

# Theta Research Note # 2

DE LAIRESSESTRAAT 180  
1075 HM AMSTERDAM  
THE NETHERLANDS  
T +31 20 5 722 733  
F +31 20 5 722 744  
I [WWW.THETACAPITAL.COM](http://WWW.THETACAPITAL.COM)

## **Brief Comment on Hedge Fund Performance in 2005**

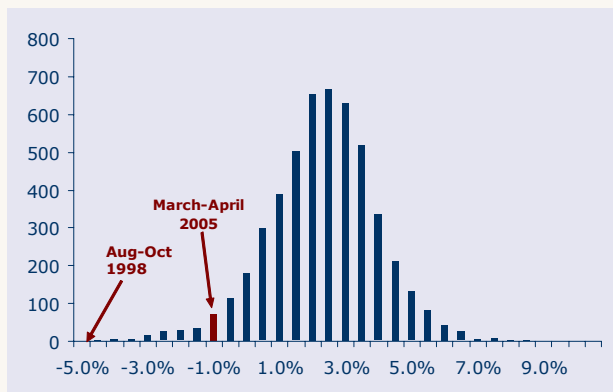
Theta Capital Management

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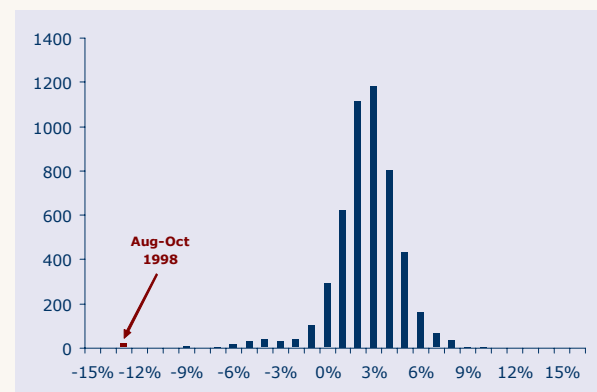
## Introduction

Following the dismal performance of hedge funds in March and April, we would like to comment briefly on the factors that impacted returns across a range of financial markets and to which hedge funds proved not to be immune. While recent returns have indeed been disappointing to many, the historical context we provide shows that we are nowhere near the most challenging period since hedge funds' inception: the fall of 1998 (see Exhibit 1 which plots the quarterly returns of the HFR Conservative Fund of Funds Index since 1990, the benchmark for our low volatility portfolios).

**Exhibit 1 HFR Conservative Fund of Funds Index**  
(Quarterly Return Distribution since 1990)



**Exhibit 2 HFR Fixed Income Arbitrage Index**  
(Quarterly Return Distribution since 1990)



Before we proceed to sketch the events that have created recent dislocations in financial markets and the impact they had on hedge funds' performance, we note that drawdowns have been most fierce in sectors of the market where trades have become very crowded and for funds whose asset size has made them almost 'too big to move'. At Theta we believe that the best way to deal with this environment is to continue to focus on relatively small and nimble hedge funds which are flexible enough to adjust their portfolio to a changing market environment. **Active risk management (which is all that hedge funds are supposed to do) may at times call for the simplest tool available: cash.** It is sometimes better to avoid disaster than to generate a minimal gain!

## So what went wrong?

Going into 2005, there was still a strong sense of risk appetite in global financial markets despite little visibility about the next trend in equities. Furthermore, the consensus seemed to be that we were at an inflection point in credit spreads (a fairly good indicator for risk aversion) and they could only move wider from here. **We believe the events in March and April reflected a general re-pricing of risk across asset classes, the occurrence of which was widely anticipated but its timing still unexpected.** It is this general re-pricing of risk that causes many (under normal market circumstances) unrelated positions and strategies to behave in a very similar way in times of market stress. In other words: when things turn bad, all correlations jump to one.

We identify the following **chain of events that caused the dislocations** in early 2005:

1. The last few years have witnessed a very strong inflow of assets into arbitrage strategies where opportunities are by definition limited (predominantly by institutional investors searching for diversification and low volatility). We believe these massive inflows have created potentially unstable hedging parameters for arbitrage trades;
2. The earnings revision and ratings downgrade of GM and Ford, although widely expected, triggered a sell-off in credits across the board as many investors had to rebalance their positions;
3. During the sell-off, hedging parameters proved unstable which generated losses and forced arbitrageurs to reduce leverage;
4. The reduction of leverage and fears about upcoming redemptions triggered forced selling into illiquid markets which, in turn, pushed credit spreads wider across the board.

## Quality of hedges drastically reduced

As mentioned above, it is the general re-pricing of risk that causes many unrelated positions and strategies to behave in a very similar way in times of market stress. The strategies that are most sensitive to this are relative value or arbitrage strategies. In a typical relative value trade, the long position is hedged with a short in related securities, so as to capture the perceived arbitrage opportunity. The success of the trade depends in part on the stability of the correlation between longs and short. However, during periods of extreme market dislocations, correlations tend to deviate from historical patterns, thereby drastically reducing the quality of arbitrageurs' hedges (Exhibit 2 on the previous page illustrates what happened when hedges stopped working and market liquidity dried up for the fixed income arbitrage strategy in 1998). This problem is particularly acute for low volatility hedge fund portfolios since these tend to hold a large portion of relative value hedge funds. Our solution to this problem has been to diversify towards more directional investment strategies such as long/short equity and global macro. In previous crisis periods, these strategies provided a 'natural hedge': managers were able to profit by shorting the assets that sold off in a straight line. However, this strategy failed in recent months as many asset classes that global macro managers typically trade (equities, currencies and oil) failed to trade down in a clear trend. Even fixed income managers failed to benefit from the strong rally in bond markets, as most of them were positioned on the opposite side, trading on increasing price pressures and further rate hikes by the Fed.

## Forced selling in convertible bonds

In March and April, we witnessed a dramatic sell-off in convertible bonds caused by the ongoing negative sentiment in the convertible bond market related to potential upcoming fund redemption activity, and second, further weakness in US credit markets. Although these drivers were similar to the ones in March, the magnitude and breadth of the deterioration seemed to intensify in April.

Interestingly, we reduced our exposure to convertible arbitrage last year. In our view, the dominance of hedge funds in this market had increased the risk that even small events could trigger significant bouts of volatility. As we wrote in our Q3 2004 Quarterly Review: *"A potential risk in the convertible arbitrage strategy is the notion that investors may get bored with disappointing returns and may decide to reduce their exposure significantly. In turn, this could trigger a sell-off in the convertible markets"*. Indeed, convertible arbitrage funds have been experiencing capital outflows for months now and Goldman Sachs estimates year-to-date outflows to be close to -15%. The managers facing these redemptions were forced to sell into an illiquid market, forcing prices and liquidity down even more. Also, many multi-strategy managers with an allocation to convertible arbitrage strategies have experienced significant drawdowns.

Following the sell-off, many managers now consider convertible valuations very attractive on a relative and absolute basis. Although we believe the current environment will ultimately provide a number of compelling opportunities for convertible bond investors, unfortunately we feel hard pressed at the moment to predict the path the market will take to get there.

## Single name events impact overall credit markets

The events that triggered the miniature flight to quality and caused the sell-off in credits and equities were all closely related to the downward earnings revision of General Motors in March and the expected credit downgrade of its debt to 'junk' status which materialized in May. Although widely anticipated, most investors were caught off guard by the timing of the move and the simultaneous downgrade of Ford's public debt. In search for yield in a low interest rate environment of the past years, many investors moved 'down the credit curve' and into the emerging area of collateralized debt obligations; pools of corporate bonds that are bundled together and sold to investors in tranches of varying risk. Because both GM and Ford constitute a large part various credit indices (together, almost a third of the euro high yield market) as well as of many CDO portfolios, their ratings downgrade triggered a wave of rebalancing transactions, thereby magnifying the initial move in credit spreads.

The combination of fewer bids (reduced liquidity) and forced sales resulted in considerable mark-to-market losses. **One of our credit managers reported that, despite the already bad mark-to-market, he could not get any dealer to trade on its prices.** Similar to convertible bonds, increasing fear of upcoming redemption activity caused a contagion of price compression combined with extremely low liquidity in overall credit markets. However, while we have no evidence of significant redemptions from credit hedge funds, traditional high yield mutual funds continue to experience capital outflows: year-to-date \$6.3 billion left the market, compared to inflows of \$3.1 billion a year ago.

Looking ahead, while credit fundamentals remain strong (as evidenced by historically low default rates, strong balance sheets, and improving earnings), we anticipate a significant further widening as well as increased volatility of credit spreads. Therefore we will continue to focus on, value-driven managers in this area who are flexible enough to adjust positions to a less benign and more volatile credit environment.

### **Violent equity markets also impact high-quality positions**

Equity markets sold off during the month of March and April as global economic statistics became increasingly negative. A softening US economy with a widening trade deficit, making inflation risks and leading indicators turn negative, contributed to a rise in volatility. The sharp fall in emerging market equities was caused by an increase in global risk premia as a result of the poor US growth numbers rather than any region specific event. March's move away from risk trades, with small-cap and cyclical stocks underperforming, continued into April as economically sensitive sectors underperformed. In addition, commodity and energy stocks reacted to the drop in oil prices to below \$50 per barrel and sold off sharply. **The severity of the sell-off and the fact that it was indiscriminate caused all positions to move, even the high-quality positions with low beta and those in special situations.** As a consequence, event driven managers –pursuing merger arbitrage strategies that are generally much less sensitive to overall market movements than long/short equity - also faced considerable losses.

### **Conclusion**

In summary, the natural hedges at portfolio level (diversification into some directional strategies to mitigate portfolio volatility) did not work this time because the events described above occurred simultaneously. This is the main reason for the disappointing performance of our low volatility portfolios. **On a more positive note, severe market dislocations such as those witnessed in March and April always create interesting investment opportunities for those who have the patience (and cash!) to wait for the market to calm down.** We take comfort from the fact that many of our managers in credit-related strategies have been trading with cash positions of up to 50% and are effectively waiting to re-enter the market and benefit from future developments rather than current uncertainties.

Sincerely Yours,

*Bernard Boonstra  
Wouter ten Brinke*

For more information, please contact us at:

#### **Theta Capital Management B.V.**

De Lairesestraat 180  
1075 HM Amsterdam  
The Netherlands

Telephone: +31 (0) 20 5722733  
Fax: +31 (0) 20 5722744  
E-mail: [info@thetacapital.com](mailto:info@thetacapital.com)  
Website: [www.thetacapital.com](http://www.thetacapital.com)