

Hedge Funds: Where Did That One-Star Fund Go?

by Benjamin N. Alpert, CFA | 03-23-09 | 06:00 AM

Morningstar certainly selected a lively date to launch its initial batch of Morningstar Ratings for hedge funds*: January 2008. One year later, hedge funds had suffered their worst 12-month performance in forever, dropping more than 20% in aggregate and spurring a wave of investor redemptions.

In response, hedge funds did what hedge funds do best--they quit. Folded shop, returned what assets remained, expired. They became ex-hedge funds. Either that, or they crawled into a cave to lick their wounds, continuing to exist but ceasing to be seen in daylight by refusing to update their performances in public databases such as Morningstar's. All in all, of the 1,732 single-strategy hedge funds that received a rating from Morningstar during the March 2008 launch, a whopping 615 funds--36%!--disappeared over the ensuing 12 months.

So much for any analysis of how the hedge fund star rating fared during its first year. With the database so ravaged by dropouts, it would be impossible to state with any accuracy how funds from each of the star-ratings groups performed during that period. Then again, such an exercise would have been premature, as the star rating is a long-term measure that is assigned only to funds that have at least three years' worth of performance, and which therefore should really be judged only over periods of equivalent length.

But what is not premature is measuring how the ratings corresponded with the drop-out rate during this period of unprecedented hedge fund carnage. Was there a relationship between the level of the initial star rating and the probability that the fund receiving that star rating vanished? Or were the departures spread equally across the ratings?

The answer, it turns out, is very much the former. Funds rated at 1 star entering the downturn exited the database at almost double the rate of funds rated 5 stars. Indeed, the pattern was monotonic (as finance geeks like to say), with the AWOL rate highest among 1-star funds, next highest among those with 2 stars, and so forth to lowest among the 5-star funds.

January 2008 Rating	January 2009 Rating					Drop-Out Rate
	1 Star	2 Star	3 Star	4 Star	5 Star	
1 Star	8%	21%	16%	4%	0%	52%
2 Star	7%	16%	25%	10%	1%	41%
3 Star	6%	9%	27%	20%	4%	33%
4 Star	7%	12%	18%	22%	11%	31%
5 Star	10%	12%	13%	14%	22%	29%
Total	7%	13%	22%	16%	6%	36%

The interpretation of these results is fairly straightforward. By and large, hedge funds disappear for one or more of three reasons: a) Their performance is so poor that they cannot keep current shareholders and are unlikely to attract new investors in the foreseeable future; b) their performance is so poor that even though the funds have retained most of their investors, the managers have little realistic hope of surpassing the fund's high-water mark over the next few years and thus will not earn their performance fees; or c) management is embarrassed by the performance results and does not wish for outside parties to see its funds.

There is a counterargument to the notion that the lower-rated funds terminated because of bad recent performance. That is, the 5-star funds had a head wind entering the period, in the sense of boasting strong previous risk-adjusted results, while the 1-star funds were already struggling. So, it is quite possible that in many cases a 5-star fund and 1-star fund might have posted similar results in 2008, but the 5-star fund opted to march onward, while the 1-star fund did not. The numbers therefore do not strictly support the thesis that the 1-star funds fared worse over the past year.

Nevertheless, it's a pretty good guess. If we look at the drop-out rate by category, we see a general trend that the worst performers in 2008 had the highest percentage of funds that left the database. Examples would be Convertible Arbitrage, U.S. Equity, and Distressed Securities. Conversely, the relatively successful categories of Global Trend, Global Non-Trend, and Equity Arbitrage had lower-than-average defection rates. (The Short Equity category was a notable exception, turning a profit for the year but having 83% (!) of funds drop out. The sample size was tiny with only 12 funds rated in January 2008.

Hedge Fund Drop-Off

Category	Drop-Out Rate
HF Convertible Arbitrage	56%
HF Corporate Action	34%
HF Debt Arbitrage	40%
HF Developed Asia Equity	40%
HF Distressed Securities	62%
HF Emerging Markets Equity	27%
HF Equity Arbitrage	32%
HF Europe Equity	19%
HF Global Debt	38%
HF Global Equity	25%
HF Global Non-Trend	31%
HF Global Trend	26%
HF Multi-Strategy	43%
HF Short Equity	83%
HF U.S. Equity	41%
HF U.S. Small Cap Equity	33%
Total	36%

Neither can it be proved that the 1-star funds ceased operations more than funds of other ratings. After all, it could be that, when compared with funds of other ratings, 1-star funds were much likelier to hide, as opposed to closing up their doors entirely. That could be so. But it is statistically improbable. So, we can say with good if not complete certainty that lower-rated funds were likelier to liquidate, thereby making forced sales into a difficult market.

Finally, we can state as an absolute fact that 1-star funds were a greater inconvenience to their investors by vanishing en masse from databases. (All hedge fund databases, not just Morningstar's, have been plagued in recent months by record defections.) Funds that remained alive could no longer be easily compared with peers or judged on a level third-party playing field. Instead, shareholders were restricted to using communications provided solely by the fund itself.

There is some hope for improvement. Note that the lowest drop-out rate by category, at a relatively moderate 19%, was the Europe Equity category. This wasn't because European stocks did well in 2008--in fact, quite the contrary. It was because most of these funds reside in Europe, which requires greater registration from hedge funds, some of which are

listed on exchanges. The improved reliability of European-based hedge funds has not gone unnoticed, as both the agenda of the upcoming G-20 meeting and both houses of the U.S. Congress have items that would require hedge funds to register as investment advisors. Whether such registration would go far enough in mandating the publication of performance figures, through good and bad times, remains to be seen. But it would be a step forward.

Until that time, an investor's best bet is to be wary indeed of lower-rated hedge funds. The star ratings serve only as an introduction to a hedge fund, no more--but with many relatively successful hedge funds now open to new cash and happy to accept incoming investors, it doesn't make much sense to even say hello to the 1- and 2-star funds. Save the conversation for higher-rated funds that stand a better chance of remaining in the database another year from now.

**The hedge fund ratings are calculated in a similar if not quite identical fashion to the traditional mutual fund ratings--that is, on their risk-adjusted performance over the trailing three-, five-, and 10-year periods, if available. This risk-adjusted performance is compared against peers that occupy the same investment category, with the final ratings allocated along a bell curve. The top and bottom 10% of funds within the category receive a 5- and 1-star rating, respectively, while those in the middle three ratings rungs are allocated 80% of the funds.*