

THE ALTERNATIVE VIEW

FOCUS ON HEDGE FUNDS

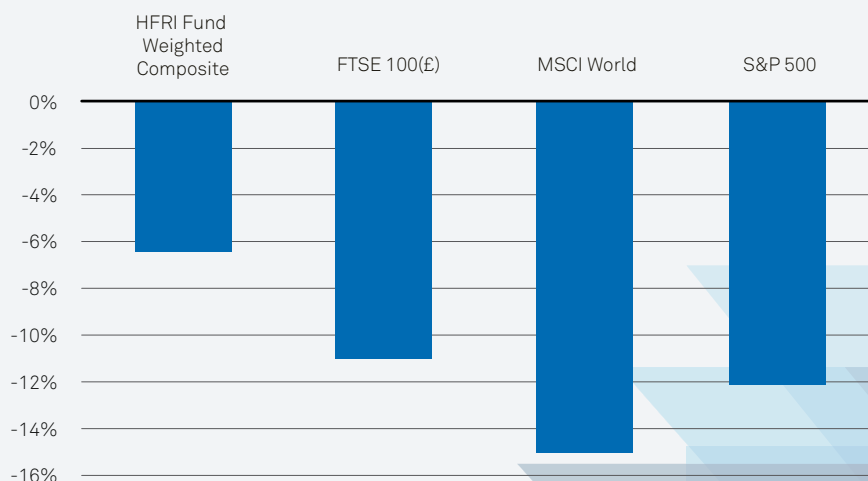
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The continuing turbulence in the global economy should, in theory, be a good reason for investing in hedge funds. After all, hedge funds seek to achieve positive returns irrespective of the market environment and so ought to be attractive in today's volatile, uncertain world. However, many investors remain hesitant about adding hedge funds to their portfolio, either because they are unsure about what hedge funds are and seek to do, or because they are simply sceptical that hedge funds deliver on their promises. So what's the real story with hedge funds?

In order to answer this question, it is important to first consider what hedge funds seek to do. In reality, a hedge fund is simply an investment vehicle that employs various strategies in order to achieve a specific objective. Hedge fund strategies cover a range of different investment styles, but the primary objectives of most are to deliver positive returns over the long term, reduce overall portfolio volatility and preserve capital. However, no single strategy can deliver positive returns every month, and there will be periods when average returns across the industry are disappointing. Most investors realise this, but this does not prevent them from being disappointed when positive returns are not achieved.

Although hedge fund indices are subject to certain biases and distortions, and therefore should be treated with caution, they can offer a useful starting point for comparison of hedge fund performance with those of other asset classes. Let's take a closer look, for example, at the data for August and September – for which hedge funds received so much bad press. As measured by the HFRI Fund Weighted Composite Index, hedge funds declined 6.4% during the period – a disappointing return perhaps, but one which outperformed all major equity indices, including the FTSE 100, MSCI World and S&P 500 (see Chart 1).

CHART 1: HEDGE FUND PERFORMANCE VS MAJOR EQUITY INDICES IN AUGUST AND SEPTEMBER 2011 (CUMULATIVE)



Source: HFRI, BlackRock, as of 30 September 2011.

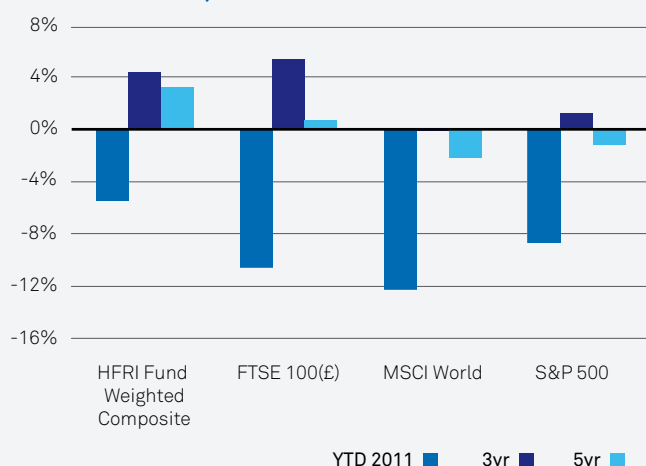
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MATTHEW BOTEIN
Head of BlackRock
Alternative Investors

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CHART 2: YTD 3-YEAR AND 5-YEAR ANNUALISED RETURNS OF HFRI VS MAJOR EQUITY INDICES (TO 30 SEPTEMBER 2011)



Source: HFRI, BlackRock, as of 30 September 2011.

Over the first nine months of 2011, the HFRI was down 5.4% – again significantly outperforming all of the major equity indices. While positive returns were not achieved in this period, it is clear that hedge funds have provided some insulation against downside losses amid a highly challenging period for risk assets – one of the historic objectives of hedge fund investors.

Hedge fund performance also compares favourably to those of the broader indices over the longer term. Chart 2 displays YTD, 3-year and 5-year annualised returns. It is also worth noting that all four primary hedge fund strategies as defined by HFRI (equity hedge, event driven, macro and relative value) generated positive annualised returns over three and five years to the end of September 2011.

What's more, hedge funds have achieved these returns while consistently maintaining muted volatility: between 1990 and August 2011 the annualised standard deviation of the HFRI Fund-Weighted Composite Index was 7.0%, compared to 15.5% for the MSCI World index. In each of the MSCI's fifteen worst-performing months over the past two

decades, hedge funds provided considerable insulation for investors (see Chart 3). During the troubled period of August and September this year, hedge funds limited losses to approximately 40% of the drawdown in global equities. Minimising drawdowns means less ground to make up during the recovery phase and therefore greater potential to achieve absolute returns.

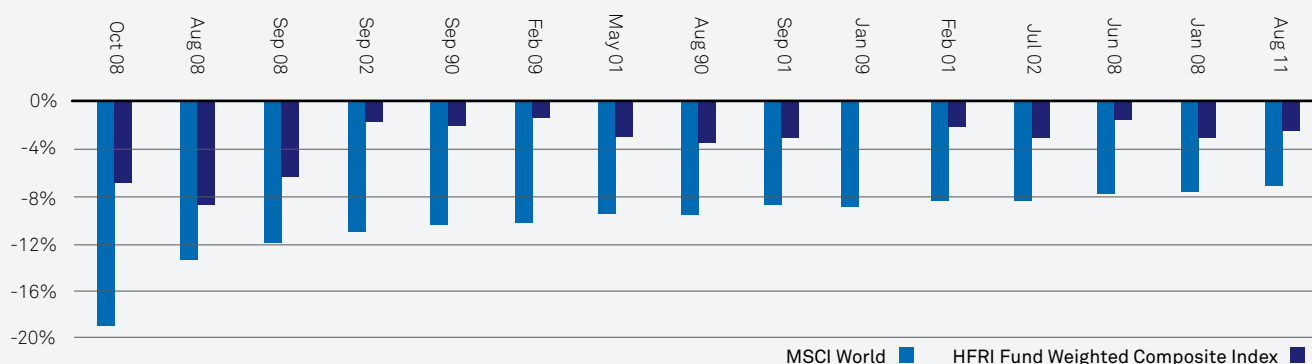
Such characteristics are particularly valued now, at a time when volatility looks set to remain for the foreseeable future and investors in traditional asset classes are faced with the dilemma of buying assets that exhibit relatively low levels of volatility but which provide lower returns, or higher returning assets that are also potentially more volatile. To many such investors, hedge funds, which can potentially enhance returns, diversify risk and limit downside losses, should seem an attractive proposition. However, the dispersion between the top and bottom quartiles within hedge funds is greater than it is in traditional asset classes, placing even greater emphasis on manager selection. Investing in an 'average' hedge fund is unlikely to be a winning proposition; it is necessary to find those who are best-in-class. Unfortunately, this is not easy when there are some 8,000 hedge funds in existence, covering a wide range of styles and strategies.

Choices, choices...

When choosing how to allocate to hedge funds, investors face three main choices: first, to outsource completely via a fund of hedge fund (FoHF) provider; second to partially outsource by working alongside a provider of tailored hedge fund solutions; and third, to invest in hedge funds using in-house talent and resources. Let's look at each of these in turn.

Investing via a FoHF manager has a number of advantages. Chief among these is diversification: given the large gap between the 'winners' and the 'losers' within hedge funds, diversifying exposure across a number of strategies and managers through a FoHF can help to limit the potential negative impact of one poorly-performing fund. A second

CHART 3: 15 WORST-PERFORMING MONTHS OVER PAST 20 YEARS FOR MSCI WORLD VS HFRI COMPOSITE INDEX



Source: HFRI, BlackRock, as of 30 September 2011.

advantage of FoHFs is that they typically will have developed infrastructure designed to identify potentially attractive hedge funds across a very large field, leveraging specialised technology, personnel and networks of industry relationships. Using these resources, quality FoHFs can identify strong potential from funds that would not appear on the radar of most investors.

FoHFs can also help significantly with portfolio monitoring as they have the means to monitor within and across hedge fund portfolios to assess changing risk exposures to crowded trades, strategy concentration, and second-order factors such as liquidity and financing risk. Of course, the services provided by a FoHF do not come for free, and investors who go down this route face paying an extra layer of fees on top of those charged by the underlying hedge funds. However, top quartile FoHF managers have performed consistently well over time and we anticipate continued strong demand in this space, fuelled by consolidation into the best-in-class providers.

For investors who do not want to fully outsource their hedge fund allocation but who also do not have the resources to manage it wholly in-house, a second option is to work alongside a provider that can help to develop tailored hedge fund portfolio solutions. Customised portfolio solutions can include emphasising or de-emphasising specific hedge fund strategies or opportunities, addressing specific liquidity needs, providing diversified or concentrated exposure, and restricting certain types of investments. Other services may include access to investment personnel with specific expertise, education and knowledge transfer, and advisory services in areas such as due diligence and risk monitoring.

The third choice facing hedge fund investors is to manage their allocations in-house. For such investors, the overriding objective will be to identify the best-in-class funds that will bring maximum potential benefits for the portfolio. This is no easy task as we believe there are minimum standards to which hedge funds should be held before they are given serious consideration in a professionally-managed institutional portfolio. Two key requirements will be:

- 1 **Clear identification** by the investor of the hedge fund's normal portfolio, providing an unambiguous separation of alpha and beta from total returns.
- 2 **Skilful judgment** by the investor that the hedge fund manager has the ability to produce a positive expected pure alpha.

The first requirement ensures that a normal portfolio for the hedge fund is carefully estimated and understood, based on a separation of returns associated with systemic

exposures and other exposures. By identifying the systemic exposures, the investor can understand how an allocation to the hedge fund impacts overall portfolio risk via the risk of the hedge fund itself and also via its correlation with other allocations.

The second requirement concerns skill. We believe this is the most critical question because the ultimate goal of investing in hedge funds is to find a positive expected return independent of the market in which the fund is invested, which is possible only with above average skill. This criterion is especially important now because of the rapidly growing flows of institutional assets into the hedge fund market and the increasing competition for talent and ideas.

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When considering which hedge funds to invest in, there are a number of issues that investors typically consider, which can be divided into three broad categories:

Organisational issues

- ▶ Fiduciary management
- ▶ Manager experience
- ▶ Alignment of interests

Operational issues

- ▶ Risk management
- ▶ Monitoring
- ▶ Operational framework

Investment issues

- ▶ Strategy Performance
- ▶ Liquidity
- ▶ Leverage
- ▶ Transparency
- ▶ Fees

All of these factors must be looked at in depth to ensure the manager is of sufficient quality.

The growing opportunity set

Whatever route to investment is chosen – via a FoHF manager, through tailored solutions or direct investing – investors in hedge funds face a rapidly changing landscape. One significant recent development for the industry, for example, has been the exodus of trading and investment talent from banks and insurance companies. A key catalyst for this was the increase in regulations governing the investment activities of these types of institutions, such as the Dodd-Frank Act in the US. Another has been that these institutions have less capital to allocate to their own

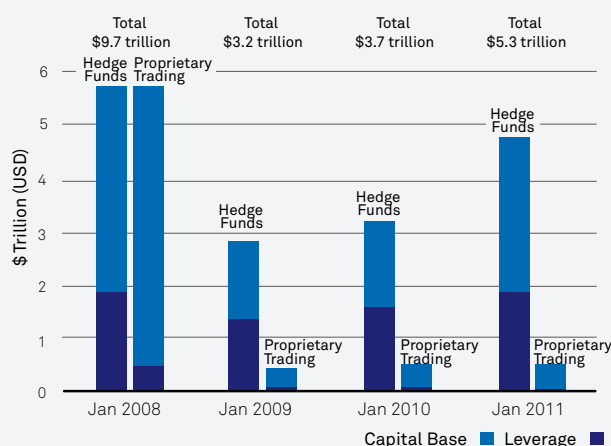
trading activities after the financial crisis of 2008. These developments have reduced the amount and type of risk many banks are willing to assume, creating opportunities for well-resourced hedge funds to pick up the mantle in certain strategies. As a result, since 2008 there has been less capital and less competition pursuing market dislocations, which we believe has made inefficiencies more pronounced and more prevalent, further enhancing the opportunity set for hedge funds (see Chart 4).

One area that is currently attracting interest is multi-asset fixed income strategies. A combination of heavy government debt supply and bank balance sheet contraction, along with variations in national growth, policy and inflation trends, has led to an environment in which securities are often mispriced, resulting in profitable investment opportunities. Macro-type strategies identify opportunities related to interest rates and government bond yields across the world, which in turn depend on the varying composition and pace of economic recovery across regions (e.g. developed markets versus emerging markets). In addition, market imbalances imply opportunities for global investors (e.g. US versus Europe).

We believe there are also compelling investment opportunities for absolute returns in the European credit markets. Continuing uncertainty over the European sovereign credit crisis is leading to mispricings within the eurozone. The European fixed income markets are exhibiting elevated volatility at the moment as market participants digest the implications of worsening economic data and the risk of policy error from the ECB. The credit markets have declined materially – in some cases back to the levels last seen in 2009, and a number of opportunities look particularly attractive on an issuer-by-issuer basis. Generally speaking, we are not at the same levels of dislocation as we were in 2008 or 2009, but there is an increasing number of compelling fundamental opportunities while yields on competing asset classes are at all-time lows.

“The proliferation of hedge funds over recent decades, and the occasional high-profile collapse, has led to much greater scrutiny – and criticism – of the industry”

CHART 4: ESTIMATED NET DECREASE OF RISK CAPITAL FROM HEDGE FUNDS AND PROPRIETARY TRADING DESKS SINCE 2008



Source: Hedge Fund Research, Inc., Credit Suisse, BlackRock; Proprietary Trading Desk Capital Base and Leverage, BlackRock Alternative Advisors estimates.

The reduced level of activity from banks, insurance companies and traditional lending sources, combined with the continued divesting of assets by market participants, has led to an asset supply/demand imbalance. We believe this environment is particularly attractive for

certain longer-dated investment strategies (eg distressed investing, direct sourcing strategies, private lending). These types of strategies typically exhibit lower correlations to the broader markets, are idiosyncratic in nature and add a diverse set of potential return streams to a diversified investment portfolio.

Finally, sophisticated investors are currently undergoing a shift in the way they are allocating their capital. Although there continues to be strong interest in more ‘perennial’ investment strategies (eg long/short equity and long/short credit), we are observing a more varied level of interest in ‘cyclical strategies’ such as distressed investing, risk arbitrage and convertible bond arbitrage strategies.

A different kind of allocation

The proliferation of hedge funds over recent decades, and the occasional high profile collapse, has led to much greater scrutiny – and criticism – of the industry. Some of this criticism has been justified: some hedge funds do not truly hedge, while others do not have the experience and talent to generate sufficient performance to justify the fees they charge. However, it is important that investors understand what the top quartile hedge funds can offer in terms of potential returns, risk diversification and insulation against the downside – provided the right partner is found that best meets investor needs and addresses their individual risks.

Indeed, the evidence suggests that, rather than decreasing allocations to hedge funds, many investors are doing the opposite: according to HFRI, total hedge fund assets have rebounded from their 2009 low to approximately \$2 trillion – close to the previous peak reached in 2008. Moreover, hedge funds continue to be a recipient of capital, showing net inflows of \$8.7 billion* during Q3 2011 (one of the most ‘risk off’ quarters of the past decade) and \$70.1 billion* for the first three quarters of 2011, compared to \$55.5 billion* for the whole of 2010.

Interestingly, we have observed a number of institutional investors increasingly integrating hedge fund investments into their larger traditional allocations rather than maintaining a distinct alternative asset class category, for example by assimilating a long/short equity manager into the broader equity allocation of the overall portfolio. This shows that some investors no longer view hedge funds as a separate asset class to which a fixed allocation should be maintained, but rather a flexible tool to reduce overall portfolio risk.

This latter innovation may herald the beginning of a new era for hedge funds in which they are no longer regarded as an ‘alternative’ investment to be held at the periphery of the portfolio in the hope of adding some extra returns, but rather as a core holding designed to help investors meet their liabilities. Allocations to hedge funds with investment talent, strong research capabilities, robust operational infrastructure and appropriate due diligence and risk management can bring major benefits; it is important that investors understand this as they position their portfolios for the challenges that lie ahead.

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