HDF
20 Years in Funds of Hedge Funds

April 15th, 2008

HDF Briefing

Long/short equity funds of funds and the financial crisis

Alpha erased in March 2008

Our long/short equity FoHFs performed disappointingly in March 2008. While their net long position was approximately 20% to 25%, they experienced between two-thirds and 100% of the equity market decline in March. For example, HDF Xiphias International lost c. 4.41% compared with a 5% drop in the MSCI World index. This destruction of alpha was attributable to:

- Substantial market volatility in March: a steep -12% drop in the first two weeks, from 27 February to 17 March, was followed by a strong rally in the wake of the Bear Stearns' bail-out (+11% from 17 March to 7 April).
- Significant sector rotation, especially in the second half of March, triggered for example by large buybacks of short positions on financials and reselling of long positions on commodities.
- More forced unwinds by market participants still looking for liquidity. This lack of rationality caused undervalued stocks to sink and stocks with negative prospects to rise, with the result that even the best managers have incurred losses.

Creating medium-term alpha

It makes no sense to judge performances over one month. Over nine months, from the equity market peak of early July 2007 to the end of March 2008, our equity funds of funds lost around four tenths as much as equity markets during the same period:

- HDF Xiphias International was down c. 9.1% compared with a 22% decline for the MSCI World index
- HDF Eurovest was off c. 8.8% compared with 20% for the MSCI Europe index

HDF allocation decisions

As we said in the HDF Briefing on 31 March, we think that the financial crisis will take time to settle down and that its economic impact will exceed the equity market's current expectations. As a result, in early 2008 we continued to reduce the exposure of our funds of funds to the direction of equity markets by further reducing allocation to the most optimistic and least flexible funds and temporarily selling equity index futures. We are increasing the cash components of our portfolios so that we will be able to reposition them as efficiently as possible once the financial crisis is over and markets regain their senses. We are holding on to funds with the quickest reaction times and those most able to adjust their positions rapidly to reflect market conditions.

Comparison with the 2000-03 equity market decline

During a period in which equity markets lost half their value between April 2000 and March 2003, our long/short equity funds of funds still managed to post positive returns in each calendar year. **Today's situation has more in common with the liquidity crisis of 1998:** HDF Xiphias International cumulative losses in 2008 – the fund lost c. 12% between 31 October 2007 and 31 March 2008 – are greater than its biggest losses in the early 2000s (-5.3% in the spring of 2000) but less than the 13.6% drop posted in 1998. Why are we seeing such a drawdown today?

- **In 2000, the equity market decline was triggered by corporate situations**, notably a fall in earnings caused by slowing economic growth at a time when valuations were fairly high. Equity managers foresaw the decline early on and were able to reposition themselves accordingly.
- **The 2008 decline is the result of a liquidity crisis (as in 1998) and a financial crisis** at a time when companies are in good health and their order books are full. It took longer for fundamentals-focused equity managers to adjust and to understand the impact that the financial crisis could have on corporate earnings. They have found it harder to reposition in a market where stock prices are being influenced by players who are unwinding their positions because they need liquidity, not because of a company's intrinsic worth. We think that the positioning of their portfolios is now similar to the situation in late-2000.

Outlook

Prices have strayed far from their intrinsic values, opening up attractive opportunities to generate returns on both the long and short sides of the market for investors who stand their ground rather than sell at the worst possible moment. We are confident in our managers' ability to seize the opportunities that will arise when markets regain their senses, regardless of their eventual direction (or lack thereof). We are also confident in their capacity to cope with the financial crisis because or their limited use of bank leverage. Note that our long/short equity funds of funds posted double-digit gains one year after the 1998 liquidity crisis, with HDF Xiphias International gaining 34.11% in 1999.

Your usual commercial contact at HDF remains at your disposal for any additional information you may require.

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