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After Strong Year for Hedge Funds, Investors Return

By PAUL SULLIVAN

WHILE the stock market was surging back last year, so, too, were hedge funds.

This recovery may anger the average investor who equates hedge funds with the bad deeds of Wall Street. And the funds' quick return may surprise sophisticated investors who are still smarting from the money they lost in their rush to move their portfolios to cash.

But in its most recent report, BarclayHedge, which tracks the flow through hedge funds, said 2009 was the best year for the industry's performance against the Standard & Poor's 500-stock index since the company started tracking this in 2000.

As a result, money has started to return to hedge funds, particularly into those focused on distressed debt, fixed-income and so-called event-driven strategies where a manager takes a position in a company because he believes its situation is about to change. In February, investors put \$16.6 billion into hedge funds, according to BarclayHedge. Assets in the industry as of the end of February stand at a 16-month high of \$1.5 trillion.

"After it's all said and done, hedge funds did outperform the broader stock indices in 2008," said Sol Waksman, president of BarclayHedge. "As bad as the losses were, they were much worse in the broader stock markets."

An even more optimistic prediction by Deutsche Bank's Alternative Investment Survey estimated that \$222 billion would be invested in hedge funds this year. Mr. Waksman said he believed this was overly rosy. "It's a record-setting number," he said. "I hope they're right."

Even if Deutsche is wrong, the point is that interest in hedge funds appears to be picking up again. So will this time be different? Are investors who are returning now chasing something that has already passed? Here are some of the crucial points to consider:

WAS IT REALLY LIQUIDITY? At the nadir of the credit crash, the rap against hedge funds was that they used their gating provisions to prevent investors from pulling their money out. In some cases, this increased investors' losses, because they ended up selling other securities to get cash.

In reality, provisions surrounding when and how investors could withdraw their money had been clearly stated in hedge fund documents. The hasty sales were driven by the fear that the entire system was going to collapse.

What happened 18 months ago is not going to change how top managers allow their investors to pull out their money, advisers say. Hedge funds will continue to require investments to be locked up, particularly the top-performing funds. That means people need to accept quarterly, semiannual or yearlong lockups.

"If you want to invest with the best managers, you have to live with their rules," said Martin Gross, president of Sandalwood Securities, a fund that invests in hedge funds focused on debt. "Some people get this and want to be invested with that great manager. Others are very nervous about locking their money up."



Michael Sonnenfeldt, president of Tiger 21, left, and Robert Frey, a former managing director at Renaissance Technologies, a top hedge fund.

He pointed out that a lack of liquidity forces people to stick with their investment strategy. The bad news is that those who filed forms to redeem their money at the end of March 2009 missed out on the rally.

A liquidity budget may be the better option. This is essentially an assessment of how much money you can stand to have out of reach and how much money you need to keep liquid. Investors with those budgets would have been able to set aside a safe amount of money and allow the hedge fund strategies to play out.

NOTHING GOES UP FOREVER On the whole, hedge funds were down 18 to 19 percent at the end of 2008. This shook up some people, even though the broader market indexes were down as much as 40 percent.

“Clients fall into two groups,” said David Bailin, global head of managed investments at Citi Private Bank. “The ones who believed in absolute returns — that hedge funds will never go down — are shell-shocked and gone. The second group did the tough analysis.”

By this he means they looked at hedge funds for their relative returns. And those who stuck with that strategy have been rewarded. Mr. Bailin said 75 percent of the funds his group worked with were at or above their Jan. 1, 2008, high-water marks.

A DEEPER DIVE Hindsight may be 20/20, but there is something to be learned from how managers positioned their portfolios in the downturn. David Donabedian, chief investment officer at Atlantic Trust, which manages \$16 billion, said the downturn had allowed him to differentiate between hedge funds with solid strategies and those driven by the momentum of the bull market.

“There is now a track record for how the industry performed from October 2007 to March 2009,” he said. “You can look at how they protected assets: were they market-timing or did they do it through security selection?”

It is also worthwhile to do due diligence — the buzz phrase since Bernard L. Madoff’s Ponzi scheme was revealed. While all investors want to understand how the hedge fund intends to make money, the savvier ones are performing what Robert Frey, a former managing director at Renaissance Technologies, one of the top hedge funds, called “operational due diligence.” In addition to asking how the black box investing strategy works, investors should also want to know how the firm does business.

“People didn’t ask about it before,” Mr. Frey said. “Now they want to know the process. They want to see the details. They want to know how to avoid the next Madoff.”

WHAT NEXT? But human nature being what it is, investors also want to know the next hot areas. Three strategies appear to be particularly popular.

The first is long-short equity, which allows a manager to bet against a stock he does not like. “Good companies and bad companies have come back together,” Mr. Bailin said. “We need someone who is going to do fundamental analysis.”

The second area is emerging markets, because investors want to have more options than simply purchasing stocks and bonds in a particular region. The third is distressed debt, which gained added relevance after the credit squeeze. Mr. Bailin said it could provide as much as a 20 percent annual return for the next few years.

Yet beyond finding the next hot strategy, there has also been a move to rethink what a hedge fund should be used for: Is it to get outsize returns, or to preserve capital regardless of what happens in the broader markets?

Mr. Frey said he had preservation of capital in mind when he started the Frey Multi-Strategy Fund in February. “I’m not worried about a double-dip recession, but a low-growth world,” he said. And in that world, the more circumspect strategy may suit investors who were burned.

Michael Sonnenfeldt, who made his money as a real estate developer and investor, said he had maintained his allocations in hedge funds, but he had become choosier.

“If you’re in an elevator and it drops 20 floors and you survive, you’ll never get into an elevator again without remembering that,” Mr. Sonnenfeldt said. He is the president of Tiger 21, a learning group for high-net-worth investors. “Our members suffered unexpected, unpredicted losses that their economic life couldn’t prepare them for. They’re pawing their way back into risky investments.”

