Third Quarter 2014

Hedge Fund Update

Broadly speaking, hedge funds were flat for the quarter (the Credit Suisse Hedge Fund Index returned 0.6% and the HFRI Fund Weighted Composite Index, -0.1%). Performance in many equity markets was much worse for the quarter, with the Russell 2000® returning -7.4%, MSCI Europe, -7.0%, and MSCI Emerging Markets, -3.4% (all in US$ terms). Larger-cap US stocks, which hedge funds typically do not gravitate toward, continued to post small gains, with the S&P 500 returning 1.1% for the quarter, the Dow Jones Industrial Average, 1.9%, and the Nasdaq, 2.2%.

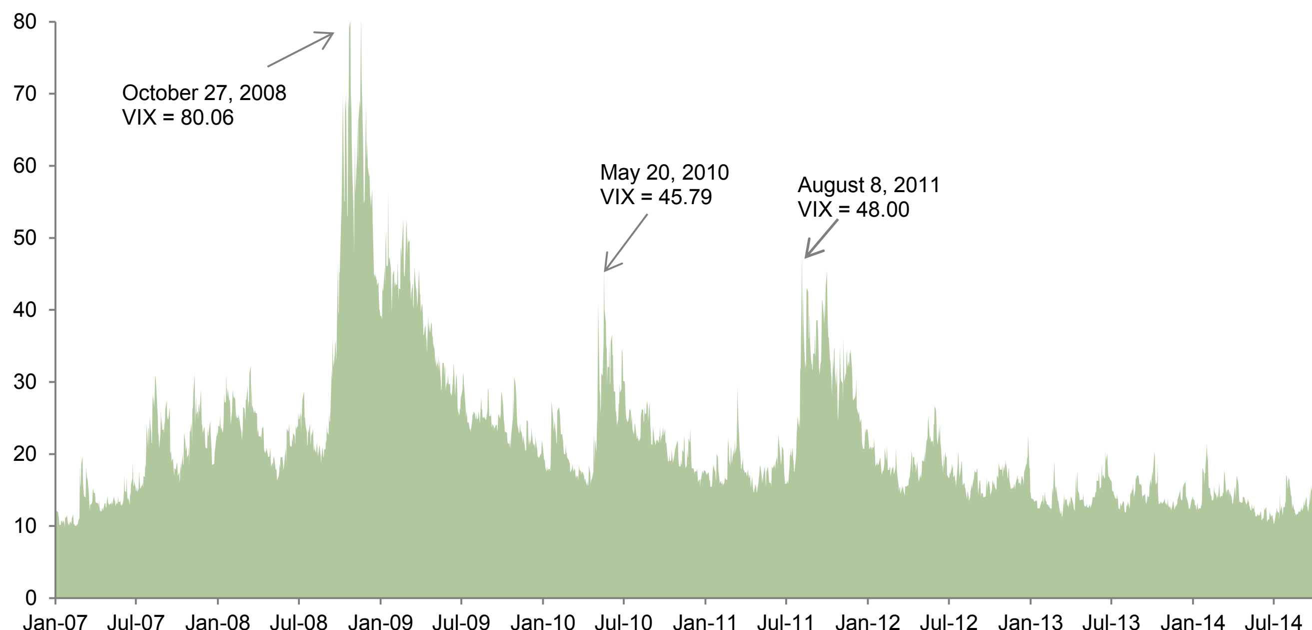
The third quarter's market environment saw an improvement in some factors that have weighed on the performance of certain hedge fund strategies. There was a quiet but welcome return of accelerating volatility, as the VIX rose from below 11 to end the quarter above 16 and the US Treasury market experienced yield curve moves, and continuous trends (without reversals) in commodities, fixed income, and foreign exchange. The divergence of central bank policies is even more pronounced than in the first two quarters. The Federal Reserve is winding down asset purchases (quantitative easing), having expanded its balance sheet by roughly 400% since 2008; meanwhile, the European Central Bank is well behind and just gearing up for asset purchases. Japan appears to be losing the battle to rejuvenate the economy, exacerbated by the (almost suicidal) increase of the consumption tax. Finally, the growing realization that the United States is now energy independent—and the world's largest natural gas exporter—combined with the fall in gold sent commodities into a tailspin: oil prices have fallen over 15% since mid-June.

On the back of these and other factors, some pure trend and systematic global macro managers, particularly those with an FX bias (and US$ exposure), produced eye-popping returns in excess of 20% for the quarter. The average pure trend manager returned 8.9% and the average systematic global macro manager returned 7.0% for the quarter. Discretionary macro managers with exposure to emerging markets and Japan, which had suffered in the first and second quarters, rebounded (improving by about 400 bps over second quarter performance), and partially erased some previous losses. On the other side of the ledger, commodity-focused managers generally had poor returns for the quarter as broad commodity indexes such as the S&P GSCI™ slid over 10% on the back of plummeting oil prices. Fixed income arbitrage managers experienced an uptick in volatility in September, resulting in a 0.7% gain for the quarter. The median US long/short hedge fund manager in our database returned -1.4% in the third quarter.

Mid-October Update

As the calendar turned to October 1 and fourth quarter trading commenced, volatility returned to markets, particularly in US equities, and some idiosyncratic events hit many hedge funds.

On the first day of the quarter shares of Fannie Mae and Freddie Mac (which are fairly widely held by a number of hedge funds) suffered losses (some share classes in the 50% range) after a lawsuit filed by Fairholme Capital and Perry Capital was rejected (various shares continued to trade down over the following days leading to a drop nearing the 70%



range following the event). While this is clearly a massive mark-to-market loss for those hedge funds involved, the Fairholme Capital/Perry Capital decision will be appealed and numerous other outstanding suits remain to be navigated. For many funds—even if they chose to crystalize the losses suffered in October—their decision to invest in Fannie and Freddie in the late 2008/early 2009 time frame still produced large profits to their funds and investors (some saw gains on the order of two or three times initial investment). There is much more to be seen on Fannie and Freddie in the months and quarters to come.

After trading hours on October 14, AbbVie Pharmaceutical signaled that it was considering calling off its merger with Shire PLC following the Treasury Department's rule changes aimed at making inversions (US companies relocating overseas for tax purposes) more difficult. On October 15, AbbVie officially reversed course on the merger, leading to an enormous sell-off for Shire (over 30% on the day). In part because of the size of the transaction ($54 billion), the spread was attractive enough for many hedge funds to get involved. In a traditional merger arbitrage trade, hedge funds are long the target (Shire) and short the acquirer (AbbVie)—in this case, the hedge didn't work as Shire declined over 30% while AbbVie remained flat, creating sizeable mark-to-market losses for many funds. Losses were particularly prominent for many large hedge funds that were able to scale the position up given the size of the deal. The reverberations from the break in the AbbVie deal impacted a wide range of other merger-related trades (not just other inversions) leading to other mark-to-market losses for many event-oriented hedge funds.

Volatility and downward price pressure continued across a number of natural resource markets in October, leading to losses for a handful of hedge fund managers. Oil prices, which as noted earlier have been falling since their calendar-year high June, came close to the psychologically

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important $80 a barrel price in mid-October. Coal and natural gas commodity prices have also suffered downward price pressure so far in October. Several widely held natural resources–related equities traded down meaningfully in October including Civeo (down over 50% since September 26 as a result of an inability to convert to a REIT), Energy Transfer Equity (down over 20% from October 1 to October 15), WPX Energy (down over 30% in the same period), and Cheniere Energy (down about 25%). In some ways similar to Fannie and Freddie, many hedge funds that held these equities have still profited handsomely despite the recent pullback (Cheniere Energy and Energy Transfer Equity are still up 52.7% and 27.8% year-to-date, respectively).

During periods of volatility we want our managers to have the confidence, conviction, and staying power (which is why we focus so heavily on the quality of the business and ensure an asset/liability match at the funds we invest with) to run into the fire. These periods of stress and dislocation create future profits for managers that have the courage to maintain a level head and put capital to work. True to form, several high-quality hedge fund managers have decided to raise new capital over the last several days as they have become more excited about the current opportunity set.

Looking ahead, the trends in the third quarter that intensified into October like increasing volatility should provide opportunities for tactical diversifying strategies that rely on volatility. Overvalued equities, US$ strength, and very narrow high-yield spreads should be sources of volatility. In addition, divergent monetary policies, from the hawkish US Federal Reserve and Bank of England to the very accommodative European Central Bank and Bank of Japan, will provide both arbitrage and macro opportunities for appropriately tactical managers. ■

—Q Belk and Chuck Haigh, Managing Directors

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