

The Association of Private Client  
Investment Managers & Stockbrokers  
Working for the Investment Community

# QReview

Winter 2008/2009 Newsletter



**APCIMS**

Working for the  
Investment Community

# About APCIMS

*The Association of Private Client Investment Managers and Stockbrokers (APCIMS) is the trade association that represents those firms who act for the private investor and who offer them services that range from no advice or execution only trading through to portfolio management for the high net worth individual. It has 200 members operating at over 500 sites, with more than 25,000 regulated personnel.*

## Our Members

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- undertook just under 20 million trades on behalf of their clients last year;
- manage in excess of £400bn for the private investor;
- are the largest community of their type in Europe.

## APCIMS Objectives

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- to promote the interests of our members with governments, regulators, financial institutions and all participants in the financial services community;
- to provide information and assistance to our members across a broad range of regulatory, business and market matters;
- to communicate industry change to our members, so that they can anticipate trends and opportunities;
- to lead the debate in Europe in the development of the European securities industry.

## APCIMS Relationships

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APCIMS has strong working relationships with:

- London Stock Exchange
- Euronext LIFFE
- Euroclear UK & Ireland
- London Clearing House
- Plus Markets
- Financial Services Authority
- HM Treasury
- EU Commission
- EU Parliament
- Committee of European Securities Regulators
- Other European trade associations

**Nick Rawdon-Jones**  
Campion Capital



## Are hedge funds viable investments?

There is no denying that most hedge funds have lost money this year. According to the HFRI Fund Weighted Composite Index, the average hedge fund is down an estimated 18% to the end of November. To put this in perspective, this is the worst year for hedge funds since this index started in January 1990.

Hedge funds can make money in bull markets, bear markets and non-trending markets but have seriously struggled in this full blown liquidity crisis. Many hedge funds rely on fundamental analysis to extract value from mis-priced securities. There is no question that mis-pricings have emerged across a number of asset classes, but in a market driven by fear rather than fundamentals, attempting to extract value can prove costly, especially in the current liquidity constrained financial system.

## Flexibility

Before assessing whether hedge funds add value to portfolios, investors must first recognise how to classify or view such funds. It is important to understand that hedge funds aren't an asset class in their own right, but are instead actively managed funds investing in mostly traditional asset classes such as equities or bonds. Some, depending on their investment strategy, may also trade currencies, interest rates and commodities. Hedge funds are essentially not too dissimilar to traditional unit trusts, except that they have greater flexibility to actively manage their assets in pursuit of absolute rather than relative returns. Part of this flexibility comes from being able to sell short and thereby profit from falling markets; however, this strategy has come under pressure this year as regulators moved to ban shorting specific stocks in the hope of curtailing stock price declines. Unsurprisingly, their efforts proved futile and equities continued on their downward spiral.

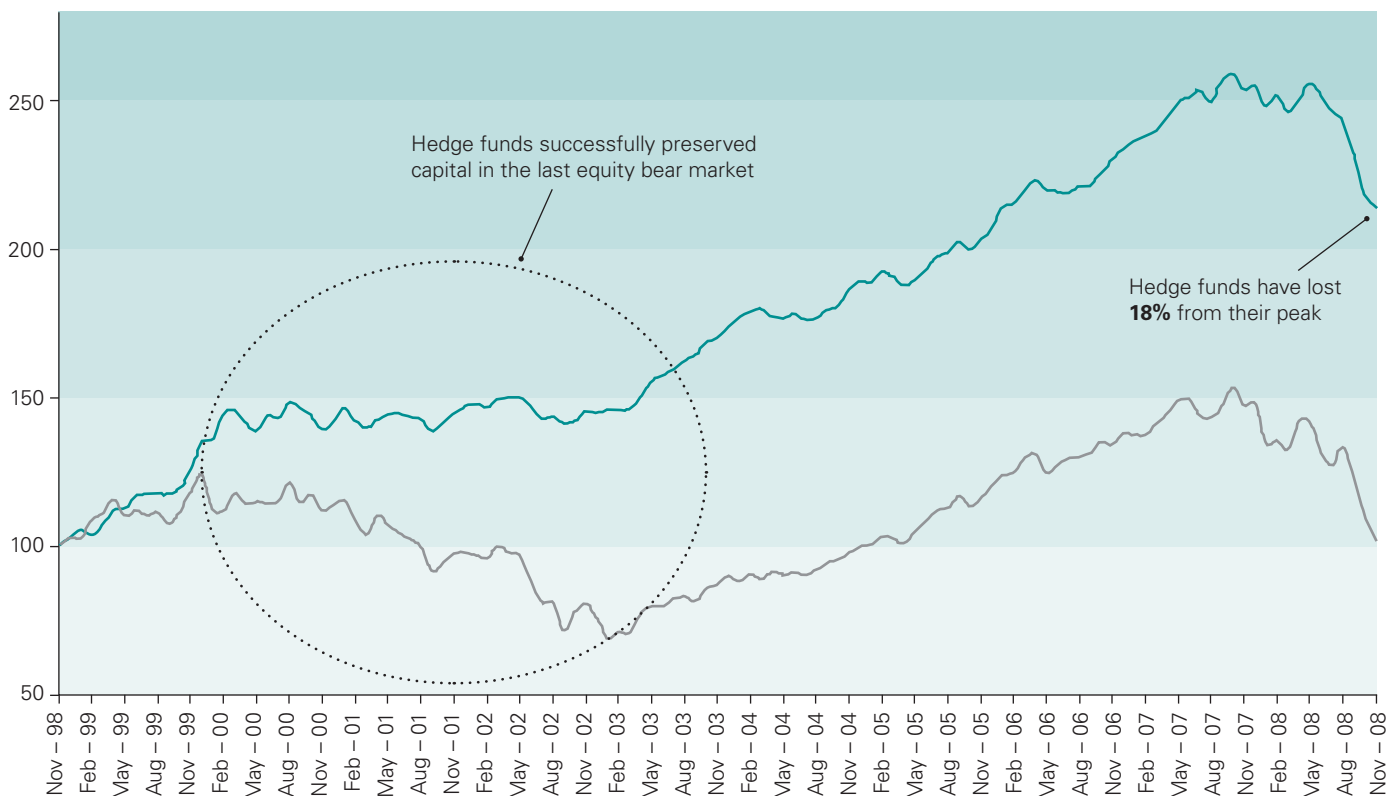
## Hedge fund performance

On a year to date basis hedge funds are down 18% which means they must regain 22% to get back to their peak; equities, on the other hand, have lost in excess of 40% and will therefore need to rise by 67% to regain their peak. Furthermore, drawdowns are having considerable implications for long term performance, as can be seen from the graph below:

With equities now showing only a very slight positive total return over the last ten years, hedge funds compare favourably: £1,000 invested on 1st December 1998 in equities would today be worth £1,086 (gross of fees) while if invested in hedge funds, it would today be worth £2,132 (net of all fees). Moreover, the historical hedge fund returns have been achieved with a fraction of the volatility of equities.

**Hedge fund returns (Dec 1998 – Nov 2008 inc\*)**

— FTSE 100 TR (FTPTT100)  
— HFRI Fund Weighted Composite (HFRIFWI)



\* Nov estimate HFRI Fund Weighted Composite -3%  
Source: www.hedgefundresearch.com, Bloomberg

### Risk/return for hedge fund strategies

As illustrated on the opposite page, overall returns for hedge funds have been attractive relative to equities. However, in order to quantify these returns more efficiently, investors must also take into account the volatility or standard deviation required to achieve these returns. In simple terms, higher standard deviation results in volatile portfolio valuations while low standard deviation provides a more transparent and efficient means of planning for future liabilities and generates a more stable income stream. The chart below, covering the last ten years, shows how an array of hedge fund strategies have performed relative to the risk they have taken to achieve such returns. We have also included equities and gilts for comparison.

The farther to the left hand side of the chart the lower the risk (defined here as standard deviation), and the higher on the chart, the higher the average annual return over the period. As might be expected, most strategies tend to produce greater returns with higher levels of risk, with the exception of equities which have produced some of the lowest returns with the highest levels of risk.

### Hedge fund structures

Traditionally, hedge funds were domiciled offshore, as that was the preference of high net worth individuals who typically held most of their assets offshore. Offshore domiciles also provide hedge funds with the flexibility to sell short and to make use of other hedging tools which may be unavailable in regulated domiciles. Offshore funds are suitable for SIPPs and offshore bonds, but are typically taxed to income tax and require high minimum investments. However, as UK investors have embraced

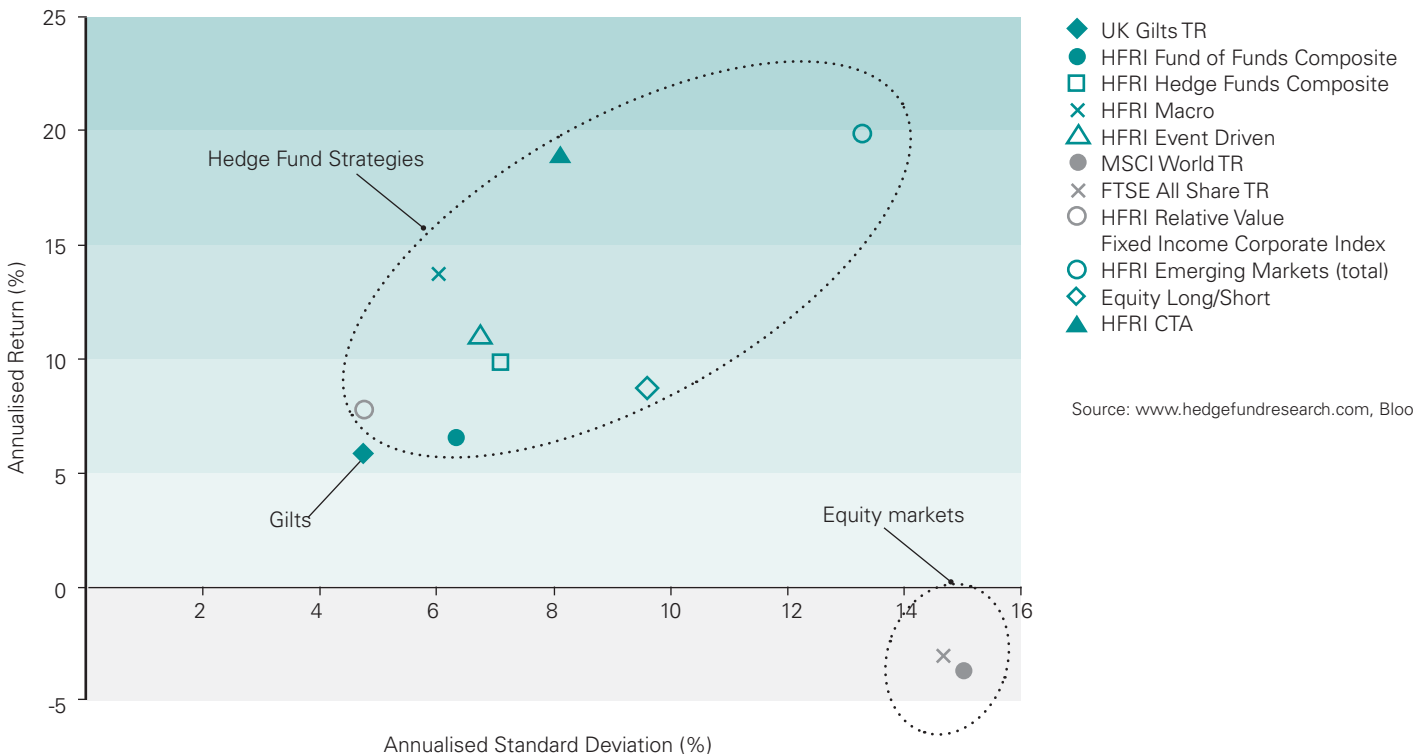
hedge funds, they have also demanded the creation of some innovative structures, as well as the re-invention of more typical structures, to cope with issues such as liquidity, taxation and transparency. Below we discuss the advantages and disadvantages of the three most popular structures available to UK-based investors:

#### Closed-end investment companies

In recent years many funds have issued shares in investment companies, usually listed on the London Stock Exchange, providing investors with access to underlying funds with the benefit of offering daily liquidity, regulatory oversight and taxation to capital gains tax. However, investors should be aware that such structures may add risks to the investment. These include:

- **Liquidity** – many investment companies are small and may therefore not provide suitable liquidity in the secondary market, particularly in times of market stress
- **Premium/discount risk** – shares may trade at a premium or discount to the underlying net asset value of the fund
- **Extra volatility** – shares may be more volatile than the underlying NAV, particularly in times of market stress
- **Wind-ups** – we expect many funds to trigger their discount floor mechanisms in 2009, forcing the wind-up of investment companies and the return of cash to investors

Hedge Fund Strategy Performance Jun 1998 – Oct 2008 inc



Source: www.hedgefundresearch.com, Bloomberg

## Structured Notes

Some investment banks have also issued notes on hedge funds, with the objective of replicating the performance of the fund's underlying NAV without the addition of premium/discount risk, but with the benefit of providing daily liquidity and taxation to capital gains tax. However, investors should once again be aware of a number of factors:

- **Liquidity** – investors have the option of taking daily liquidity on a spread offered by the banks, or month end dealing at NAV
- **Counterparty risk** – investors in structured notes rank as senior unsecured creditors; there is therefore an inherent credit risk with the issuing bank. It is vital to understand the issuing bank's credit worthiness

## UCITS III

- We have seen a few unit trusts launch with certification under the UCITS III regime. This regulation gives managers some flexibility with regard to shorting, but lends itself only to the equity long/short strategy.

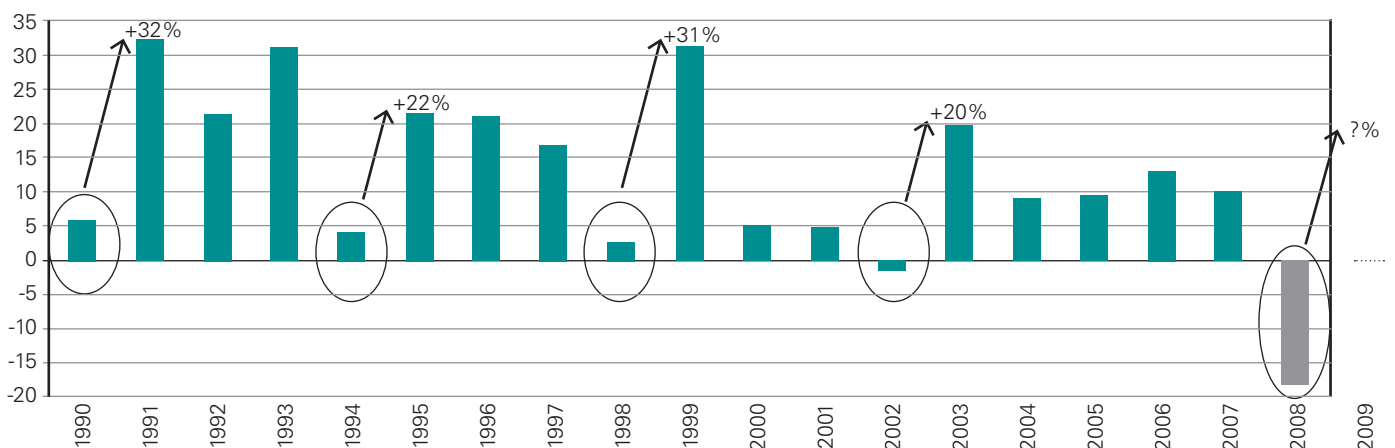
## The current opportunities

The events of 2008 have been extraordinary by any measure. Forced liquidations by stressed sellers, withdrawal of leverage, immense pressure on banks' balance sheets and record levels of inter-bank lending rates came together to create the perfect storm for financial markets. The stampede towards safe haven assets caused mayhem in a number of asset classes as previous valuation metrics were abandoned in the hunger for Gilts and US Treasuries, which have dropped to their lowest yields for many decades.

While the implications for the economy are severe, there is little doubt that 2008's liquidity squeeze has created some of the best opportunities in decades for investors. A number of equities are trading at historically low valuations, even when a severe recession is priced in to earnings expectations. Closed-end investment companies are trading at almost 40% discounts to their underlying net asset values. High yield bonds are currently pricing in a depression even more severe than that of the 1930s and several highly rated mortgage backed securities are assuming that default rates from prime lenders will rise to over 60% from the current 3% level. The list goes on.

While it is unrealistic to expect liquidity to return to markets in a hurry, there will come a point when capital will start to be deployed to take advantage of such stressed opportunities, particularly with government rates at historic lows.

## Hedge Fund Opportunities Post Market Crises



As can be seen from the chart below, hedge funds tend to perform best in the years following a crisis and 2009 could present some of the most attractive returns in history.

## Overview

- 2008 has created an enormous number of opportunities
- Hedge funds have historically generated some of their best returns after market crises
- Less competition for the same opportunities
- No leverage will be required to generate attractive returns
- It is a lot easier to 'bounce back' from a -18% return than a -40% return
- The industry will survive and evolve
- Hedge funds remain a vital tool for private and institutional investors

Hedge funds are not only a viable investment but essential to private and institutional investors alike. Their success in preserving capital and long term out-performance has been a result of their active approach to investment management and their flexibility to short and make use of hedging tools. 2008 has been a tough year for hedge funds as liquidity disappeared, causing immense strain on market fundamentals. The outlook, however, is set to produce some of the best opportunities in decades following one of the most severe market crises in history.

Campion Capital, an Associate Member of APCIMS, offers specialist advice and research on alternative investments. For further information on hedge funds, please visit [www.campioncapital.com](http://www.campioncapital.com)

## Benefits and fallacies of hedge funds

### Benefits

- ✓ Emphasis on capital preservation
- ✓ Pursuit of absolute returns not relative
- ✓ Reduced volatility – strong risk-adjusted returns
- ✓ Skill-based investing (alpha)
- ✓ Alignment of interests
- ✓ Attracts some of the best talent

### Fallacies

- ✗ Guaranteed positive absolute returns
- ✗ Higher returns every year
- ✗ Consistent predictable monthly/annual returns