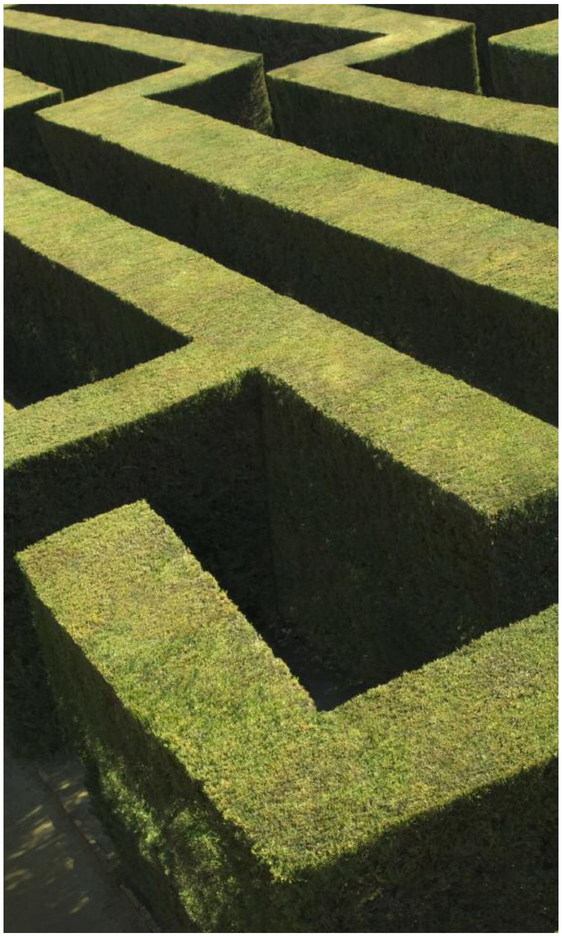

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The Dog that Didn't Bark

A Review of 2007 Hedge Fund Performance

By

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The polite word for 2007 is "challenging." Most money managers would use less polite language. The collapse of the U.S. credit bubble created challenges for all managers, both long-only and hedge funds. Within the hedge fund community, there were high-profile losses at some funds, and equally high-profile gains at others, but the hedge fund averages reveal something much less dramatic, namely, decent returns in a tough environment. The averages fail to capture the drama precisely because they are diversified portfolios, which is one reason why the aggregate hedge fund community was able to survive 2007 in decent shape. Despite endless hand-wringing about hedge funds as a threat to the financial system, hedge funds were not the main cause of the credit crisis, nor were they the main victim. Hedge funds are the explosion that didn't happen: the dog that didn't bark.

The main cause of the crisis was an environment of unsustainably tight yield spreads, in which investors accepted modest amounts of incremental yield in exchange for "tail risks" that were dramatically under-appreciated. Many hedge funds participated in the "yield hog" game, but they were merely part of a larger trend based outside the hedge fund sector. Ironically, the main victims of the credit collapse are not the ("lightly-regulated") hedge funds but the ("heavily regulated") banks, which are now in the intensive care unit, receiving capital transfusions from sovereign wealth funds and other sources. Having spent many years trying to reduce balance sheet risk and increase fee-related income, the banks wound up with exactly what they were trying to avoid: massive balance sheet risk.

Although the focus of this paper is 2007, we should note that 2008 is already proving to be highly "challenging." Several highly-leveraged fixed income hedge funds have imploded, Bear Stearns is no more, and anxiety still runs high even after unprecedented levels of Federal Reserve intervention. Hedge Fund Research reports that their Diversified Fund-of-Funds Index is down 1.5% for the first two months of 2008. Considering the market background, many investors would be glad to have that return.

Hedge Fund Performance

The table on page 2 shows hedge fund returns compiled by Hedge Fund Research. For each strategy we show the return for 2007 as well as measures of risk and dispersion. For risk, we show the worst monthly return and the annualized standard deviation of monthly return. For dispersion, we show the 5th percentile return and the 95th percentile return within each strategy group. We cannot vouch for the accuracy or the comprehensiveness of the HFR data, but the general direction of the numbers is consistent with what we have observed. A few highlights are worth noting.

For starters, notice that funds-of-funds performed well in 2007. Although these investment vehicles are often criticized for their extra layer of fees, they do offer several advantages. Every fund-of-funds delivers manager diversification, and the better funds offer intensive manager due diligence and intelligent strategy allocations. These advantages had real value in 2007. HFR divides the fund-of-funds group into several sub-groups depending on risk level and other factors. The full group was up 10.0%, with the various sub-groups showing returns ranging from 7.7% to 12.8%. These results are exactly in line with the expectations of many funds-of-funds investors, who are trying to beat LIBOR by 3% to 5% or more. These returns are especially interesting given that many of the underlying hedge fund strategies had somewhat tepid performance.

As you would expect, dispersion within the specific strategy categories is much higher than within the fund-of-funds universe. A good fund-of-funds manager can add substantial value by avoiding the big negative numbers that are present in virtually every category.

As seen below, only four strategies did better than 10%: equity hedge, 10.5%; equity non-hedge, 12.3%; macro, 11.2%; emerging markets, 25.0%. Funds-of-funds were either tilted toward the better performing strategies, or made good manager picks within the strategies, or both.

2007 Hedge Fund Review

	2007 Return (%)	Return In Worst Month (%)	Standard Deviation (%)	5th Percentile (%)	95th Percentile (%)
Fund of Funds: Composite	10.0	-2.2	5.2	22.9	-2.7
Fund of Funds: Diversified	9.7	-2.2	5.1	8.5	2.0
Fund of Funds: Strategic	12.8	-2.4	6.3	29.5	-2.5
Fund of Funds: Market Defensive	10.8	-2.9	5.7	17.4	0.1
Fund of Funds: Conservative	7.7	-1.8	3.8	15.3	-4.2
Equity Market Neutral	5.2	-1.3	2.4	23.1	-12.2
Convertible Arbitrage	4.7	-1.0	3.7	18.4	-12.2
Fixed Income Arbitrage	2.7	-1.5	3.2	19.8	-30.6
Event-Driven	6.7	-2.5	5.5	32.2	-10.8
Merger Arbitrage	7.1	-1.5	3.8	54.5	-6.1
Distressed Securities	5.1	-2.2	4.6	17.2	-6.6
Equity Hedge	10.5	-2.8	6.1	47.1	-10.3
Equity Non-Hedge	12.3	-4.7	9.0	74.3	-18.1
Emerging Markets	25.0	-2.7	8.3	80.8	0.6
Macro	11.2	-2.1	5.4	34.8	-12.7
Short Selling	4.7	-2.9	9.5	23.9	-4.0
S&P 500	5.5	-4.2	9.7	--	--
Russell 2000 Value	-9.8	-8.5	12.9	--	--
Russell 2000 Growth	7.1	-6.9	12.3	--	--
Russell 1000 Value	-0.2	-4.9	10.3	--	--
Russell 1000 Growth	11.8	-3.7	9.6	--	--
MSCI AC World Index Free	11.7	-4.4	9.9	--	--
MSCI EAFE	11.2	-3.3	9.6	--	--
MSCI Europe	13.9	-3.2	10.9	--	--
MSCI EMF	39.4	-7.1	18.4	--	--
Lehman Bros. Gov/Credit	7.3	-0.9	2.9	--	--
ML High Yield	2.2	-3.1	5.7	--	--
ML All Convertibles	4.5	-3.9	7.6	--	--
LIBOR 3 Month	5.4	0.4	0.1	--	--

Source: Hedge Fund Research. See index definitions on page 4.

Notice that, although there was substantial dispersion within each of the fund-of-funds categories, this dispersion was conspicuously biased toward the upside. Returns at the 5th percentile level are in the range from 15% to 30%, while returns at the 95th percentile level are in the range from zero to -5%.

As you would expect, dispersion within the specific strategy categories is much higher than within the fund-of-funds universe. A good fund-of-funds manager can add substantial value by avoiding the big negative numbers that are present in virtually every category. Having emphasized that the strategy averages mask considerable dispersion, let's have a closer look at some of those averages.

Examining the Numbers

Equity market neutral (up 5.2%) and fixed income arbitrage (up 2.7%) are designed to be "hedged" strategies with minimal levels of directional market risk. Equity market neutral includes the quantitative long value/short growth managers who came under considerable pressure during the summer of 2007 as credit anxieties sparked fears about the financing of private equity deals. Those deals often target value stocks, so the long value/short growth bet lost money. As for fixed income arbitrage, this strategy typically revolves around positive carry trades, which are essentially a bet on stable or tightening yield spreads. This strategy faced a major headwind as credit spreads and mortgage spreads widened. Under the circumstances, it is remarkable that the group was able to post a positive return.

Event driven, merger arbitrage, and distressed securities strategies all generated returns ranging from 5% to 7%, which is also impressive considering the turmoil of the markets. Despite anxieties about the financing of private equity transactions, the broader M&A market enabled managers to turn in a positive year. As for sub-prime exposure, there were winners as well as losers. The winning group includes a few well-publicized funds that had large and concentrated short positions, but there were also a number of less-publicized situations where managers earned good (but not outrageous) returns from short positions that were less aggressively sized.

Equity hedge funds were up 10.5% while the "equity non-hedge" group (i.e., more long-biased) was up 12.5%. These are good numbers, given that the S&P 500 was only up 5.5%, but they also suggest some ability to take advantage of disparities within markets. For example, 2007 was a year in which growth dramatically outperformed value (among both large cap and small cap stocks) and non-U.S. stocks did better then the U.S. If you were tilted in the right direction, there were opportunities to do substantially better than the S&P 500.

The macro funds were up 11.2% as many managers made money from volatility in the interest rate, currency, and commodity markets. In addition, many macro funds with a momentum orientation were drawn to the strong uptrend in emerging markets equities, which became a source of good returns.

Short sellers were up 4.7% in 2007, which is a good number, considering that the S&P 500 was up 5.5%. However, strength in the broad index masked weakness in specific sectors, especially the small cap value sector, which was down 9.8% for the year. Clearly, though, the short sellers were not clairvoyant enough to have had massive short positions in the small cap value sector. This is consistent with the broader theme: navigating through the storm without major damage, but also without dramatic profits.

The hedge fund universe is the target of massive amounts of hype, both positive and negative. According to the positive hype, hedge fund managers are investment geniuses ("reliable alpha generators") whose talent enables them to make money independent of market direction. According to the negative hype, the hedge fund universe is a swarm of over-confident market junkies who will pursue any risk to earn the 20% performance fee. The year that just finished is yet another useful illustration that both kinds of hype have little connection with reality. The hedge fund community was not demolished in 2007, nor did it coin money. If you spent 2007 on Mars, the year-end results might make you wonder what all the fuss was about. If you were on earth during 2007, you'd think the numbers are pretty good.

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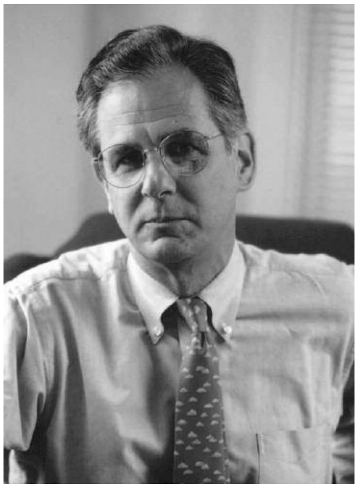

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From 1970 to 1982 Bob was a member of the faculty of Yale University. In 1982-83 he was a member of the faculty of the University of Massachusetts at Amherst. He is the author of All About Hedge Funds *(McGraw Hill, 2002). He holds a B.A. from Princeton, a B.Phil. from Oxford, and a Ph.D. from Cornell.*

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The HFRI Monthly Indices ("HFRI") are a series of benchmarks designed to reflect hedge fund industry performance by constructing equally weighted composites of constituent funds, as reported by the hedge fund managers listed within HFR Database. The HFRI range in breadth from the industry-level view of the HFRI Fund Weighted Composite Index, which consists of more than 2000 funds, to the increasingly specific-level of the sub-strategy classifications. **The HFRI Fund of Funds Composite** consists of more than 800 funds. All HFRI constituents are required to report monthly, net of all fees performance and assets under management U.S. dollars. Constituent funds must have either (a) $50 million under management or (b) a track record of greater than 12 months.

Fund of Funds: Diversified – Exhibit one or more of the following characteristics: invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets.
Fund of Funds: Strategic – exhibit one or more of the following characteristics: seeks superior returns by primarily investing in funds that generally engage in more opportunistic strategies such as Emerging Markets, Sector specific, and Equity Hedge; exhibits a greater dispersion of returns and higher volatility compared to the HFRI Fund of Funds Composite Index. A fund in the HFRI FOF Strategic Index tends to outperform the HFRI Fund of Fund Composite Index in up markets and underperform the index in down markets.
Fund of Funds: Market Defensive – exhibit one or more of the following characteristics: invests in funds that generally engage in short-biased strategies such as short selling and managed futures; shows a negative correlation to the general market benchmarks (S&P). A fund in the FOF Market Defensive Index exhibits higher returns during down markets than during up markets.
Fund of Funds: Conservative – exhibit one or more of the following characteristics: seeks consistent returns by primarily investing in funds that generally engage in more "conservative" strategies such as Equity Market Neutral, Fixed Income Arbitrage, and Convertible Arbitrage; exhibits a lower historical annual standard deviation than the HFRI Fund of Funds Composite Index. A fund in the HFRI FOF Conservative Index shows generally consistent performance regardless of market conditions.
Equity Market Neutral: employs strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. Equity Market Neutral Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.
Convertible Arbitrage: includes strategies in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple components of the spread is a convertible fixed income instrument.
Fixed Income Arbitrage: Now known as Fixed Income – Corporate. These srategies include those in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple components of the spread is a corporate fixed income instrument.
Event Driven: Investment Managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments.
Merger Arbitrage: strategies employ an investment process primarily focused on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction.
Distressed Restructuring Strategies: employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings.
Equity Hedge: Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors.
Equity Non-hedge: Now known as Quantitative Directional. These strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale.
Macro: refers to a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets.
Short-Selling: Now known as Short-Biased strategies. These employ analytical techniques in which the investment thesis is predicated on assessment of the valuation characteristics on the underlying companies with the goal of identifying overvalued companies.
Emerging Markets: have a regional investment focus in one of the following geographic areas: Asia ex-Japan, Russia/Eastern Europe, Latin America, Africa or the Middle East.
S&P 500: The Standard & Poor's 500 (S&P 500) Composite Stock Price Index is a widely accepted, unmanaged index of overall U.S. stock market performance.
Russell 2000 Value: The Russell 2000 Value Index is an unmanaged index, which measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.
Russell 2000 Growth: The Russell 2000 Growth Index is an unmanaged index which measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.
Russell 1000 Value: The Russell 1000 Value Index is an unmanaged index which measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. Russell 1000 Growth - The Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.
MSCI AC World Index Free: The MSCI ACWI (All Country World Index) Index) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The index includes 48 country indices comprising 23 developed and 25 emerging market country indices.
MSCI EAFE: The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The index includes 21 developed market country indices.
MSCI Europe: The MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The index includes 16 developed market country indices.
MSCI EMF: The Morgan Stanley Capital International Emerging Markets Free Index, a free float-adjusted market capitalization index that is designed to measure equity-market performance in the global emerging markets. The index includes seven emerging market country indices.
Lehman Brothers Government/Credit: A broad-based unmanaged index of all government and domestic corporate bonds that are investment grade with at least one year to maturity.
Merrill Lynch High Yield: The Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.
Merrill Lynch All Convertibles: The Merrill Lynch All U.S. Convertible Securities Index is a market capitalization-weighted index of domestic corporate convertible securities that are convertible to common stock only.
LIBOR 3 Month: Libor is a commonly used benchmark reflecting the yield at which highly rated banks lend to each other.