

WEEKLY MARKET MONITOR

JULY 9, 2007

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DO HEDGE FUNDS HEDGE?

Hedge funds are lightly regulated investment funds whose investors are wealthy individuals and institutions such as pension funds. The various types of hedge funds span the investment universe as do the investment and trading strategies employed. Although some finance professionals consider hedge funds alternative investment vehicles akin to private equity funds, we believe that hedge funds should properly be viewed as traditional investment “styles” embodied in a different contractual form. This contractual relationship between the general partners of a hedge fund, who typically receive two percent of the assets under management plus twenty percent of profits generated by the fund, is obviously an extremely lucrative arrangement for the hedge fund general partners. It is less obviously a beneficial relationship for hedge fund investors. What, then, explains the tremendous growth and popularity of hedge funds? This week we will examine some of the features of hedge fund investment strategies.

- How do hedge funds hedge?
- Do hedge funds really hedge?
- Do hedge funds represent hedged investments for traditional long-only individuals and institutions?

We begin by examining the concept of hedging. Hedging is a method of transferring risk. Financial markets have developed many types of securities and contracts which enable individuals and firms as well as financial institutions



to transfer and manage risk. For example, a utility company—perhaps because of regulatory constraints—may have only a limited ability to pass increases in fuel costs to consumers. Consequently, the utility may wish to hedge against possible increases in the price of fuel. If the utility uses natural gas to generate electricity it may want to lock in the future price of natural gas and will enter into a “forward” contract to purchase gas at a known price and quantity at a future date. By entering into this forward contract the utility is protected against increases in the price of gas above the contract price but would also forego any savings if the price of gas were to fall below the contract price at the future date. Hence hedging involves giving up some possible gains in order to receive protection against possible adverse outcomes.

In the example above, the utility company was “long” natural gas and the seller of the forward contract was “short” natural gas. The “long” investor benefits from price appreciation as the utility would benefit by buying a hedge which delivers protection if gas prices rise. The “short” investor benefits from price depreciation as the seller of the forward contract would benefit by selling a contract which generates profits if gas prices fall.

In the case of a hedge fund specializing in energy investing—or even more narrowly specializing in the market for natural gas—the fund could manage risk by taking both “long” and “short” positions with desired risk and expected return characteristics. A hedge fund with limited risk tolerance could manage their risk by taking long and short positions which largely offset each other, hence offering limited upside potential with significant downside protection. Another hedge fund with greater appetite for risk would take long and short positions which offered greater expected returns but also had greater exposure to losses in the event of adverse price movements. In addition, a hedge fund could use forward contracts and other derivatives to magnify the fund’s risk profile. A hedge fund could use derivatives to leverage the fund’s assets and gain exposure to assets (e.g. natural gas contracts) worth a multiple of the value of the firm’s assets under management. By employing leverage, a hedge fund could generate very high returns from favorable price movements but could also expose

itself to very high losses from adverse price movements. In sum, hedging tools such as derivatives are principally designed to manage and transfer risk but may also be used to magnify risk.

Hedge fund risk profiles are as varied as hedge fund investment styles and strategies. Many hedge funds utilize no leverage and maintain sophisticated risk controls and a consistent investment style (e.g. U.S. small cap equity) and strategy (e.g. quantitative long-short) and hence genuinely represent hedged investments. At another extreme are hedge funds which utilize maximum leverage and trading strategies of the highest risk. The combination of high leverage and high risk trading strategies is often the cause of high-profile hedge fund implosions (e.g. Amaranth, which lost \$6 billion in a week). Since hedge funds often lack transparency with regard to their risk profiles and investment styles and strategies, the question of whether or not a hedge fund represents a hedged investment can be quite difficult to answer. In addition, what hedge funds lack in transparency, they also tend to lack in longevity, as their short track records also contribute to the difficulty of evaluating the expected performance of a fund.

One option for potential hedge fund investors who may find it difficult to conduct due diligence on individual hedge funds is to invest through a fund of funds. A fund of funds is a vehicle through which investors gain exposure to a set of hedge funds. Due diligence on the individual funds is conducted by the manager of the fund of funds and/or an investment consultant. Investors in a fund of funds may also gain diversification benefits, but this and other gains also come at the cost of the fees charged by the fund of funds. These fees are in addition to the fees charged by the underlying hedge funds.

Another issue for potential hedge fund investors considering investing in hedge funds via a fund of funds is the extent to which investment in a fund of funds will result in (high cost) replication of part of the existing portfolio. For example, if the underlying hedge funds in a fund of funds were long-only sector funds together comprising the major sectors of the U.S. equity market, then the investment would be a high-cost replication of a long-only U.S. equity portfolio.

It would require sustained alpha generating performance, which is value-added by a fund manager relative to the fund's benchmark, by this fund of funds to compensate for such a costly replication strategy.

Most investors in hedge funds appear to be motivated by the expectation of high returns. Hedge funds are often among the first to exploit potential market inefficiencies and utilize innovative new financial products and strategies. The opportunity to gain exposure to different investment

styles and strategies—especially when particular styles and strategies are not employed in house—is also a motivation for hedge fund investment. In addition, investing in hedge funds may be the means to gain exposure to entire new markets—think carbon trading—which may have growing effects (either direct or indirect) on the total portfolio. In such a case, a prudent investor, having conducted thorough due diligence, may be interested in these types of investments if—properly hedged—they increase total portfolio efficiency.

Hedge funds may be subject to liquidity, the use of leverage, as well as other risks and costs described above.

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