# Portfolio Insights

**January 2009**

*Lake Wobegon is a fictional town created by Garrison Keillor where "All the children are above average."*

## Hedge Fund Managers Capsize in "Lake Wobegon"

Over the past several years, we have grown increasingly concerned about the perception that hedge fund investing is a free lunch. The belief that in nearly all market environments equity-like returns can be earned with minimal risk has been soundly put to rest in 2008. Through the end of November 2008, the average hedge fund has fallen by over 19.4% (according to the HFRI Fund-of-Funds Composite Index) compared with the 37.7% decline in the S&P 500®. The combination of illiquid securities, leverage, and exotic derivatives has proven to be toxic for virtually all investors. A well-managed hedge fund should protect investors from some of that risk.

At Hawthorn, we often viewed hedge funds as an essential tool when constructing portfolios for our clients. Hedge fund managers may never regain their former status but qualified investors should not exclude hedge funds from thoughtful consideration in a well-constructed portfolio.

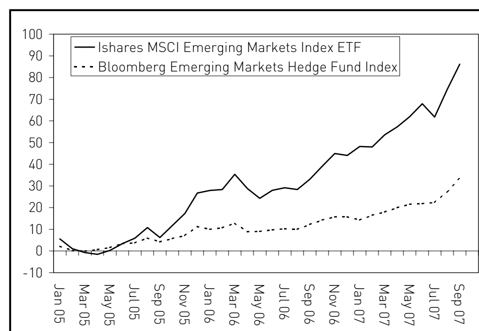
As 2009 begins, investors should remember these basic hedge fund principles.

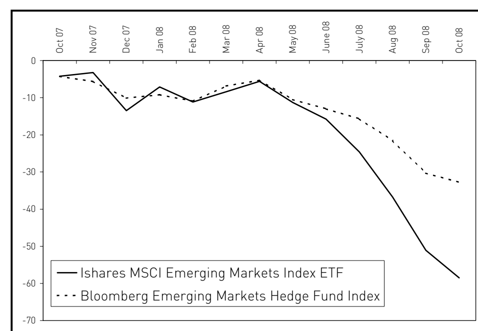
- **Understanding the underlying long-only strategy is key when using a focused hedge fund strategy.**

  As the charts below illustrate, the correlation between an emerging market exchange traded fund (in this case, iShares MSCI Emerging Markets Index ETF) and a Hedge Fund Index of emerging market managers (Bloomberg Emerging Markets Hedge Fund Index) is significant. When emerging market securities were rising, the hedge fund index rose, but not as much as the ETF did. The hedge fund index was not immune to the decline even though the underlying managers had the ability to short the market.

### Emerging Market Fund-of-Funds vs Emerging Market ETF

| | 1/31/05-10/31/07 (33 months) | | 10/31/07-11/28/08 (13 months) | |
|---|---|---|---|---|
| | Total Return | Difference | Total Return | Difference |
| Bloomberg EMHF | 86.15% | -69.93pp | -31.44% | 26.37 |
| IShares MSCI EM ETF | 156.09% | | -57.81% | |




*Source: Bloomberg lp*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This correlation between strategies holds true for many different equity and fixed-income markets. An investor must have an opinion as to the direction of the underlying long-only strategy in order to make a good decision on his hedge fund strategy.

Investors with very bullish views may want to simply own a long-only asset. Investors who want to capture most of the upside but are also concerned about a decline in values may want to consider a hedge fund to dampen return volatility.

- **Investors should value hedge fund returns because they are different, not because they are better.**

  Most hedge funds did not provide the absolute positive returns investors hoped for in 2008. Most of the well-managed funds, however, did produce returns that declined less than the long-only market averages. It is this low correlation to the broad market averages that we believe adds value to an investor's portfolio. By dampening the overall volatility of a portfolio, hedge funds allow investors a greater chance to achieve long-term investment goals.

- **Investors' liquidity is an asset that has value.**

  When investors lock up their funds in limited partnerships for periods ranging from a few months to several years, they are taking on the risk of illiquidity. They should be compensated for taking on this risk with a greater potential return.

- **Investors have been paying alpha prices for beta returns.**

  Not every hedge fund manager is above average. Many have merely been capturing market returns enhanced by leverage to justify high fees. Hedge fund assets at the end of 2008 are predicted to decline 35-45% from June 30, 2008, levels according to a Morgan Stanley report dated November 28, 2008. Those managers truly generating strong risk-adjusted returns should be successful in this evolving industry.

- **Transparency is necessary in funds to which investors commit capital.**

  Whether investors choose to invest through an individual fund or through a fund-of-funds, there must be an understanding of the underlying strategy and investments. The recent announcement of fraud at funds managed by well-known managers only serves to highlight the need for investors to commit capital with as much information as possible.

We believe a carefully researched portfolio of hedge funds can have a positive impact on a portfolio by lowering volatility. However, due to the turmoil faced by some managers because of deleveraging their portfolios to meet investor withdrawals, we are cautious toward this asset class. We recommend that investors defer any new commitments to hedge funds through the first quarter of 2009.

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