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Energy Stocks Pump Up Market Returns While Hedge Funds Disappoint

Ron Surz, PPCA, 9/6/05

The year 2005 is two-thirds over and thus far the U.S. stock market has disappointed investors with low single-digit returns, earning about 3.4%. But we would have been even more disappointed had it not been for energy stocks, which have pumped up the entire market for the year to date. Energy stocks have returned 38% in the past 8 months while other sectors have struggled to break even. Since energy is about 9% of the market, the contribution of energy stocks to overall market performance is 3.4% (9% of 38%), so energy constitutes the entire market return to date, with the other sectors collectively breaking even. Energy has also led foreign markets, earning 40% for the year to date, but overall foreign markets have fared better than the U.S., earning 10%. In the following we examine sector and style performance for the month of August and for the year to date, analyzing both U.S. and foreign markets. Then we turn our attention to hedge fund performance with some observations on investor expectations and judgments.

U.S. Stock Market

Exhibit 1 details sector returns for August and the past 8 months. With the exception of a modest 0.2% return in Healthcare, all other non-Energy sectors have lost money in the month of August. Energy returned more than 6% in the month. For the year-to-date, Energy has significantly dominated, although Healthcare and Telephones-&-Utilities have delivered positive returns. It's not a pretty picture without Energy. The irony in the strong showing of the Energy sector is that it bodes ill for the economy since it is driven by concerns about current and future supplies of oil and gas. The picture with Energy isn't pretty either. See more on this troubling fact in "Hedge Funds" below.

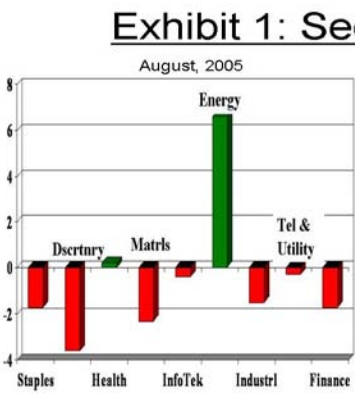
Moving on to style effects, Exhibit 2 shows market performance broken out by style. Energy stocks come in all styles so it's not clear which styles benefit most from Energy's run-up. Mid-cap Growth is the only positive performing style in the month, while large-cap Core performed worst with a 1.8% loss. Note also that large Core performed worse than both large Growth and large Value, a phenomenon that we also observed in the second quarter. This is an indication of opposing investor convictions to Value and Growth, leaving Core in the dust; it might represent an inflection point in style preferences. For the year to date, mid-size companies have fared best, especially mid-cap Core. By contrast, large cap Core and small Growth are the only losing styles. As for overall style, Value leads the year with a 6% return, although we have seen Growth stocks recovering somewhat in the past several months. We define large companies as those in the top 65% of the market's capitalization; this is currently 270 firms with capitalizations exceeding $12 Billion. Mid cap is the next 25%, and currently comprises 1000 companies with capitalization between $1.6 Billion and $12 Billion. The remaining 5000 firms are classified as small companies. Style classifications within size categories combine earnings yield, dividend yield and book-to-price to create a defensiveness measure. The top 40% are classified as Value, the bottom 40% as Growth, and the 20% in the middle as Core.

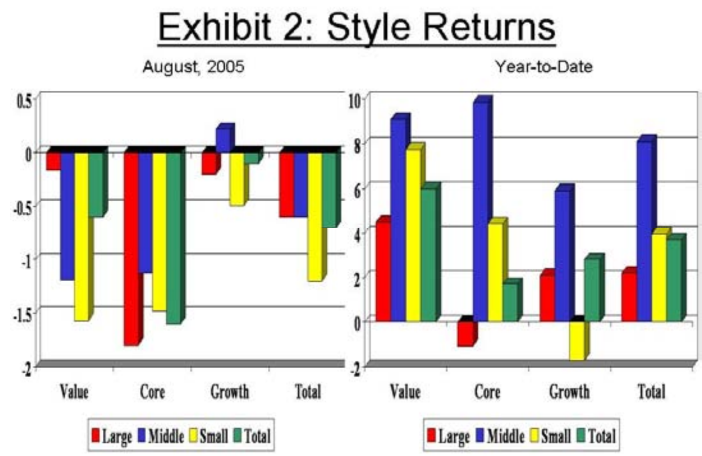
Foreign Markets

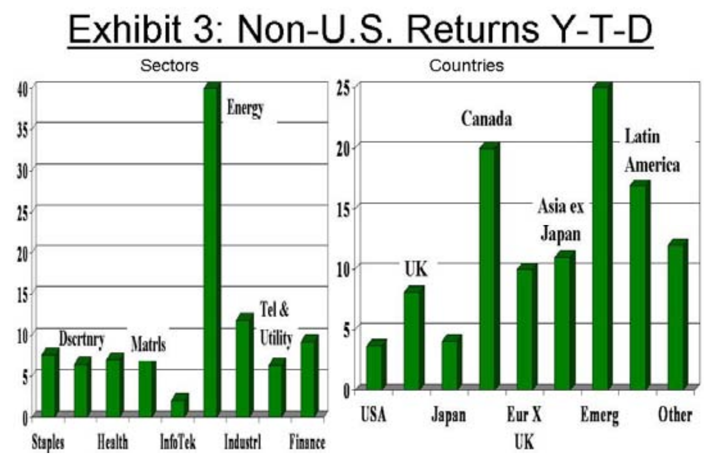
Exhibit 3 shows sector and country results for the year to date. Like the U.S, Energy has dominated, returning 40%. But unlike the U.S., other sectors have all delivered positive returns, generally in the 5-10% range. As for countries, Emerging Markets and Canada, with their natural resources, have fared best.

Hedge Funds

Disappointing markets breed interest in hedge funds because of their promise of good performance regardless of market conditions. Hedge funds have reached the $Trillion mark, and are forecast to continue growing at a rapid pace, so they are becoming increasingly important. But investors have been disappointed with hedge fund performance lately. Some of this disappointment is the result of unrealistic expectations. For example, true market neutral

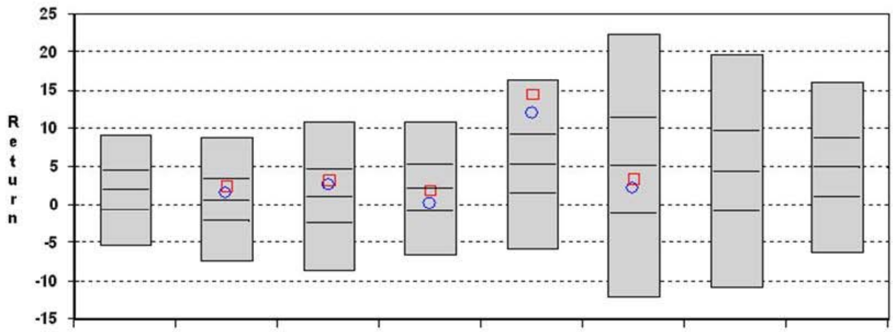






funds have an expected return close to Treasury bills, a return commensurate with the risk. This is the return that will be delivered if no value is added by the investment manager's decisions. With Treasury bill returns running at 1-2% until recently, even a skillful market neutral manager, adding say 2%, would return a mere 3-4% in a year. Even investors looking for transportable alpha won't look at a fund delivering a mere 3-4% per year, although pure market neutral is just right for transporting. The other source of disappointment is misrepresentation by hedge fund managers. Many, if not most, funds that call themselves "market neutral" are not market neutral at all because they routinely make style, sector and directional bets. As a result investors have been purchasing beta, or market exposure, for a very high price, and generally getting very little, if any, alpha, or value added. We use market neutral as an example for the entire hedge fund industry because of its popularity and simplicity. Investors should buy alpha, or skill, not beta. Invest smart. The challenge is identifying managers who have skill. This challenge cannot be met with peer group comparisons even though peer groups are the current benchmarks of choice. Everyone who has earned the CFA (Chartered Financial Analyst) designation has learned the problems with peer groups: they are loaded with biases. But biases are not the major problem with hedge fund peer groups. The fact that hedge funds are unique is the big problem. Dr. Harry M. Kat documents the lack of correlation among funds in the same peer group. For example Kat finds correlations to be a mere 0.23 among funds in market neutral

Exhibit 4: Opportunities in
Market Neutral Hedge Funds



Total Market Percentiles	Jun 2005 Return Rnk	Jun 2004 Return Rnk	Jun 2003 Return Rnk	Jun 2002 Return Rnk	Jun 2001 Return Rnk	Jun 2000 Return Rnk	Jun 1999 Return Rnk	Jun 1998 Return Rnk
5th	9.19	8.82	10.88	10.79	16.36	22.24	19.64	16.16
25th	4.54	3.47	4.76	5.18	9.24	11.43	9.71	8.65
50th	1.93	0.70	1.19	2.14	5.32	5.14	4.44	4.92
75th	-0.68	-2.07	-2.38	-0.90	1.40	-1.15	-0.83	1.19
95th	-5.33	-7.42	-8.50	-6.51	-5.72	-11.96	-10.76	-6.32
S&P 500	6.30 *18*	19.11 *1*	0.26 *57*	-17.99 *99*	-14.83 *99*	7.24 *42*	22.76 *1*	30.16 *1*

peer groups, substantiating the fact that these funds are different from one another and therefore should not be compared to one another. Accordingly, it is virtually impossible to construct an appropriate peer group for a specific market-neutral manager.

The solution to the problems with traditional peer groups is actually quite simple, at least in concept. Performance evaluation ought to be viewed as a hypothesis test where the validity of the hypothesis "Performance is good" is assessed. To accept or reject this hypothesis, construct all of the possible outcomes and see where the actual performance result falls. If the observed performance is toward the top of all of the possibilities, the hypothesis is correct, and performance is good. Otherwise, it is not good. In other words, the hypothesis test compares what actually happened to what could have happened. This is accomplished through the use of Monte Carlo simulations that generate all of the possible implementations of the hedge fund manager's strategy.

In constructing a specific custom peer group, Monte Carlo simulations follow the same rules that the individual hedge fund manager follows in constructing his/her portfolio. The simulator randomly creates 10,000 portfolios that conform to the same portfolio construction parameters followed by the actual hedge fund manager. The result is a scientific and unbiased backdrop for evaluating that manager's performance, as well as a credibility check on the manager's reported return. A reported return outside the realm of possibilities is suspicious. In a poetic sense the manager is hoist upon his own petard. **You can't afford unvalidated reported performance.** The following Exhibit 4 provides an example of this approach applied to a pure market neutral manager. This manager "pair trades" so for every stock that he buys long he takes a short position in a comparable company. The manager also employs rigorous risk controls to keep the portfolio neutral in multiple dimensions: style, sector, dollar, beta, etc. 200 positions are held long and 200 positions are held short, and all companies are in the S&P500. The exhibit shows the opportunities for annual periods ending in June.

❑ *"10 Things That Investors Should Know About Hedge Funds." The Journal of Wealth Management, Vol 5, No. 4, Spring 2003, pp 72-81*

Note the blue box in the middle of the legend. These are the expected annual returns for a pure market neutral strategy – pretty low wouldn't you say? The manager shown in the floating bars has generally added value, even earning 15% (13% net, the blue dot) in the year ending 6/30/01. But in most years his returns have been in the 2-5% range. Would you hire this manager? Well it depends on the alternative. The boxes shown in the bottom of the exhibit highlight periods when the S&P has performed well or poorly. The red boxes are bad for hedge fund interest because traditional markets are performing well. Green is good for hedge funds because traditional markets have performed poorly. Recent markets through June, 2005 have been good for traditional investing, bad for hedge funds, but this appears to be changing. Expect renewed interest in hedge funds.

Conclusion

Investors benefit from discontinuance of traditional peer group comparisons because peer groups have documented deficiencies, and therefore risks. Fair and accurate yardsticks are provided by a contemporary application of hypothesis testing that employs Monte Carlo simulations to create a background of all possible portfolios.

Notes

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