Commentary on the Hedge Fund and Fund of Funds Industries

Newport Capital Advisers, Inc., has researched and recommended separate hedge funds and fund of funds for its consulting clients since its formation in May 1995. Newport views hedge funds as potential sources of diversification that provide access to especially skilled investors whose services are available only through the vehicle of a hedge fund. The investment experience with hedge funds at Newport has been both profitable and instructive. It occurred during a period of significant equity market advance, decline and subsequent advance since late 2002, as well as of increasing institutional acceptance of the use of hedge funds. Newport's ten year experience provides what it believes is a useful guide to hedge fund and fund of funds use.

Hedge funds are not homogeneous. The only factors that they tend to have in common are the legal structure and compensation arrangement, which typically has a management fee of 1% to 2% and incentive compensation on profits that is typically 20%. Generalizing about hedge funds beyond their legal structure as private partnerships with similar fee structures can be very misleading, as even nominally similar strategies can vary considerably in their execution and risk and return profiles. The spread of returns among nominally similar strategies has been much wider than for those of unhedged investment strategies.[•] Therefore, manager selection is far more important with hedge funds than with unhedged managers.

The reason that one might want to allocate assets to hedged funds, especially long-biased equity hedge funds, is the prospect of increased returns and lower volatility. A hypothetical portfolio that had 75% of its assets in the mean Russell US equity account and 25% of its asset in the mean Russell US Equity hedge fund would have had an annualized return of 13.91% for the ten years ended December 31, 2004 with an annualized standard deviation of return of 15.03%, an improvement over the US equity mean portfolio return of 11.82% with 17.31% annualized standard deviation.

As private partnerships, hedge fund general partners typically have very wide latitude in their deployment of assets. They have two primary ways to make—and to lose—money. They can own securities (long positions) and they can borrow them and sell them short (short positions). They can also use margin to increase the amount of capital for investment. Obviously, leverage can be very profitable or very unprofitable; it is not asymmetric and must be used with the utmost care, if at all.

Perhaps the most important aspect of hedge funds is that they are partnerships. It is remarkable that many investors in hedge funds are so mesmerized by the prospect of asymmetrical risk—that they can make money with relatively little risk of loss—that they invest without ever meeting the general partner(s). Of all of the press stories about hedge funds, and the vast majority are negative and warn of bubbles and fraud, none have mentioned the concept of partnership. When one enters a partnership, whether in legal form or on informal terms, one certainly wants to have a full measure of one's partner and confidence in that person's ethical and intellectual integrity. In our view, such knowledge is the primary risk management factor for a hedge fund investor.

Hedge Fund Selection

The key to successful hedge fund investing is manager selection. Manager selection is a complex process. Lesson number one is that one must know the general partner(s) well. Lesson number two is that the world is a far more random place than most successful people assume; thus diversification among hedge funds, or any other investments, is one's only true friend. Yes, concentrating one's investments can lead to outsized returns, but also to outsized losses. For those who view diversification as "diworsification" we can only say good luck, for we are not about macho investing.

There is ample evidence that hedge funds perform best when in their early years, but the failure rate of new hedge funds is a risk. Adding to the analytical complexity is that many of the best hedge funds close to new investors soon after their formation. How then is one to know which fund to select if there is little or no performance history upon which to direct more specific inquiry or upon which to base a decision? These stubborn facts have presented a conundrum for institutional investors, who have typically defined risk relative to market benchmarks and have tended to favor firms that had at least three years of history, preferably five, and assets under management of at least $100 million, but preferably much more. Institutions have therefore tended to engage large, established hedge fund organizations with apparently scalable asset management strategies, organizational infrastructure and other institutional clients or limited partners. This brings us to lesson number three: Among the profitable experiences of investing in hedge funds for a decade is the observation that growth of assets under management can often have a significant, adverse impact on investment returns. Of course, a five year or greater performance record can deliver comfort to a prospective investor, but such records must be viewed in the context of a number of variables, importantly including assets under management and the individuals responsible, for as those two factors change the validity of the past performance is also likely to change, perhaps significantly. The use of quantitative analysis to gauge the effectiveness of a manager can be very helpful, but may also mask risk about the future due to potential changes in qualitative factors.

[•] The Frank Russell US Equity Hedge Fund Universe average fund produced a net annualized rate of return of 16.80% for the ten years ended December 31, 2004 within a range of 33.5% and 1.11% per year. The Russell Equity Accounts Universe (unhedged and gross of fee) mean account return was 11.82% a year within a range of 20.43% and 8.04% a year. The S & P 500 return with dividends reinvested was 12.07% a year. Annualized standard deviation of return for the mean US Equity Hedge Fund was 12.97%, for the unhedged Equity Account was 17.31% and for the S & P 500 was 17.54%.

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Hedge fund selection is highly subjective and requires a multi-faceted approach. We seek to identify structural and specific competitive advantages in our hedge fund selections. Examples of structural advantages include industry sector specialists, as their focus provides an informational advantage, managers who limit assets under management to preserve investment flexibility relative to their universe of potential investments, firms that take great care with personnel growth, funds that are selective in their admission of limited partners, funds with a clear focus on incentive compensation, funds not dependent upon leverage, managers who do not make low conviction investments, managers who do not attempt to time broad stock market movement, but that base their decisions on specific fundamental factors for each security, and funds that operate in securities sectors less likely to be adversely impacted by technical factors such as limited liquidity due to potential broker/dealer capital constraints. Specific advantages primarily relate to investment research acumen. A list of desirable and undesirable characteristics follows:

<u>Desirable Characteristics:</u>
GP(s) easily accessible
GP's are humble, intellectually flexible and competitive
A significant portion of the manager's net worth is invested in the fund
Decisions are driven by original fundamental, in-depth research
Investment process is clearly defined
Team is highly motivated and focused on returns
Robust portfolio information and trading systems
Pragmatic, not stubborn on investment ideas
Has recovered from unfavorable performance experience
Not excessively bullish or bearish
Demonstrates investment philosophy consistency
Favorable industry references and a well-established network
Positive returns in rolling twelve month periods
Excellent administrative, legal and accounting support
Focused response to LP questions

<u>Less Desirable Characteristics:</u>
Growth of assets under management and staff outpace ability to preserve competitive advantage
Inflexibility on investment posture
Extreme forecasts expressed in portfolio without hedges
Arrogance and/or inaccessibility, particularly as firm grows
Key employee turnover
GP(s) delegate too much authority

<u>Is There a Bubble in the Hedge Fund Industry?</u>

If a bubble can be defined as a point in time and level at which expectations are unlikely to be met, the answer about hedge funds is that it depends upon what strategy one references. Several categories may well be at "bubble" levels and others are very likely not. Strategies that have low volatility and can be leveraged to produce competitive returns have attracted relatively large sums as institutions have clamored to increase their allocations to these low "vol" (volatility) funds with low expected correlation to equity markets and may be nearing bubble levels. (Low correlation refers to the degree to which returns are dependent, in this case, on those variables that influence equity returns.) Managers of such funds insist that there is little risk in their use of leverage because the funds in which they invest have low volatility when combined. The example often given is that leveraging a 91 day (13 week) US Treasury Bill has essentially no risk. Of course one has to wonder, then, what kind of return it can produce given the rate earned compared to the rate paid to borrow. But obfuscation of the actual risks inherent in underlying, allegedly low "vol" constituents of such funds that themselves use sometimes significant leverage has become a fine art. It is likely that only extreme episodes similar in magnitude to that of August 1998 when Long Term Capital's problems surfaced that investors in such multi-manager funds will witness the risks of leverage. Equity hedge funds, however, appear to have ample liquidity and opportunity for long/short investors, although there will clearly be "crowded trades" as many multi-billion dollar equity hedge funds attempt to access opportunity in relatively few large capitalization securities. The most obvious example was the subject of a May 18, 2005 *Wall Street Journal* article about the losses sustained by hedge funds in General Motors Corporation equity, debt and derivative securities. The smaller, more flexible funds that can identify securities that have smaller followings appear able to continue to operate without undue liquidity pressure.

Certainly, the apparent ease of entry into the hedge fund business is an indication of what the press may characterize as exuberant hedge fund demand, but demand in itself does necessarily provide a conclusive answer. We say apparent ease because it is unlikely that most journalists have actually started a fund and attracted subscribers. The notion that money targeted for hedge funds is ubiquitous is naïve, in our opinion. That there may be few attractive alternative areas in which to invest money in a world of relatively fully priced asset classes and low interest rates is clearer and one must remain mindful of the tendency of investors to follow the best returns and invest in that which has performed very well most recently. The outcome of such a tendency is well known. Without question many asset categories globally are at full and possible excessive valuations after the aggressive central bank monetary ease from 2001 until mid-2004 that has provided significant liquidity globally. The rise in prices of financial and real assets since 2002 has tipped the concern about deflation to increasing inflation and there is no doubt about the Federal Reserve Board's resolve to keep

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inflationary expectations in check while providing enough liquidity to sustain economic growth and avoid a recession and debt liquidation. So the answer to the bubble question requires a broader perspective on hedge funds.

There are a number of major hedge fund categories and sub-categories within each and definitions can certainly vary, but the following provides perspective on the various types of hedge funds:

Equity:	Domestic Long Biased, Domestic Sector Long/Short, Domestic Opportunistic, Domestic Short Biased, Global/International
Event-Driven:	Deal Arbitrage, Bankruptcy/Distressed, Multi-Strategy
Relative Value:	Dollar Neutral Equity, Convertible Arbitrage, Bond Arbitrage, Multi-Strategy
Global Asset Allocators:	Discretionary, Systematic

One must also understand the extent to which strategies are dependent upon leverage. Recall that the Long Term Capital debacle related to a highly leveraged portfolio that could not satisfy margin calls when its holdings declined far more than its models predicted.

Discussions about a bubble often include references to “crowded shorts,” suggesting that opportunities are simply not abundant and that managers are gravitating to the same trades; thus reducing profit opportunity. There is no question that short selling can create problems for managers, but that has always been true in short selling where there is a theoretically infinite risk of loss, as a security can appreciate well beyond a rational value, unlike long positions where the risk of loss is determined by the price of the security going to zero.

Our view is that certain liquidity constrained sectors, especially those related to arbitrage, experience intervals of demand that drives down return potential and may now be regarded as susceptible to low return potential. Return potential in equities is a function of valuations and fundamental economic prospects and to the extent that valuations cannot be supported by earnings progress, return potential will be lowered. With regard to equities, there is reason to believe that skillful stock selection based upon fundamental research and the flexibility to enter into trades without undue influence on immediate price can provide attractive returns. Recall that in early March 2000 when the NASDAQ and many technology companies peaked in price after generating unprecedented returns for a number of years, certain large sectors of the equity markets that had not performed as well generated relatively good returns in the next five years. The table below may put the last major financial bubble in perspective:

	Annualized Total Returns for Five Years Ended	
	2/28/00	2/28/05
S&P 500	25.14%	-0.98%
Russell 2000	19.25%	3.20%
Russell 1000 Growth	30.77%	-9.71%
Russell 1000 Value	18.74%	7.94%
MSCI EAFE	13.22%	0.45%
IFC Emerging Markets	5.42%	7.84%

Clearly, some sectors of domestic and international equity markets performed relatively well since the bubble burst for technology and growth stocks five years ago, leaving ample opportunity for skillful stock pickers to profit from long positions as well as short positions in many companies whose deteriorating fundamental earnings prospects could not support their valuations. Perhaps the best way to characterize our approach to equity opportunities is to recite an axiom that lost its luster in the halcyon years of indexing witnessed in the 1990’s, and that is that it is a “market of stocks, not a stock market.” Our particular approach is to identify managers who seek individual stocks to own or short and to avoid those who express their views on “market” direction, as we have never identified a manager who consistently and relatively accurately predicted the direction of major stock market averages.

Due to the diversity of hedge fund strategies and variations among individual hedge funds, we believe that regardless of stress that may manifest itself in low returns or losses for large funds in the heretofore scalable strategies based upon arbitrage and leverage, many others, especially the smaller funds, will likely not disappoint investors. Of course, given the propensity of the press to report only negative hedge fund events, there are likely to be headlines when hedge funds produce disappointing results. All investors should maintain healthy skepticism about any prospective investment and be certain to conduct enough research to gain a sufficient comfort level. Hedge funds epitomize the need to investigate before you invest.

Fund of Funds

The fund of funds industry has grown rapidly since the bear market years of 2000, 2001 and 2002, with the greatest growth occurring in multi-strategy fund of funds with risk profiles that are lower than that of the equity market and that have generally low correlation to the equity market. The low correlation means that investors expect such funds to derive their returns from factors less related to those that drive the equity market. There are even index versions of multi-strategy funds that, not surprisingly, use many of the same managers as the large fund of fund groups. Much of the growth can be attributed to the attraction of the promise of steady returns in a low interest rate and expected low to negative equity market return world. The allure of this promise has been irresistible to many large institutional

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investors after they suffered low returns or losses during the wrenching bear market from 2000 to late 2002. Adding to the attraction of prospective returns independent of the equity market are the prognosticators of equity market decline and global financial decay.

On average, multi-strategy fund of funds have not delivered bond-like returns for the past five years. For the five years ended December 31, 2004, the Lehman Aggregate Bond Index was up 7.71% a year, the HFRI Fund of Funds Index was up 5.13% a year and the S&P 500 Index was down 2.30% a year. Many of the individual allocations within these funds of funds use leverage to generate returns and some depend upon significant leverage. In a rising interest rate environment with a flattening yield curve, dependence on leverage implies greater risk of loss. Another characteristic of the multi-strategy funds is that they tend to invest in very large and scalable funds. Indeed, multi-billion dollar hedge funds have been launched with the support of large multi-strategy funds of funds. There is not necessarily a positive correlation between the size of a hedge fund and its performance, yet many of the big funds just keep getting bigger. The comfort of other large investors in a fund is unsurprisingly convincing to many prospective institutional-sized investors. After all, the reasoning typically goes, how can so many large, well-respected institutional investors be wrong, or at least too far wrong? Adding to the comfort are large organization charts of funds and even brand recognition through their assiduous sales campaigns and presence at most, if not all industry seminars. So despite the restrictions on soliciting interest in private offerings that in our experience have been scrupulously observed by the industry the word is spread quite effectively. While the hedge fund industry is relatively young, there have been very few multi-billion dollar funds that have maintained their competitive edge and any number of large, formerly successful funds that have closed when the general partner or partners simply did not want to continue in what is an intensely competitive business. In such cases the general partners have enjoyed financial success beyond the imagination of most people and simply do not have to continue.

Rapid growth of a hedge fund organization is very difficult to achieve successfully. The recent trend has been for large hedge fund companies to offer different strategies from their original strategy in an effort to diversify their business risk and retain talented individuals. Their clear focus is on asset gathering that provides a stable and profitable revenue base to satisfy institutional demand for investment organizations with large asset bases, large infrastructures and sophisticated investor relations staffs. All of the above trends, we believe, have led to an implicit acceptance of mediocre returns.

Newport Capital Advisers, Inc. believes that its clients can generate returns above long-term returns in global equity markets with lower volatility by investing in those funds that are cognizant of the risks of too-rapid asset and organizational growth. By remaining small in comparison to many multi-manager funds, we believe that several long-biased, multi-manager funds can exploit the institutional impediments to engaging those funds that have remained relatively small to maintain their focus on investment returns. While it is obvious that one should focus energy on investment research and portfolio management, the fact is that many very successful, albeit small, hedge funds simply do not have large enough staffs to satisfy most institutional investors. Here we can cite an interesting account of a very large fund of funds group that conducted research at one separate hedge fund engaged by one of the this firm's endowment clients. The large multi-manager fund group's due diligence staff spent two days in the office of the manager and late on the second afternoon informed him that his fund was too small for them. His fund's performance was not a concern, just the size of his then two person firm. He never again wasted his time on such inquiry and has grown his fund through investment returns and referrals from his investors. He has recently announced the close of his fund to new investors. The opportunity to invest with dedicated, ethical, focused, talented and passionate managers of such hedge funds is rich and exciting, either separately or through multi-manager funds that reflect the principles discussed above.

Recent SEC requirements for hedge fund registration may place disproportionate administrative burdens on smaller funds, but we do not believe that the new registration requirements will deter those managers who maintain their focus on returns.

Because equity markets are volatile, it is likely that the long-biased equity funds will experience intervals of decline, so are suitable for only a portion of one's total investment program. Allocations to global fixed income and/or tax-exempt bonds, unhedged equities, real estate, private equity and inflation hedges may also be suitable for investors in such hedge funds.

The subject of hedge funds will continue to generate questions and we invite any that you may have.

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