

HEDGE FUND PERSPECTIVES

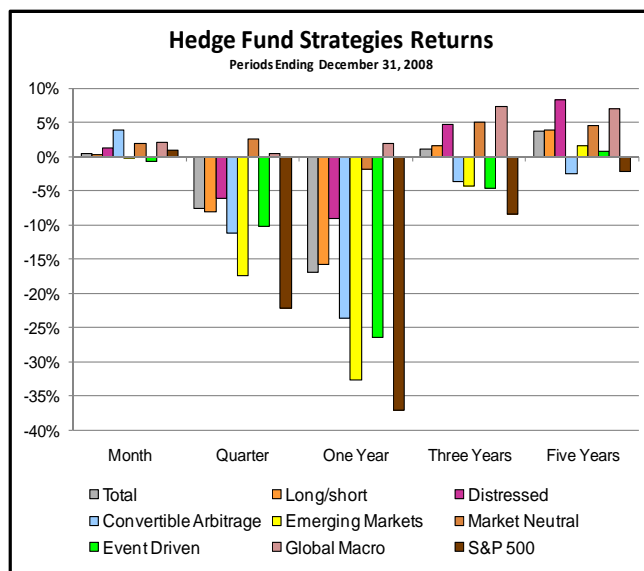
Volume I

Issue I

RECENT HEDGE FUND ACTIVITY

The average return in recent periods from various hedge fund strategies was negative, as is shown in the accompanying chart. While returns in December 2008 were generally positive, returns from the various strategies over the past quarter and year, in all but the Market Neutral strategy, reported significant losses though generally less than that of the S&P 500. Over the five-year period the average of managers following all but the Convertible Arbitrage strategy reported positive results as compared with the negative returns of the S&P 500.

These returns reflect averages of managers in the various strategies and cannot be replicated. The Hedge Fund Research, Inc. reports that the variability among hedge fund managers was especially dramatic in



2008, with the bottom 10% of hedge funds losing 62% while the top decile gained 40%. Thus, the results of any index masked a significant dispersion of results.

While hedge fund returns in recent periods are better than those of the S&P 500, the losses of the past year show that hedge fund managers have generally followed the down markets of 2008. In their December, 2008 report Hedge Fund

Research showed that the number of hedge funds declined from 7,634 to 6,808 during the year, which results in overstating the index returns in 2008 due to survivor bias. Thus, due to the wide dispersion among the results of individual managers and the inherent survivor bias these industry averages should be used with caution. ♦

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THE QUEST FOR SKILLFUL HEDGE FUND MANAGERS (CONT.)

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With the recent disclosure of the Bernard Madoff scandal, as well as the sharp fall-off in the number of hedge funds due no doubt to many strategies not behaving as advertised, it seems timely to take a look at the expected outcome from the quest to find skillful managers, which of course, is one of the primary goals of investing in hedge funds. Investors are willing to give up extraordinary fees and liquidity in the hope of finding these managers. Yet, the odds against success are substantial due to the following considerations:

- For the most part hedge fund managers are trading with one another or other professional managers.
- Positive past results are not indicative of future performance as there is simply a great deal of random noise in short-term returns.
- The cost to search among the large hedge fund managers is high.

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trading with one another or other professional managers. Consequently, in the aggregate this trading is a zero-sum game before fees. There is no theoretical reason to think that over the long-term one manager can systematically outsmart the others. While in any short period there will be winners and losers, separating skill from luck in advance is difficult indeed and after fees the expected outcome relative to the average return is negative.

Because there is a lot of random noise in returns, past performance is not a useful tool to separate skill from luck. Quite simply, it takes too much history to confirm that an observed positive alpha can be repeated. For example, consider short-term (monthly) returns as random numbers the movement of which can be described statistically by their average and their variability (standard deviation). Assume we want to be 95% sure that an observed positive alpha is not simply good luck. Using the profile of the past results of the S&P 500, a hedge fund with an observed annualized alpha of

2.0% and returns that are highly correlated with the index (correlation coefficient of 0.93), it takes forty years of history to reject the luck explanation. The number of observations to reject the luck hypothesis increases as the correlation with the selected market benchmark is reduced. Of course no hedge fund has been around for forty years. So, a hedge fund's past performance is simply irrelevant to the quest to find the manager who can consistently turn in a positive alpha.

The cost to search for the skillful manager among nearly 7,000 hedge funds is costly. According to Hedge Fund Research, Inc. there were only 530 hedge funds in 1990. While doing the necessary research to select the skillful manager from 530 managers may be plausible, identifying in advance the skillful set of managers from the nearly 7,000 hedge funds today, can be quite costly indeed. And, past performance is irrelevant in this quest. ♦

TRACKING HEDGE FUNDS IN A BEAR MARKET BY TONY PETRONIO

Hedge fund indices have made it possible to invest in a portfolio that is designed to track the performance of the overall hedge fund universe including closed funds. But just how reliable are these indices and are they representative of the entire hedge fund industry?

There are many indices that attempt to track hedge fund performance. Two of the most popular are the Hennessee Index, started in 1987, and the Hedge Fund Research Index (HFRI) which began in 1990. Both are equally weighted indices and require a 12 month track record for inclusion. The Hennessee tracks 1,000 funds and requires a minimum of \$10 million in assets under management while HFRI tracks 2,400 funds and requires a minimum of \$50 million. Each relies on the individual fund manager to volunteer his or her performance data on a monthly basis. Volunteering performance information is great when everything is working well but when the market turns and funds fail managers tend to stop reporting. The resulting index is comprised of returns from the more successful funds and does not factor in its failures. This tendency, known as survivor bias, will overstate the index. In fact, in an analysis conducted by Ammann and Moerth* over a 136-month time period from January 1994 to April 2005 survivorship bias derived from equally weighted returns is 3.5% for hedge funds and 1.7% for fund of funds.

According to HFRI, hedge fund assets peaked in 2007 at approximately \$1.9 trillion in 7,634 funds. By the end of 2008 estimates are down to \$1.4 trillion in 6,808 funds. This drop in assets of \$461 billion is due to market movement which accounts for \$307 billion and \$154 billion in hedge fund redemptions. By the end of 2008 there were 826 or 10.8% fewer hedge funds than one year earlier not including fund of funds. This raises the question how does the loss of 826 hedge funds impact the index?

From 1994 to 2005 the number of hedge funds increased more than 400% to 6,665 funds as assets increased from \$186 billion to \$1.1 trillion. This is a net increase in both assets and number of funds each year. It is during this time period that Ammann and Moerth estimate survivor bias to be

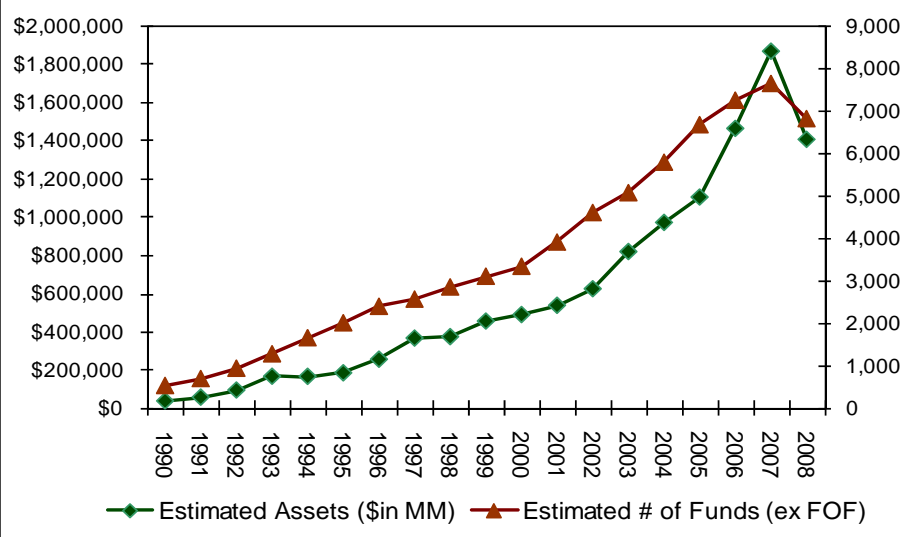
approximately 3.54%. Should we apply the same principles used to estimate survivor bias in the current market environment? If we make a conservative assumption that the average net return of all of the funds which liquidated during 2008 is -50% and apply the fallout rate of -10.8%, we can conclude that survivor bias in the current market could be 5.4% or higher.

There is no doubt that tracking an asset class with "black box" models, low regulation and no transparency is a very challenging task. At this time, however, the Hennessee and HFRI indices are two of the best barometers we have available and in my view they are better indicators in good markets than bad. ♦

* Ammann & Moerth, *The Journal of Wealth Management*, "Performance of Hedge Funds," Summer 2008

"... survivor bias in the current market could be 5.4% or higher."

**Estimated Number of Hedge Funds and Growth of Assets
1990 - 2008**



Source: HFR Year End, 2008 Industry Reports, © HFR, Inc., January, 2009, www.hedgefundresearch.com.



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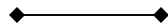


Anthony J. Petronio

As the Managing Director at Coppice Asset Management, Tony is focused on bringing Coppice's unique investment services to individual and institutional investors. Prior to joining Coppice he was Senior Vice President and General Manager of East Coast Sales and Operations for Green Point Mortgage Funding, Inc., a Capital One Company. His prior experience includes fourteen years in the financial services industry, ownership and operation of a printing and graphic design business, and customer relations at

Aspen Skiing Company in Aspen, CO. He is a graduate of Drexel University with a BS in Business Administration.

Tony enjoys woodworking, skiing and fitness. He has completed a cross-country USA bicycle fundraising trip for the benefit of Push America, an organization dedicated to enhancing the lives of people with disabilities. He and his wife, Michelle, live in Sudbury, MA with their three daughters, Lauren, Lexi and Ella. ◆



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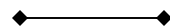


Robert J. Ryan, Ph.D.

Bob is focused on establishing the investment philosophy and financial models of Coppice Asset Management. Bob's professional experience includes three years as the Chief Financial Officer of Carlisle Companies, a NYSE traded firm, where he was involved in all corporate finance activities. Bob also served as the Vice President and Treasurer of Agway Inc., a Fortune 500 company. He has been a director of several corporate boards, including food processing, international trade, insurance and banking concerns.

Bob has also served on the faculty of Syracuse University where he taught MBA courses in securities markets and corporation finance. He completed his PhD in finance at Syracuse University in 1989. He was awarded an MBA with distinction from Cornell's Johnson Graduate School of Management in 1971.

Bob and his wife, Linda, enjoy spending time at their family retreat on Lake Champlain in Vermont. He marvels at the insights provided by John Prine and Henry David Thoreau on the human condition. ◆



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