C|A

Fourth Quarter 2014

Hedge Fund Update

In the fourth quarter, many of the trends that had played out throughout 2014 continued, and in some cases accelerated. Like most quarters this year, on the surface, fourth quarter hedge fund returns (0.7% for the Credit Suisse Hedge Fund Index and 0.5% for the HFRI Fund-Weighted Composite Index) look disappointing when compared to widely quoted, US-centric equity market indexes (the S&P 500 returned 4.9%; the NASDAQ, 5.7%; and the Russell 2000®, 9.7%). In contrast to the broad US market, various subsectors of the US market, like energy, suffered serious losses, and non-US markets struggled during the quarter (in US$ terms, the MSCI EAFE Index returned -3.6%; the MSCI Emerging Markets Index, -4.4%; and the MSCI Europe Index, -4.4%). Given widely dispersed strategies, exposure profiles, and geo-graphic focus, hedge fund performance is always difficult to summarize by looking at one number.

This quarter's update reviews trends in the fourth quarter and the year for long/short hedge funds, as well as for diversifying hedge fund strategies.

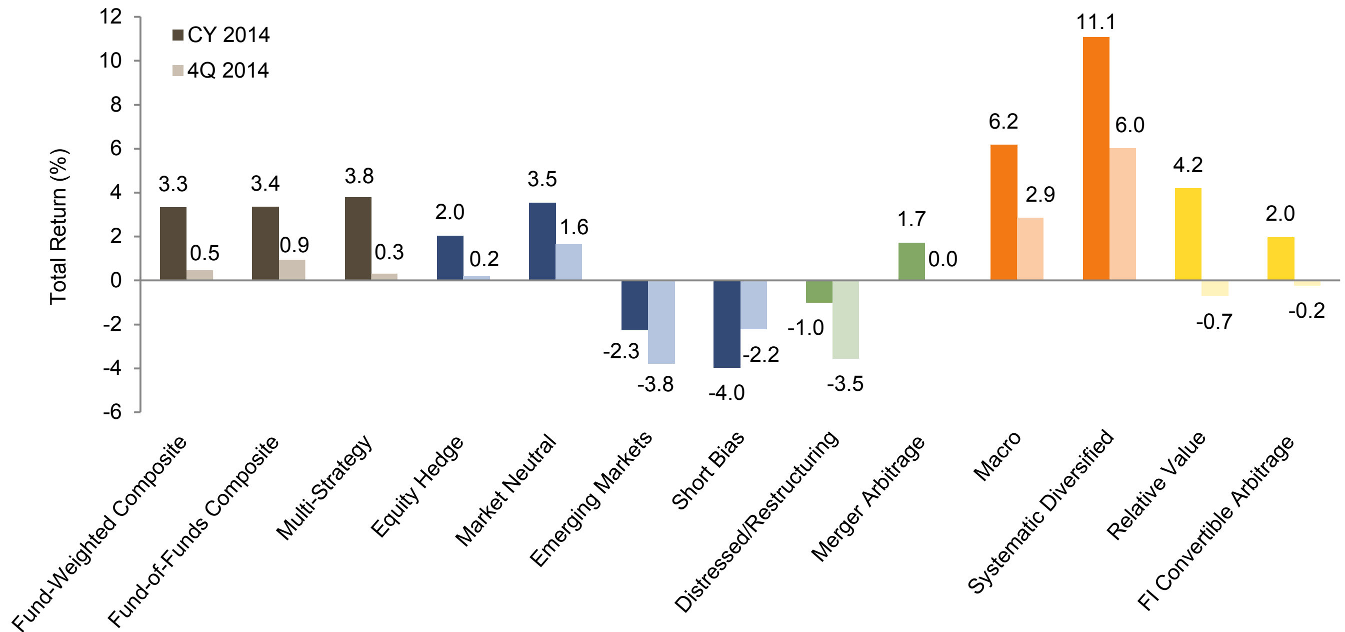
Long/Short Hedge Fund Strategies

For many managers that focus on fundamental strategies, and particularly those that have an event bias, the fourth quarter was extremely challenging—and depending on exposure to two specific events, may have defined their year. In our previous update we walked through the specifics surrounding Fannie Mae and Freddie Mac and the collapse of AbbVie Pharmaceutical's attempted acquisition of Shire PLC, but will provide a brief summary here.

On October 1, Fannie Mae and Freddie Mac suffered losses in the range of 40% 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 in the range of 50% following the event). The latter half of fourth quarter didn't see much news around this topic, but given the size of the funds involved and the number of lawsuits and appeals yet to be heard, Fannie and Freddie will likely be discussed again in future quarterly updates. Over October 15 and 16, following the Treasury Department's rule changes aimed at making inversions (US companies relocating overseas for tax purposes) more difficult, AbbVie officially reversed course on its merger with Shire, leading to a massive sell-off for Shire (approximately 30% over the two days). In part because of the size of the transaction ($55 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 about 30% while AbbVie remained flat, creating sizeable losses for many funds.

2014 Hedge Fund Performance: HFRI Indexes

January 1, 2014 – December 31, 2014



Source: Hedge Fund Research, Inc.

Note: Hedge Fund Research data are preliminary for the preceding five months.

Aside from these two events, the volatility and price movement in the energy market also created havoc (and opportunity) for many hedge funds. In addition to the dramatic decline in the spot price of oil, the equity securities of energy-related companies saw serious declines during the quarter. The S&P Energy Index returned -10.7% for the quarter, and the S&P Oil and Gas Equipment Services Index, -20.1% (both indexes returned -7.8% for the year). While turmoil in energy will likely create direct opportunities in the energy space (of note is the size of the potential distressed credit opportunity), most hedge fund managers that we have spoken with are still in “wait and see” mode. Some managers have considered the second derivative effects of lower energy prices and are looking at areas like consumer discretionary.

Looking back at 2014, one of the more prominent themes was the continued pace of launch activity. Over the course of the year, the five largest fund launches each launched with more than $1 billion in assets under management, and combined for total assets of approximately $7.8 billion. While both the pace and size of new launches are impressive, what is particularly interesting to us is that in many cases, investors must make a decision on a fund before launch or risk being shut out of a fund permanently (as funds seek to open and close on day one with their desired capital base). From the perspective of a hedge fund investor, the allocator must be

C|A research publications aim to present you with insights from a variety of different viewpoints. The views of our Chief Investment Strategist can be found each quarter in VantagePoint.

nimble enough to move quickly and must be connected to the major players to have the necessary relationships to access oversubscribed new launches.

Diversifying Hedge Fund Strategies

Volatility arrived in 2014 and accelerated into the fourth quarter, producing long-awaited strong returns in trend-following, quantitative, and systematic macro strategies. In general, the 2014 environment was characterized by pronounced yield curve flattening, equity and fixed income directional strength, a collapse in commodity prices, and US$ strength. The spread between two- and 30-year US Treasuries flattened by over 140 bps in 2014, with over 60 bps of flattening in the fourth quarter alone; the same was broadly true in swaps, where spreads between two- and 30-year swaps flattened by 158 bps and 68 bps in calendar year 2014 and the fourth quarter, respectively. The same flattening in intermediates was more pronounced in cash than in swaps: the spread between five- and ten-year Treasuries flattened over 125 bps, and in five- and ten-year swaps by 70 bps over the course of 2014. Turning to directional strength in equities and fixed income, the S&P 500 returned 14% in 2014, almost 5% of that in the last quarter. US long bonds (as measured by the Barclays Long Government Bond Index) returned nearly 25%, with 8% of that attributable to the last quarter. In 2014, the US dollar strengthened against a broad currency basket by 10%—5% of that coming in the final quarter. And finally, oil prices fell over 45% by the end of 2014.

The very strong, continuous trends in broad indexes and spreads produced generally excellent returns among "systematic" and "quantitative" managers. For a group of quantitative futures and pure trend-following managers that we follow, average returns for November were in excess of 6% and in December, 2.5%. For the year, these funds produced an average return of 21%, ranging from 5.5% to 62.4%. Returns for a group of systematic global macro we follow were less pronounced, averaging 13% for 2014, with about 5% being generated in November and December. Risk premia and risk parity strategies we follow averaged returns of 5.6% and 7.4% for the year, respectively, while the average interest rate relative value strategy was flat for the quarter and returned low single digits for the year.

Divergent monetary policies among central banks—the US Federal Reserve has ended quantitative easing, while the European Central Bank is just starting a program—and the potential for some of the broad trends of 2014 to continue and new ones to emerge—such as sharp equity corrections and the prospect for pronounced yield curve movements in the United States and Europe—mean there should be clear opportunities for skillful macro managers in 2015. The first few weeks of the new year have demonstrated that as central banks are tested in their attempts at currency management, violent currency shifts may become the norm and will provide opportunities for skillful managers. ■

—Q Belk and Chuck Haigh, Managing Directors

Copyright © 2015 by Cambridge Associates LLC. All rights reserved.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of US and global copyright laws (e.g., 17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report is nontransferable. Therefore, recipients may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. This report is provided for informational purposes only. The information presented is not intended to be investment advice. Any references to specific investments are for illustrative purposes only. The information herein does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction. Some of the data contained herein or on which the research is based is current public information that CA considers reliable, but CA does not represent it as accurate or complete, and it should not be relied on as such. Nothing contained in this report should be construed as the provision of tax or legal advice. Past performance is not indicative of future performance. Any information or opinions provided in this report are as of the date of the report, and CA is under no obligation to update the information or communicate that any updates have been made. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Fiduciary Trust, LLC is a New Hampshire limited liability company chartered to serve as a non-depository trust company, and is a wholly-owned subsidiary of Cambridge Associates, LLC. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorized and regulated by the Financial Conduct Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G). Cambridge Associates Investment Consultancy (Beijing) Ltd is a wholly owned subsidiary of Cambridge Associates, LLC and is registered with the Beijing Administration for Industry and Commerce (Registration No. 110000450174972).

CAMBRIDGE C|A ASSOCIATES