HEDGE FUNDS

A New Paradigm

by Corey Case, COO and Co-Head of J.P. Morgan Alternative Asset Management

THE ECONOMIC CRISIS OF 2008 tested hedge fund managers, funds of funds and advisors, but since then industry asset levels have rebounded to their pre-crisis levels (Exhibit 1, on the following page). We anticipate that asset growth will accelerate in 2011. In light of higher barriers to entry, a significant portion of the asset flows have gone to larger hedge funds, and we expect this trend to continue. Perhaps most important, many fund managers have responded to the demands of institutional investors and have adjusted their investment and operating procedures to make them more transparent. In addition, stepped-up oversight by auditors and regulators likely will draw additional institutional investors to the sector.

With broader markets more fully valued than they were at the end of 2008, investors increasingly are turning to hedge funds as an attractive, less constrained investment solution to generate returns with less volatility than traditional markets. Further, as their composition becomes more institutional in nature, hedge fund investors are looking at hedge funds in a different light. They are no longer considering hedge funds an “asset class.” Rather they are more appropriately analyzing and disaggregating the funds on a risk factor basis to fit them within their overall allocation framework.
Hedging Today's Uncertainties

Even though investors concurred that a number of asset classes were historically cheap at the beginning of 2009, trepidation prevailed with regard to the viability of the entire financial system as well as for prospects of economic growth. The financial system has since rebounded and is operating far more efficiently, and asset classes are no longer historically cheap. Credit spreads have retreated from record levels back to their historical averages or lower—unfortunately just as many underfunded institutional investors have been trying to match liabilities through increasing the duration of their assets and reaching for yield.

Yet despite this progress, the possibility of macro shocks, such as a sovereign default in Europe or a return to a recession are significant, and outbreaks of volatility, such as the May 2010 “flash crash,” still remain. In meeting obligations to their constituents in a post-crisis era, then, institutional investors face the challenge of generating substantial returns in a healing but still high-risk environment. Those who choose to access risk solely via traditional allocations are becoming increasingly constrained.

Hedge Funds Are Not an Asset Class

Responding to this challenge, many investors are reconsidering whether simply carving out a small “slice” of their asset allocation for “alternatives” makes sense. Rather, they are evaluating hedge funds within traditional allocation categories, such as equity or fixed income, based on the funds’ component risk factors. While we are certainly not advocating the use of hedge funds as a replacement for all—or even a majority of—traditional allocations, the fact that hedge funds can deliver less beta is compelling. By incorporating hedge funds directly within an equity or fixed income allocation, and not simply grouping them into a small “alternatives” allocation, investors can effectively avoid placing a heavy “bet” on the market’s direction. This allows investors to participate more fully in equities or fixed income, through active beta allocations, in which case the amount allocated is based on an investor’s perception of whether the market is properly valued.
The approach also allows investors to benefit from exposure to alpha allocations— in the case of hedge funds, returns are driven less by beta and instead more by a litany of factors including market or stock inefficiencies, trade structures, investment talent, technology, relative values, shorting, volatility, correlation and shareholder activism. As this trend takes hold, our view is that there will be a shift from a "Constrained Asset Allocation Model" to a "Risk Factor Based Asset Allocation Model." Exhibit 2, on the previous page, illustrates how these models may differ as they relate to an institutional investor’s equity and fixed income allocations.

**Risk Factor Based Bottom Line**

By adopting a risk factor based allocation model, investors can expand their sources of alpha while diversifying their holdings. The likely result will mitigate some downside exposure while keeping the door open to the upside. Exhibit 3 shows the performance of the S&P 500 and the HFR Equity Hedge Composite. The Equity Hedge Composite, which tracks results of equity long/short hedge fund managers, performed much better when the S&P 500 fell, and still captured significant appreciation during positive periods. So over the long term not only did a hedge fund allocation reduce volatility, it also enhanced compound returns—since, after all, short-term preservation of capital often is more important than short-term return on capital, given its impact on long-term compounding.

As Exhibit 4 shows, long/short equity managers have not only delivered incremental returns to traditional equities, they have tended to produce outsized incremental returns in negative equity markets, thus protecting a broader equity portfolio. The bottom line represents the HFR Equity Hedge Index’s cumulative outperformance of the S&P 500 on a monthly basis since 1995, while the top line represents the same outperformance, but only counting months when the S&P 500 was negative. The example, while simplistic, underscores that a blended return profile may be much more beneficial to institutional investors struggling to rebalance their plans to asset allocation targets and budgeting for capital and funding requirements.

**HFRI Equity Hedge Index substantially outperformed the S&P 500 during the market’s worst months...**


![Graph showing worst months of S&P 500 returns from October 1995 to September 2010.](source: Bloomberg, Hedge Fund Research. Financial information is through September 31, 2010.)

**...moderating losses while still participating in gains**


![Graph showing average hedge fund equity returns during S&P 500 up and down months from October 1995 to September 2010.](source: Bloomberg, Hedge Fund Research. Financial information is through September 31, 2010.)

**Hedge edge: Hedge funds have generated superior equity returns over time**

**EXHIBIT 4: CUMULATIVE EXCESS RETURNS, HFRI EQUITY HEDGE INDEX VS. S&P 500**

![Graph showing cumulative excess returns of the HFRI Equity Hedge Index vs. the S&P 500 from 1995 to 2010.](source: Hedge Fund Research and S&P.)
The outsized incremental returns that the long/short equity strategy has delivered in volatile markets can protect a broader equity allocation. Exhibit 5 shows the extent to which the cumulative hedge against negative environments overcame the excess return given up in positive environments and added up to a superior overall result.

Of course, implementing a risk factor based allocation involves obvious operational challenges, including regulatory requirements and committee member biases. From a pure investment perspective, however, liquidity is the largest impediment. Hedge funds simply are not as liquid as traditional long only allocations, and to participate in this strategy investors will need to sacrifice some level of liquidity.

Yet the value of this approach is readily apparent. Not only have hedge funds proven resilient through the ups and downs of a lengthy market cycle, but the best and brightest investment talent has gravitated to this less-constrained segment of asset management—and will continue to do so in our view. And perhaps figuring as importantly as any other element in hedge funds’ revival, the industry itself has taken important steps to seal the cracks that the crisis revealed in its foundation.

### Smoother ride: HFRI Equity Hedge Index returns have outgained the S&P 500 with substantially less volatility

**EXHIBIT 5: RISK/REWARD, OCTOBER 1995-SEPTEMBER 2010**

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<thead>
<tr>
<th></th>
<th>Return (%)</th>
<th>Volatility (%)</th>
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<tbody>
<tr>
<td>S&amp;P 500</td>
<td>6.45</td>
<td>16.31</td>
</tr>
<tr>
<td>HFRI Equity Hedge Index</td>
<td>10.71</td>
<td>9.73</td>
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<tr>
<td>HFRI Outperformance</td>
<td>4.26</td>
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Source: J.P. Morgan Alternative Asset Management, Inc.  
Note: For illustrative purposes only.