

## { Overview }

The market returns from September 2008 through mid-2010 have introduced some extraordinary market movements to investors across nearly all asset classes. This volatility, punctuated by the massive drawdown in the fall of 2008, has led the investment community to question some long-held assumptions regarding risk/return patterns and historical relationships among various asset classes. We believe this questioning is healthy, and necessary, in a world that is dynamic and increasingly less predictable. As such, in this paper we endeavor to conduct a thorough re-assessment of *multi-strategy hedge funds*, an asset class primarily using credit that has recently come under great scrutiny as return patterns, liquidity profiles, and competing asset classes (specifically, long-only credit strategies) have raised a number of questions related to their attractiveness on a go-forward basis.

Our analysis is based upon a comparison of multi-strategy hedge funds to long-only credit strategies because both are viewed as *diversifiers* with lower volatility and attractive risk characteristics relative to a typical equity oriented portfolio. Since their inception decades ago—and with the exception of four months in 2008—multi-strategy hedge funds (often identified as absolute return, or low volatility funds) have had favorable risk/return characteristics relative to long-only credit funds, outperforming these over time, with similar—or lower—levels of volatility. However, as credit markets sold off sharply in late 2008 and rebounded sharply in 2009, multi-strategy hedge funds lagged their more liquid counterparts, leading some to question their role in a portfolio.

This paper will define these two investment areas, compare and contrast their performance, and detail the complementary roles within a portfolio context given each asset class' drivers of risk and return. Based upon this analysis, we continue to believe multi-strategy hedge funds should be considered part of a client's policy portfolio, with long-only credit strategies being utilized on a more dynamic basis.

## { Investment Strategies Defined }

### LONG-ONLY CREDIT FUNDS

Long-only credit funds invest in liquid credit instruments including government bonds, mortgage securities, corporate bonds, high yield bonds, emerging market debt, and convertible bonds. The risk of capital loss via default embedded in these strategies ranges from very low (government bonds and investment grade securities) all the way to high (high yield strategies). Typically, these funds offer daily liquidity and thus are constrained to investing in securities that are easily tradable. Despite participating in tradable markets, these funds can be impacted by liquidity issues when, as happened in 2008, sellers overwhelm buyers as credit markets seize and investors are forced to sell their most liquid securities to raise capital.

### MULTI-STRATEGY FUNDS

Multi-strategy hedge funds employ many different investment strategies, thereby creating confusion about the types of investments made by these managers. Many of these funds are focused on limiting market exposure and have the flexibility to invest in all parts of the capital structure, including those securities purchased by long-only managers. Their broader investment toolkit may also include utilizing leverage

and employing various hedging and arbitrage strategies. Unlike their long-only credit counterparts, multi-strategy funds also have the advantage of being able to drive value creation and exploit inefficient markets, as described below. Following are various strategies/capabilities employed by multi-strategy managers:

*Restructurings* – Investing in restructurings may involve taking positions in securities that are distressed or near distressed. When a company is in need of a debt restructuring, a portion of its debt generally trades at a significant discount to par, creating opportunities to purchase undervalued securities. Oftentimes, after purchasing these securities, multi-strategy managers become actively involved in working with the company to restructure the existing debt and/or in providing capital for new debt. As a result, multi-strategy managers can directly impact the value realized from their investment rather than relying strictly on the yield of the securities they hold. **Key driver(s) of returns: value creation.**

*Bankruptcies* – Managers with an expertise in bankruptcies may have their own internal staff of professionals (including lawyers) specializing in bankruptcies, as well as having relationships within the judicial system. In large part, their success in investing involves exploiting their experience and knowledge of:

- Disparate bankruptcy processes in different jurisdictions
- Differences in how bankruptcy judges across the country deal with various situations
- Relationships between lawyers representing the different constituencies and the judges handling the cases

Managers who excel in this space need to have great experience in analyzing a company's capital structure and determining what each security will be worth in a bankruptcy proceeding. While the company is in bankruptcy, the securities are often fairly illiquid as the market value is not readily ascertainable. In addition, bankruptcies often take an extended period of time to work out; as a result the payoff may not be realized for months or even years. In exchange for this illiquidity, hedge funds investing in distressed securities focus on situations with high return potential. **Key driver(s) of returns: inefficiencies, legal expertise and relationships, value creation.**

*Capital Structure Flexibility* – When credit yields are not attractive, multi-strategy funds can adjust their investment focus to areas of the capital structure where more attractive risk-adjusted returns are found. These can include bank debt, bonds, trade claims, convertible debt, preferred stock, or even common stock. **Key driver(s) of returns: inefficiencies, investment flexibility, broad range of investment expertise.**

*Arbitrage* – Exposure to arbitrage strategies is designed to allow multi-strategy funds to generate returns by exploiting pricing abnormalities between two instruments. These strategies have low correlation to the markets and have historically generated high risk adjusted returns. Common arbitrage strategies include merger arbitrage, convertible bond arbitrage, and capital structure arbitrage. **Key driver(s) of returns: inefficiencies, broad range of investment expertise.**

*Hedging and Shorting* – When a long-only manager has a negative opinion on a security, the only option is to avoid purchasing that security for the portfolio—potentially, a wasted insight. Multi-strategy funds have a broader opportunity set and a higher probability of realizing value from their analysis because they can both invest long and sell short, enabling skilled managers to find investment opportunities in both strong and weak credit market environments. Also, managers may fine-tune the risks embedded in their

portfolios through the ability to hedge against general market movements or to specifically hedge out certain risks they are not willing to take, while isolating risks that they find more palatable. **Key driver(s) of returns: inefficiencies, fundamental research, ability to exploit negative opinions through shorting.**

*Leverage* – Multi-strategy funds have the ability to utilize leverage in an effort to enhance returns. The use of leverage varies greatly depending on the investment strategy. For example, hedge funds that focus on distressed investments rarely utilize leverage, while those focusing on arbitrage strategies often utilize high leverage in order to magnify the profits on small mis-pricings between securities. **Key driver(s) of returns: inefficiencies, fundamental research, ability to exploit negative opinions through shorting.**

In summary, unlike long-only funds, multi-strategy funds have the ability to:

- Adjust to various market environments by investing both long and short
- Invest in different parts of the capital structure
- Invest in less liquid credit investments, such as restructurings and bankruptcies, where they can often create value by being active in the process
- Exploit pricing abnormalities through arbitrage strategies
- Enhance returns through leverage

### { A Review of Non-Investment Related Characteristics }

*Liquidity* – While long-only credit funds generally offer daily liquidity, most multi-strategy hedge funds offer liquidity quarterly, semi-annually, or annually. Almost all of these investments are held in a limited partnership or LLC/hedge fund structure. Hedge funds typically have a mix of liquid and less liquid investments, requiring liquidity terms intended to match the underlying liquidity of the portfolio. However, it is important to note that not all funds in the multi-strategy space have the same liquidity profile. Some invest primarily in liquid securities and, as a result, may not have a lockup. Some may have quarterly liquidity, while funds with higher allocations to less liquid investments, such as distressed strategies, may have an initial lockup period of one to two years with annual or semi-annual liquidity. **One of the risks of investing in multi-strategy funds is their liquidity. Investors need to be aware of their personal liquidity needs before they invest in multi-strategy funds.**

*Fees* – Hedge funds have a higher fee structure than long-only credit funds with management fees of 1% to 2% versus management fees that are typically less than 1% for long-only credit funds. Multi-strategy hedge funds also typically charge an incentive fee of 20% of profits earned. In order to make up for the higher fee structure, hedge funds are expected to generate higher gross returns than long-only credit managers.

*Transparency* – Long-only credit funds are required to report their holdings quarterly while hedge funds have no specific reporting requirements. *Nevertheless, Convergent maintains close relationships with the hedge funds we utilize and we require transparency via the fund's monthly and/or quarterly reports and also through frequent contact with the funds' managers.*

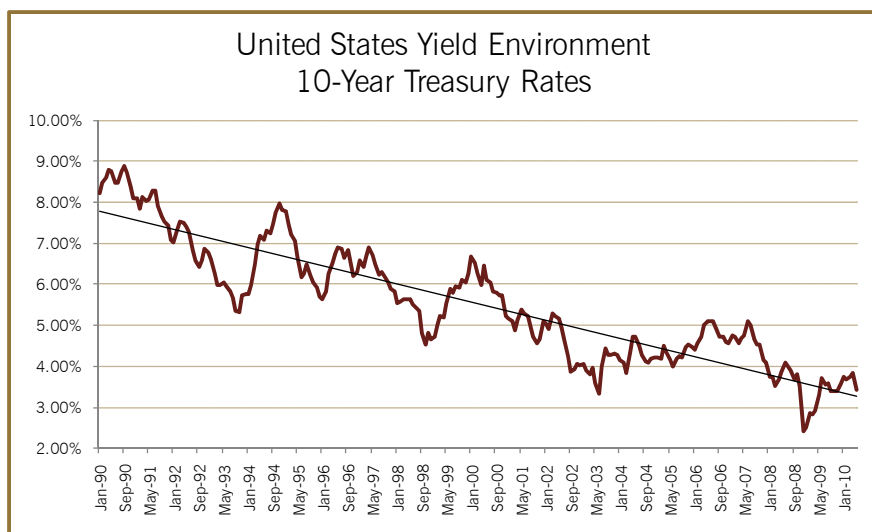
*Tax Reporting (for taxable investors)* – Long-only credit mutual funds are required to report their distributions (dividends and capital gains) to shareholders for tax reporting purposes via the various 1099 forms. Given their LP or LLC structure, hedge funds provide investors a K-1 which, in most cases, does not arrive by April 15<sup>th</sup> and, as such, requires investors to file for extensions.

In summary, investors need to be aware of the following non-investment related items when considering multi-strategy funds. These items result in additional complexity which makes investing in hedge funds most appropriate for sophisticated investors:

- Liquidity constraints require thorough personal liquidity analysis in order to target appropriate allocation. Allocations to hedge funds should be considered long-term investments.
- While fees are higher for hedge funds, it is important to remember that all returns (long-only and hedge funds) are reported net of fees.
- Obtaining acceptable levels of transparency can be accomplished; equally important, being able to assess and analyze all data.
- More complex tax reporting for taxable investors requires working closely with your accountant.

### { Performance Comparison }

Long-only credit funds are yield-dependent and are expected to perform best in falling rate environments. Hedge fund indices date back to 1990, the midpoint of a 20-year bull market for bonds (i.e., a falling rate environment) interrupted for only short periods of time by periods of rising rates. Therefore, this has been a particularly strong period for the interest rate sensitive bonds that tend to make up a large portion of long-only credit funds.

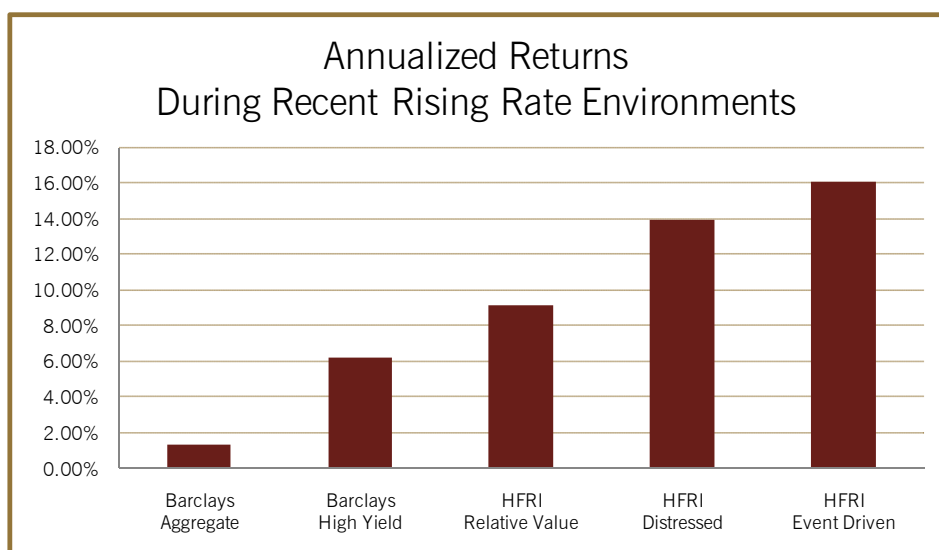


Long-only credit funds are expected to have returns that more closely match or potentially even exceed those of multi-strategy hedge funds during falling rate environments due to the former's full exposure to the market and focus on large, liquid names. By contrast, hedge funds are not trying to capture general market movements but rather are attempting to add value through their skills in security selection, trading, and process. Multi-strategy hedge funds, true to their moniker, are generally hedged, though they will increase and decrease exposure to account for their macro views on the rate environment and the opportunity set. As a result of this hedging, hedge funds are not expected to outperform long-only credit funds when markets are moving upward quickly (such as 2009), but they are expected to outperform over time and particularly in rising rate environments.

*Despite the virtually unprecedented 20-year bull market for bonds favoring long-only managers, multi-strategy hedge funds have outperformed their counterparts during this time. From January 1990 to June 2010, return and volatility characteristics for the primary multi-strategy hedge fund indices are detailed below along with the return and volatility characteristics for the primary long-only credit and equity indices.*

	<u>Annualized Return</u>	<u>Standard Deviation</u>
<b>HFRI Distressed/Restructuring Index</b>	<b>12.67%</b>	<b>6.66%</b>
<b>HFRI Event Driven Index</b>	<b>12.29%</b>	<b>6.96%</b>
<b>HFRI Relative Value Index</b>	<b>10.62%</b>	<b>4.49%</b>
<b>Barclays High Yield Index</b>	<b>8.71%</b>	<b>9.52%</b>
<b>Barclays Aggregate Bond Index</b>	<b>7.10%</b>	<b>3.84%</b>
<b>S&amp;P 500 Index with Dividends</b>	<b>7.63%</b>	<b>15.10%</b>

You can see in this chart that interest rate sensitive securities, which make up a large portion of the Barclays Aggregate Bond Index (i.e., treasuries, municipal bonds, mortgage securities, and high quality corporate bonds), are particularly sensitive to rising rate environments which has led to the outperformance of multi-strategy funds during those periods. In fact, during the combined three periods<sup>1</sup> included in the graph data, the return of the Barclays Aggregate Bond Index did not keep pace with the pace of inflation over those same time periods.



### { Role of Multi-Strategy Hedge Funds in Portfolios }

Convergent utilizes multi-strategy hedge funds as a component of the risk portion of a portfolio.<sup>2</sup> Multi-strategy (credit or credit and equity) funds are designed to bring important diversification benefits to the portfolio, typically behaving differently than long-only credit funds in varied environments while also maintaining low correlation to equity markets. Since its inception in January 1990, the HFRI Fund of Funds Conservative Index has the following correlations to primary equity and credit indices:

Barclays Aggregate Bond Index	0.09
Barclays High Yield Credit Index	0.47
S&P 500 with Dividends	0.51

Also consider, with rates on a fairly consistent decline over the past 25+ years and with 10-year treasury rates currently at just below 3%, it is likely rates will remain consistent or rise in coming years as there is

<sup>1</sup> The combined three periods are September 1993 – December 1994, September 1998 – February 2000, and May 2003 – June 2006.

<sup>2</sup> Convergent typically identifies “risk assets” and “low risk assets” as primary delineators in a portfolio. Low risk assets include cash, high grade municipal bonds and treasuries, while equities and high yield bonds fall into the “risk asset category.”

little room for them to continue to decline. Given that scenario, we believe the coming rate environment may give the edge to multi-strategy hedge funds over long-only funds since the latter tend to perform poorly relative to other asset classes when interest rates are rising.

Furthermore, multi-strategy funds have historically outperformed long-only credit funds with volatility levels that are only moderately higher than traditional (i.e. core) fixed income funds. This outperformance has, historically, compensated investors for the restrictive liquidity versus long-only funds.

### { Outlook }

To reiterate, both types of investments play different, but complementary, roles in the client portfolio. While a lot of the low hanging fruit has been picked in credit markets since the extreme liquidation (and mis-pricings) sparked by Lehman's collapse at the end of 2008, we believe there are still many opportunities in credit space investing for both long-only and multi-strategy managers.

Convergent utilizes long-only credit strategies in client portfolios when presented with an attractive risk/reward environment and, potentially, as a better alternative to equities on a risk-adjusted basis. Investing in long-only managers, such as high yield and emerging market specialists, can provide yield, transparency, liquidity, and comparable risk-adjusted returns to some equity strategies with a hefty yield to cushion the impact of periods involving market stress.

Returns in the multi-strategy space can be expected to be driven by a manager's ability to influence outcomes and invest in all levels of the capital structure. As we will likely see slower economic growth in the coming years, the distressed cycle should last longer. However, this cycle is more liquid than prior cycles as the breadth of players has expanded. Market volatility and turmoil, sparked by events like the Greek sovereign debt crisis, should create a larger number of sellers. Managers that are well positioned should be able to buy securities that others haven't been able to buy for months/quarters. For example, in the multi-strategy space, some of the opportunities in the intermediate term include:

- **Complex Restructurings:** Many companies, coming out of the recession, are in dire need of restructuring across the capital structure. Multi-strategy managers with enough resources can become actively involved in working with the company to restructure the existing debt and/or in providing capital for new debt in order to drive value creation.
- **Event Driven:** Liquidations don't have a natural buyer base with returns expected to be in the low teens. Once something is in liquidation, it is hard to analyze leading to better returns.
- **Post Reorganization:** After restructurings, these securities involve great variation in the outcomes. Many will be lousy, some will experience average returns, and a small amount should generate outsized returns.

It is also important to highlight that many multi-strategy managers have learned and applied lessons from the recent crisis to attempt to mitigate future risk. Lessons learned include:

- Minimal use and much more controlled application of leverage
- Defining liquidity terms that match up better with the underlying liquidity of their investments

## { Conclusion }

When liquidity dried up amid the extreme credit crisis experienced in late 2008, many multi-strategy hedge funds found that a higher percentage of their assets became illiquid than would normally be the case. This, coupled with higher than usual investor redemptions, caused some funds to limit redemptions and/or set aside illiquid assets to be returned as markets normalized and these assets were able to be sold at reasonable prices. As the market recovered in 2009, most hedge funds that experienced liquidity problems in 2008 were able to return the majority of capital back to investors who chose to redeem, with the only real exception being funds heavily concentrated in direct loans and private equity oriented investments where liquidity remained constrained.

These liquidity issues were concerning to investors and caused Convergent to re-examine an asset class that it has been deeply familiar with and invested in for many years. Despite the difficulties experienced in 2008, we continue to believe that a reasonably sized allocation to multi-strategy funds (for those clients who qualify) is prudent given the funds' abilities to generate compelling expected returns in multiple different market environments, while offering a reasonable risk profile and diversification benefits to the rest of the portfolio.

Long-only credit managers also play an important role in portfolios. These strategies offer high liquidity, can generate ongoing income, provide some currency exposure in the case of foreign bonds, and offer diversification benefits, all traits that are a complementary addition to their multi-strategy counterparts.

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