

Hedge funds for private clients

Written for APCIMS (The Association of Private Client Investment Managers and Stockbrokers)

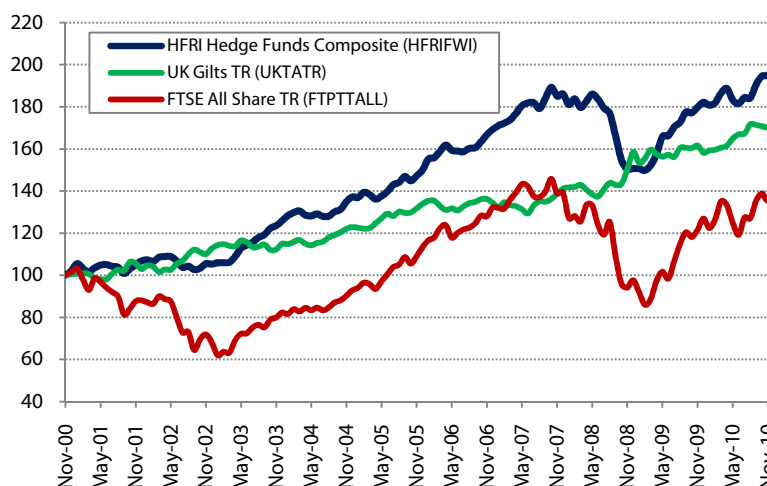
By Nick Rawdon-Jones, *Campion Capital*

A preconceived view of hedge funds suggests they are risky, speculative, leveraged investment vehicles. This image has been supported by the financial media which, until very recently, was poorly informed on the subject. Hedge funds have been partly to blame given their understandable lack of enthusiasm for discussing strategies or positions with the press. Press articles therefore invariably focused on the aggressive activities of an unrepresentative collection of funds, such as **Long Term Capital Management (LTCM)**. While *some* hedge funds are indeed aggressive, the vast majority target a risk profile that is **lower** than traditional long-only equity investments.

Hedge Fund Returns

Hedge funds have been around since the 1940's and recently have become more transparent, focusing on providing investors with frequent reports, regular NAV's and full disclosure of top positions.

In fact, many now provide far more information than their long-only cousins. Many hedge funds publish returns on Bloomberg and are quoted daily in the Financial Times.



Understanding hedge funds

Given that there are now approximately 10,000 hedge funds worldwide, managing over US\$1.5 trillion across an array of strategies, it can be difficult to understand how to incorporate hedge funds within a private client's portfolio, never mind finding the right fund to invest in.

An investment discipline

Firstly, one must understand that hedge funds should be regarded as an investment discipline rather than an asset class such as bonds, equities or commodities. Their objective is to produce absolute (i.e. positive) returns while minimising portfolio and market risk, regardless of market direction. Hedge funds may invest in any or all of the aforementioned asset classes, although they typically specialise in one asset class dependant on the manager's area of expertise.

Alignment of interests

Hedge fund managers typically have a large portion of their personal wealth invested alongside investors. This allows joint participation in any gains while ensuring that managers act quickly to preserve capital when markets fall. Everyone's interests are aligned in rising or falling markets.

Capital Preservation

In order to preserve capital hedge fund managers are given greater flexibility than managers of long-only funds. They have a far wider remit on the use of financial tools such as shorting or buying put options, which allows them to reduce or hedge out any unwanted risk promptly and at any given time. The emergence of new financial tools has been an important development for hedge funds that are now able to hedge out risk in a far more efficient manner than ever before. However, it is a common misconception that hedge funds will make money in every market condition. They will not. When you invest in a hedge fund, you are investing in that manager's skill and he won't be right 100% of the time.

Hedge funds attract talented individuals

Hedge funds typically charge a 1.5% management fee and 20% of profits. For managers with proven track records, capable of achieving consistent positive returns, the financial rewards can be immense. This incentive has a positive effect for the industry as it tends to attract the most talented managers in the market. However, it is important to note that these fees are high and investors should be aware of what they are paying their managers.

Hedge Fund Strategies

Individual hedge funds tend to focus on specific strategies determined by the manager's area of expertise. Over 40% of hedge funds employ equity related strategies, known as Equity Long/Short, where managers can profit from rising, flat and falling markets. Other common strategies include Convertible Bond Arbitrage, Event Driven and Global Macro among many others. The expected return between funds and strategies varies a great deal and two funds following the same strategy can have very different risk profiles.

Why have hedge funds become so popular?

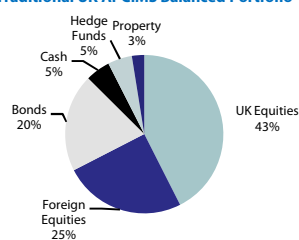
With investors making money across the board during the bull market, few were interested in low risk hedge funds targeting annual returns of 10-12%. Between 1988 and 2000, equity markets experienced an extensive run, rising from 1800 to nearly 7000 points in the case of the FTSE 100. Throughout that period investors continuously added to their equity holdings and failed to re-diversify as prices soared, leaving them increasingly exposed to one asset class. It was not uncommon to see portfolios holding in excess of 80% in equities. When the bear market struck in 2000, investors were unprepared, with some suffering losses in excess of -30% over the following three years.

These losses led to an overhaul in investment philosophy in favour of diversification across multiple, uncorrelated asset classes. Something as simple as a 10% allocation to hedge funds at the cost of equities (i.e. a weighting of 65% equities, 25% bonds and 10% in hedge funds) would have reduced the overall fall by a quarter while also reducing volatility. If we used equal weightings across equities, bonds and hedge funds this would have cushioned the fall to less than -5% without compromising much of the return in the bull market.

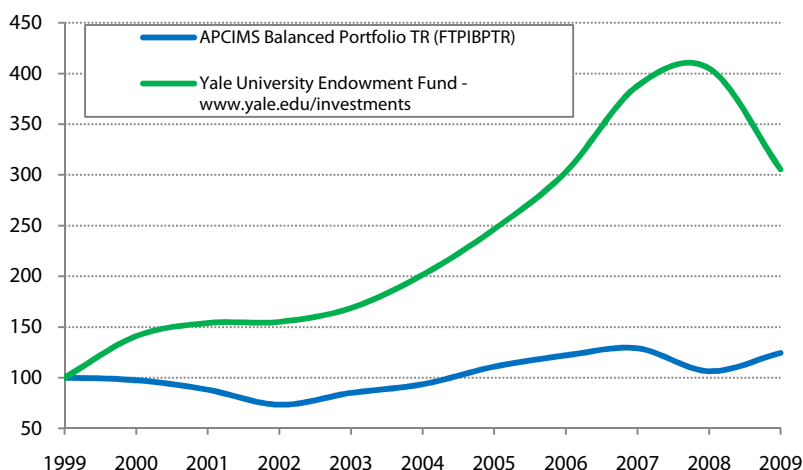
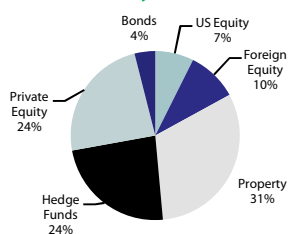
The pioneers in diversification were the U.S. University Endowment funds, which began this process some 15 years ago, aiming to produce equity-like returns with bond-like volatility. At the forefront of this is the Yale Endowment fund, which uses equities, bonds, private equity and hedge funds among other asset classes for its diversification. A number of well-regarded studies of institutional portfolios conclude that approximately 90% of the variability of returns stems from asset allocation, leaving approximately 10% of the variability to be determined by security selection and market timing. Yale has produced an average annual return of +16.6% since 1985 with considerably less volatility than equities.

We outline below *Yale's* most recent asset allocation in comparison to a typical *UK Balanced portfolio* and how both have performed over the last 10 years.

Traditional UK APCIMS Balanced Portfolio



Yale University Asset Allocation



Growth of Yale endowment compared to that of an average UK balanced portfolio
Rebased at 100 in Jan 1999

Is now the time to be investing in hedge funds?

With markets having almost doubled from their lows in 2003, investors may be unsure as to whether to invest now. As history shows, however, trying to time markets typically proves costly. The only way to avoid being exposed is to diversify sooner rather than later.

The real question for UK investors should be which strategy to invest in and determine how much to allocate. Being familiar with equities, UK investors are likely to benefit from investing in Long/Short Equity funds for two reasons: firstly, they are easy to understand and tend to offer in-depth transparency through monthly reports, frequent NAV's and direct access to the manager himself. Secondly, L/S funds can also offer downside protection in negative equity markets, which are likely to cause losses within private client portfolios.

The reality is that hedge funds now offer private investors a far greater opportunity than ever before. Markets and strategies that were previously only accessible to proprietary trading desks at large investment banks can be accessed with ease and transparency. If anything, investors should embrace the new opportunities. There is no doubt that hedge funds are here to stay and can no longer be ignored.

Nick Rawdon-Jones is an investment consultant at Campion Capital, a specialist firm offering advice on hedge funds to the UK private wealth industry, pension funds and family offices. For a detailed hedge fund report on equity Long/Short or the success of US Endowment funds' asset allocation, please email research@campioncapital.com.

For in-depth information on the industry and strategy definitions visit www.campioncapital.com