// HEDGE FUND monitor

First Quarter 2005

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Encore Performance – Bravo or Boo?

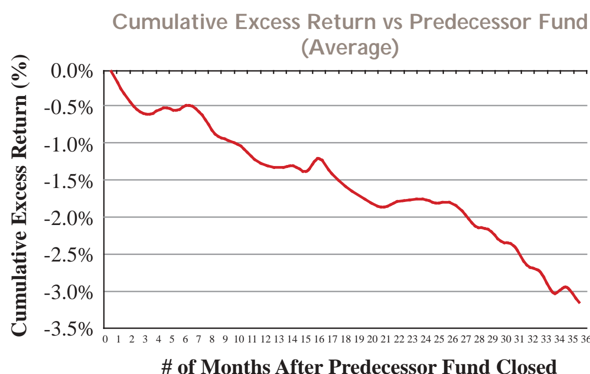
The natural cycle of a successful hedge fund often includes closure. When assets under management grow to a level where the marginal dollar added to the manager's strategy undermines the total profit for that manager, the disciplined response is to stop accepting new money. Faced with this reality, the fund-of-fund (FoF) community with dollars to allocate has effectively three responses to underlying manager closures: (1) allocate money to a new manager in a comparable strategy, (2) close that FoF product and open a new FoF product, or (3) stop accepting new money entirely for any FoF product. Each of these options has different implications for investors.

Looking at experience to date, we see that the FoF community has largely ignored the last option. This is perhaps not surprising, since the strong negative feedback mechanism from accepting new money is missing or muted in the FoF's profit equation. That is, incentive fees are a much smaller part, if any, of FoF compensation than they are for hedge funds, allowing the rational FoF enterprise to pursue new money as fast as it can comfortably put it to work. Or uncomfortably, as the case may be.

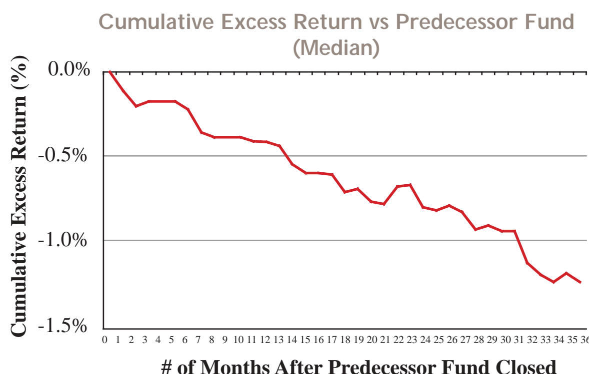
The first option is easiest and most common to consider, especially for FoFs with significant manager concentration. Diversifying manager concentration risk is normally a prudent practice. Many FoFs have remained competitive as their underlying manager line-up expands from 15 or 20 to 50 or more. However, a flood of new allocations undeniably has a potentially dilutive effect on that FoF's performance. The potential for above-average returns drops as the most attractive managers have increasingly smaller impact on the portfolio. The law of averages will take over, all things being equal. Eventually, at the extreme, such FoFs must consider the second option to prevent existing investors from defecting, especially when new investors do not even want to get in.

The second option for FoFs seems to show restraint in the face of unchecked asset-gathering temptations. At least for existing investors. The challenge then is for that FoF to win confidence from new investors that a new line of FoF progeny will behave as well as the predecessor. Pointing to expanding research platforms coupled with a significant degree of initial manager overlap, FoFs can often make convincing cases to a skeptical audience. Indeed, it's a natural leap of faith that the new FoF's performance will be competitive with the first when the previously successful process is held out as repeatable. Without a long history of multiple FoF generations in hedge fund investing, it was hard to argue otherwise.

However, with each passing month, evidence to the contrary is piling up. Using FoF returns available through March 31, 2005, we compared the monthly net returns of each second generation FoF with those of its respective predecessor managed in a similar manner. Of the 15 FoF managers reviewed with such matched pairs, only two had an encore performance that matches or beats its original fund performance to date. As shown in the chart below, the average cumulative underperformance after 36 months is 3.13%, or 1% per year.



In the median case, the cumulative underperformance over 36 months is much less (-1.22%) but still similarly persistent. This analysis suggests that few FoFs are as good as, let alone better than, the first. In this environment of capacity constraints within underlying funds, it is perhaps not surprising that the "second best" manager is, on average, worse than the originally best choice.



Excuses by these FoFs with a poorly performing encore are plenty, without even acknowledging this "second best" effect. For example, a closed FoF is no longer affected by significant cash flows in or out, whereas the newly opened FoF faces the implementation challenge of carefully allocating new assets, particularly in this current frenzy of unprecedented investor interest. Also, fees charged by the underlying funds are often higher for new money now being invested, further dampening the successor FoF's relative performance. Or, if these fees are not being raised, the new lock-up terms are longer, decreasing desirable liquidity.

To counter this headwind of concerns, FoFs often argue that new managers with a name to prove achieve more attractive returns than larger, more established funds, who have stronger

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motives to just protect their huge pile of insider capital while reaping management fees on outsider capital. Even if true, this mitigating explanation does not appear to undermine the current evidence favoring investment in a FoF before it closes, as opposed to its FoF sequel.

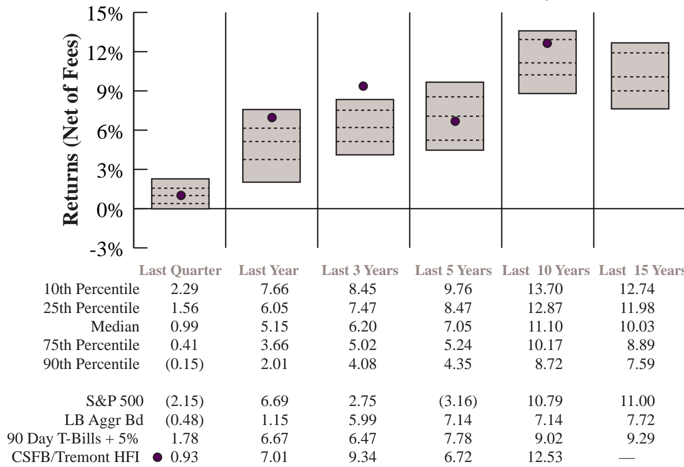
For those FoF managers who close one FoF only to open up another FoF with a different strategy emphasis, the evidence is more difficult to evaluate, but still suspicious. As hedge fund returns have been compressed in recent periods, these second generations of "different" FoFs often have higher volatility targets, ostensibly to achieve higher returns. A full market cycle that includes a bear market for hedge funds as well as for the capital markets might be needed to reveal the comparable quality of this next generation.

No matter how fund sponsors choose to invest, a portfolio manager accessing top-quality talent, new or old, is the lead character worthy of applause.

Hedge Funds Hold Steady as Markets Sag

After a heady finish last year, equity markets quickly lost momentum in the new year. Dictated by the Fed's "measured pace," rising interest rates increasingly threatened to undermine popular carry trades in the arbitrage markets. Nevertheless, hedge funds generally eked out small gains in this more selective equity and credit market. As a proxy for broadly diversified programs of hedge fund strategies, the median manager in the **Callan Hedge Fund-of-Fund Database** gained 0.99% last quarter, after all fees. Over the last year, the median manager netted 5.15%, or 3.48% above the risk-free rate.

Callan Hedge Fund-of-Fund Database Group
Returns for Periods Ended March 31, 2005

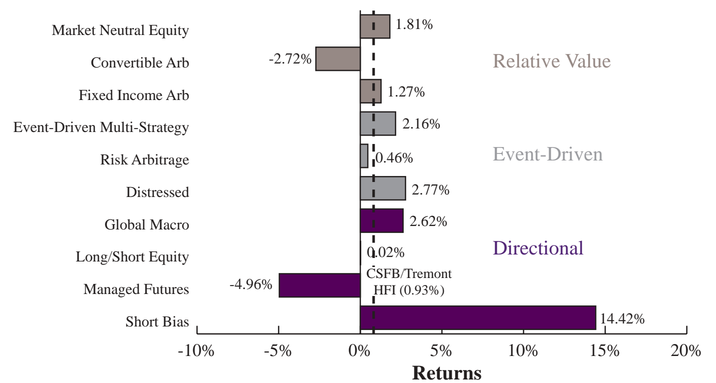


	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
10th Percentile	2.29	7.66	8.45	9.76	13.70	12.74
25th Percentile	1.56	6.05	7.47	8.47	12.87	11.98
Median	0.99	5.15	6.20	7.05	11.10	10.03
75th Percentile	0.41	3.66	5.02	5.24	10.17	8.89
90th Percentile	(0.15)	2.01	4.08	4.35	8.72	7.59
S&P 500	(2.15)	6.69	2.75	(3.16)	10.79	11.00
LB Aggr Bd	(0.48)	1.15	5.99	7.14	7.14	7.72
90 Day T-Bills + 5%	1.78	6.67	6.47	7.78	9.02	9.29
CSFB/Tremont HFI ●	0.93	7.01	9.34	6.72	12.53	—

Representing an asset-weighted universe of individual hedge funds, the **CSFB/Tremont Hedge Fund Index** edged ahead 0.93% last quarter, net of fees. During the quarter, February (+1.43%) was the bright spot of performance when the S&P 500 rose 2.10%. Roughly split between directional and non-directional strategies, this unmanaged composite index has gained 7.01% in the past year.

With no support from last quarter's sagging S&P 500 (-2.15%), the average *Long/Short Equity* manager (+0.02%) barely broke even. The *Short-Bias* manager (+14.42%) was this quarter's star performer, rebounding from a miserable performance in the previous quarter. A distant second, the *Distressed* manager reaped 2.77%, continuing its long healthy run despite already high valuations in the underlying credits.

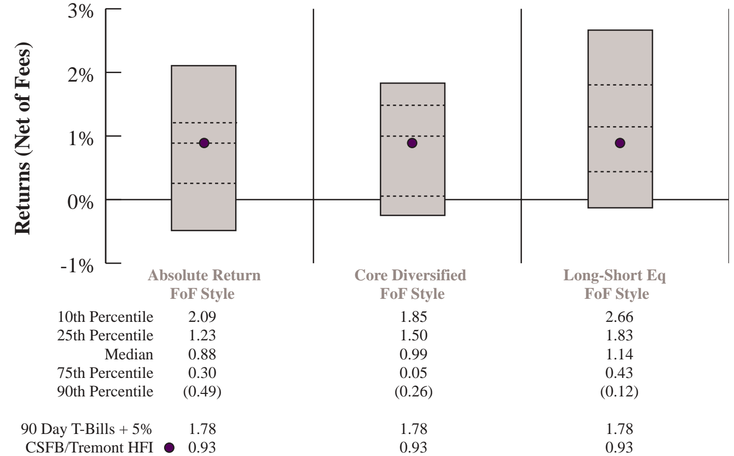
CSFB/Tremont Hedge Fund Strategy Performance
Returns for Quarter Ended March 31, 2005



Increasing market volatility improved trading opportunities for *Market Neutral Equity* (+1.81%) but not enough to help *Convertible Arbitrage* (-2.72%), where investor redemptions continued to plague performance. Discretely anticipating broad market trends last quarter, *Global Macro* advanced 2.62%. In contrast, the characteristically momentum-based *Managed Futures* (-4.96%) was caught flat-footed, retracing half of its fourth quarter jump.

Given the weakness in convertible arbitrage and other related strategies, the median manager within Callan's **Absolute Return FoF Style** group (+0.88%) slightly trailed the **Long-Short Equity FoF Style** manager (+1.14%). Exposed to both of these styles, the **Core Diversified FoF** manager split the difference with a 0.99% gain.

Callan Hedge Fund-of-Fund Style Groups
Returns for Quarter Ended March 31, 2005



	Absolute Return FoF Style	Core Diversified FoF Style	Long-Short Eq FoF Style
10th Percentile	2.09	1.85	2.66
25th Percentile	1.23	1.50	1.83
Median	0.88	0.99	1.14
75th Percentile	0.30	0.05	0.43
90th Percentile	(0.49)	(0.26)	(0.12)
90 Day T-Bills + 5%	1.78	1.78	1.78
CSFB/Tremont HFI ●	0.93	0.93	0.93

Did You Know…

about Callan's hedge fund advisory services?

- Education – determine whether hedge funds are appropriate for you
- Investment policy – document hedge fund goals and guidelines
- Asset allocation – define the appropriate strategic mix
- Manager structure – assess a manager's fit within a portfolio
- Manager search – follow a defined process for identifying qualified fund-of-fund managers using an independent third-party
- Performance evaluation – measure how well a fund-of-fund is adding value vs. its peers

For more information, contact your Callan consultant, Jim McKee, or Kelly Hicks at 415.974.5060.