



What Comes Next for Hedge Funds?

By

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Executive Summary

- We believe the hedge fund model will endure and evolve while the industry goes through a consolidation that will favor firms with strength, stability and experience.
- Hedge funds are adapting with changes to investor terms and increased transparency, and are actively anticipating changes to market dynamics, such as, the development of exchange trading of credit default swaps (CDS).
- Regulators contemplating change need to be attuned to both the deficiencies and unique strengths of the current hedge fund industry structure. Hedge funds, through the Managed Fund Association (MFA) and other industry groups, are currently engaging in constructive dialogue on these issues with the regulatory agencies.
- A rebound in hedge fund returns is likely to follow improvements in financial system stability and abatement of redemptions, but there are no guarantees.
- The investment opportunities for hedge funds are expanding, especially as corporate defaults increase within the business cycle, yielding opportunities in capital structure arbitrage, distressed debt investing, and fundamental long/short strategies.

Introduction

In 2008, the painful unwinding of the great global credit bubble resulted in the most challenging period in memory for hedge fund investors. Investors had to cope with tremendous downward market pressure and intraday volatility, the outright failure and near-failure of many significant global financial institutions, and the unprecedented global regulatory response. In light of these events, we would like to step back and offer our perspective on where the hedge fund industry goes from here, focusing on three main topics: near-term outlook; how hedge funds will adapt; future investment opportunities.

We are experiencing a period of significant industry change and investor uncertainty. As stressful as such periods can be, they also lay the groundwork for substantial alpha opportunities. The key for investors will be to make pragmatic allocation decisions, while distinguishing the stronger hands from the weaker industry participants.

The Hedge Fund Industry — Near Term Outlook

We should state up front our belief that hedge fund investing is not going away. Consider index track records through the 10 years ended March 31, 2009: hedge funds had an average annualized return of 7.1%, bonds 5.7%, and world equity negative 1.8% (Exhibit 1). The contrast over the past 10 years is even sharper with U.S. long-only portfolios, especially since U.S. individuals and institutions have traditionally held the most equity-centric portfolio allocations. During that period, the annualized total return for the S&P 500 has been negative 2.9%, with the last five years even worse (Exhibit 2).

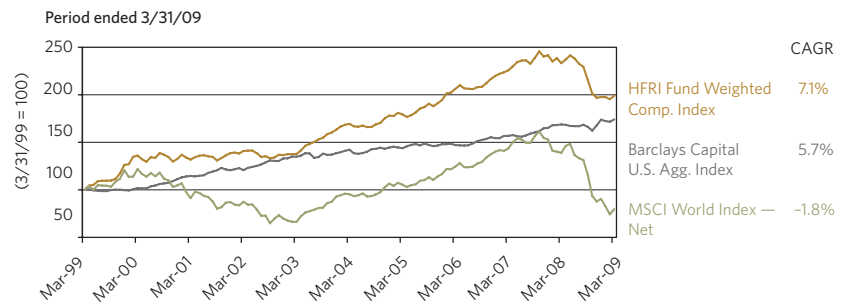
We believe the hedge fund industry will shrink meaningfully, whether measured by assets under management, investors, or managers. Ivy Asset Management LLC, like many market participants, believed for many years that there were far too many unskilled hedge fund managers.

The net result is that a long-only equity allocation of just 50%-60% may be responsible for most of the risk in a portfolio. And, after being effectively blindsided by falling stock markets twice in this decade alone, many institutional investors are looking for ways to better manage overall volatility without unduly sacrificing return.

These comparisons show the potential of the hedge fund model: allowing a talented manager to deploy a relatively unconstrained and/or multi-disciplinary investment strategy in search of absolute returns. The model may be even more valuable if we are indeed in the midst of a longer-term bear market — like the 1968-1982 period, where equity markets remained largely flat, plagued by sharp declines and short-lived rallies. Therefore, the “search for alpha” — which is a core mission of hedge funds — will likely remain an important component of investment portfolios going forward.

But whatever the longer-term merits of hedge funds, 2008 was undoubtedly a turning point. We believe the hedge fund industry will shrink meaningfully, whether measured by assets under management, investors, or managers. Ivy Asset Management LLC, like many market participants, believed for many years that there were far too many unskilled hedge fund managers, with the benign equity and credit markets of 2003 through mid-2007 resulting in thousands of new fund launches. For many of these managers, the returns were driven not so much by skill as by a favorable market environment combined with easy access to leverage. Hedge fund performance has always been characterized by a wide dispersion of returns — in part because of the great variety of strategies offered, but also because of the wide range of skill among managers. Last year’s performance is a good example. According to Hedge Fund Research, Inc., the top decile of funds, measured by performance, gained 62%, while the bottom decile lost 40%.

Exhibit 1 — 10-Year Total Return Index Comparison¹



Source: Bloomberg, LLC

Exhibit 2 — Index CAGR through March 31, 2009

	S&P 500 Total Return	HFRI Fund Weighted Composite
10 Year	-2.9%	7.1%
7 Year	-3.2%	4.9%
5 Year	-4.8%	3.2%

Source: Bloomberg, LLC

¹ The S&P 500 Index is an unmanaged capitalization-weighted index of 500 publicly traded stocks. The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The HFRI Fund Weighted Composite Index comprises more than 2000 constituent hedge funds tracked by Hedge Fund Research, Inc., and is designed to reflect the overall performance of the hedge fund universe. The indexes are trademarks of the Standard and Poor’s Corp., MSCI/Barra and Hedge Fund Research, Inc., and are used herein solely for comparative purposes. The foregoing index licensors do not sponsor, endorse, sell or promote the investment strategies or products mentioned in this paper and they make no representation regarding the advisability of investing in the products or strategies described herein.

The key for hedge fund investors, of course, is to consider funds that are best positioned to survive this period with the firm intact and the business on solid ground.

An important point to make here, however, is that while many hedge funds have been able to profit from the recent destabilization, they are as dependent as any financial firm on the solid underpinnings of the financial markets. Most notably, these include transparency of counterparty risk and something resembling normal liquidity in tradable securities. The systemic market tides of September 2008 were so strong that just being in the water, no matter the depth of exposure, made one susceptible to drowning. Once some stability to the financial system is restored and redemptions abate, we believe that hedge fund returns, in the aggregate, will rebound strongly. The positive performance of hedge funds in the first quarter of 2009 lends credibility to this point. The key for hedge fund investors, of course, is to consider funds that are best positioned to survive this period with the firm intact and the business on solid ground.

Redemption Pressure — Sources and Effects

Industry publications have been forecasting redemptions for the hedge fund industry from anything from as low as 15% to as high as 35% in the near term. Our view is that this is directionally correct (money will be coming out of the industry) but exact figures are difficult to estimate. Anecdotal evidence suggests that most of these redemptions are coming from levered hedge fund investors and hedge fund of funds that have significant private client and bank distribution efforts, primarily in Europe and Asia. As private clients have experienced disappointing returns recently, many have rushed to liquidate their portfolios. To date, the majority of institutional investors — such as pension funds, insurance companies, and endowments — have continued to take the longer term view. They have not meaningfully reduced their hedge fund allocations, except where emergency liquidity has been needed, or where recently invested parties have been disappointed by results. In fact, for reasons noted earlier, institutional investors continue to move to alternative strategies at the expense of traditional long-only market exposure.

We believe the more immediate effects of these anticipated hedge fund redemptions will be threefold. First, weaker firms will be driven out of business. While the demise of these marginal firms will make the industry stronger, their forced selling may be occasionally disruptive to certain sectors of the market. Second, remaining hedge funds will add to already-large cash positions as they prepare for potential outflows. With high cash levels and low market exposure, such funds are vulnerable to short-term underperformance if the market continues with sharp rallies in the near term. On the plus side, cash positions provide the ability for hedge funds to proactively invest in what many managers believe is an opportunity-rich environment. Thirdly, the departure of many high net worth and retail investors will lead to the hedge fund industry becoming almost fully “institutionalized” in its investor base, meaning the vast majority of capital will come from pensions, endowments, insurers, banks and other institutional investors. These investors generally prefer higher quality management firms that offer more investor-friendly terms and high degree of transparency; hedge funds that wish to capture these assets will have no choice but to follow suit.

Consolidation — And Decreased Competition

The industry’s consolidation will serve as an important cleansing, both of weaker investment firms and of investors who viewed hedge fund investing as a portfolio panacea — usually those with a short-term horizon and/or less experience. There will be much less competition in the hedge fund industry, both in terms of investor dollars and number of investment firms. Consolidation is never as easy and painless as one might like, but with short-term choppiness comes longer term profit opportunities.

Competition is also diminishing with the closing and scaling back of many proprietary trading operations at investment banks such as Goldman Sachs, Morgan Stanley and Lehman Brothers, who were among the biggest hedge fund competitors over the past few years. They deployed multi-billion dollar,

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often leveraged, proprietary trading strategies identical to those of many hedge funds. With the trading desks gone or greatly diminished, the opportunity set for hedge funds should materially improve — it is one of the brightest silver linings arising from the great market dislocation of 2008.

This is not a new phenomenon. In 1998, many hedge funds suffered in the aftermath of the Russian debt crisis, particularly in relation to then strongly performing equity markets. The hedge fund industry resized, and returns were robust for many years afterward. While the parallels with 1998 are not exact, there are, in our opinion, many similarities, albeit on a broader scale.

The Strong Survive — And Prosper

The current environment overwhelmingly favors the stronger, more experienced firms, with business stability, institutional infrastructure, seasoned investors, and broad investment expertise. While such firms are not immune to drawdowns in this difficult climate, they should generally be shallow in relation to peers. Their staying power should enable them to add quality talent that inevitably flees the weaker firms or is cast aside in the wake of investment bank consolidation. We are already seeing this phenomenon as stronger firms staff up for opportunities in strategies such as distressed assets and macro-oriented trading. Another potential pool of talent lies with large banks now under substantial government control, where they may be understandably concerned about plans for limits on compensation and bonuses. Of course, some of the departing investment professionals may seek to start their own hedge funds, which would provide a partial offset to the consolidation trend.

On the fund of hedge funds side, the same principle holds true: a number of investment professionals will likely exit the business. Typically, the vulnerable firms include those that have depended on momentum-driven “flavor of the month” products to spur growth and/or have attracted less-stable investor bases. Most importantly, many of these firms have not managed their asset-liability mix properly, relying on “hot” money to fund long-duration investments.

Similarly, the popularity of self-directed hedge fund investing may wane, as both less-sophisticated direct hedge fund investors — and in many cases their consultants — rethink the results of their manager selection process. We believe that, as a result, proven fund of hedge fund managers will likely see increased interest in their services, including a greater emphasis on solutions-based activity, such as portfolio customization, risk modeling and liquidity management. Fund of fund advisors that can offer the waterfront of investor solutions are likely to thrive at the expense of firms with a narrower range of capabilities.

How Hedge Funds Will Adapt

We see the industry adapting in several key areas: investor terms, manager transparency, and regulatory frameworks.

Investor Terms

Hedge funds and fund of funds that offered liquidity as an asset-raising technique are suffering in today’s environment. Promises of greater liquidity attracted short-term, “hot money” capital that tends to chase whatever strategy happens to be working at the time. As noted above, this frequently results in a bad asset/liability profile for the manager, who becomes a forced seller and/or has to recognize painful mark-to-market losses. Going forward, we believe that many higher quality firms will lengthen, not shorten, investor liquidity constraints, so that in times of duress they will not be forced to take actions detrimental to the portfolio to satisfy short-term capital flight. This is consistent with the greater “institutionalization” of the hedge fund marketplace as investors with longer time horizons are often willing to accept liquidity terms that are anathema to retail investors. Overall, the industry will likely bifurcate between longer-dated strategies and the more “liquid” end of the spectrum, with fewer firms willing to occupy the middle ground. Liquidity management, however, is an important consideration for certain investors, due to regulatory, asset/liability or other considerations. This requirement can be

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addressed via managed accounts (where the investor controls the assets, and thus can liquidate on demand), allocation to more liquid strategies such as exchange-traded futures, alongside the less liquid portfolio, or the various investable hedge fund indices and other liquidity products, including recently launched hedge funds of ETFs. While these products (many of which are based on quantitative models) do provide a liquidity benefit, their ability to provide an attractive performance profile is still being tested in the marketplace.

Transparency

The transparency debate is an old one within the hedge fund investment community. We believe that institutional investors, who have long argued for more accurate and consistent reporting, will increasingly dominate the hedge fund investment landscape. Their longstanding desire will likely be heard and accepted by managers, with the tumult of 2008 driving the point home. As noted above, certain very large investors (e.g. state pension funds) have the asset size to enable investment in a managed account structure, as a means for better portfolio transparency and control of assets. There is an important parallel development for fund of hedge fund firms. In the past, client funds usually were invested in the underlying hedge funds via the commingled pools of fund of hedge fund managers. Now, those firms are increasingly looking to use managed accounts to invest in other hedge funds, or for customized portfolio mandates. As with the larger investors, this structure may provide the client of fund of hedge funds with improved liquidity features, transparency and control over the assets, depending on the underlying investments.

While the managed account structure may prove to be an overall positive for investors, the key differentiators for fund of hedge fund managers will be the same as they have always been. Those who can leverage the transparency with their own insight into market data and risk factors will add value for their clients and succeed. As we move forward from 2008's instability, our view is that both investors and investment firms will realize the benefits of increased transparency.

Regulatory Framework

Much has been made of the global ban on short selling that the SEC instituted last September, and it was indeed a source of pain for many hedge fund strategies. In October, bans on short selling were relaxed until August 2009, and it appears the regulators have entered into a constructive dialogue with the hedge fund industry. We believe such future actions may take the form of enhanced disclosure of outright short positions, modeled along the lines of current Form 13F disclosure rules (quarterly, lagged in time) for long positions. Exceptions will likely be made for short positions used to hedge exposures, such as convertible bond arbitrage or equity market neutral strategies.

The ability of convertible arbitrage managers to hedge equity exposure enables them to participate in the purchase of new convertible issues. In a declining economic environment, with long-only convertible managers on the sidelines, this source of demand is one of the few avenues struggling companies have available to raise capital. U.S. regulators do not appear to be inclined to shut off such sources of funding for corporations.

With regard to equity market neutral managers, the statistical arbitrage community plays a vital role in providing market liquidity, driving significant volume on global equity exchanges. If regulators were to hamper their ability to short and hedge exposures, this would deprive many stocks, especially small cap issues, of a major source of liquidity and could exert downward pressure on prices.

The recent meeting of the G20 in London underscored the extent to which the international community favors strengthened regulation of the global financial system, including hedge funds. However, it is too soon to predict what new direction reform efforts may take following that meeting. In the U.S., in the near term, we believe a negotiated settlement will be reached with regulators, whereby shorting will still be allowed—with blanket exceptions made for hedging—but taking place in a disclosure regime that guards against potentially abusive practices. We do

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not see this significantly affecting the alpha of long/short strategies, as there are many ways to express a view of a company other than outright shorting of its stock.

Credit Default Swaps (CDS)

An area where we believe greater regulation is needed, and will be welcomed, is in the governance of over the counter (OTC) CDS contracts. For years, many hedge funds believed that a centralized exchange would be superior to the OTC system — one in which investment and commercial banks alone have complete pricing transparency and, importantly, control over profit margins. CDS-related dealing activity, as one might expect, was a major source of investment bank revenues in recent years.

CDS contracts, when utilized properly, can be a valuable tool to hedge credit risk or express a view on a company, and they have been an increasingly significant part of the hedge fund toolkit. As CDS contracts move to a regulated exchange, pricing transparency should be improved and fears of counterparty risk, which helped spark the flames of the current crisis, should be greatly reduced.

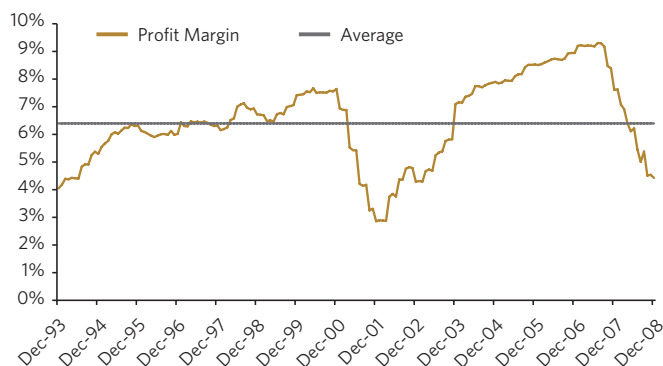
The Opportunity Set

The logical question at this point relates to where we see opportunities in hedge fund investing. For the near term, hedge fund performance may continue to be uneven, as managers are generally unwilling to broadly increase market exposures given the continued illiquidity in many sectors and concerns about potential investor redemptions.

However, the recent dislocations have created a range of opportunities in most of the market sectors and strategies in which we invest. This should create a fertile environment for 2009, assuming the markets reclaim a degree of normalcy, including financial stability, adequate liquidity and the ability to discriminate between higher- and lower-quality companies.

If a more stable environment does ensue, it should benefit hedge fund investors relative to long-only investors, because we are still likely to face sustained economic weakness. It appears that while corporate profits are down from their peak, margins are still substantially higher than where they bottomed out in the 2000-2002 recession (Exhibit 3). Equity markets need earnings to sustain the “E” in the P/E ratio, and if they are not forthcoming, long-only exposure to equities may prove less than rewarding. Such an environment tends to favor the hedge fund model of managers skilled in security selection, prudent hedging and astute short exposure.

Exhibit 3 — S&P 500: Profit Margins



Source: Bloomberg, LLC

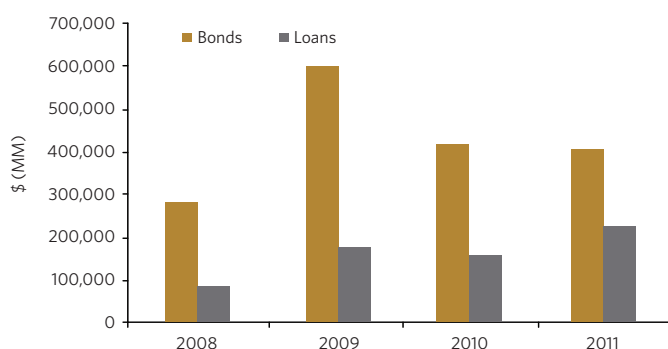
In the very near term, we continue to see opportunities in macro-oriented and systematic trading, where market trends have been successfully exploited by a class of managers who were largely profitable in 2008. In addition, managers are continuing to see historically low valuations in parts of the convertible bond market that were severely beaten down last September. These depressed values have

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already begun to be exploited at some stage, as the stronger firms deploy capital into a strategy that has been under intense pressure. Indeed, many convertible strategies have appreciated 20% or more so far in 2009, according to available data.

Within event driven strategies, merger arbitrage also has begun to offer attractive spreads, even on cash transactions where the risk of a breakage is almost immaterial in relation to the annualized return. We see long/short equity as more difficult in the very near term, given the extremely high levels of market volatility and low levels of dispersion between stocks. However, as dispersion increases and volatility continues to decrease, longer term we are more positive on the long/short equity sector. We are also favorable on distressed investing, as the great global credit bubble continues to unwind, leaving distressed companies and teetering capital structures in its wake. A significant amount of debt is coming due over the next few years, and companies will face a much different refinancing environment than that of 2003-2007 (Exhibit 4). This provides the backdrop for a particularly attractive environment for distressed and special situations strategies.

Exhibit 4 — Bonds and Loans Coming Due 2008 through 2011



Source: JP Morgan

While we are optimistic about the opportunities in distressed securities strategies, our general view is that asset prices still have some room to fall, and higher quality distressed assets have yet to become available. In our experience, the first default waves are largely made up of the weaker companies whose bonds have the lowest recovery values. As better quality companies come under pressure, higher quality assets come into the market and thus better recovery scenarios can be realized. The experience of many investors with “hung bridge” (leveraged buyout loans) investments made in late 2007 and distressed asset-backed securities investments made last year shows that being too aggressive too early can be painful.

Investors should bear in mind, however, that this expanded opportunity set exists in a uniquely difficult and risky business environment. Now more than ever, hedge fund success requires a broad range of investment skills on the part of managers, who must assess business models and strategies that are evolving rapidly in a credit-scarce economy and volatile markets, where the federal government plays an increasingly active role. They must know the strength, character and ethical mindset of management teams and be nimble enough to seize opportunities as they arise. Fund-of-fund managers are likewise challenged to refine their skills to today's realities.

Conclusion

We believe that hedge funds will be a durable feature of the investment landscape for years to come. In the near term, we expect the industry to shrink and undergo a healthy cleansing. Ultimately, we expect improvements to the hedge fund model to evolve, with the participation of surviving stronger managers, seasoned investors and regulators who need to be attuned to both the deficiencies and unique strengths of the current industry structure.

We believe that today's dynamic environment offers investors ample opportunities for potentially attractive returns. The key lies in finding managers who have the robust capabilities and business strength to capitalize on current market conditions.



Sean Cumiskey
 Sean Cumiskey is Ivy's Managing Director and heads the Investment Strategies Group. Mr. Cumiskey is a member of Ivy's Executive Committee, Investment Committee and the Investment

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