

# Hedge Fund Investment in a Post-Crisis World

## Special Report

November 2009

# BLACKROCK

In February, we published the Special Report *Hedge Funds in Crisis*, which addressed the convergence of industry-wide factors that had fueled a sharp erosion of investor confidence in the hedge fund model. Among others, these factors included:

- the impact of leverage and retrenched financing,
- the consequences of insufficient due diligence efforts,
- the implications of redemption activity on investor decision-making, and
- the exaggeration of hedge fund investment expectations.

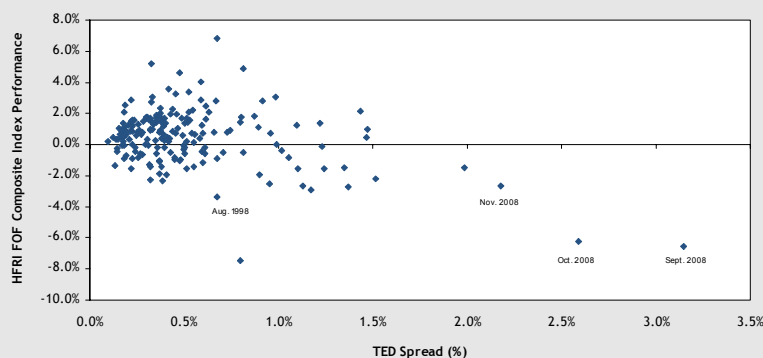
In the Report, we offered our views on the future for the hedge fund industry and potential opportunities for those able to persevere through an extremely difficult financial period. Since its release, a number of advantageous events for hedge fund investors have occurred. Here, we highlight more recent developments that we believe are advantageous for hedge fund investors and outline our view of their potential impact on the industry, investors, and investment opportunities.

## A Recovering Financial System, but an Uncertain Economic Outlook

By their nature, hedge funds strive to mute sensitivity to *primary* risks (i.e., broad market factors) relative to traditional portfolios. However, their ability to utilize leverage and their flexibility to pursue less followed and market-efficient investment opportunities can produce a strong sensitivity to *systemic* risks (i.e., overall health of the financial system). Last year, heightened fears over the potential for financial system failure severely restricted access to capital and reduced market liquidity. This phenomenon severely reduced asset prices, forcing many investors, particularly leveraged investors such as hedge funds, to aggressively sell positions to return capital to panicked lenders and investors.

However, as systemic risks have faded, we believe the environment for hedge funds has dramatically improved (see Figure 1). Hedge funds generally have better access to capital now, potentially easing certain financing and operating pressures. Investor confidence has grown, enhancing liquidity and bolstering the ability of hedge funds to establish and exit positions. Counterparty stability has improved substantially, reducing hedging costs and counterparty-related risk.

Figure 1: Impact of Credit Liquidity Improvements HFRI Conservative FoF Index vs. TED Spread, monthly results (August 1995 - Sept 2009)



Source: Hedge Fund Research Inc., Bloomberg; data as of September 2009

## About BlackRock

BlackRock is a premier provider of global investment management, risk management, and advisory services. As of 30 September 2009, the firm manages US\$1.43 trillion across equity, fixed income, real estate, liquidity, and alternative strategies. Clients include corporate, public, and union pension plans, insurance companies, mutual funds, endowments, foundations, charities, corporations, official institutions, and individuals worldwide.

Through BlackRock Solutions®, the firm offers risk management and advisory services that combine capital markets expertise with proprietary-developed systems and technology. BlackRock Solutions provides risk management and enterprise investment services for US\$7.25 trillion in assets.

BlackRock serves clients in North and South America, Europe, Asia, Australia, Africa, and the Middle East. Headquartered in New York, the firm maintains offices in 21 countries around the world.

## About BAA

BlackRock Alternative Advisors (“BAA”), BlackRock’s fund of funds platform, provides a variety of absolute return, private capital, and hybrid FoF strategies to investors worldwide. As of 30 September 2009, BAA has over \$21 billion in discretionary assets under management and more than a decade of experience serving a broadly diversified global client base.

BAA’s Investment professionals are located in Seattle, New York, Princeton, Durham, London, and Hong Kong.

Copyright © 2009 BlackRock. All Rights Reserved.

While the financial system has strengthened, economic uncertainty remains. Despite sizeable rallies in equity and credit markets, the global economy remains badly shaken by recent events. As a result, consumer and business activity, primary drivers of economic growth, have materially slowed and perhaps fundamentally changed. In our opinion, the timing and path to eventual growth are unknowable and will prove to be challenging for investment approaches contingent upon the health of the broader economy.

The sources of return for Absolute Return Strategies (ARS) are generally not predicated on economic growth, but instead on the isolation of idiosyncratic fundamental mispricings that exist because of market inefficiencies. These mispricings and their subsequent corrections are generally less dependent on economic direction and more reliant on the overall health of the financial system.

Additionally, hedge funds generally benefit from a higher degree of investment flexibility, drawn from a variety of sources, including:

- an ability to invest throughout the capital structure, allowing managers to tailor risk and return exposures and fully utilize the characteristics of different kinds of securities to take advantage of a particular situation;
- an ability to invest long and short in order to hedge unwanted market risks and better isolate specific mispricings;
- an ability to selectively use derivative instruments to potentially create asymmetric risk and return profiles by not only striving to maintain a strong upside for gains, but also to mute the potential for losses.

We believe these additional degrees of flexibility can be advantageous in managing risk and generating positive returns in either a strong or weak economy.

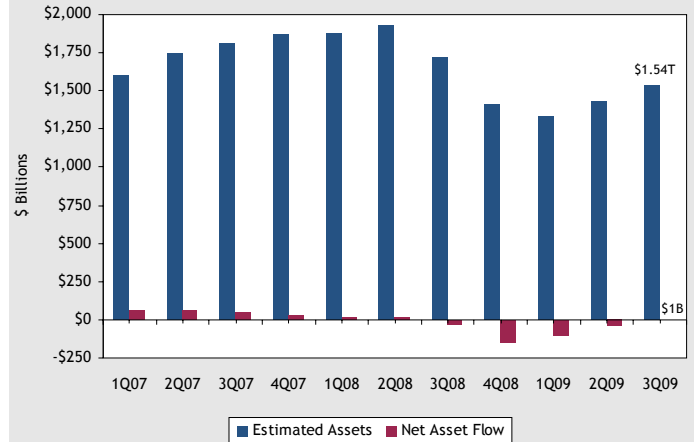
## Industry Resilience and Investor Redemptions

Amid the stress in 2008-2009, a heightened level of investor redemptions from the hedge fund industry added both technical and operational pressures for asset managers, forcing many funds to enact liquidity controls, such as suspensions and gates, to balance the needs of exiting investors while protecting value for ongoing investors. In select cases, the level of redemptions led managers to fully liquidate, as remaining net assets were insufficient for the business to operate effectively.

Based on our own experience and industry estimates, we believe that redemption requests have slowed across the hedge fund industry from the levels seen in late 2008 and early 2009. Subsequently, technical selling pressure has been reduced, market liquidity has improved, and many managers have lifted suspensions and gates earlier than anticipated.

We believe the recent deceleration in redemptions demonstrates the overall resilience of the hedge fund industry. Despite the worst financial market environment in several generations, poor performance relative to expectations, and a heightened level of investor redemptions, hedge fund assets are still estimated to exceed \$1.5 trillion as of 30 September 2009 (Figure 2) and remain a significant part of institutional portfolios and the investment marketplace.

Figure 2: Estimated Growth of Hedge Fund Assets/Net Asset Flow



Source: Hedge Fund Research Inc.; data as of 30 September 2009

## Fundamental Changes in Supply and Demand for Hedge Fund Opportunities

Profound fluctuations in investor risk appetite catalyzed trillions of dollars of assets changing hands over the past year. This painful process not only has resulted in periods of tremendous volatility, but also generated a vast supply of opportunities for hedge fund managers. As some investors sought liquidity at nearly any price and indiscriminately sold assets in the midst of the crisis, the opportunity and premium available to investors willing to commit capital significantly expanded. These investors were rewarded with asset prices that were in many cases unusually disconnected from fundamental value.

In addition to an expanded opportunity set, the financial crisis has had another impact - many investors that would normally compete over these trades were forced to reduce their activity or even exit the markets. Many investment banks that have historically been formidable competitors to hedge funds have significantly abridged or disbanded their proprietary trading efforts. Further, the attrition of weaker hedge fund managers has led a broader consolidation of the hedge fund industry. As a result, there is far less competition within strategies undertaken by hedge funds.

We believe the combination of increased investment opportunity and reduced competition is particularly favorable for hedge fund investors. While certain trades have been positively influenced by the abatement of technical pressures, many other determinants of pricing inefficiencies - including continued market volatility, economic uncertainty, misaligned incentives, and government intervention - will continue to drive abundant opportunities, often at significantly lower levels of leverage or, in select cases, with no leverage at all. Many of these opportunities are unavailable to traditional portfolios that are restricted to long-only cash investments.

One prominent example has been convertible arbitrage strategies, which were particularly hurt by investor deleveraging in 2008. Despite a 53% return in the HFRI Convertible Arbitrage Index year-to-date (through September), the price level of convertible securities remains attractive relative to their synthetic counterparts, which are a combination of a similar-duration bond and a call option. Discounts to fair value are still over double that of the last notable lull in 2005, and far cheaper than the price premium offered only a few years ago. Importantly, skilled managers often use hedges to isolate price differences between the convertible security and its component exposures, so returns are generally less dependent on the overall direction of the markets.

Managers who specialize in bankruptcy reorganization are seeing opportunities that may last for years to come. In the first eight months of 2009, the volume of high yield and leveraged loan defaults has already far exceeded that experienced in 2001 and 2002 combined, the last US recession. Should the economy slow further, this opportunity set is expected to grow as more companies fall into distress.

Finally, the beleaguered mortgage markets are also providing an interesting set of investment opportunities. For example, the FDIC is tasked with auctioning mortgage assets of failed banks to potential investors. Given the extraordinary pace of bank failures thus far in 2009, strong incentives for regulators to return capital quickly to bank depositors, and a limited investor appetite for mortgages, many of these assets are being sold at a substantial discount to book value. Managers with strong credit skills can identify those loans with attractive prospects, generating substantial returns.

Some of the most compelling investment environments for skilled hedge fund managers have occurred following periods of market stress, and we believe the current environment is no different. The backdrop for capital deployment remains very attractive, and one for which we consider hedge funds particularly well-suited.

## Renewed Focus on Operational Due Diligence

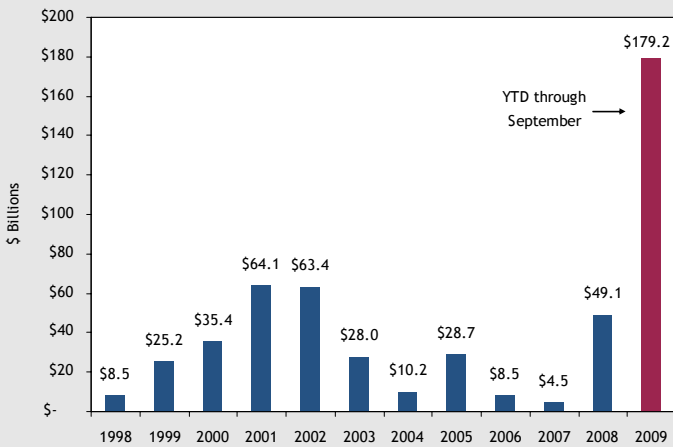
In the wake of Bernard Madoff's highly publicized fraudulent activities, there has been a more intense focus on understanding an investment organization and its operational processes, as well as on the adequacy and efficacy of the due diligence procedures of hedge fund investors.

Addressing the potential for frauds in a due diligence program is not a task for half-hearted practitioners. Mr. Madoff's massive Ponzi scheme is largely a result of operational obfuscation where rigorous operational due diligence steps could have raised enough questions and concerns to avoid investment. Mr. Rajaratnam's activity with Galleon Group deals with the acquisition of "inside" information, potentially detectable through a thorough practice of independently assessing manager claims and statements. In both cases, a manager evaluation process reliant on past performance, rather than ongoing proactive inquiries, would not be enough to uncover these issues or others like them. Such an approach does not drill down to understand and identify causal factors behind returns, which we believe is a critical step in avoiding problem investments.

As we have discussed, the severity of the crises affecting the investment industry this past year has weakened many hedge fund organizations. Importantly, however, the crisis has also revealed a handful of hedge fund industry participants, such as advisors, marketers, and investment managers, to have inadequate due diligence practices. While the results have been tragic for many of their clients, it has re-introduced a healthy skepticism among the larger investor community, and increased the value of a robust due diligence process.

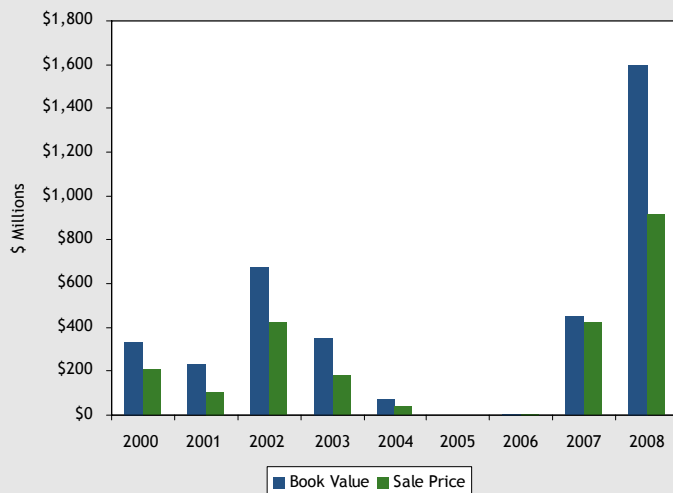
In our view, a robust process must include a thorough examination of personnel and staffing, internal control environment and operational processes, role of key service providers, asset stability, and financing risks, among many other factors. As a larger number of experienced investors hold their managers to a higher standard of due diligence and encourage an alignment of incentives between investor and manager, they can initiate and strengthen a valuable check against weak, flawed, or fraudulent organizations.

Figure 3: High Yield and Leveraged Loan Default Volume



Source: JPM Default Monitor; data as of 30 September 2009

Figure 4: FDIC Performing and Non-Performing Loan Sales 2000-2008 (Discount to Book Value)



Source: FDIC

## Conclusion

In our view, the rationale for hedge fund investments as part of an overall portfolio strategy continues to be sound. Specifically, due to their focus on idiosyncratic risks, we believe hedge funds will continue to display lower correlation to primary market risk factors.

We believe that pricing inefficiencies, the primary driver of hedge fund returns, will continue to provide opportunities, perhaps even to a greater degree than we have seen in the past. Though hedge funds are not immune to broader cyclical forces, we believe that the sources of these inefficiencies—market segmentation, government intervention, complexity, and lopsided incentive structures—are permanent features of capital markets and are certainly characteristics of today's environment.

Further, we believe that hedge funds will continue to be one of the most appropriate vehicles through which to exploit inefficiencies. They are often managed by very experienced investors whose incentives are closely aligned with those of their investors and who can invest using the widest possible range of strategies and securities.

Many of the factors that created headwinds in late 2008 and early 2009 - a threatened financial system, strong technical selling pressures at both the market and the fund level, a growing divergence between asset prices and fundamental value, and prominent headlines regarding failures and frauds within the investment community - have substantially abated year-to-date. Historically, periods of extreme stress (e.g., 1929, 1974, 1994, 1998, 2004) were followed by three to five years of excellent risk/return opportunities. We believe the next few years will afford a similar investment environment.

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of 11 November 2009 and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will come to pass. Any investments named within this material may not necessarily be held in any accounts managed by BlackRock. Reliance upon information in this material is at the sole discretion of the reader. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index.

Hedge funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss; can be highly illiquid; may not be required to provide periodic pricing or valuation information to investors; may involve complex tax structures and delays in distributing important tax information; are not subject to the same regulatory requirements as mutual funds; and often charge high fees.

### Certain Risk Factors

**Past results are not necessarily indicative of future results.** Historically, funds of funds and hedge funds have produced gains and losses due to changes within the equity, interest rate, credit, currency, commodity and related derivative markets. Additionally, gains and losses are impacted to varying degrees by investment acumen, market volatility, corporate activity, securities selections, regulatory oversight, trading volume and money flows. These elements and/or their rate of change may not be present in the future, and thus future performance may be impacted. Any investment in a fund involves a high degree of risk. Investments in funds of funds and hedge funds can be highly illiquid.

The performance of funds of hedge funds will depend on the performance of the underlying hedge fund investments. There can be no assurance that a multi-manager approach will be successful or diversified, or that the collective performance of underlying hedge fund investments will be profitable. Hedge fund managers may be subject to limited regulation (or may not be registered with any regulatory body), may experience potential conflicts of interest with respect to their management of allocated fund assets and from time to time, vis-à-vis other underlying hedge fund managers, may take opposing positions with respect to particular securities or investments. Funds of hedge funds will rely on information provided to them by the underlying hedge fund managers and there may be limited ability to confirm or verify such information.

Hedge fund managers may implement a variety of investment strategies and techniques, including short selling, leverage, hedging (such as derivatives, swaps, forwards, futures and options) and securities lending. Hedge fund managers may invest in a wide array of investments, including non-US investments, non-US currencies, distressed assets, illiquid investments (such as those subject to legal or regulatory restrictions on transfer), and commodities and futures, each of which may have diverse associated risks, including counterparty risk, credit risk and liquidity risk.

The secondary market for investments in hedge funds or its underlying fund investments is a recent development and as such may exhibit illiquidity, wide or non-existent bid-offer spreads, and brokerage charges. In addition, there may be restrictions on transferring fund investments. A fund may be leveraged, which may increase the risk of investment loss, and its performance may be volatile. Funds of funds and hedge funds may involve complex tax structures; therefore, there may be delays in distributing important tax information. Funds of funds and hedge funds are not subject to the same regulatory requirements as SEC registered funds or mutual funds and are not required to provide periodic pricing or valuation information to investors. The Fund and its underlying fund investments may have significant fees and expenses that would reduce returns.

For distribution in EMEA for Professional Investors only, or ("professional clients", as such term may apply in relevant jurisdictions). In Japan, not for use with individual investors. This material is being distributed/issued in Canada, Australia and New Zealand by BlackRock Financial Management, Inc. ("BFM"), which is registered as an International Advisor with the Ontario Securities Commission. In addition, BFM is a United States domiciled entity and is exempted under Australian CO 03/1100 from the requirement to hold an Australian Financial Services License and is regulated by the Securities and Exchange Commission under US laws which differ from Australian laws. In Australia this product is only offered to "wholesale" and "professional" investors within the meaning of the Australian Corporations Act). In New Zealand, this presentation is offered to institutional and wholesale clients only. It does not constitute an offer of securities to the public in New Zealand for the purpose of New Zealand securities law. BFM believes that the information in this document is correct at the time of compilation, but no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by BFM, its officers, employees or agents. This document contains general information only and is not intended to be relied upon as a forecast, research, investment advice, or a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The information does not take into account your financial circumstances. An assessment should be made as to whether the information is appropriate for you having regard to your objectives, financial situation and needs.

© 2009 by BlackRock. No part of this document may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written consent of BlackRock.