Writing sample

Assignment— Reorient clients of fund of funds from losses in 2008 to opportunities likely in 2009

(Letter to clients)

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2008: A bloody year in the financial markets

In a chain reaction, the financial crisis that began in 2007 went critical in 2008. The plummeting value of mortgage-backed securities caused enormous write-downs at banks and hedge funds. Share prices of financial institutions plunged. Interbank lending came to a standstill. Credit markets were disrupted. Bear Stearns failed. IndyMac Bank went into receivership. Lehman Brothers went bust. The U.S. government bailed out AIG. Phone calls that said, “Your collateral was further hypothecated” produced sweaty brows. Money market funds broke the buck. The commercial paper market ceased to function. Banks cut credit to corporations. Prime brokers raised interest rates to hedge funds. Prime brokers imposed restrictions on funds’ ability to borrow. Panic swept equity markets. Everyone was selling everything. Regulators tightened restrictions on short selling. The U.S. Securities and Exchange Commission temporarily banned outright the short selling of 950 financial stocks. Bid-ask spreads widened. The U.S. government’s plan to buy toxic assets stuttered and stalled. Governments infused equity capital into financial institutions. Several times equity markets surged only to dive deeper. Equity market volatility soared. Consumer spending plunged. The outlook for corporate profits worsened. For corporate bonds, the risk of credit downgrades forced prices down. Concerns about counterparty risk turned market players wary and defensive. Investors fled to the safety of government backed bonds. The global economy entered a recession. Fears of short-term deflation rattled policy makers. Fears of long-term inflation pushed down the prices of longer dated bonds. Commodity prices— except for gold—plunged. Global government bonds experienced extreme volatility. Investors fled emerging-market investments for the relative safety of the U.S. dollar and Japanese yen. U.S. automakers begged Congress for a bailout. Policy makers argued about how best to stimulate economies. CitiGroup staggered and reeled. And so on.

2008: Few hedge-fund strategies worked

The near meltdown of the financial system in 2008 created difficult trading conditions for most hedge-fund strategies.

Plunging stock prices caused long/short equity funds that were long to suffer heavy losses. For long/short funds that wanted to be short, the ban on short selling meant they could not implement their strategies.

The ban on short selling meant hedge funds could not implement market-neutral strategies. Funds with convertible bond arbitrage strategies could not hedge their bond positions against price declines in the stocks into which the bonds were convertible. Funds with statistical arbitrage strategies could not sell liquidity by selling short.

Defaults and near defaults by issuers of convertible bonds played further havoc with convertible bond arbitrage strategies.

With everyone selling everything, historical relationships among asset prices ceased to exist. Correlations of asset returns approached one. Strategies that exploited historical relationships no longer worked.

The SEC's temporary ban on short selling of financial stocks sparked a technical rally and produced a short squeeze. Hedge funds with short positions in those stocks suffered losses.

The surge in market volatility derailed momentum strategies.

Huge liquidations of bonds and rampant volatility of bond prices wrecked fixed income arbitrage strategies.

Global macro and other funds that bet that asset prices would converge with their economic values saw those differences expand instead of shrink.

The turnaround in commodity prices punished hedge funds that had taken bullish positions.

Funds with long positions in distressed securities saw the market prices of their holdings drop even further.

2008: A harrowing year for hedge funds

Widespread strategy failures caused many hedge funds to suffer heavy losses. Heavy losses meant hedge funds faced margin calls. To meet margin calls, funds had to sell whatever securities they could. Forced hedge-fund liquidations pushed market prices for securities even lower.

Many hedge funds were highly leveraged. Leverage multiplied losses.

Investors unhappy with returns withdrew money. According to TrimTabs, hedge-fund investors in September withdrew a record $40 billion. Redemptions forced funds to liquidate additional assets at fire-sale prices.

For hedge funds, losses and redemptions translate into paltry fee income. The traditional hedge-fund fee structure has been 2% of assets under management plus 20% of profits. For funds running losses, 2008 performance fees are going to be 20% of nothing.

For hedge funds with losses, lower net-asset values mean the basis on which management fees are calculated is smaller. At many funds, big investors have negotiated asset-management fees down to 1%. At small funds, 1% of assets under

management isn't going to cover Bloomberg, rent, technology and other expenses.

To again be eligible for 20% of profits, hedge funds with losses in 2008 first have to get asset values back up to their high-water-marks.

2008 losses will force many hedge funds out of business

The losses they suffered in 2008 are taking their toll on hedge funds. Many will disappear— either by going bust or by deciding that the low fees they can expect to earn will not be worth their efforts.

Manny Roman, the co-chief executive of GLG, Europe's biggest hedge fund, has predicted that between 25% and 30% of the world's 8,000 hedge funds will disappear . John Mack, CEO of Morgan Stanley said that his contacts in the industry are telling him that, over the next year, the number of hedge funds could shrink by 30%. *The Economist* has speculated that, over the coming year, the number of funds in business could fall by half.

Which hedge funds will disappear? The greater a fund's losses on investments, the greater its leverage, the lower its fee for assets under management, the smaller its asset base and the greater its redemptions, then the more likely the fund will close up shop— or has done so already.

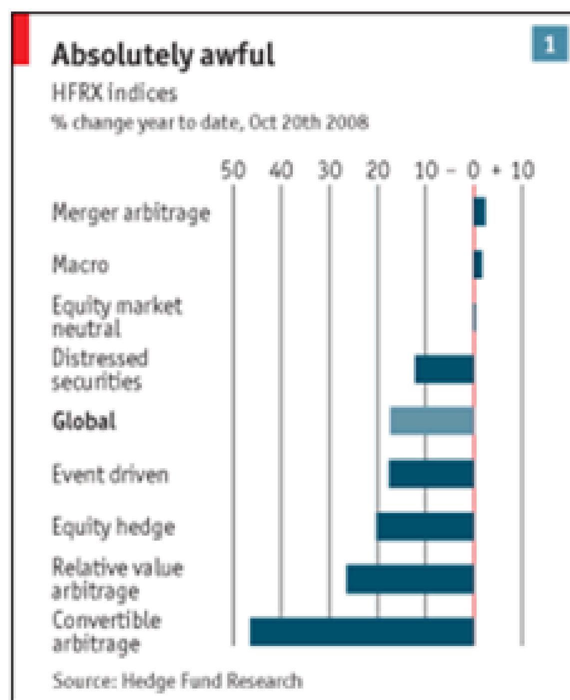
2008: The fittest hedge funds survive

In the hedge-fund industry, 2008 has been a year of Darwinian shakeout. The near meltdown in the financial markets stress tested funds' strategies, personnel, infrastructures, fee structures, relationships with prime brokers and relationships with investors. Hedge funds robust enough to survive the trading conditions of 2008 should be well positioned to excel under more favorable trading conditions.

2008: Hedge funds were down absolutely but outperformed long-only equity mutual funds

To justify their performance fees, hedge funds tout their ability to generate exceptional absolute returns. Their returns, they claim, do not depend on market direction. Yet, hedge funds are not without risk. They cannot generate exceptional returns— or even positive returns— under all trading conditions.

Selected Hedge Fund Strategies, YTD Performance



Source: The Economist

As of October 22, according to Hedge Fund Research (HFR), the typical hedge fund had lost almost a fifth of its value so far this year. Convertible-arbitrage funds— which typically buy a company's convertible bonds and sell its stock— had lost 46%. Performance through October 22 makes 2008 hedge funds' worst year since HFR began compiling records in 1990.

Despite being leveraged, hedge funds have done better in 2008 than equity mutual funds and equity-index funds. As of October 22, the S&P 500 had lost 38% of its value.

Investors tempted to abandon hedge funds may wish to consider how they would've fared had they had their hedge-fund money in long-only equity mutual funds.

2009: A new world

During 2008, in the United States, we heard a great deal about change. In 2009 a new administration with strong majorities in both houses of Congress will take office. To boost the economy, president-elect Obama has promised a strong two-year stimulus package. While Senator Obama ran a campaign from the left of his party, his personnel appointments thus far suggest that he intends to govern from the center and that he intends to govern pragmatically— not ideologically. The economic challenges he and his appointees face are daunting. Yet strong actions with strong support from Congress and the public could help stabilize the economy.

The financial crisis is creating new opportunities

Surgeons have a saying: “All bleeding stops eventually.” Eventually the Great Deleveraging of the global economy will have run its course. Eventually financial institutions, hedge funds and other investors will stop having to dump securities at whatever prices they can get. Eventually trading conditions will become more favorable to some if not all hedge-fund trading strategies.

To be successful, hedge-fund trading strategies do not need rising markets. Hedge-fund strategies do, however, benefit from these trading conditions:

- Ability to sell short
- Ability to sell liquidity
- Availability of credit
- Narrow bid-ask spreads
- Tendency for securities’ market prices to converge with their economic values
- Tendency for market prices of related securities to move toward rational prices relative to one another

As massive forced selling of securities wanes, these more favorable conditions are likely to reappear.

Moreover, we at Omega and many other analysts believe that the financial crisis is likely creating enormous opportunities for hedge funds. Forced selling forces the market prices of many securities away from their economic values. Big jumps in market volatility often produce situations in which related securities are mis-priced relative to one another. Divergences of prices from economic values and relative mis-pricings create arbitrage opportunities. As forced selling wanes, hedge funds robust enough to have survived 2008 will be set to profit from the convergence of security prices with economic values. They will be set to profit as the prices of related securities move into rational relationships with one another.

Volatility in the financial markets may continue to be high. Whether markets go up or down, higher volatility creates larger profit opportunities for option-trading strategies.

2009: New thinking, new policies, new patterns, new possibilities

In the wake of the biggest financial crisis since the Great Depression, the intellectual landscape has changed and will change further. The near meltdown of the markets dealt a heavy blow to the Efficient Market Hypothesis. The notion that unregulated financial markets gravitate toward states of equilibrium has become hard to defend.

Hyman Minsky’s dictum that “stability creates instability” has gained credibility. In the minds of policy makers, the Efficient Market Hypothesis now duels with the Financial Instability Hypothesis. Evolution in economic thinking will produce different regulations and policies. Different regulations and policies will produce different patterns in the financial markets.

However the financial markets evolve, the hedge funds that survived 2008 will be watching. They will be looking for patterns and trends. They will be analyzing how securities’ market prices compare with their economic values. Hedge funds will be looking for arbitrage and other opportunities. They will spot them. They will seize them.

2009: We hope you will be with us

At Omega, we are monitoring how robustly different hedge funds and trading strategies are coping with this year’s difficult trading conditions. We are in discussion with hedge funds about how the evolution of trading conditions matches up with their strategies.

As we look to 2009, we know that many of the world’s brightest people and hungriest minds work at hedge funds. We believe that the intellectual acumen that hedge funds bring to the financial marketplace make them excellent investment vehicles for institutional investors and qualified individuals.

We hope that investors who have profited from their investments in hedge funds in years prior to 2008 will be with us as trading conditions evolve in ways that once again allow hedge funds to execute their trading strategies successfully. We hope that you will be with us as the hedge funds with which we do business exploit new patterns and new possibilities in the world’s financial markets.

With best personal regards,
John Smith