

Outlook 2009 Hedge Funds in the New Playing Field

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Review 2008

By now, everyone will have had its portion of year-end letters filled with clichés describing the ‘unprecedented’ events of 2008. Therefore, we will refrain from adding even more noise and will limit ourselves to highlighting a few key points about this liquidity crisis and how it posed particular challenges for hedge funds. Then we will quickly move on to share with you our investment outlook and how we will position ourselves in the new playing field for hedge funds, in terms of our business, investment process, and portfolio positioning.

Why was 2008 so bad?

- **No place to hide.** Unlike in the early 1990s and 2002, all asset classes, bar government bonds, were down. This posed a challenge for hedge fund portfolios that are widely diversified across asset classes, markets, and regions. In a sense, the broad-based sell-off in 2008 was the mirror image of years of synchronized global growth since 2003, which we described in the Q1 2007 letter ([see here](#));
- **Stability breeds instability.** The prolonged period of stability we experienced in the past decade, has led to a state of complacency among many market participants and regulators. Large amounts of financial leverage provided the new liquidity needed to support asset values and keep existing investors happy. However, in 2008, leveraged investors such as banks, CLO managers and hedge fund managers realized that they had been running a mismatch between the liquidity of their assets and the liquidity of their liabilities. All were fiercely reminded of Hyman Minsky’s *Financial Instability Hypothesis*, which states that the financial structure of a capitalist economy becomes more fragile over periods of prosperity. As a result, many hedge funds have imposed redemption restrictions, which has also impacted some of our portfolios;
- **The banking crisis.** Leverage in the financial sector was higher than ever before, particularly with banks. Lehman’s bankruptcy made it particularly difficult for hedge funds which are so reliant on counterparties for their active trading strategies. The failure of Lehman created a true trading vacuum, when banks suddenly realized that counterparty risk was more than just a paper risk. They tried to reduce exposure to anything that moved, thereby forcing hedge funds to sell positions into a completely illiquid market;
- **Extremely rapid re-pricing of liquidity.** The fact that the bulk of our losses were incurred in just two months (Sep and Oct) illustrates that things were very different this time around. However, no excuses here. We have held a bearish and cautious stance toward credit since early 2006 (as communicated in the Q2 2006 letter, [see here](#)), but we failed in sufficiently implementing this view in our portfolio positioning. Many of our managers completely missed the speed and magnitude with which risk would be re-priced in securities markets across the globe;
- **Mark-to-margin versus realized losses.** Mark-to-market valuations in this market have been driven less by the value of a particular asset

“The financial structure of a capitalist economy becomes more fragile over periods of stability”

Hyman Minsky

The banking crisis and government intervention made 2008 particularly challenging for hedge funds

The sharp rebound in credit in January confirmed our suspicion of “mark-to-margin” behaviour by banks

Governments have become active and dominant market participants

Investors need to dispose of the “buy-on-dips mentality” of the bull market

than the financial condition of the counterparty valuing the position. The lower the counterparty marks a position, the more cash or collateral can be demanded to be posted against levered positions (thus the term “mark-to-margin”). We clearly witnessed this behavior in December 2008 when prime brokers (pressured by year-end audits and scrutiny on the part of investors - many of which governments) were marking down credit positions by 30 points or more on the last day of the year. Cash credit markets in general and convertibles in particular suffered from this “marking-to-margin”.

- **A change in the rules of the game.** Governments in both the US and Europe emerged as active market participants by nationalizing some banks while failing to support others. Also they had a dramatic adverse impact on market liquidity and trading conditions by imposing short-selling restrictions. Many of our hedge fund managers mention “the government” as the biggest risk in current markets: government actions are per definition hard to predict as they are driven by political motives rather than by financial or profit maximization motives on which financial markets are build.

Investment Outlook

In short, we expect:

- volatile markets in all asset classes;
- characterized by short and medium-term trends;
- with, for the time being, a bearish tone.

Investors will need to dispose of their rigid “buy-on-dips mentality” which is typical for a bull market. The current market environment requires an open mind and a flexible long/short investment approach, preferably across multiple asset classes.

Let us be clear: the road ahead will be bumpy. The global economy remains on a path to correct the large macro imbalances built over the last seven years on the back of a potent expansionary credit cycle. 2009 will be an ongoing contest between the destructive power of systemic de-leveraging and massive government action to avert depression. There is very little visibility on long-term trends both in the global economy and in financial markets. Asset allocation will have to reflect this, i.e. will necessarily have a more medium-term bias within a flexible framework.

In our Outlook 2008 (published in January last year) we described how we would position our portfolios in the coming year:

“So, how do we try to benefit from these developments? In essence, we see three phases:

1. During the credit unwind (current: hedge funds with short positions in):

- *Mortgage credit: residential and commercial, in the US and Europe*
- *US consumer credit: credit cards and auto loans*
- *Corporate credit: focus on high yield and lower rated CDO tranches which carry default risk, rather than spread risk*

2. More volatility/price dispersion in all risky assets (current: long/short positions in):

- Emerging markets sovereign debt
- European sovereign debt

3. After the credit unwind:

- Distressed ABS and MBS
- Distressed corporate credit

Still too early for long-biased deep value positions in corporate credit

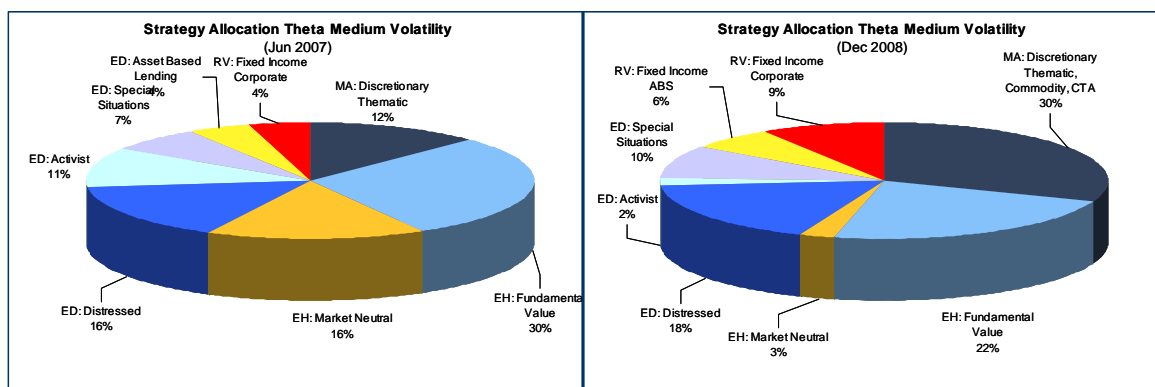
While our investments in funds with a short bias to mortgage and corporate credit (phase 1) has worked well, we have clearly underestimated the sheer magnitude and indiscriminate nature of the forced liquidations by banks, hedge funds, CLO's and other leveraged investors. In addition, there was indeed more volatility and price dispersion in risky assets (phase 2) but the complete lack of liquidity in (emerging) credit markets made it virtually impossible for long/short managers to trade or hedge effectively. Further, the de-leveraging is still underway and the impact of the financial meltdown on the real economy remains yet to be seen. This means that it is too early to establish long-biased deep value positions in corporate credit (phase 3). It has also become clear that the phases described in our Outlook 2008 are not just sequential but to a large degree overlapping and by no means exhaustive. Looking ahead, our priorities for fund research and portfolio positioning can be classified in three phases:

Portfolio positioning has shifted to macro/trading funds and liquid long/short equity and credit

- **Phase 1.** Trading funds in liquid instruments that can benefit from higher volatility (fundamental macro, systematic trading, commodities). At the same time, we will further raise cash levels to create flexibility to invest when the opportunity is there;
- **Phase 2.** Long/short credit and equity to benefit from dislocations. Conditional upon the return of liquidity to the market. Maintain focus on liquid instruments.
- **Phase 3.** Deep value, long-biased opportunities in distressed ABS and corporate credit and emerging markets. Moderate exposure to less liquid assets.

These priorities will guide our fund research and portfolio construction efforts in the coming months. With an investment opportunity set so large, we need to make sure we have the proper exposure (in terms of size and flexibility) to these opportunities. Obviously, exposures and fund allocations will differ across the three Theta portfolios. For a more schematic overview of our investment outlook, please see the table in the Appendix.

Chart 1 Portfolio positioning Theta Medium Volatility (see appendix for explanation of terms)



Our managers with short bias in corporate and ABS credit are selectively buying senior assets at distressed levels

The charts above illustrate that our portfolio positioning is already substantially different from the start of the credit crunch in the summer of 2007. More specifically, almost a third of our Medium Volatility portfolios are now in liquid trading strategies such as macro, CTA and commodities traders. Activists have been eliminated and we have eliminated all exposure to asset-based lending funds as we believe these funds will have a hard time in an environment of rising defaults. Finally, our fixed income corporate and ABS managers still have a short bias but they are gradually (and selectively) buying assets in the top of the capital structure, where many securities are trading at distressed levels.

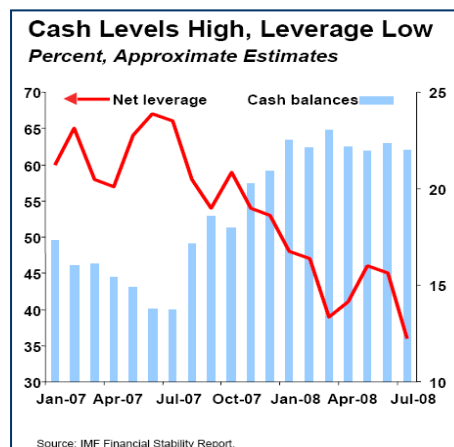
Within these strategic guidelines, we try to maintain a diversified exposure to all market risk factors (on both historical and forward-looking basis) identified by Theta in its portfolio risk management methodology. We also increasingly look to further reduce single manager risk by allocating smaller capital amounts to individual hedge funds. For a more detailed overview of investment opportunities, we refer you to the previous quarterly letter “The Opportunity Set for Hedge Funds” ([see here](#)).

Hedge funds are going through an inevitable phase in their evolutionary process

The new playing field

We view the current state of the hedge fund industry as an inevitable phase in an evolutionary process. Many weak hands that had little *raison d’être* to begin with are being forced out while others seize the opportunity to strengthen their position through adaptation and innovation¹. In a bull market, alpha generation underperforms leveraged beta, but now the trend is back towards alpha and gross hedge fund leverage has decreased, partly in response to the dramatic increase in market volatility (see chart below).

Chart 2 Hedge fund leverage reduced to historically low levels



¹ An even more optimistic way to look at it is Schumpeter’s concept of ‘creative destruction’, in which it is the entrepreneur’s job to break out of the steady-state economy and develop new products and techniques, and thereby be the prime cause of economic development.

Investors want uncorrelated returns based on liquid markets in fund structures that only deal with top-tier counterparties. This evolutionary process also allows investors in hedge funds such as ourselves to help enforce a shift in the balance of power between hedge funds and their investors. Keywords are transparency, operational structure and alignment of interests.

To illustrate what we look for in our manager selection process, we often use the famous quote from Charles Darwin: "*It is not the strongest of species that survive, nor the most intelligent, but the ones most adaptive to change*". This is true now more than ever. So how do we as an investment manager adapt to the changing environment?

We adapt to the new playing field by focusing more on top-down allocation across investment themes and asset-liability management at hedge funds

- **Investment process and strategy allocation.** More focus on top-down allocation of capital across strategies and investment themes. To improve our strategic thinking, we hold quarterly Investment Strategy Meetings. The conclusions from these meetings are taken to our new platform for top-down portfolio management: the Portfolio Risk Team. This team is responsible for portfolio construction and risk management and will operate alongside the Fund Teams, which are responsible for due diligence and monitoring of individual hedge funds. In addition, we are making significant progress in a new portfolio risk management system which facilitates enhanced monitoring and thereby risk control;
- **Manager selection & monitoring.** We will further increase our focus on asset-liability management (ALM) at hedge funds, whereby we distinguish between *market liquidity* and *funding liquidity*. Traditionally, focus has been on the liquidity of assets (market liquidity) but going forward the liability side of hedge funds' balance sheets (funding liquidity) will also be of more importance in our operational due diligence and monitoring process. Funding liquidity can take three forms at hedge funds: margin/haircut risk (can be adapted to market conditions on a daily basis); rollover risk (rolling over short-term borrowing may be more costly or even impossible); and redemption risk (risk that equity holders withdraw funds);
- **Operational excellence.** Investors in hedge funds are becoming more demanding about operational structure and due diligence. Our operational structure has always been of high quality, with independent service providers, a sophisticated portfolio administration system (of which Theta was the first user in continental Europe) and a highly skilled operations staff. To further enhance our operational due diligence effort, we are currently in the process of hiring an additional operations professional;
- **Asset-liability management at Theta.** Our operational risk management and pro-active liquidity planning efforts have served us well, as we can continue to provide liquidity to those investors wishing to redeem from our funds. In the second half of 2008 we have taken actions to further improve balance sheet quality and liquidity of our funds. Unfortunately, as some of the underlying funds of Multistar Low Volatility created redemption restrictions, we were forced to create a side-pocket for investments which we can not

Streamlined and liquid portfolios with growing cash balances can focus on unprecedented investment opportunities

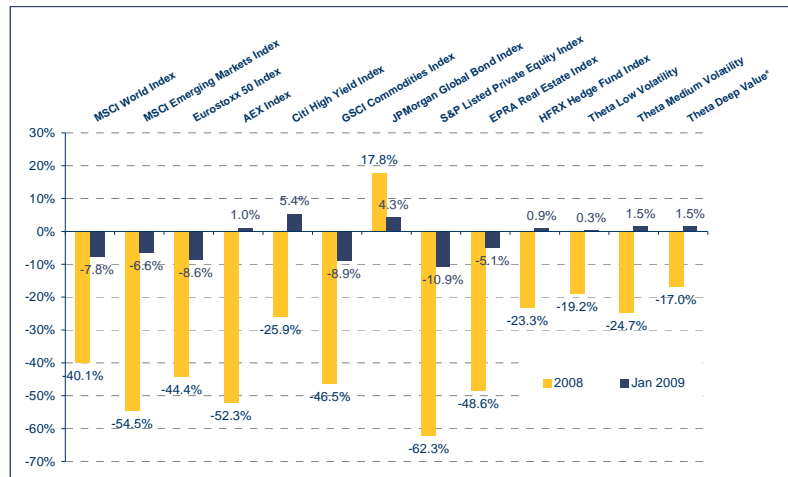
We will take transparency one step further with updated reporting and due diligence packages

Our operational infrastructure, loyal client base and motivated investment team are important assets in the new playing field

currently exit in full or in part. However, for all our funds we have started the new year with a cleaner balance sheet and the combination of a streamlined and liquid portfolio with growing cash balances, allowing us to focus on unprecedented investment opportunities. No leverage is needed to achieve target returns and, as a result, most of our hedge funds do not apply leverage at this stage. Finally, we have a credit facility in place which we can use to dampen the cash drag from our currency hedges, should the USD rally further (all our FX exposure is hedged into EUR);

- **Transparency.** Clients have always appreciated our transparency, but it is our ambition to take this one step further. Therefore, we are updating our extensive reporting package, which can be used in the quarterly reporting meetings with professional clients. The updated package will contain a detailed performance attribution analysis and a portfolio risk report, showing our allocation of risk across investment strategies, geography and market risk. The risk report also provides historical and forward-looking stress-tests. Furthermore, we are in the process of updating our due diligence material to reflect the changes in investment process and infrastructure described above. The full Theta Due Diligence Package (including DDQ, investment manual, compliance manual, valuation policy, disaster recovery policy, and our implementation of the CFA Institute's Asset Manager Code of Conduct) will be available in the Downloads/Resources section of our website soon;
- **Business.** Net outflow of investor money in 2008 was limited to 7% of our assets under management, which compares favorably to what many of our peers are reporting. We note that the impact of negative performance is the flipside of an important historical source of our assets under management - internally generated performance. While we clearly prefer to see our assets grow rather than shrink, we note that we have a lean-and-mean organization, run by a highly skilled and motivated team whose interests are well-aligned with those of our investors. We have no issues keeping our investment team intact and the experiences of 2008 are now part of our collective memory. We will do our best to use it wisely.

Chart 3 Hedge funds versus other asset classes

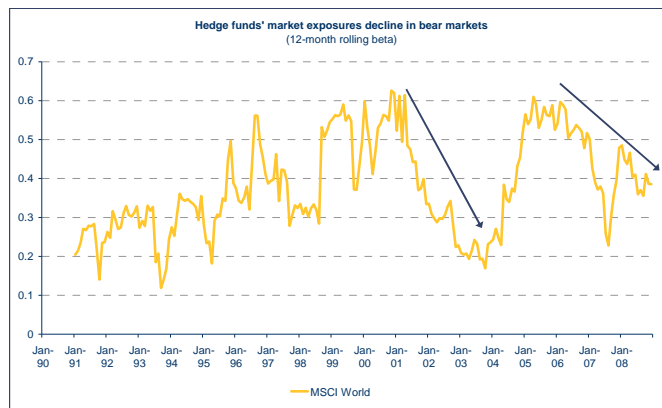


The hedge fund proposition

Active money management of hedge funds still works: more upside than downside and lower volatility when compared to equities

While 2008 performance has been disappointing, the proposition of hedge funds still remains largely intact. Theta has always presented hedge funds as having an asymmetric return profile, rather than an ‘absolute return profile’ (often explained as always positive returns). Historically, diversified portfolios of hedge funds captured about 65% of the upside of equities and 25% of the downside. In the extreme conditions of 2008, hedge funds captured ‘only’ 50% of the downside of equities, and in the first two months of 2009 hedge funds again provided much needed downside protection (see Chart 3 above). Another critique widely voiced in recent months is that hedge funds had a high correlation to equities. However, as we noted in *The Asymmetry of Hedge Fund Investing* (Q1 2007, [see here](#)), correlation can be a very poor measure of risk. Not only does it ignore potential asymmetry in returns, it also does not take into account the lower volatility of hedge fund returns, when compared to equities. Chart 4 below uses a better measure of market exposure: beta (the correlation between two assets, multiplied by the ratio of their volatilities). It clearly shows how hedge funds reduce market exposure during bear markets; one of the most important attributes of active money management.

Chart 4 Active money management



Source: Bloomberg

Appendix

Theta Investment Outlook

Phase 1 - De-leveraging

Phase 2 - Market Normalization

Phase 3 - Economic Recovery

Market environment

Price drivers	Markets trade on technicals: de-leveraging, redemptions	Hedge fund redemptions could re-inforce selling pressure (in illiquid market segments)	Global government stimulus will be deflationary: long risky assets (asset class selection)
	Fundamentals, valuations irrelevant	Fundamentals do matter again, growth dominates value	Valuations and earnings growth are key return drivers
Risk drivers	Macro risk dominates, government interventions, extreme risk aversion	Idiosyncratic risk more relevant	US consumer and financial sector will not re-leverage quickly
	High correlation among asset classes	Asset classes trade more on own fundamentals	Higher yields provide more downside protection
Trading environment	Liquidity is key, on-run/off-run spreads and bid/offer spreads remain wide, basis trades are killed	Country/sector risk	Idiosyncratic company risk, equity and subordinated creditors may still suffer impairment
	Responsive trading in bear market with short relief rallies	Markets bottom, rallies more pronounced	Buy-on-dip strategies
Liquidity	Highly volatile without clear direction	Short-term trends are back, but volatility remains high	Long-term trend and momentum trades, volatility subsides
	Liquidity is key, causing dislocations between want-to-sell and can-sell	Corporate balance sheets are OK, but earnings still under pressure	Compelling risk-reward for illiquid assets, cautious on levered assets

Investment opportunities

Long: unlevered assets Short: levered assets, corporate credit, selective financial institutions, countries with weak fiscal and reserve positions	Mean reversion trades in dislocated markets, mostly debt.	Recovery of financial institutions, distressed corporate & ABS credit
	<ul style="list-style-type: none"> Senior vs. junior ABS Loans vs. bonds Converts, swap spreads 	Debt-for-equity swaps
Trading volatility and short-term trends across currencies and liquid asset classes	Long short credit & equity in liquid names. Government-guaranteed bank debt	US assets will outperform Europe in a recovery
	Long-biased equity (including emerging markets) still too early	Reflation trades: commodities, emerging markets, gold
	Asia still too sensitive to global slump	Asia: low leverage, strong growth, high savings rates
	Investment grade debt outperforms equity in early stages of economic recovery (pull-to-par effect)	Infrastructure/industrial commodities: low valuations, fiscal stimulus in EM and entry at bottom of energy cycle

Hedge fund strategies

Cash (to facilitate redemptions and have ammunition)	Equity market-neutral (factor models work better on fundamentals)	Long-biased deep value equity
Focus on managers with no leverage, independent of banks' risk aversion	Long/short credit & equity Multi-strategy credit, convertibles	Distressed debt (corporate & ABS)
Downside protection through short bias, long volatility	Sector funds (long/short equity): healthcare, technology, financials	Emerging markets debt & equity
Overweight liquid macro and short-term trading strategies, CTA's	Increase short+long term trend following trading strategies	Overweight long-term trend followers
Commodities traders with fundamental focus	Global macro: dollar vs. gold, commodities, relative value between countries, sector and asset classes	Global macro: dollar vs. gold, commodities, relative value between countries, sector and asset classes
Consider 'overlay' hedge against tail risk of another liquidation wave		

Favoured manager attributes

(Government) event risk high - trading skills important	Event risk remains high and volatility remains elevated - trading skills	Skilled managers who understand the new financial landscape
Long/short managers with macro view in liquid markets	Dislocation all across the credit spectrum - Multi-strategy credit managers with strong infrastructure	For distressed: restructuring specialists. Other risky assets: fundamental value investors

When the phase is over - indicators to watch

House prices stabilize and asset write downs are over, so banks' recapitalization can truly start	Peak in default rates - bottom in economic cycle (2010-2011?)
Redemption pressures from banks, hedge funds, CLO's recede	When deflation scare turns into inflation concern
Interbank lending resumes and Libor-OIS spreads come down	Leveraged investors start buying assets
Real money starts buying beaten-down assets	Insider buying (share/debt buybacks, corporate insiders)
USD declines (the world worries about US debt position again)	
News flow and sentiment stops becoming progressively worse	

HFR Strategy Classification

MA: Global Macro

- Discretionary Thematic
- Systematic Commodities
- CTA

EH: Equity Hedge

- Fundamental Value
- Market Neutral
- Technology/Healthcare

ED: Event Driven

- Distressed/Restructuring
- Activist
- Special Situations
- Asset Based Lending

RV: Relative Value

- Fixed Income ABS
- Fixed Income Corporate
- Multi-strategy

For more information about the HFR Strategy Classification System, please visit our website:

<http://www.thetacapital.com/hedge%20fund%20glossary.aspx>