AlphaFinance Advisors

The long lock up conundrum

An analysis of how the 'star' managers of long lockup funds fare against their peers

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The long lock up conundrum

Introduction

With many 'star names' in the hedge fund industry being able to use their clout to lock up investor assets for lengthy periods, the notion that illiquidity is a price worth paying for better performance should be scrutinized. This paper will analyse how the performance of 'long lock up' funds compares to the performance of their cousins who do not impose such punitive conditions on investors whilst assessing comparative performance in difficult market conditions.

Funds examined

For the purpose of the paper, the definition of long lock up fund applies to hedge fund holdings with a liquidity of greater than 2 years. Since data on long lock up funds is not so widely available, we could only use 8 long lock up funds held by our clients for the paper. Details of the funds are listed below with the fund names withheld to preserve confidentiality agreements:

Fund Name	Style	Liquidity (in days)
Fund 1	Emerging Markets	775
Fund 2	Event Driven	775
Fund 3	Event Driven	775
Fund 4	Long/Short Equity	898
Fund 5	Fixed Income Arbitrage	883
Fund 6	Event Driven	913
Fund 7	Emerging Markets	838
Fund 8	Long/Short Equity	913

Methodology

In order to meet the objectives of the paper and ensure the analysis is fair, it was worth taking a little time to look at the performance of hedge funds from several different angles. Below, the different means employed of drawing a fair comparison are outlined:

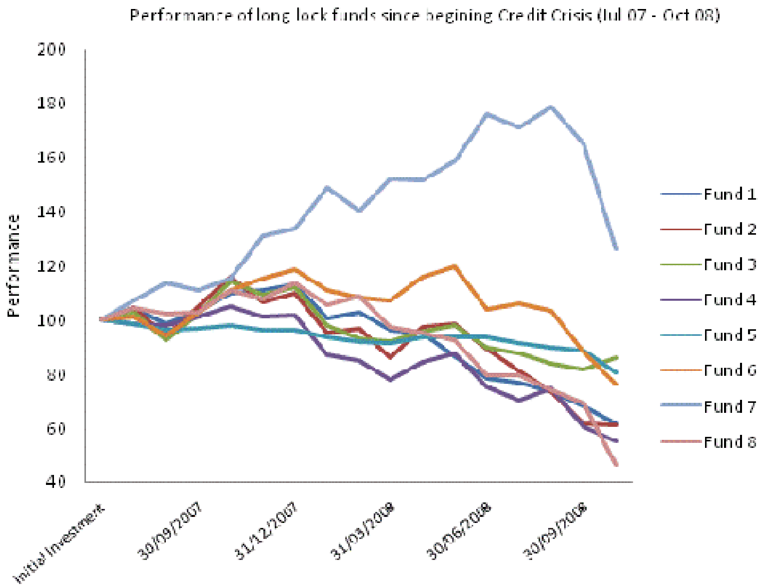
- Examine performance over past 3 years and 16 months (July 07 – Oct 08) to understand long run performance and track record in the challenging market conditions that have ensued since July 2007 (outbreak of global credit crisis)
- Compare an 'Equally Weighted Portfolio' of long lock up funds against EDHEC Fund of Fund (FOF) benchmark
- Compare an equally weighted portfolio of long lock up funds against a 'weighted style benchmark'
- Compare performance of each long lock up fund to its individual style benchmark

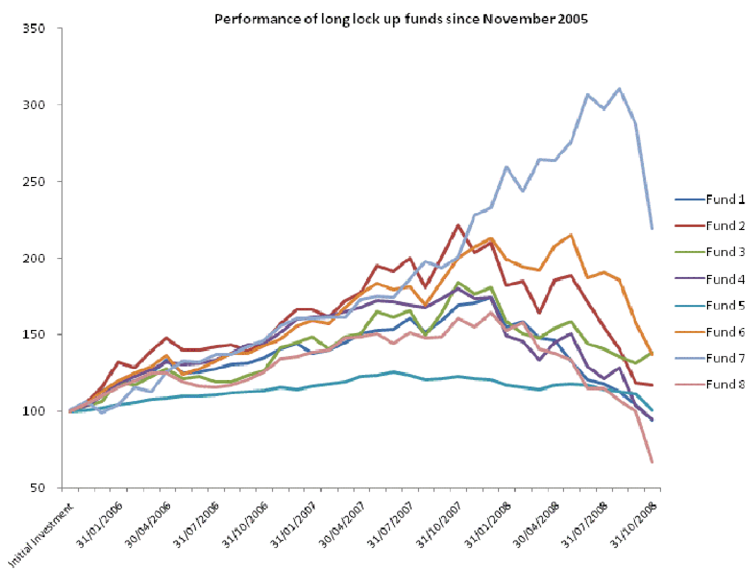
In creating an equally weighted portfolio of the long lock up funds, it was assumed that say $100 is invested in each of the 8 long lock up funds.

To create a 'style weighted benchmark" it was assumed that $100 was invested in a style benchmark for each long lock up fund of a given style. Given the style make-up of the long lockup funds the 'style weighted benchmark' would comprise of the following:

- $300 is invested in the EDHEC Event Driven benchmark
- $200 in the EDHEC long/short equity benchmark
- $200 in the EDHEC Emerging Market benchmarks
- $100 in the EDHEC Fixed Income Arbitrage benchmark.

The graphs below concern the performance of long lock up funds over a 3 year and 16 month period. In examining these graphs it is clear the performance of the Fund 7 significantly outstripped the performance of the other long lock up funds. To ensure fair analysis when comparing a basket of long lockup funds against benchmarks, it is worth creating two portfolios of long lock up funds and omit fund 7 from one of the portfolios to examine long lock up performance without fund 7 skewing the results.



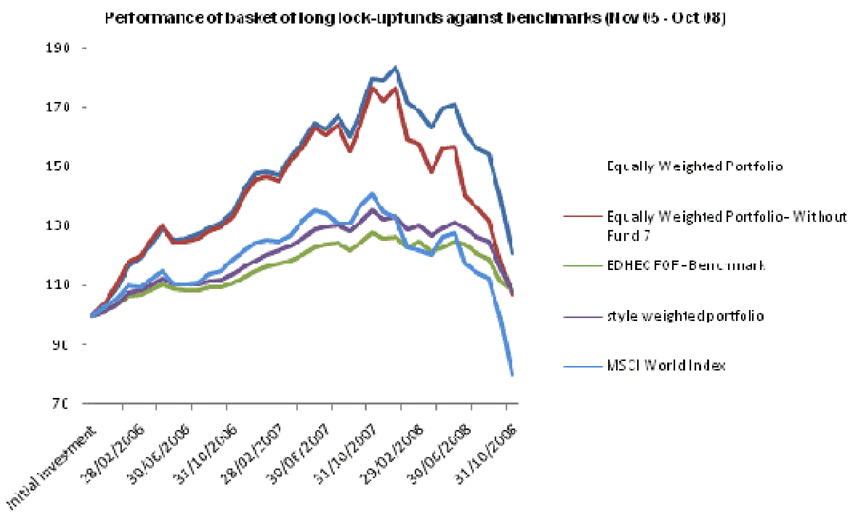


Results

Comparison of an equally weighted portfolio of long lock up funds against benchmarks

3 years

	Long Lockup Returns	Long Lockup Returns without Fund 7	EDHEC FOF Returns	style weighted portfolio
Total Returns	39.25%	7.08%	8.54%	7.75%
Standard Deviation	15.67%	16.76%	6.86%	8.62%
Annualized Return	11.67%	2.31%	2.77%	2.52%
Sharpe Ratio (rf=1%)	0.74	0.14	0.40	0.29



Over a 3 year period we can see the equally weighted portfolio of long lock up funds significantly outperform the EDHEC FOF returns on total returns basis or returns per unit of risk. The long lock up fund portfolio is also outstripping the performance of the weighted style benchmark. However, it has already been noted that Fund 7 is likely to have been delivering a lot of the outperformance and this is revealed when we remove Fund 7 to find the other long lock up funds:

- Slightly underperforms the EDHEC FOF benchmark and style weighted benchmark
- Significantly underperform the EDHEC FOF benchmark and style weighted benchmark on a excess returns/risk basis

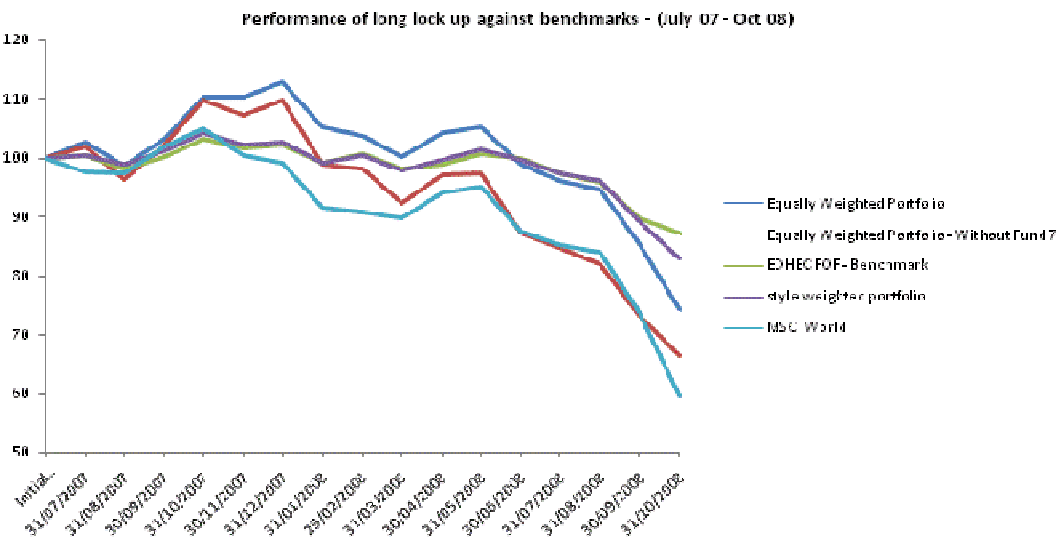
Hence, so far we can clearly see that the long lock up funds need Fund 7 as a group to register outperformance and without Fund 7, they seem like mere mortals.

What is striking about the performance of the long lockup funds is the extent to which they register outperformance and then revert back to the 'mean' once market conditions turn sour. If we compare the performance of the long lockup funds against the MSCI world index, it is almost as if the performance of long lockup funds were a levered play on the beta of the global equity markets during the not too distant equity market bull run.

Since Credit crisis (16 months)

	Long Lockup Returns	Long Lockup Returns without Fund 7	EDHEC FOF Returns	style weighted portfolio
Total Returns	-25.88%	-33.31%	-12.63%	-16.66%
Standard Deviation	18.33%	19.96%	8.31%	10.39%
Annualized Return	-20.12%	-26.20%	-9.63%	-12.78%

N.B: Sharpe ratio has not been calculated since in negative return scenarios ranking performance with negative Sharpe ratio goes against logic e.g. for two funds with same negative returns, the one with higher volatility will have a higher Sharpe ratio. Intuitively the Sharpe ratio should reward lower volatility



Since the credit crisis broke out last summer, manager ability has obviously been tested with many not fairing too well. The group of long lock up funds has underperformed the benchmarks. Taking fund 7 out of the basket makes the underperformance even more significant. It is evident during times of extended market turmoil the long lock up fund managers have not been able to live up to their star billing.

Fund Comparison with Benchmarks – 3 years

Fund Name	Fund 1	Fund 2	Fund 3	Fund 4
Benchmark	EDHEC Emerging Markets	EDHEC Event Driven	EDHEC Event Driven	EDHEC Long/Short Equity
Total Returns	-5.69%	17.24%	38.75%	-5.43%
Benchmark - Total Returns	6.34%	10.21%	10.21%	7.21%
Return comparison	UNDERPERFORM	OUTPERFORM	OUTPERFORM	UNDERPERFORM

Fund Name	Fund 5	Fund 6	Fund 7	Fund 8
Benchmark	EDHEC Fixed Income Arbitrage	EDHEC Event Driven	EDHEC Emerging Markets	EDHEC Long/Short Equity
Total Returns	1.00%	36.78%	119.19%	-33.10%
Benchmark - Total Returns	4.26%	10.21%	6.34%	7.21%
Return comparison	UNDERPERFORM	OUTPERFORM	OUTPERFORM	UNDERPERFORM

Over the past 3 years, 4 of the 8 long lock up funds have outperformed their respective style benchmarks which means that choosing a long lock up fund does not necessarily guarantee outperformance relative to other funds with the same style.

Fund Comparison with Benchmarks – (since outbreak credit crisis) – Jul 07 – Oct 07

Fund Name	Fund 1	Fund 2	Fund 3	Fund 4
Benchmark	EDHEC Emerging Markets	EDHEC Event Driven	EDHEC Event Driven	EDHEC Long/Short Equity
Total Returns	-38.63%	-38.78%	-14.01%	-44.89%
Benchmark - Total Returns	-24.27%	-15.46%	-15.46%	-15.47%
Return comparison	UNDERPERFORM	UNDERPERFORM	INSIGNIFICANT OUTPERFORM	UNDERPERFORM

Fund Name	Fund 5	Fund 6	Fund 7	Fund 8
Benchmark	EDHEC Fixed Income Arbitrage	EDHEC Event Driven	EDHEC Emerging Markets	EDHEC Long/Short Equity
Total Returns	-19.34%	-23.79%	26.11%	-53.70%
Benchmark - Total Returns	-7.46%	-15.46%	-24.27%	-15.47%
Return comparison	UNDERPERFORM	UNDERPERFORM	OUTPERFORM	UNDERPERFORM

In the past 16 months, we can see that only 2 funds have been able to outperform its respective style benchmark from a total returns perspective with all the other funds delivering inferior performance compared to their peers in what has been a challenging market climate. It should be noted that the insignificance of Fund 3's outperformance is not worth the constraints of extra illiquidity. Although this analysis is somewhat simplistic we can clearly see the each fund is unable to deliver the outperformance implicitly promised in difficult times.

Conclusions

Long lockup portfolio vs. benchmark – 3 year	INCONCLUSIVE
Long lockup portfolio vs. benchmark – since credit crisis	LONG LOCKUP UNDERPERFORM
Long lockup portfolio vs. style benchmarks – 3 year	INCONCLUSIVE
Long lockup portfolio vs. style benchmarks – since credit crisis	LONG LOCKUP UNDERPERFORM

The table above summarizes the analysis conducted on long lockup fund performance. What is apparent here is the lack of analysis to support the case of long lockup funds. When a basket of long lockup funds were compared to the benchmark over a 3 year period we saw significant outperformance but removal of the now famous 'Fund 7' brought the long lockup basket performance in line with the benchmarks. Analysing performance over the past since July 07 (outbreak of credit crisis) saw long lockup funds severely lag the benchmarks in performance, which is damming for long lockups since one could be forgiven for expecting relative outperformance in challenging times.

Switching the analysis to an individual fund basis the 3 year time period proves inconclusive since four of the eight funds deliver outperformance relative to peers with the rest underperforming. On a 16 month basis six of the eight funds underperform their peers with the extent of the lag for each fund quite severe. Hence, what is conclusive in this analysis is that the long lockup funds have not been able to justify their punitive liquidity conditions with the outperformance inherently promised.