

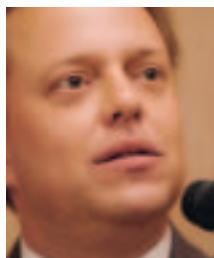
The Future of Hedge Funds



The Experts



Drago Indjic



Kevin Pilarski, '04 (XP-73)



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Edgar Sullivan

What lessons were learned in 2004, and where are hedge funds headed in 2005? Early this year, *Chicago GSB* spoke to several experts, some of whom had presented their views to more than 300 alumni and other business professionals in London last fall. Cohosted by the University of Chicago UK Alumni Association and the Global Finance Roundtable and sponsored by Dow Jones Indexes/Stoxx Ltd., the panel discussion was held at Le Meridien Piccadilly. Excerpts from that presentation—and subsequent conversations with the experts—follow. **By Melissa M. Bernardoni | Photos by Dan Dry | John Rowsell photo courtesy of Glenwood Capital Investments LLC.**

On the biggest lesson learned in 2004

Markets are a perennial teacher. We used a model comprised of three elements—LIBOR [London interbank offered rate], expected alpha, and a touch of beta (.2)—to explain historical returns for diversified portfolios of hedge funds. The model did a reasonably good job of explaining returns for our first three years of investing in hedge funds—2001, 2002, and 2003—but our performance during much of 2004, particularly in the middle two quarters, did not line up well with market behavior

as depicted by this model. The primary lesson is that a market in which volatility is at a historical low and correlations among stock returns are at their highest level in 25 years can be a particularly challenging environment for generating strong excess returns. We are currently researching a more robust model to explain historical performance.—**Edgar Sullivan**

There is no such thing as a traditional rate cycle. The behavior of long rates as the Fed tightened in 2004 was evidence of that.—**Rajiv Sobti**

Feature Hedge Fund Panel

As financial markets were decreasing, people realized that in certain arbitrage strategies, like convertible or statistical arbitrage, we can't create alpha without having volatility in the market; these sophisticated strategies did not make a lot of money in 2004. Lesson two is trending: for example, in commodities and the U.S. dollar weakness against a few other currencies. Whoever caught the strength made money.—**Drago Indjic**

On the outlook for the hedge fund industry in 2005

There will continue to be a bifurcation of investors in the hedge fund market. With the advent of larger or so-called conservative institutions coming to the market, they typically require greater transparency and can't withstand the volatility of some strategies. In the past, the primary investors in hedge funds were high-net-worth individuals, university endowments, and foundations. As the market evolves and large institutions like pension plans come into the mix, they are less comfortable with the volatility of the strategies with a higher return variance. Typically, CTAs and global macro funds, for example, are highly volatile, whereas strategies like equity market neutral, convertible arbitrage, and merger arbitrage typically experience less volatility, and as a result have a lower return stream. Those less volatile strategies are likely to take in more money and may or may not have lower returns because more dollars are chasing a limited pool of arbitrage opportunities.

Additionally, there's a consolidation in the industry—JPMorgan buying a huge piece of Highbridge, for example—because the industry is starting to mature. These bigger firms want access to established funds and have the distribution capabilities to raise additional assets. The big question for 2005 is, How much more transparency will funds be willing to give up? Typically, larger institutional clients demand it, as that is what they are accustomed to in the traditional asset management world.

“There is no such thing as a traditional rate cycle. The behavior of long rates as the Fed tightened in 2004 was evidence of that.” —**Rajiv Soboti**

Finally, fee structures on individual hedge fund managers are unlikely to come down. They're likely to stay high, especially amongst the well-performing, established managers. We're clearly in a seller's market on the hedge fund side. But, on the fund-to-fund side, there's going to be increased pressure on fee levels to come down. Institutional clients are highly sophisticated and are likely to question whether the extra layer of fees is worthwhile, especially if performance is mediocre.—**Kevin Pilarski, '04 (XP-73)**

I anticipate a re-widening of risk premiums as the Fed is perceived as being more hawkish than was originally priced in. Investors in hedge funds should be wary of the presence of credit strategies. It is likely to be a tough period for hedge fund strategies in general.—**Rajiv Soboti**

On what we'll learn in 2005

In 2005, we will finally be able to see a trade-off between alpha and size of some of the hedge funds. I believe it's very difficult to manage hedge fund assets once they go beyond \$1 billion. Now we have seen many of the organizations who are actually going through this \$1 billion barrier, and very soon we'll be able to see if there is a trade-off, or if there is an optimal size of a hedge fund or a fund of hedge funds.—**Drago Indjic**

On the importance of reputation

Clinton Group had a significant percentage of their assets redeemed by investors this year over questions regarding the valuation of their fixed-income portfolios. The CFTC [Commodities and Futures Trading Commission] and SEC later reviewed these accusations and gave Clinton Group a clean bill of health, but by then the assets had already left the firm. Reputation, or at least the perception of accuracy, needs to be much more guarded, and hedge fund managers need to be much more concerned with their firms' reputational risk.—**Kevin Pilarski, '04 (XP-73)**

On what to look for in 2005

Keep your eye on what's going on within the whole, what's called the event-driven space in the hedge fund arena in particular, because it's made up of a multitude of different strategies. Some of them are things like

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simply distressed debt, but others are things like merger arbitrage, corporate reorganization, corporate events and other activities proving to be a catalyst for recognition of value. And while distressed debt has really carried the day for a lot of people in the hedge fund business over the last 18 to 24 months, it won't be as strong going forward because we're seeing very strong returns, lower and lower volatility, and that usually tells you a strategy may be topping out at this stage.

What is almost countercyclical to that is you saw a pickup in merger activity in the fourth quarter. While spreads are not tremendously great (from the merger arbitrageur standpoint), deal flow almost begets more deal flow. It's indicative of a corporate sector that's willing to be more aggressive in looking at doing deals at this stage. All the interest you're starting to see in IPOs is reminiscent of that, too. If there's an area to keep your eye on for some unique opportunities—not the way people have made money in those spaces over the last 24 months, but going forward—I think there will be some very interesting areas.—**John Rowsell**

On European hedge fund advancements

In a purely academic sense, some fundamental research in finance developed in Europe is unique and leading-edge in the hedge fund area. For example, a very important generalization of Sharpe ratio, omega function, was developed in Europe. We'll probably see more application of omega theory, a European invention, in the States. Second, hedge fund regulation, very important for institutional investors, has advanced more in Europe than in the States. However, what Europe lacks is the

risk-taking culture: more hedge fund “early stage” capital.—**Drago Indjic**

On what will shape 2005 returns

The factors expected to shape 2005 returns are indeed mixed, but on balance they suggest that returns are likely to equal or perhaps surpass the 4 percent to 6 percent return achieved by most diversified portfolios of hedge funds in 2004. A higher LIBOR rate, increasing mergers and acquisitions activity, and a possible

increase in volatility from historical lows should exert upward pressure on returns. At the same time, however, with credit spreads very narrow and equities seemingly fully valued, some factors that contributed positively to 2004 returns are likely to be more restrained in the current year.—**Edgar Sullivan**

About the Experts

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