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Face of a New World

The Hedge Funds after the Crisis

Introduction

One of the most emotive issues for hedge funds during the crisis has been methods used by managers to defer providing liquidity when they received significant redemptions.
In many less liquid asset classes, sales can only be made at significant discounts.
This creates a dilemna between the rights of redeeming investor with urgent liquidity needs and the rights of remaining investors to have the value of the portfolio optimised.

It has been estimated that around 25% of the industry has been forced into some form of restructuring of their liquidity terms.
The offshore fund structures and LP structures typically used by the hedge fund industry afford a manager much more flexibility than the equivalent retail fund structures. There are some clauses typically in most fund documents:

• A gate limiting redemptions to a maximum percentage in a given period.

•Ability to deliver the underlying investment in species.

•A right to suspend calculation of NAV in period of material price uncertainty.

Lets look more closely to some of these terms and their consequences.

Introduction

Gates:

Gates are allowed in most funds offering memorandums to restrict the level of outflows e.g. 20% per quarter. However, one of the problems is that everyone feels the need to « game the gate » and put in a redemption notice to at least have the option for maximum participation in liquidity. There is also reluctance for potential new investors to commit due to the perceived overhang. Therefore, longer term a fund may wish to bring in a more comprehensive restructuring.

Suspended NAV:

This is mainly used as an interim measure. It is normally at the discretion of the directors of a fund and tends to be used to buy time until a better plan can be implemented. Because of director’s liability it is not a good long term solution. Following suspension, shareholders will be asked to vote for set options which can take the form of increased side pockets, longer lock-up, wind down of the fund, and so on.

Increased Side Pockets:

A side pocket enables a fund to take a portion of the assets and treat them more like private equity where distribution with be based on eventual realization. In the 2008 stressed cycle, funds have increasingly used side pockets retrospectively when positions accounting for a significant part of the portfolio become illiquid. Even when fund prospectus does not allow side pockets, the same effect can be achieved by use of an SPV (Special Purpose Vehicle). The SPV buys the less liquid assets of the fund and the SPV units are delivered to redeeming investors in species. The manager still remains in control of selling down SPV assets.

How it has impacted strategies

Certain strategies were always much more vulnerable to liquidity risk. This is especially true for **credit related strategies including convertible bonds**. The least affected strategies tended to be the more directional strategies. Convertible bonds proved one of the most vulnerable as **only 29%** of funds were able to keep to their normal liquidity terms.

Based on estimations, the highest other redeemed strategies in the 2008 H2 were:

- Statistical Arbitrage 48%
- European Long Short 25%
- Fixed Income Arbitrage 25%
- Emerging Market Long Short 24%
- Quantitative Market Neutral 24%
- Asia Pacific Long Short 20%

Some of the most heavily redeemed strategies were those that tended to offer easier liquidity terms with monthly or quarterly redemption windows and tended to be run more liquid portfolios. This has also been exacerbated by some of the fund of fund industry's own liquidity mismatch issues for example giving their investors better liquidity terms that they obtained from their hedge fund investments.

Multi-strategy and event driven strategies were the only ones that saw positive asset flows in 2008.

How it has impacted Star Funds

• **Centaurus Capital** and **Polygon Investments Partners** put gates in place, limiting what proportion of assets investors can withdraw at one redemption gate.

• **Gottex Fund Management**, **Wermuth Asset Management**, **Auriel** and **Atlantis Investment Management** all suspended withdrawals in October 2008 to ensure all investors would be treated fairly and to protect the value of those still in the funds.

•**RAB Capial**, **Ramius Capital**, **BlueBay Asset Management** and **Henderson Global Investors** proposed favorable fees for investors for certain funds so investors will stick to them.

These measures did not prevent investors to pull a record of $31 billion.

Other findings included a decline in the billion-dollar club. That refers to the numbers of firms with $1 billion or more under management, which shrank to 311 from 395 at the beginning of 2009.

As of Jan 1, 2009 (assets in billion of dollars):

Bridgewater Associates	$38.6
JP Morgan	$32
Paulson & Company	$29
D.E. Shaw Group	$28.6
Brevan Howard	$28.6
Och-Ziff Capital Management	$22.1
Man AHL	$22
Soros Fund Management	$21
Goldman Sachs Asset Management	$20.6
Farallon Capital Management	$20
Renaissance Technologies	$20

How it has impacted the global Hedge Fund Industry?

There is a big hole in the hedge fund industry, as nearly $1 trillion in assets has disappeared over the last six months of 2008.

In the end of 2008, a combination of poor performance and investors' withdrawals led to **33 percent drop** in the asset managed by the hedge funds, according to a report by HedgeFund Intelligence.

In January 2009, hedge funds were left with a total **$1.8 trillion under management** and that amount continue to drop during the first months of the year.

The decline in assets during 2008 was split relatively equally between negative performance and asset outflows:
On a regional level, redemptions were more responsible for a fall in assets in Europe and emerging markets, while in the US and Japan, losses on investments accounted for a bigger proportion of the decline. Asia saw the highest rate of liquidations.

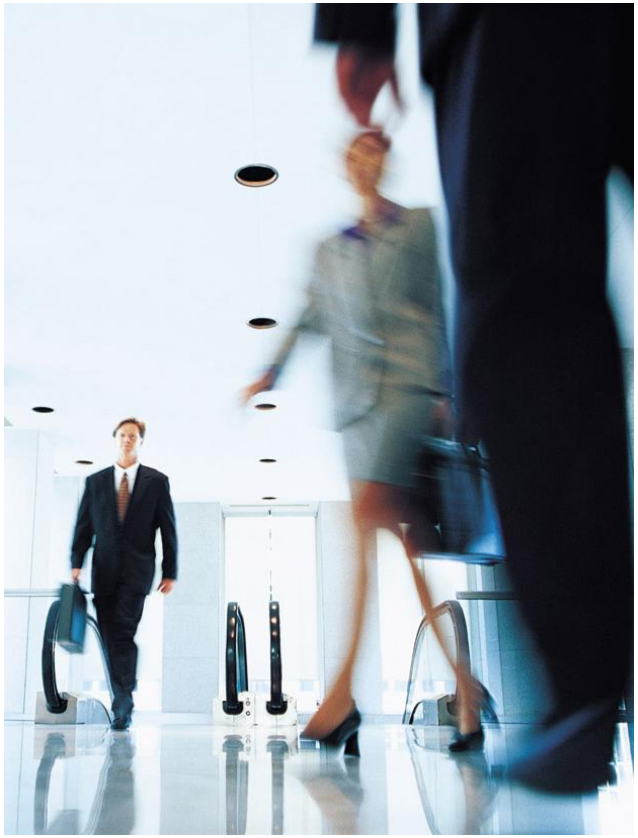
• The average hedge fund lost 15.7% in 2008.

•Among funds of funds, 85% lost money.

•The bulk of losses came between September and November 2008.

•The number of hedge funds fell by 10% in 2008 to around 10,000 with most closures coming in the latter part of the year.

Nevertheless, hedge funds outperformed many of the underlying markets, such as the S&P index which saw a 38% drop.



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