Trade Strategy

Ana Avramovic
+ 1 212 325 2438

Behind the Gates: Hedge Funds in Focus

Key points

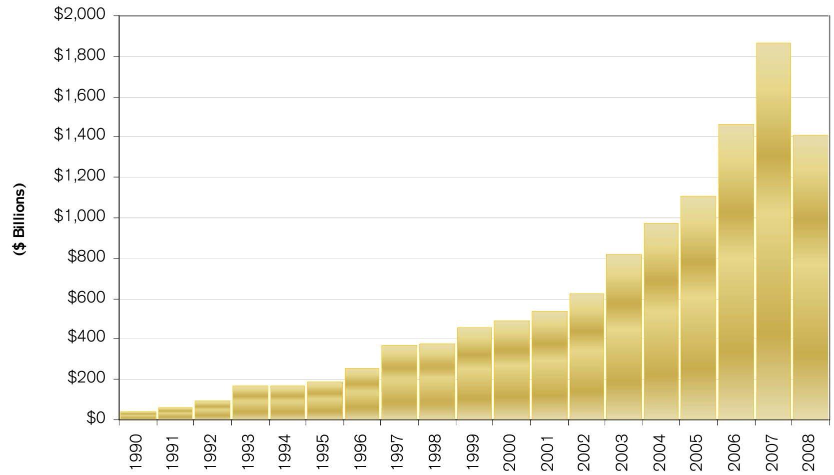
- Hedge funds, like most other asset classes, suffered a good deal in 2008
- Among the superlatives:
  - Most fund closings ever
  - First time more funds were liquidated than launched
  - Largest amount of redemptions in a single month, quarter and year
  - Worst market returns in nearly 20 yrs
- In this report we examine the industry's assets and fund flows
- We also review the profile of the industry by number of funds, redemption terms, and a breakdown of AUM by strategy

Hedge Fund Industry Not Immune to Losses

Total Industry Assets Fall to 2006 Levels

2008 was a tough year for investors in almost all asset classes. Even the hedge fund industry was not immune as deleveraging, investor redemptions, and market losses caused total industry assets to fall to around $1.4 trillion, a level not seen since 2006, according to Hedge Fund Research. Assets peaked at just under $2 trillion in June 2008.

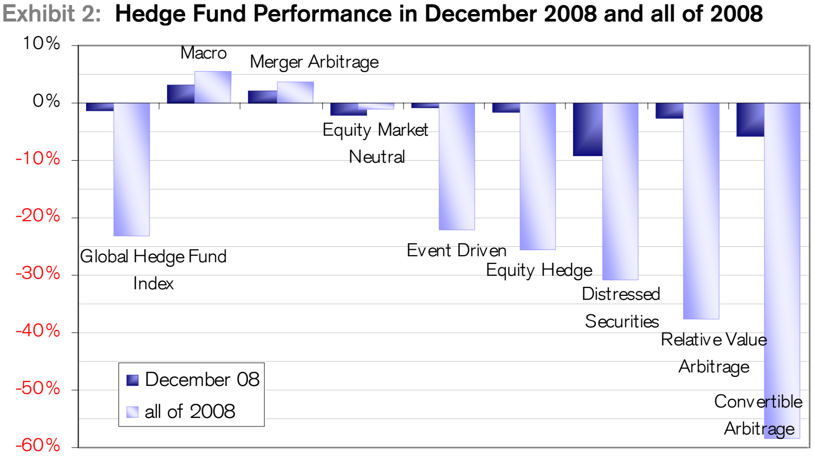
Exhibit 1: Total Hedge Fund Industry Assets Globally at Year End



Source: Credit Suisse: Portfolio Strategy, HFR

2008 also marked the largest decline in total assets. Combined losses of almost -$500 Bn (due to redemptions + market losses) were in stark contrast to the record gain of +$400 Bn seen in 2007. This is substantially more than the -$0.4 Bn decline in 1994, the only other year when assets declined.

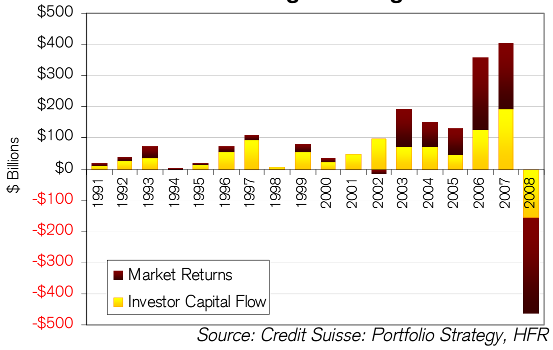
Exhibit 2: Hedge Fund Performance in December 2008 and all of 2008



Source: Credit Suisse: Portfolio Strategy, HFR

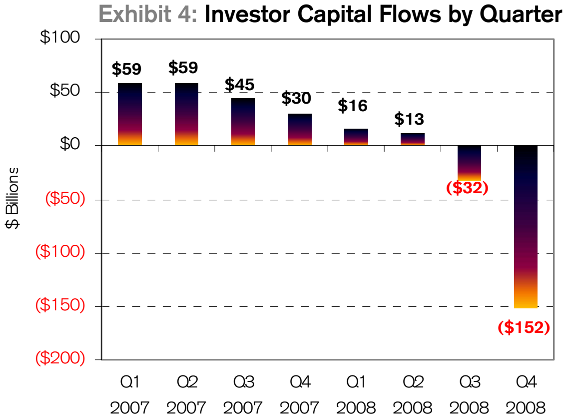
Strategy	December 08	all of 2008
Global Hedge Fund Index	**-1.2%**	**-23.3%**
Macro	3.3%	5.6%
Merger Arbitrage	2.2%	3.7%
Equity Market Neutral	-2.1%	-1.2%
Event Driven	-0.8%	-22.1%
Equity Hedge	-1.7%	-25.5%
Distressed Securities	-9.2%	-30.7%
Relative Value Arbitrage	-2.8%	-37.6%
Convertible Arbitrage	-5.8%	-58.4%

Exhibit 3: **YoY Change in Hedge Fund Assets**



Source: Credit Suisse: Portfolio Strategy, HFR

Exhibit 4: **Investor Capital Flows by Quarter**



Source: Credit Suisse: Portfolio Strategy, HFR

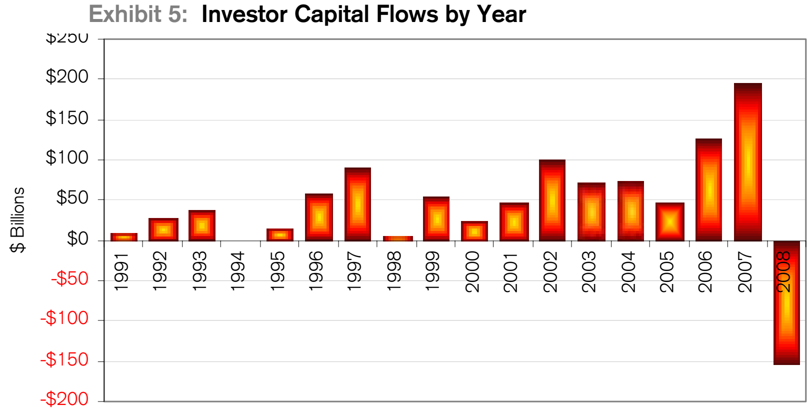
Q4 was a Quarter of Dubious Distinction

Beginning in 2007, every quarter's net capital flows were less than the previous quarter and finally turned negative in the second half of 2008.

By the end of Q3, outflows had almost completely reversed inflows from the rest of the year. When combined with market losses, Q3 alone erased inflows from all of 2007.

Of course, Q4 proved to be even worse with record redemptions and a record decline in total assets. Losses from market performance were worse in Q3 2008, but only because the asset base was larger. Q4 market returns were still worse.

Exhibit 5: **Investor Capital Flows by Year**



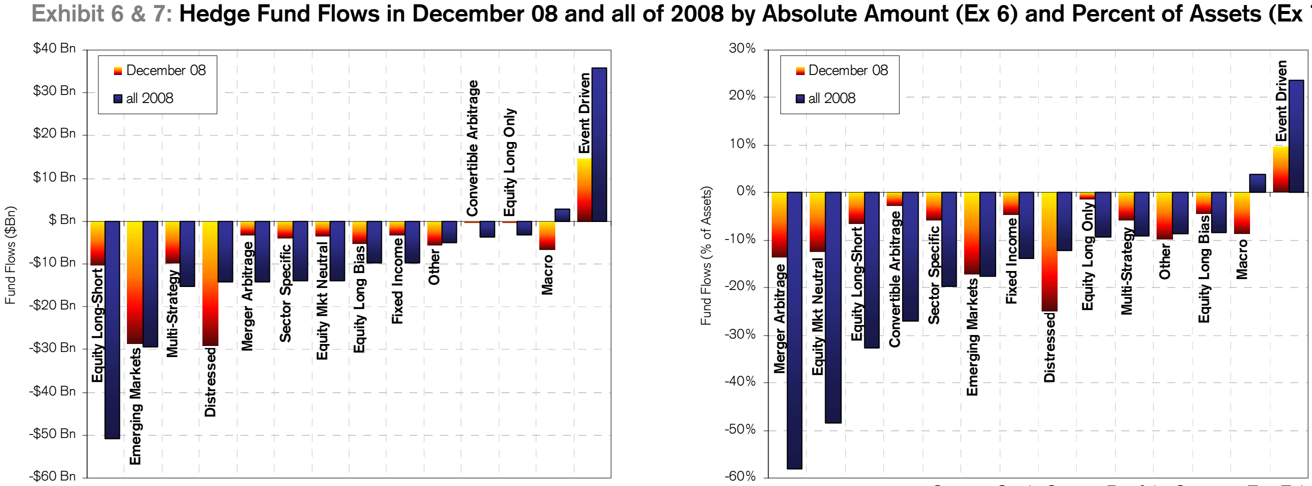
Source: Credit Suisse: Portfolio Strategy, HFR

Examining Hedge Fund Flows by Strategy

Breaking down the outflows by specific hedge fund strategy, we find that:

- Event Driven was the only strategy that received money in December
- For all of 2008, Macro was the only other strategy (besides Event Driven) with net inflows
- Equity Long-Short suffered the most outflows in 2008, over -$50Bn (33% of assets)
- As a percent of assets, Merger Arb lost almost -60% of assets in 2008, but it also represents only a relatively small amount of all industry assets (about 2%, according to TrimTabs; see pg 3)
- Distressed and Emerging Markets fared the worst in December both in terms of absolute flows and % of assets

Exhibit 6 & 7: **Hedge Fund Flows in December 08 and all of 2008 by Absolute Amount (Ex 6) and Percent of Assets (Ex 7)**



Source: Credit Suisse: Portfolio Strategy, TrimTabs

Profile of the Industry

Exhibit 8: Distribution of Hedge Fund Assets by Strategy

Credit Suisse/Tremont		TrimTabs	
Convertible Arbitrage	1.9%	Convertible Arbitrage	1.2%
Dedicated Short Bias	0.7%	*Distressed Securities*	7.5%
Emerging Markets	7.4%	Emerging Markets	12.4%
Equity Long-Short	23.9%	Equity Long Bias	10.0%
		Equity Long Only	3.1%
		Equity Long-Short	12.9%
Equity Market Neutral	3.5%	Equity Market Neutral	2.0%
Event Driven	27.4%	Event Driven	14.1%
Fixed Income Arbitrage	3.7%	Fixed Income Arbitrage	5.3%
Global Macro	15.4%	Global Macro	6.0%
Managed Futures	4.2%	*Merger Arbitrage*	1.9%
Multi-Strategy	11.8%	Multi-Strategy	13.7%
		Other	4.4%
		Sector Specific	5.6%

Source: Credit Suisse: Portfolio Strategy, TrimTabs, CS/Tremont

Breakdown of Assets

Since hedge funds do not report official figures, there is no definitive source for data on the industry. Various data providers conduct their own fund surveys to generate estimates, which may vary from provider to provider.

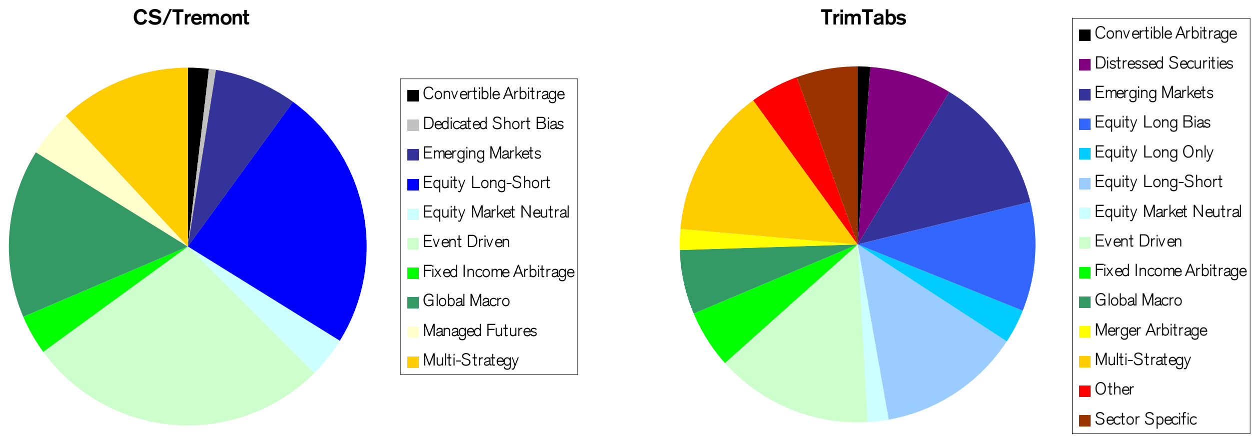
According to Credit Suisse/Tremont, Event Driven and Equity Long/Short comprise the bulk of the hedge fund universe, collectively accounting for nearly half of the entire industry (Ex 8 & 9). In this case, Equity Long/Short includes Long Bias, Long Only and Long/Short (not market neutral).

TrimTabs further distinguishes between these 3 categories and estimates that of that category, Long-Short accounts for roughly half, Long Bias for 40%, and Long-Short for the remaining 10% (Ex 8 & 10).

Interestingly, especially in light of all the criticism short sellers have faced recently, CS/Tremont estimates that Dedicated Short hedge funds account for *less than 1%* of all strategies (by total assets).

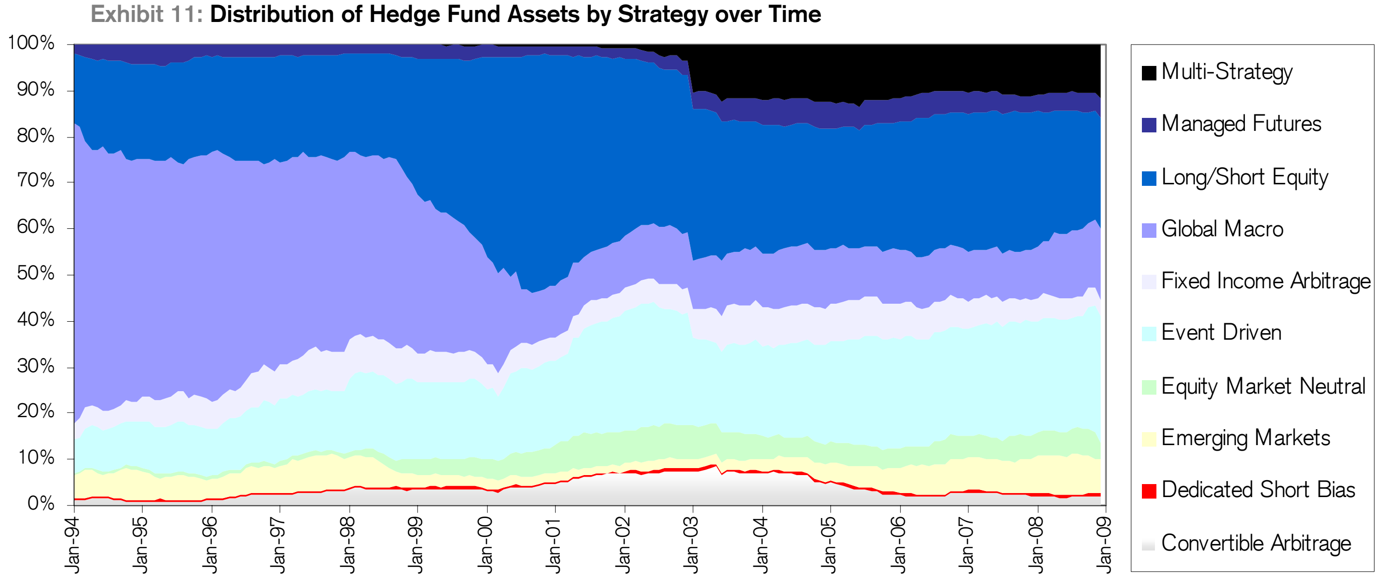
Please refer to the Appendix for a description of hedge fund strategies

Exhibit 9 & 10: Distribution of Hedge Fund Assets by Strategy According to Credit Suisse/Tremont (Ex 9) and TrimTabs (Ex 10)



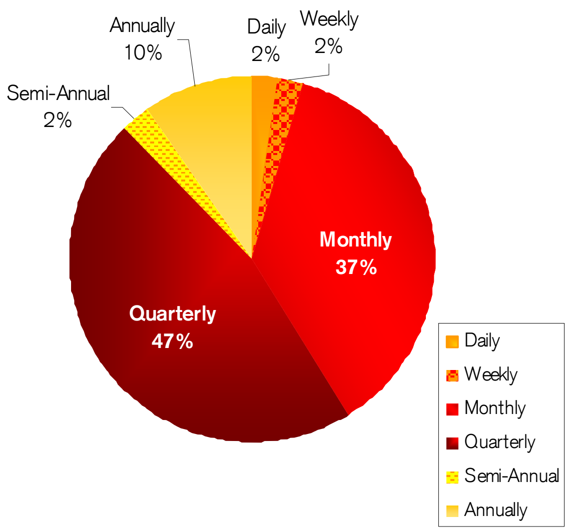
Source: Credit Suisse: Portfolio Strategy, TrimTabs, CS/Tremont

Exhibit 11: Distribution of Hedge Fund Assets by Strategy over Time



Source: Credit Suisse: Portfolio Strategy, CS/Tremont

Exhibit 12: **Breakdown of Hedge Fund Assets by Redemption Terms**



Source: Credit Suisse: Portfolio Strategy, TrimTabs

Redemption Terms

Unlike mutual funds, many hedge funds impose lock-up periods on invested assets. Investors are only allowed to make withdrawals at designated intervals. While this affords the investor less liquidity, it allows the fund manager to implement longer-term strategies without having to worry about constantly keeping extra cash on hand in order to meet an ad-hoc redemption request.

The investment terms vary from fund to fund, but according to TrimTabs, the bulk of hedge funds allow monthly or quarterly redemptions. Shorter periods are much rarer (Ex 12).

The Future of the Industry: Consolidation Ahead

Many industry experts expect the industry to contract substantially in the coming years. We're already seeing the attrition underway as 2008 saw an estimated 920 funds close according to Hedge Fund Research, the most ever and the first time more HFs were liquidated than launched.

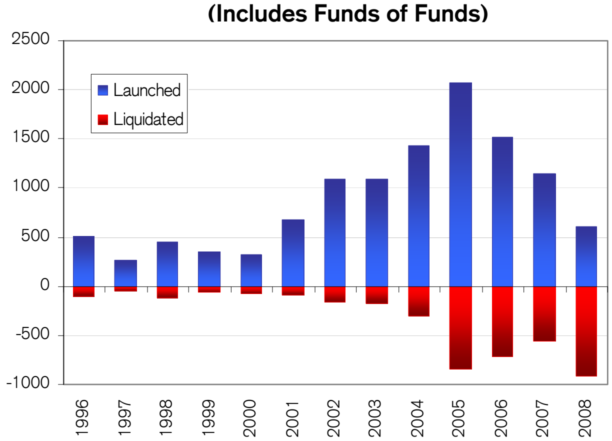
However, it is unlikely that people will pull out of hedge funds entirely because, despite their poor returns in 2008, they still outperformed many markets and remain a positive factor in reducing volatility within a portfolio.

That being said, investors may become more selective about which funds they invest in and may demand more disclosures, especially in the wake of the Madoff scandal. In addition, people may be losing confidence in hedge funds' ability to deliver alpha and may not want to pay high management fees if funds aren't delivering that alpha that they expect. Indeed, some funds have already altered their fee structure to eliminate blanket management fees and/or reduce their take of profits. We may see more and more funds adopt similar structures as they compete for investor dollars in a contracting environment.

According to Alpha Magazine, the 10 largest hedge funds account for roughly 20% of industry assets; the top 100 comprise 75% of AUM. We may see even further consolidation in the coming years.

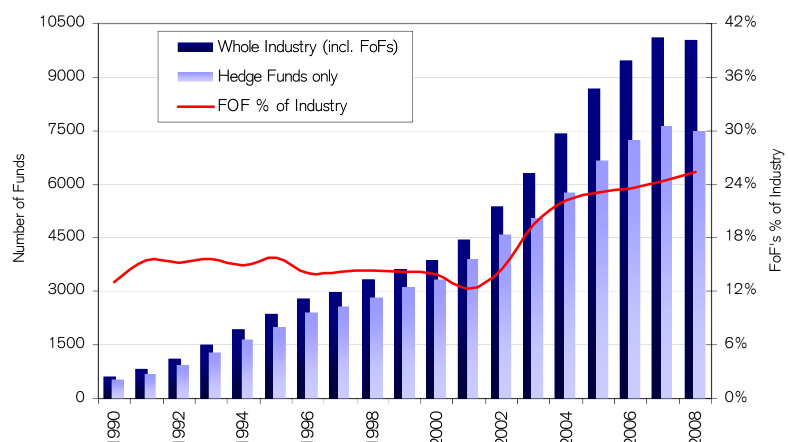
We also see from Ex 14 that Funds of Hedge Funds have become a larger portion of the market over time, as high as 25% in 2008 (see Ex 14). We may see that trend reverse as investors balk at paying an extra layer of fees or prefer to perform their own due diligence of specific funds rather than trusting someone else to do so.

Exhibit 13: **Total Hedge Fund Launches & Liquidations (Includes Funds of Funds)**



Source: Credit Suisse: Portfolio Strategy HFR

Exhibit 14: **Number of Hedge Funds & Funds of Funds**



Source: Credit Suisse: Portfolio Strategy HFR

Appendix: Description of Hedge Fund Strategies

Equity Hedge / Directional

Dedicated Short Bias: May go long and short securities but maintains net short exposure

Emerging Markets: Invests in securities from "emerging" countries

Equity Long/Short: Takes both long and short positions as appropriate

Equity Market Neutral: Attempts to profit from idiosyncratic risks while minimizing systematic market exposure through offsetting long and short positions

Quantitative: uses computer models to select stocks

Also includes: **Sector Specific** or **Style Specific** (Value/Growth)

Relative Value

Seeks to profit from mispricings between related securities while minimizing exposure to the broad market

Includes: **Capital Structure Arbitrage**, **Convertible Arbitrage, Credit Arbitrage, Fixed Income Arbitrage, Statistical Arbitrage/Pairs Trading, Vol Arb**

Event Driven / Special Situations

Seeks to capitalize on specific corporate events such as mergers (**Risk/Merger Arbitrage**), bankruptcies (**Distressed Investing**), regulatory changes, litigation, restructurings, etc.

Also includes: **Activist funds**

Broad

Global Macro: Invests based on high-level macroeconomic themes using any securities in any market (including currencies, equities, debt, commodities)

Managed Futures: Gains exposure to various markets (bonds, equities, currencies, commodities) via futures; often based on technical analysis and market trends, but some strategies also employ fundamental analysis

Multi-Strategy: allocates capital between a variety of above strategies, shifting allocations as opportunities change

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