

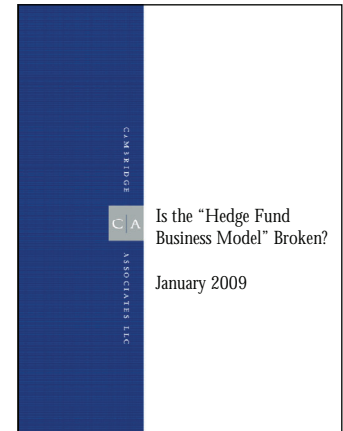


CAMBRIDGE ASSOCIATES LLC

## CAMBRIDGE ASSOCIATES RESEARCH REPORT ABSTRACT

### Is the “Hedge Fund Business Model” Broken?

- Although data for the final few weeks of the year are not yet available, it is clear that 2008 will be the worst-ever year in the hedge fund industry—by a very wide margin. Through the end of November, the Hedge Fund Research (HFRI) Fund Weighted Composite Index, which we believe to be a reasonable proxy for the performance of marketable alternative strategies, was down 18.18%. (To place this return in historical context, the second-worst return for the index—which dates back to 1990—was -1.45%.) Additionally, many core substrategy indices have underperformed the composite index: through the end of November, the HFRI Equity Hedge (Total) Index was down 26.03%, the HFRI ED: Distressed/Restructuring Index was down 20.77%, and the HFRI RV: Fixed Income-Convertible Arbitrage Index was down 35.50%.
- The inability of hedge fund managers to fulfill their absolute return mandate in 2008 has prompted some investors to question the role of marketable alternative strategies in institutional investment portfolios. Hedge fund managers did a better job of preserving capital than traditional asset managers, but were confronted with a host of challenges—counterparty failures, regulatory intervention, and unprecedented capital redemptions—that made it extraordinarily difficult to deliver returns.
- While we expect hedge fund managers to perform poorly in environments characterized by rapidly declining asset prices and liquidity, we believe losses in 2008 were unexpectedly poor for three reasons. First, managers faced the worst counterparty crisis in the history of the hedge fund industry. Second, federal securities regulators intervened in the global capital markets on an unprecedented scale, introducing a series of emergency orders that temporarily restricted short selling and made it difficult for managers to execute certain marketable alternative strategies. Third, the global liquidity crisis became so acute that investor redemptions from hedge funds vastly exceeded expectations, resulting in a wave of forced selling that further depressed asset prices.
- Net returns in the hedge fund industry are dependent on three factors: the competitive landscape, strategy-specific opportunity sets, and the total costs associated with accessing these returns. The surfeit of capital that depressed returns





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## ABSTRACT (CONTINUED)

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in recent years has washed out of the system with remarkable speed, radically changing the competitive landscape in the hedge fund industry. When one considers the sale or closure of several large U.S. investment banks (e.g., Bear Stearns, Lehman Brothers, Merrill Lynch), the curtailment of proprietary trading activity at the handful of surviving investment banks, and the dramatic reduction in leverage ratios at these banks, it is likely that 65% to 75% of the capital that was allocated to marketable alternative strategies in recent years has been eliminated—especially since most Wall Street proprietary trading businesses were rumored to be massively leveraged. Barriers to entry should rise considerably and effectively restrain competition. Those hedge fund firms that survive current events will likely be well positioned to capitalize on price inefficiencies to come, and the reduction in capital should serve to increase the return on assets. The credit crisis has also resulted in extremely attractive opportunity sets in most marketable alternative strategies. Convertible bonds are as cheap as they have ever been and many managers see pronounced security mispricings in the long/short equity market. Finally, the credit crisis should lead to a structural abatement of cost pressures. In our view, the 2% of assets plus 20% of net profits fee schedule that was foisted on investors during the past three years should be permanently consigned to history.

- Despite recent poor performance, we strongly believe that the current shakeout in the industry is a net positive for long-term hedge fund investors. Firms that survive the shakeout should be able to generate attractive risk-adjusted returns in coming years. Yet we are cognizant that significant near-term challenges remain. Organizational risks in the industry remain extremely high—especially with most firms below high-water marks and the global liquidity and credit crises still weighing on asset prices—and more firms will undoubtedly fail in the upcoming year. At the same time, we currently regard most credit markets as very undervalued, U.S. equities as fairly valued, and equity markets outside the United States as undervalued, suggesting that from an intermediate- to long-term perspective long-only investment return prospects are more attractive than they have been in years. In this environment, manager selection becomes paramount, as prospective returns from marketable alternative strategies will be even more dependent on manager selection than they have been in the past. Superior skill in security selection, capital allocation, and risk management will be necessary to justify the higher fees and constrained liquidity of marketable alternative investments. Firms that are most likely to survive the shakeout have strong and flexible capital bases, deep investment teams, long track records, sizable capital reserves, modified (or annual) high-water-mark provisions, and shared equity ownership.

*Full report available only to clients of Cambridge Associates.*