

The State of the Hedge Fund Industry

A Discussion with John Anderson of J.P. Morgan Alternative Asset Management

December 2009

Hedge funds were not exempt from the carnage that rocked markets in 2008. John Anderson traces the background to the declines and then discusses where we are now, the likely effect posited changes will have on the industry and why hedge funds remain important as a source of risk adjusted returns.



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The views and opinions expressed are based on the current market environment and are subject to change without notice.

What exactly happened in 2008?

The bulk of declines were experienced after the Lehman bankruptcy in September. Generally, the challenges for hedge funds were driven by one of the following factors, which all were at least partially driven by the massive delevering and liquidations that occurred during this period:

1. "Long-bias": This refers to the correlation of a fund's performance to that of the overall market. Some strategies (such as distressed securities) have a long bias by construction, and others, including market neutral ones, may have a latent bias. This latent bias is often disguised as an exposure to another factor, for example illiquidity or credit quality. Hence, as markets suffered in the fall of 2008, the long-bias of many funds caused declines.
2. Basis risk: The primary risk when executing relative value trades is that the pricing relationships move in an opposite direction than expected, without an offsetting movement from the related security or securities paired/hedged against it. In other words, if you invest in a convertible bond and hedge that position by shorting the stock of the same company (convertible arbitrage), if the convertible falls and the stock price remains stagnant (or worse, increases in value) the loss is amplified, especially when leverage is used - as it often is in relative value positions. Long positions declined while hedges did not provide enough protection in 2008, again, very much driven by delevering and forced selling in an environment where liquidity was scarce.
3. Overcrowded stock positions held by managers (or shorted by managers) - many of the companies, from a fundamental perspective, may have been good "stock picks", but the technical pressure overwhelmed fundamentals (including in short positions).

Bank proprietary trading desks wound down their operations in the second half of 2008 and spurred liquidations of many widely held stocks. In turn, hedge fund managers were forced to liquidate positions to satisfy redemptions, to meet margin calls or simply to reduce gross exposure, and many of these widely held positions were therefore sold (or covered in the case of shorts) to raise cash.

As if these forces were not enough, frauds such as Madoff ensnared many prominent hedge funds of funds, private banks and consultants, causing additional investment losses and business challenges. The combination of these factors is likely to lead to changes in the industry.

Will transparency increase among hedge funds?

In the aftermath of 2008, it is not surprising that the drumbeat for more transparency from hedge funds is getting louder. While it is unlikely that specific reforms will be adopted in the near term, we are confident that transparency will increase. Following the dramatic market stresses and volatility of 2008, the revelation of the fraud committed by Bernard Madoff and the increasing pressure on and from regulators, managers will be required to be more transparent.

As the balance of power shifts to investors, those with the requisite scale, resources and expertise will be far more competitively positioned, because they will be able to demand more information from managers and, perhaps more importantly, to digest, analyse and act upon it. Furthermore, hedge funds of funds and individual funds with scale will also be better equipped to provide their investors with detailed exposure data on a "look through," consolidated basis. In addition, the scope of operational due diligence will expand to include numerous checks and evaluations of a manager's business operations, service providers, financial statements and legal documents.

With this increase in transparency, fiduciaries such as hedge funds of funds and consultants who recommend direct investments in hedge funds will also be held accountable for not conducting the proper amount of due diligence. There will be no more "free passes" on research and analysis.

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Will there be fee revisions?

Quite simply, we expect management fees to decline and come into alignment with the actual ongoing expenses of the business, such as salaries, overhead and a modest profit. Performance fees, on the other hand, should continue to create a strong incentive and compensate handsomely those managers who perform well.

Funds of funds will have a much better ability to negotiate for fee reductions from underlying managers, which should be passed through to the investors in the funds of funds. As hedge fund managers attempt to rebuild their businesses and asset bases, they have generally been willing to negotiate fee breaks and in some cases an economic participation in the growth of their overall business, for larger investors. We have been active in demanding we are treated as business partners as much as investors for funds where we could be described as “anchor investors”.

After many managers halted withdrawals last year, can we expect changes in how investors assess fund terms?

Investors will need to be much more discerning about liquidity when evaluating hedge fund managers. Our own analysis concentrates both on the liquidity of a manager's portfolio and the liquidity terms managers offer to investors, as well as demands on the fund's liquidity from leverage providers such as prime brokers and swap counterparties. The study of a fund's terms, investor base, amount of leverage employed and underlying exposures will remain critical to a proper due diligence process. So will scenario analysis, which allows investors to consider various what-ifs and to be better positioned to exit a vulnerable fund before it is forced to suspend redemptions or issue fund holdings in kind.

Can you provide some examples of what a dynamic liquidity scenario analysis would entail?

While a fund's redemption terms are important, many other variables can have an impact as well:

■ Does the manager's portfolio warrant such restrictive liquidity? If yes, is it perhaps not restrictive enough?

The liquidity of the fund's assets must be assessed. Sometimes, managers may be offering liquidity that is too generous, in which case it might make sense to propose that the manager revise these terms with the investor base.

■ Does the manager employ leverage? If so, what form(s) does it take—prime broker financing, OTC swaps with ISDAs, futures, options, etc.?

This is a critical piece of information, since leverage providers will often demand that their capital be returned if the fund's equity declines by some threshold amount. Because leverage providers have a first call on capital (i.e., before redeeming investors), they can put a manager in a precarious position if the liquidity of the assets is not consistent with the ability of a manager to de-lever the portfolio in a difficult environment.

■ Who are the other investors in the fund in terms of their seasoning (i.e. how long they have been invested), concentration levels and liquidity needs?

If the majority of the fund's AUM is with seasoned investors who have owned shares beyond the lock-up period, then a gate—whether investor-level or fund-level—becomes even more important. If a gate is not in place, then new investors have no flexibility to redeem their assets even if the majority of the other investors redeem. In satisfying these redemptions the manager may be forced to liquidate the most-liquid assets first, potentially leaving remaining investors with a less-liquid portfolio.

Another important consideration is the fund's client base (i.e., individuals, institutions, funds of hedge funds, etc.). For example, if the fund has significant pools of capital invested that are also seeking liquidity, the manager is at a greater risk of receiving unmanageable withdrawals if proper restrictions are not in place. In 2008, several hedge fund of funds were also wrapped inside structured products, including principal-protected notes. Because many such structures were leveraged vehicles, leverage-ratio requirements forced them to quickly withdraw from the underlying hedge fund of funds upon only a minimal decline in performance, which in turn meant that these hedge fund of funds were forced to quickly place redemptions with their underlying managers.

■ Can the manager manipulate the fund's liquidity by moving items into and/or out of the side pocket portfolio?

Side pockets are typically for the fund's most illiquid assets and are not subject to the same redemption terms as the remaining assets. Investors should try to learn when positions can be moved into a side pocket, how they are valued, whether performance fees are charged, etc.

■ Does the manager have side letters or share classes that offer preferential liquidity?

If the manager does, investors should attempt to understand the terms and the assets invested by each investor with preferential liquidity, to assess how they are positioned if the manager faces redemptions.

■ How does the manager value illiquid assets?

If the manager has discretion to value his or her assets, it can lead to losses being diluted by new investors when the assets are marked too high, or excessive losses being borne by redeeming investors if the assets are marked down before the fund satisfies redemptions. A number of hedge fund managers use the services of an independent valuation agent to value illiquid holdings. Of course, this means that investors need to understand the working relationship between the agent and the manager, and whether the valuation agent is reputable.

Is there as much risk and/or leverage in the hedge fund industry as there was a year ago?

If you consider the level of leverage as one element of risk, then risk has come down. The drivers of the reduction in leverage are both demand and supply.

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The demand for leverage by hedge funds has declined and will remain much lower than it has been previously, we estimate by 30%-50% cumulatively across the industry. Strategies that have historically used high leverage witnessed dramatic declines in 2008 as “basis risk” took hold and a number of managers who traded strategies such as fixed income arbitrage, statistical arbitrage and even fundamental equity long/short managers who used excessive leverage incurred outsized losses. In addition to hedge fund managers who reduced leverage or closed, another large segment of highly leveraged investors has declined in influence as well: proprietary trading desks. In the past, these desks may have been highly leveraged, depending on the trading strategy. Many were shut down by large banks starved of capital or by those struggling to improve their balance sheets and many of those that remain now employ less leverage.

The supply of leverage has also decreased. First, several historical providers have ceased to exist, with Lehman Brothers and Bear Stearns being two prominent examples. Second, the credit crisis has resulted in the remaining providers scaling back their own balance sheet risk, and in some cases finding themselves constrained by capital shortfalls. The result is that leverage is less readily available (especially for non-“A list” clients of prime brokers) and may include unappealing terms.

One can say that there is an equilibrium that has played out in the market for leverage. The demand by hedge funds and proprietary trading desks is much reduced and so is the supply.

This is a positive for investors. In many circumstances the embedded returns that exist in many trades today do not require a manager to “lever-up” their portfolios. Before last year a decent amount of leverage would have been required to generate the same returns.

Why are potential returns more attractive today? Can hedge funds still be viewed as a portfolio diversifier?

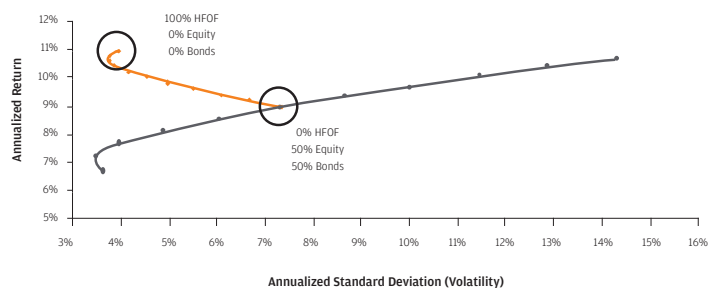
As hedge fund and proprietary trading desk assets have declined, so has the amount of competition and money that otherwise would be making markets more efficient. We have seen a lot more dispersion among individual stock returns, sector returns, earnings multiples, analyst estimates, etc, and all of this bodes well for hedge funds. Furthermore, from an asset allocation perspective, this should mean that managers rely far less on beta and more on their fundamental stock picking skills. With less beta and net long exposure among equity based strategies, the correlation benefits of hedge funds over the near-to-medium term could be even more compelling.

Consider equity long/short managers as an example. While there was some appreciation due to the equity market rally year-to-date through September, more of the performance came from good stock picking and trading. The strategy (as represented by equity long/short managers in the JPMorgan MSF Composite) is actually outperforming the S&P 500, having increased by +22.36% vs. +19.26% for the S&P 500. Importantly, the average net long equity exposure of managers over the period was only +35.93%, a sign that managers were able to capture dispersion in lieu of beta. This was perhaps most apparent in

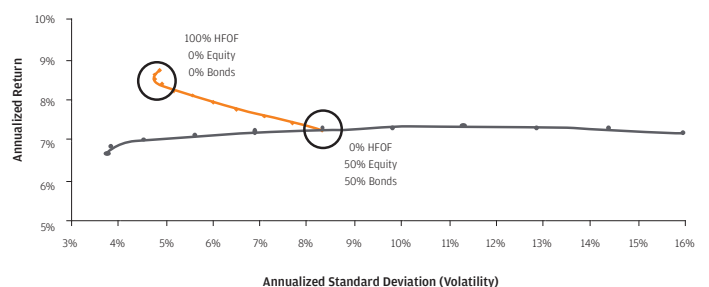
January, when the S&P 500 index declined by -8.43%, and equity long/short managers were actually positive by more than +2%. This ability to protect capital in declining markets and to generate returns from long and short positions is a value proposition that hedge funds bring to the table that long-only funds cannot.

While returns may be potentially attractive, low levels of correlation to the broader markets are another benefit that a hedge fund of funds can offer, and are a primary reason that investors are allocating today. Consider a simple analysis of what hedge funds (as measured by the JPMorgan MSF Composite), do to the returns and volatility of the overall portfolio when added in 10% increments to a portfolio of stocks and bonds. The first chart covers the period from April 1995 through December 2007, and the second chart covers the period from April 1995 through September 2009. While most would not have questioned the benefits of hedge funds before the financial crisis of 2008, in fact, even when one includes 2008 returns, hedge funds were still able to do a much better job of preserving capital than equities and credit over much of the crisis, and generally enhanced returns and/or lowered the overall risk of portfolios over the entire period.

APRIL 1995 – DECEMBER 2007



APRIL 1995 – SEPTEMBER 2009



The JPMorgan Multi-Strategy Funds Composite (JPM “MSF Composite”) is a capital-weighted composite reflecting the performance of eight core commingled funds/separate accounts, which share the same fundamental investment approach: J.P. Morgan Multi-Strategy Fund, Ltd. (MSF, Ltd.), which inceptioned in April 1995, J.P. Morgan Multi-Strategy Fund, L.P. which inceptioned in April 1997 (and subsequently closed in December 2006), J.P. Morgan Multi-Strategy Fund II, Ltd. (MSF II, Ltd.), which inceptioned in October 2001, J.P. Morgan Multi-Strategy Fund II, L.P. which inceptioned in October 2001, J.P. Morgan Multi-Strategy Fund, LLC which inceptioned in August 2004, and three separately managed discretionary accounts which inceptioned in January 2002 (and subsequently closed in June 2009), January 2008 and April 2008, respectively. The MSF Composite is comprised of discretionary assets representing approximately \$3.5 billion (as of June 2009). Performance returns are presented net of management fees, incentive fees and estimated expenses based on an approximation of the total fees and expenses applicable for the discretionary assets mentioned above on a dollar-weighted basis. The funds/separate accounts have different inception dates and certain funds are currently closed to new investors.

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How did the Madoff fraud impact your industry and your business?

At JPMorgan Alternative Asset Management we have been investing in hedge funds for almost 15 years and we have never invested in a fraud, including Madoff. Those who invested with or recommended Madoff to investors have generally either gone out of business or witnessed more severe redemptions than many of their peers. Furthermore, while the investment losses from investing in or recommending a fraud are certainly painful, the Madoff scandal made it clear that the disruptions to an organisation and the negative publicity can also be damaging, and can distract an organisation from its core mission and tie up significant resources.

Generally the industry is much stronger and more regulated, and investors and their fiduciaries are more “aware” of what to avoid and what to seek out given all of the publicity surrounding Madoff. Many of the common red flags (e.g. unknown auditing firm, lack of access to key professionals) will now be more thoroughly scrutinised by investors. However, now that investors are more aware of these common red flags, this could mean frauds will become more complex. At JPMorgan Alternative Asset Management we are trying our best to stay one step ahead.

What firms will be best positioned to compete in the current environment?

First, while certainly challenging and disappointing from a performance perspective, last year was quite good for the stronger players in our industry from a competitive positioning standpoint. This applies to both single strategy hedge funds and hedge funds of funds. Firms who were responsive to clients, made decisions in the interest of acting as a fiduciary, confronted mistakes or challenges directly and were open with their investors about these challenges (with an appropriate dose of humility) are now well positioned. For hedge funds of funds in particular, those who avoided Madoff and other frauds are now positioned to benefit from the new competitive landscape.

We are already seeing signs of the trickle-down effect of the increasing demands of clients, consultants, and regulators. Given this backdrop, scale will be key. Namely, at the individual hedge fund level, managers must address demands for more access, information and transparency from their direct investors and regulators, as well as requests driven by fund of funds who will themselves also receive more demands for “look through” information to these same underlying hedge funds. All of this means that hedge fund and hedge fund of funds managers will need to be staffed with sufficient highly qualified professionals and have the necessary infrastructure to support them in the form of systems and technology.

At the hedge fund of funds level, investors are going to want the same scale and access to information and have increasingly become more cautious when considering small to mid-sized “boutique” fund of funds managers. The bias is increasingly moving towards larger, established providers, with very large asset levels and/or affiliated with larger financial institutions; such an affiliation provides at least some comfort that there is additional oversight or resources available to leverage best business practices.

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