing convergence between private equity and hedge funds. As a result, analysing liquidity risk will be a crucial point when doing due diligence going forward.

³⁴ We use the terms liquidity premium and liquidity costs synonymously to the just as commonly used terms illiquidity premium and illiquidity costs.

³⁵ E.g. Amihud and Mendelson (1986) or Acharya and Pedersen (2005) among others.

³⁶ Depth refers to a large number of market participants and high trading volume at all times, i.e. G7 FX, tightness is the opposite, and immediacy means the sense of urgency, i.e. how quickly a security can be sold without a fire sale.

Figure 8: Investor liquidity profile has to be aligned to the liquidity of the underlying strategy



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009.

Global macro was not as liquid as perceived

Can the true liquidity of an asset always be assessed beforehand? This is an important issue as, in retrospect, it is now clear that many funds underestimated their liquidity in a crisis. It was always evident that some strategies, such as distressed, were highly illiquid. In contrast, global macro was thought of as fairly liquid but some were clearly not as liquid as they needed to be in the second half of 2008.

➔ *Going forward, we expect a much clearer distinction between liquid and illiquid hedge fund strategies. Investors can then choose to accept or forgo the liquidity premium according to their preferences. Nevertheless, we think that there is a liquidity premium to be earned on illiquid strategies. However, investors have to keep in mind that even with stress testing and simulations, the actual liquidity in a crisis may disappear even for strategies that are liquid 'under normal market conditions', as became evident last year.*

Hedge funds are restructuring liquidity terms...

As we addressed earlier, we currently see a decrease in the number of funds that are gated, suspended or side-pocketing. We estimate that between 10% and 20% of all hedge funds are currently applying one of these measures. The most pronounced improvement has been in global macro. In event driven and relative value the percentage remains fairly high.³⁷ Many funds are now restructuring their liquidity terms as these are no longer dictated by supply and demand but rather by what is appropriate for each strategy. On a positive note, there are also funds that are changing liquidity terms in favour of investors. During the boom years, a number of hedge funds were able to dictate liquidity terms which often did not reflect the liquidity of the underlying assets but rather constituted a quality premium. We would like to emphasise that investors are cognisant that certain strategies do require longer notice periods, gate provisions, or some form of lock-up period, and many investors are explicitly dedicating a portion of their portfolios to such investments. On the other hand, they are also pushing for higher liquidity in liquid strategies.

...and the distinction between liquid and illiquid funds will become easier

³⁷ Man Investments

There will still be leverage...

...but not for illiquid strategies

Prime brokers are classic leverage (and service) providers to hedge funds

Counterparty risk is still the number one concern

Leverage works both ways

Leverage is perhaps one of the most hotly discussed topics when it comes to hedge funds. Most single hedge funds and fund of hedge funds (FoHFs) use some form of borrowed capital to purchase assets, increase the expected return or create an investment product. We think that most hedge funds have used leverage responsively and quickly de-levered when their asset values shrunk. However, we also think that sporadically, leverage was overused and some funds were too slow in reducing it. The issue was not so much the actual leverage ratio, but rather collapsing liquidity in parts of the capital markets.³⁸ As a result, the main problem has been leverage in illiquid holdings. Often these holdings were perceived to have little investment risk and high Sharpe ratios. Leveraged loans or MBS, for example, produced steady returns during 2002-2007. Hence, a portfolio of such securities was not considered particularly risky and was able to receive a fair amount of leverage.

Besides coordinating the valuation of hedge fund assets, prime brokers are the classic leverage providers to hedge funds. In addition, they frequently offer various services such as infrastructure support, credit lines, custody of assets, and act as counterparty for various OTC derivative transactions. As most prime brokers are also investment banks they had to reduce their leverage. This means that going forward, the leverage they provide to hedge funds will be more difficult to obtain and pricier. The good news is that for the time being hedge funds will be less dependent on leverage to generate attractive returns as risk premiums are still very high across many asset classes.

Results from a recent survey³⁹ indicate that counterparty risk is still the number one reason for terminating a prime broker relationship. To address this concern, prime brokers are increasingly offering special purpose vehicles to mitigate such risks. Examples include bankruptcy remote vehicles whereby the hedge fund's assets would not be affected by the broker's failure. Other important criteria are:

- Safety of assets in custody with prime broker
- Client service capabilities
- Reputation of prime broker
- Competitiveness of financing rates
- Ability to obtain hard to borrow securities
- Access to balance sheet
- Competitiveness of rebates and fees
- Trading capabilities

As seen in the next figure, leverage used by hedge funds decreased over 2008, but rose slightly in H1 2009. Multi-strategy hedge funds continue to have higher leverage than others, as they run more diversified portfolios. This can be seen in the context of growing risk appetite and an easing of redemption pressures.

³⁸ E.g. convertible bonds, leveraged loans, EM corporate credit, ABS, MBS and other exotic instruments.

³⁹ 2009 Global Custodian

Figure 9: Leverage applied by hedge funds⁴⁰

Hedge fund strategy	Year end 2007	Year end 2008	June 2009
Overall book	2.9	2.0	2.5
Long short equity	2.4	1.8	2.1
Multi-Strategy	3.5	3.0	3.5

Source: Credit Suisse Prime Brokerage Client Base, June 2009.

➔ *We think this is over now and sizable leverage will only be given to liquid portfolios. Moreover, leverage will be more expensive and harder to come by. Nonetheless, leverage will still be a part of the hedge fund industry. When managed carefully, it can lead to superior outcomes. Moreover, leverage to hedge funds (and hedge fund investment products) will be more straight forward as hedge fund product structures are being simplified with reduced layers. Furthermore, loan-to-value (LTV) ratios have declined considerably⁴¹ and the cost of leverage is higher.⁴²*

Operational improvements and more investor-friendly terms

Besides the aforementioned changes in the hedge fund industry and as a reaction to the events of 2008, investors are understandably placing more emphasis on the separation of investment management and administrative duties. Possible areas of improvements are shown below:

Figure 10: Operational improvements for hedge funds

Operational improvements	Key points
Third party valuation	Allows for a reconciliation between in-house and external NAV calculations
More frequent price publication	Liquid and transparent hedge funds may opt for offering more frequent price publication, often weekly or even daily
Managed accounts	Legal ownership, segregation, transparency and risk management
Multiple prime brokers	Diversification of counter-party risk
Third party custody	Significant reduction of fraud risk

Source: Man Investments.

⁴⁰ There are many definitions of leverage. This measure refers only to assets held at Credit Suisse as a prime broker and thus does not reflect hedge fund clients' total leverage which may deviate from this. In the given example, the current leverage of 2.5 for the overall book indicates that for every USD 100 of equity, hedge fund clients have USD 250 of gross market value exposure (long and short).

⁴¹ Banks that previously offered LTV of 75% are now offering 55-60%

⁴² Prime brokers that previously offered Libor+100 can now charge Libor+300-400

We should see a major shift towards more investor-friendly terms

Regarding terms, we should see a major shift towards more investor-friendly terms and structures. Currently, many hedge funds are taking a proactive stance with the goal of gaining market share once inflows pick up. Large institutional investors like CALPERS⁴³ set the tone earlier this year, saying they intend to review their relationship with hedge fund managers. Besides the already mentioned areas of transparency, liquidity, operational improvements and asset control, CALPERS is also demanding a better alignment of interests between the hedge fund and its clients.

*'Fees should be based on long-term rather than short-term performance. The present model provides the possibility of a hedge fund manager realising a 20% performance fee at the end of a bonanza year. If the fund suffers a significant decline the next year, the manager could still have a large net gain at the end of the two years, but the investor may break even or even lose money.'*⁴⁴

Investors will demand better alignment of interest

We do not believe that one single fee model will apply to all hedge funds. After all, hedge funds are private investor pools and subject to supply and demand. We believe that investors are likely to benefit from this discussion overall since the industry has become a buyer's market. In this setting, there will be strong performing funds that are able to maintain the classic fee model while others will lower fees and/or improve terms to attract new inflows. As a general trend we think that institutional investors will put more emphasis on the alignment of interest between the manager and the investor. As a consequence, there could be a variety of potential fee/incentive structures. While the management fee model should be more reflective of the complexity of the strategy, performance fees could be linked to specific hurdle rates such as the risk-free interest rate or an absolute hurdle. Another discussion point could be delayed pay-out of performance fees upon realisation, i.e. similar to the fee model applied to private equity investments. And last but not least liquidity terms should be better aligned with the liquidity of the underlying assets.

The importance of being transparent

Transparency has become a key criterion

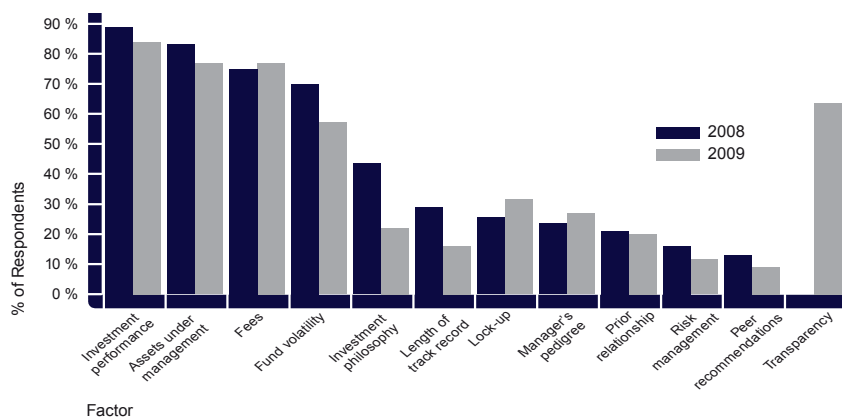
As a result of the events in 2008, hedge fund investors have started to ask for more control over their hedge fund assets. Also, transparency has become a key criterion. A recent survey conducted by Deutsche Bank shows that transparency has become one of the top five criteria for selecting a hedge fund manager. While transparency can have several different meanings, it generally entails the concept of 'look through'. Look through refers to either position, process or risk transparency.⁴⁵

⁴³ California Public Employees' Retirement System

⁴⁴ Abstract from the CALPERS 27 March 2009 press release (calpers.ca.gov).

⁴⁵ Position transparency: All single positions are disclosed/process transparency: whole investment process is disclosed, e.g. asset allocation, portfolio construction etc/risk transparency: provides an aggregated view on portfolio and aims to detect 'hidden' risks that cannot be seen from single positions.

Figure 11: Comparison of most important factors when assessing a hedge fund



Source: Deutsche Bank, Alternative Investment Survey, February 2009.

The MAC is owned and controlled by the investor but managed by the hedge fund

As a result of this increased demand for transparency and asset control, investors have started to ask more for hedge fund investments through managed accounts. A managed account (MAC) is an investment structure that is owned or controlled by the investor but mirrors the strategy of an existing hedge fund. A robust MAC will typically include an independent board of directors and a network of contractual relationships between the MAC and its trading counterparties and service providers.

The basic steps required to establish a MAC include:

- Investment Management Agreement (IMA)
- Bank and prime brokerage agreements
- Transaction agreements including ISDA⁴⁶ and ISMA⁴⁷ agreements
- Administrator service agreement

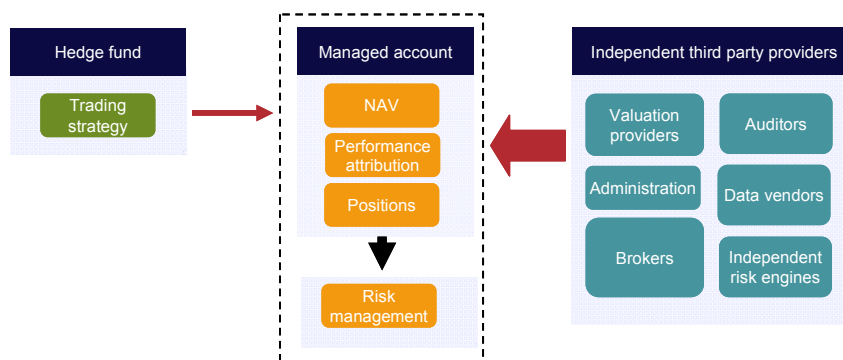
Benefits of MACs

While MAC structures differ from investor to investor, the central premise remains the same: investors can benefit from additional control and transparency. As the diagram below shows, the investment manager agrees commercial and legal terms with the MAC. Managers are responsible for trading the strategy within the agreed terms.

⁴⁶ ISDA: International Swaps and Derivatives Association

⁴⁷ ISMA: International Securities Market Association

Figure 12: A simple MAC structure



Source: Man Investments. Diagram shows simplified MAC structure.

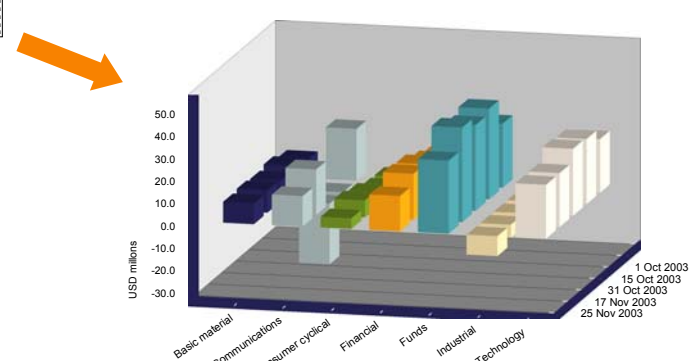
The key benefits to the investor are:

- Position level transparency available on a daily, weekly or monthly basis (particularly important to institutions looking to manage their exposure across multiple portfolios)
- Daily P&L reports, including total and individual P&L, aggregated accounts by positions, regions, currencies and securities exposure, data delivered at various levels of transparency
- Ability to customise investment and risk guidelines
- Operational control
- Counterparty and service provider selection
- Enhanced risk and cash management
- Segregated assets – no cross liability with other entities
- Assets are placed in approved custodian accounts and in the investor's name

In short, investors gain the ability to tailor their investment programme and receive enhanced liquidity. In addition, they can have the ability to adjust leverage, change the liquidity profile of the investment and adjust instruments and trades as agreed between the parties. Investors also gain additional business and risk transparency because they should have direct contact with all service providers and counterparties. Furthermore, in a worst case scenario, the investor can terminate the MAC within 24 hours and transfer the positions to another hedge fund manager who then liquidates the positions on the investor's behalf.

Figure 13: Example of how single positions are aggregated to reflect sector exposure

ISIN	Instrument	Sector	Instrument Type	Instrument Type Description	E	Value (USD)		Local Currency	
						Value	Vol	Value	Vol
0000000000	CASH - US DOLLAR	CASH	CASH	CASH	C	0.00	0.00	-7594.00	-7594.00
0000000000	CASH - EURO	CASH	CASH	CASH	C	-297.46	0.00	-297.46	-297.46
0000000000	CASH - BRITISH POUND	CASH	CASH	CASH	C	16105.75	0.00	16105.75	16105.75
0000000000	CASH - US DOLLAR	CASH	CASH	CASH	C	0.00	0.00	1421.96	1421.96
0000000000	WMT CASH 10 EURO INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	2591.00	EUR 1000.00	7.00	EUR 1000.00
0000000000	WMT CASH 10 EURO INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	2778.00	EUR 1000.00	2.00	EUR 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	3708.00	EUR 1000.00	5.00	EUR 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	4242.00	GBP 1000.00	1.00	GBP 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	111.00	EUR 1000.00	0.00	EUR 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	188.50	EUR 1000.00	0.00	EUR 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	113.51	USD 1000.00	4.00	USD 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	8027.50	EUR 1000.00	2.00	EUR 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	4950.00	CHF 1000.00	-1.00	CHF 1000.00
0000000000	ESR S&P 500 INDEX FUTURE	FUTR	COMFUT	COMMODITY - FUTURE	GC	910.00	AUD 1000.00	-1.00	AUD 1000.00
0000000000	UNILEVER NLDX	STOCK	EQUITY	EQUITY - LISTED	O	82.00	EUR 1000.00	0.00	EUR 1000.00
0000000000	UNILEVER NLDX	STOCK	EQUITY	EQUITY - LISTED	O	46.00	EUR 1000.00	2370.00	EUR 1000.00
0000000000	AMEREN LTD (NYSE FULLY PAID	STOCK	EQUITY	EQUITY - LISTED	O	8.16	USD 1000.00	47346.00	464746.00
0000000000	AMEREN LTD (NYSE FULLY PAID	STOCK	EQUITY	EQUITY - LISTED	O	12.00	USD 1000.00	2702.00	26712.00
0000000000	BHP BILLITON LTD	STOCK	EQUITY	EQUITY - LISTED	O	8.07	USD 1000.00	38170.00	348467.00
0000000000	BHP BILLITON LTD	STOCK	EQUITY	EQUITY - LISTED	O	6.00	USD 1000.00	2702.00	26712.00
0000000000	BHP STEEL LTD	STOCK	EQUITY	EQUITY - LISTED	O	2.80	USD 1000.00	9200.00	26712.00
0000000000	BHP STEEL LTD	STOCK	EQUITY	EQUITY - LISTED	O	2.00	USD 1000.00	0.00	0.00
0000000000	MINERALS AUSTRALIA GROUP LTD	STOCK	EQUITY	EQUITY - LISTED	O	1.20	USD 1000.00	43230.00	50770.00
0000000000	MINERALS AUSTRALIA GROUP LTD	STOCK	EQUITY	EQUITY - LISTED	O	6.00	USD 1000.00	6100.00	5400.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	1.00	USD 1000.00	-1215.00	-921.40
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	1.70	USD 1000.00	-16540.00	-14655.11
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	33.00	USD 1000.00	4100.00	27940.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	33.00	EUR 1000.00	4900.00	27940.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	140.00	EUR 1000.00	-49.00	-370.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	1.70	EUR 1000.00	4900.00	27940.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	1.00	EUR 1000.00	-1500.00	-1000.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	1.20	EUR 1000.00	1870.00	1870.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	15.00	EUR 1000.00	3000.00	3000.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	15.00	EUR 1000.00	-1500.00	-1500.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	42.00	EUR 1000.00	-2100.00	-2100.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	1.00	EUR 1000.00	0.00	0.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	24.00	EUR 1000.00	0.00	-2400.00
0000000000	OMERON LTD	STOCK	EQUITY	EQUITY - LISTED	O	15.00	EUR 1000.00	4500.00	4500.00



Source: Man Investments, schematic illustration only.

Limits of MACs

MACs do, however, have some limitations. For a start, a MAC structure can add between 50 to 100 basis points to the cost of investing in hedge funds as they demand increased services to manage daily data. This charge is typically netted from performance. MACs can also present operational and relationship challenges with the hedge fund managers. Extra resources and effort required by a manager to integrate properly with a potentially new service provider can be demanding. The working relationship between some managers and service providers can be complex as ultimate ownership of the relationship with these service providers rests with the managed account rather than the manager. Hence managed accounts increase the operational burden on hedge fund managers.

Moreover, MACs are not suitable for all trading strategies. Accurate data is difficult to collect on a daily basis and may not be particularly useful from certain hedge funds, such as event driven managers that trade in highly illiquid markets, complicated instruments and hard to price assets. Hence, if there is a gap between the underlying assets in the account and the investor's ability to interpret and act upon the data, the cost of the MAC may outweigh the benefit. As a result, MACs tend to be concentrated in managed futures, long/short equities and other exchange traded strategies that are simpler to operate and manage from an administrative perspective and which allow investors to take advantage of liquidity options.

Economies of scale

MACs require a great deal of administration and monitoring. It is critical that an investor has the know-how and resources to set up and operate the managed account in a way that does not divert the manager from the business of trading. Furthermore, it is

important that the investor receives meaningful data from the manager, as receiving information purely on a position/instruments level does not mean much when the investor cannot see which trades have been set up by the manager. There are resource limits to the number of MACs a manager can effectively operate and it is important for hedge funds to partner with investors who have the right expertise – this often means those at the larger end of the spectrum.

Finally, there is an open question as to the benefits of position level transparency. The amount of data can be overwhelming and many question investors' ability to interpret the data appropriately. Investors hire hedge funds to make investment decisions on their behalf, so creating a mechanism 'to manage the manager' is potentially counterproductive. While investors have started to ask for more managed accounts when investing into hedge funds, let us have a look at how hedge fund managers themselves reacted to these demands.

Managers who suffered huge redemptions are most willing to offer MACs...

As a broad generalisation, managers who suffered huge redemptions last year are most willing to offer MACs as they are seeking inflows to increase their AUM. In this context, it is important to note that it is not necessarily bad performance that led to huge outflows last year. Quite often those managers who did not implement gates or suspensions - i.e. who stayed relatively liquid - were abused as 'ATMs' by investors and became scapegoats for other managers who did suspend redemptions. As a consequence, a manager offering MACs is not by default a 2nd tier manager with regards to performance, as is often thought. Quite the contrary, the fact that these managers were able to meet redemption requests in 2008 when equity and credit markets started to correlate and there was no place to hide shows their investment skill and ability to reduce leverage/risk exposure before it was too late.

...but not all managers will offer them

In the same vein, it is also true that even after the turmoil of 2008 some managers are still not willing to offer MACs. Most of the time, these are managers who suffered the least last year due to acceptable performances with limited redemptions or because they put up gates/suspensions or shifted illiquid assets into side pockets. But there are also managers who simply cannot offer MACs because of the illiquid nature of their strategy, such as managers active in the credit/distressed space, as certain instruments traded such as bank debts are difficult to split into each managed account. In general, it can be said that it is easier for managers to run MACs when they are trading liquid instruments and through exchanges rather than OTC, as valuation is easier for these trades.

MACs provide transparency - liquidity only comes second

While there is a natural bias to run more MACs in liquid strategies, having a MAC for less liquid strategies can also make sense for investors, as this allows them to have full transparency over their investments and investors can control their assets, even though liquidating illiquid positions might take some time. It is important to note that the key benefits of MACs are transparency and control rather than liquidity.

Monitoring slippage of
MACs versus mirror funds is
important

Monitoring slippage⁴⁸ of MACs against their respective funds is very important as the MAC should ideally perform identically to the fund and any variation could be an indication of underlying operational issues. This is most important for liquid strategies such as CTAs and equity hedge, but less relevant for illiquid strategies such as credit/distressed as MAC investors in these strategies often explicitly ask the hedge fund manager to exclude certain illiquid names in the MAC in order to achieve a better liquidity profile.

Transparency and asset
control will drive demand for
MACs

Increasing demand for transparency and control over assets is likely to drive demand for managed accounts in the near future. MACs are powerful instruments of active management, giving professional investors the tools to upgrade their control of risk, returns and the dynamics of allocation, as well as providing important mechanisms to monitor and mitigate operational risk. They may not be for everybody, or useful for all strategies, but for users with the resources and know-how to keep pace with the changes and who can 'read' and understand the powerful data streams they furnish, MACs provide an alternative and potentially powerful route to accessing the expertise of hedge fund managers.

The window of opportunity
is now open

→ *The financial crisis of 2008 and the fraudulent activities at the end of the year have certainly opened up a window of opportunity for funds of hedge funds to negotiate MACs with hedge fund managers. While MACs are an attractive route to invest into hedge funds, we believe that once financial markets pick up again that window of opportunity will get smaller, as hedge fund managers will be less desperate to raise assets. After all, compared to standard fund investments, running a MAC is much more time-intensive for hedge fund managers and thus the less preferred way to manage their assets.*

It is widely acknowledged
that hedge funds were not
the cause of the crisis ...

Regulation is coming

Probably the most important take-away from the events of 2008 was that it was the most heavily regulated sectors of the financial sector, namely banks, that were perceived to have contributed most to the systemic risk. Hedge funds were not the main cause of the crisis and clearly suffered as risk appetite collapsed. According to the IMF, hedge funds accounted for about a tenth of the losses on loans, securitisations, and structured products linked to US residential mortgages. The majority of the losses were incurred by highly regulated financial institutions. Despite this, the current widespread re-drawing of the regulatory landscape is understandably taking in hedge funds as important players across global markets and considering in detail the optimal framework within which they should operate.

... in practice, many hedge
funds operated within a
regulated environment...

In fact, despite the general perception of hedge funds as 'unregulated', in many jurisdictions hedge funds have been operating within a regulated framework for a number of years, through regulation for example of managers, sales processes or products. This regulation has been supplemented in recent years by a number of industry-led initiatives to produce best practice standards to which the industry can adhere, demonstrating a parallel recognition on both sides of the Atlantic of the benefits

⁴⁸ In this case, slippage refers mainly to the difference in performance.

such standards can bring to investors and managers alike.

...and a number of additional initiatives have been brought to the table

In 2007, the Hedge Fund Working Group (HFWG) was set up by 14 leading hedge fund companies based mainly in London as a response to concerns about the industry including financial stability and systemic risk. In early 2008, this group issued a report outlining standards for hedge funds covering five key issues relating to hedge fund practice including disclosure, valuation, risk management, fund governance and shareholder conduct. Since then the Hedge Fund Standards Board (HFSB) was set up to monitor the standards and so far 56 managers have signed up to these standards. Other important examples of such best practice standards include the US Managed Funds Association (MFA) Sound Practices for Hedge Fund Managers, first published in 2005 and most recently updated earlier in March this year to reflect the findings of the US President's Working Group (PWG) Reports; and also the various AIMA best practice guidelines, including most recently the Guide to Sound Practices for Funds of Hedge Funds Managers. The recent G20 report (April 2009) underlined the need for unified best practice standards in the alternative investments industry, and a number of standard-setting organizations (AIMA, HFSB, PWG, MFA) are working together to draw up a combined set of global best practice standards.

Review of the role of hedge funds by international bodies

In the aftermath of the global financial crisis, the role of hedge funds has been assessed by a number of committees and work groups. Both the February 2009 'De Larosière Report' for the European Union and the 'Turner Review' from the FSA in the UK issued in March 2009 concluded that hedge funds were not significant contributors to the financial crisis. The reports also commented that hedge funds typically ran a leverage ratio well below that of banks and that their impact with respect to systemic risk was rather limited. However, the authors did identify a general need for transparency, capital requirements, supervision and international co-ordination.

The EU directive generates a great deal of controversy...

In April this year a draft of the European Commission's proposed directive to regulate alternative investment fund managers was the first attempt to put these concepts into a new framework, but it went further in a number of areas. In doing so, it generated a lot of controversy for a number of different reasons, both among those who feel that such funds and their managers should not be singled out as part of the response to the financial crisis and those who do not think it goes far enough and wish to see direct regulation at the fund level. The proposals aim to regulate managers of alternative investment funds.⁴⁹ Proposed rules over marketing in Europe by non-EU managers and funds, and rules relating to non-EU custodians, have generated a lot of comment and criticism. The draft directive also covers areas including enhanced transparency at the manager and fund level reflecting much of the current approach laid out in the industry standards mentioned above. The draft rules will be discussed in the European Parliament this autumn and are likely to attract a great deal of attention, debate and media interest, which in turn may well extend the legislative process.

Many commentators support oversight and registration of asset managers, and are pleased with the proposal regarding the European passport. However, there is also a view that the draft directive lacks clarity on some aspects such as leverage,

⁴⁹ The term alternative investment funds includes a wide array of funds, including non-UCITS funds or investment trusts which would not traditionally be seen as alternative investment vehicles.

derivative products, and rules for funds of funds and it is essential to carefully consider the impact of the text on the hedge fund industry in Europe. It follows that the end effect or indeed objective of the regulation should not be to block access to well structured hedge fund products at a time when more mainstream investments, have, in many instances, been more volatile and generated lower levels of performance over the mid to longer term.

...while the US proposal
seems closer to the
consensus' view

The US has also presented plans for an overhaul of the financial system regulatory framework. Among many proposals hedge funds of a certain size⁵⁰ would be required to report their assets, leverage, off-balance sheet holdings and investments on a confidential basis. The SEC would examine registered firms and share information with the Federal Reserve. From what we have seen in recent times, we should not expect any regulations passed before the end of this year in the US.

International co-ordination
will be required

There has been much discussion about world-wide principles for regulation of various parts of the financial system. While achieving such consistency is clearly challenging, the global nature of markets and capital flows will require co-ordinated approaches.

➔ *Heightened levels of scrutiny, deeper international regulation and added momentum for onshore formats are likely to favour those with the experience and resources to respond and provide added impetus to the institutionalisation of the industry.*

⁵⁰ The law would apply to hedge funds, private-equity firms and venture capital managers with more than USD 30 million in assets.

Conclusion

The hedge fund industry has entered a new stage in its development. While the events of 2008 were exceptional, they revealed many shortcomings in the hedge fund industry and served as a wake up call for investors.

From 2003-2007, the global economy and financial markets appeared to be in a sweet spot. The easy credit and the imbalances sewed the seeds of a great disruption. Hedge funds were not immune to these trends. Many began to trade leveraged beta or piled up illiquid holdings to diversify, exploit new opportunities and earn a liquidity premium. This came to an abrupt end last year as credit dried up and forced an asset fire sale, redemptions and full scale deleveraging. Going forward, we expect a much clearer distinction between liquid and illiquid hedge fund strategies. Moreover, leverage will be more costly and not as easily accessible. Nevertheless, leverage will remain a part of the hedge fund business model.

Besides liquidity, transparency and asset control rate high among investors' concerns. One way to improve transparency and asset control is by investing in hedge funds through managed accounts (MAC). A MAC is owned and controlled by the investor but managed by the hedge fund. Nevertheless, there are several misconceptions regarding MACs. While MACs offer perfect transparency, this does not automatically mean they offer increased liquidity. The liquidity of the MAC depends on the liquidity of the underlying strategy/markets. However, we think that MACs will play an increasingly important role and the window of opportunity is now open to arrange MACs as hedge funds are eager to re-gain assets.

We should also see a major shift towards more investor-friendly terms. This is mainly driven by large institutional investors who are reviewing their relationships with hedge funds. In essence, they will demand better alignment of interests. Operational improvements such as segregation of investment management and administrative duties are also high on the list of the new era of hedge fund investing. Furthermore, we think that new regulations and more stringent investor requirements could promote economies of scale and be a force for further consolidation in the hedge fund industry. However, it is currently unclear when and how these new regulations will be enforced and to what degree they will be internationally coordinated.

As painful as the events of the past year have been, the current environment has created a window of opportunity for investors, managers and regulators to craft a better, stronger industry. Hedge funds are contrite and eager to attract new assets, so are more amenable to change. The industry that is emerging from the ashes of 2008 will be more accountable, more transparent and more resilient to market shocks in future.

Important information

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