
Hedge Fund Holdings: First Quarter Highlights

Highlights

- Largest hedge funds are not too concentrated. Only one fund has all of its holdings in less than ten stocks.
- Hedge Funds are the most underweight Consumer Staples, Telecom Services, and Energy
- Hedge Funds are overweight Technology, Consumer Discretionary, and Materials
- Only four of 45 hedge funds with more than \$5 bln in assets have an average dividend and earnings yield greater than the S&P 500.
- Stocks which hedge funds most actively acquired during the first quarter were companies involved in major corporate actions.

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As Memorial Day approaches, investors will be assessing their returns year to date to see where they stand and whether they have a big enough cushion on the market to allow for some extra time off. As we have previously mentioned, individual investors as a group are likely to find themselves trailing the market. In this report, we will shift our attention to hedge funds and where they stand. More specifically, we will focus on the largest hedge funds with assets in excess of \$5bln.

Through the month of April, equity hedge funds were inline with the market. As of April 30th, equity hedge funds, as measured by HFRI, were up 5.1%, which matched the return of the S&P 500. Funds which focus on short selling were down 5.1%. However, looking at the performance of more specialized strategies, we found less consistency as outlined in the table below. As one example, market timers trailed the market by almost 200 basis points, as the volatility of late February and early March was a likely culprit to the subpar returns.

Rather than focus on just the returns of the overall hedge fund universe, we analyzed the holdings of each of largest US hedge funds in order to get a better picture of their methodologies and sector outlooks. We found 45 US based hedge funds with \$5 billion or more in equity assets. These funds manage an average of \$13.77 billion in stocks, representing a total of \$620 billion (4.4% of the S&P 500 market cap).

In the analysis that follows, unless otherwise noted, all figures represent levels as of 3/31/07. While we realize that a lot can change over the course of six weeks, given the large asset pools these funds control, we think it is important to know how they are positioned.

Performance of Selected Equity Hedge Fund Strategies: Jan - Apr 2007

Category	YTD Return Through 4/30	Comments
US Equity	5.1 %	Inline
US Equity Market Neutral	2.7	Underperformed
US Market Timing	3.2	Underperformed
Energy Sector	7.6	Outperformed Benchmark by 20 bps
Financial Sector	-0.1	Underperformed benchmark by 130 bps
Health Care Sector	4.9	Underperformed benchmark by 360 bps
Real Estate Sector	2.2	Underperformed benchmark by 170 bps
Technology Sector	5.1	Outperformed Benchmark by 70 bps
Short Selling	-5.1	Inline
S&P 500	5.1	

Source: HFRI

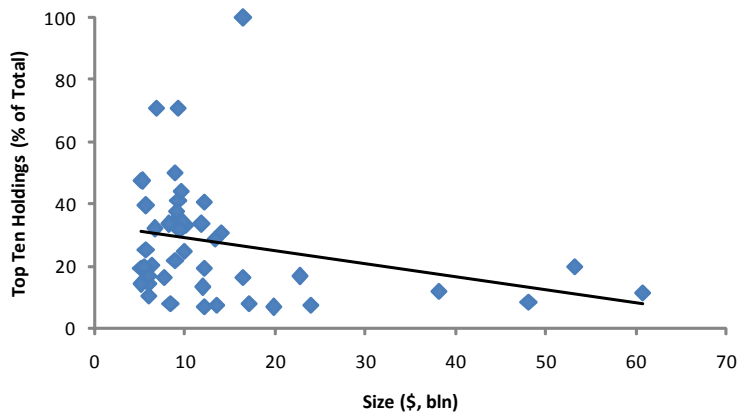
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Hedge Fund Holdings

While hedge fund managers are often portrayed as risk takers who make big bets on individual companies, we found that for the most part, they tend to spread out their assets across numerous holdings. In fact, of the 45 funds we analyzed, only one (RBS run by Edward Lampert) has all of its assets in less than ten holdings. In fact, for the average fund, the ten largest holdings make up 27.7% of total assets. This is not too far off from the S&P 500, where the ten largest stocks make up 19% of the total market cap.

At the risk of stating the obvious, we also found that the concentration of a fund (top ten holdings as a percent of total assets) is positively correlated to the size of the fund.

Largest Hedge Funds: Size vs. Concentration



Source: Bespoke Investment Group

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On a sector basis, hedge fund holdings differ widely from the S&P 500. Overall, hedge funds are underweight seven sectors, and overweight three. The biggest underweights are Consumer Staples, Telecom Services, and Energy, while the largest/only overweights are Technology, Consumer Discretionary, and Materials.

Largest Hedge Funds: Sector Weightings

Sector	Adjusted Weight	S&P 500 Weight	Percent Over/Under Weight	Performance (%)	
				Q1	Q2 (Thru 5/21)
Consumer Staples	5.31	9.32	-43.0	1.6	3.5
Telecom Service	2.57	3.73	-30.9	6.4	7.1
Energy	8.08	10.52	-23.2	1.7	12.8
Financials	17.25	21.42	-19.5	-3.4	6.1
Utilities	3.08	3.73	-17.3	8.4	7.1
Health Care	11.84	12.04	-1.7	0.6	8.5
Industrials	10.80	10.94	-1.3	0.6	7.5
Technology	16.82	15.03	11.9	-1.1	8.9
Consumer Discret.	18.48	10.23	80.7	-1.0	4.9
Materials	5.75	3.05	88.7	8.4	6.0

Source: Standard & Poors, Bespoke Investment Group

It is interesting to see the large overweight position in the Consumer Discretionary sector. While the consumer has been written off for dead by the mainstream, institutional investors seem to see value in the sector. In addition to the large overweight position of hedge funds, as of 5/21, six of the 16 S&P 500 companies which are the subject of or have already accepted takeover proposals are from the Consumer Discretionary sector.

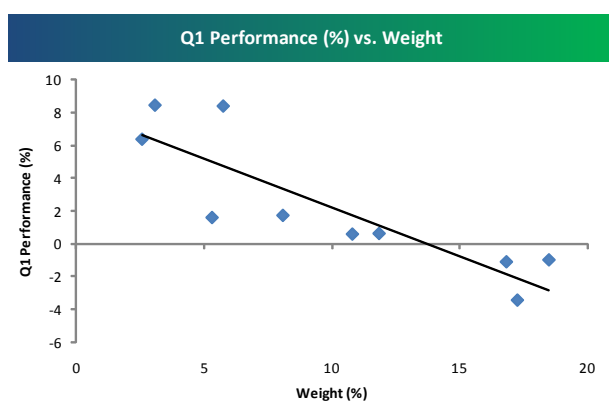
S&P 500 Pending Takeovers

Ticker	Market Cap (\$, bln)	Sector
CCU	18.8	Cons. Discret.
HET	16.0	Cons. Discret.
TRB	8.0	Cons. Discret.
HAR	7.7	Cons. Discret.
DG	6.8	Cons. Discret.
DJ	4.5	Cons. Discret.
KMI	14.4	Energy
FDC	24.6	Financials
SLM	22.4	Financials
MEL	18.1	Financials
CBSS	9.2	Financials
MEDI	13.6	Health Care
BMET	10.6	Health Care
BOL	3.6	Health Care
ACS	5.9	Technology
TXU	30.5	Utilities

Source: Bespoke Investment Group

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In what could perhaps be a signal that hedge funds have reached critical mass (or just bad luck), a chart of the overall sector weights of hedge fund assets versus each sector's performance in the first quarter shows that hedge funds were most underweight the best performing sectors, and overweight the worst performing sectors. Telecom service stocks represent the smallest sector weighting for hedge funds, but during the first quarter, they were up 6.4% (third best performing sector).



Source: Bespoke Investment Group

While it is useful to know how sectors are represented in the holdings of hedge funds, it also helps to know where the changes are. To that end, for each fund we also calculated which sector had the largest increase and decrease in its weight for the quarter. On a net basis, five funds increased their weighting by the most in the Consumer Staples sector. So even though funds are underweight the sector, they have been adding to their positions. On the flip side, Financials saw a net of four instances where it was the sector that had the largest decrease in weighting for the quarter.

Largest Hedge Funds: Sector Weightings Changes

Sector	Increase	Decreases	Net
Consumer Staples	6	1	5
Energy	7	3	4
Materials	5	1	4
Industrials	3	3	0
Utilities	1	2	-1
Consumer Discret.	9	11	-2
Health Care	4	6	-2
Technology	4	6	-2
Financials	6	10	-4

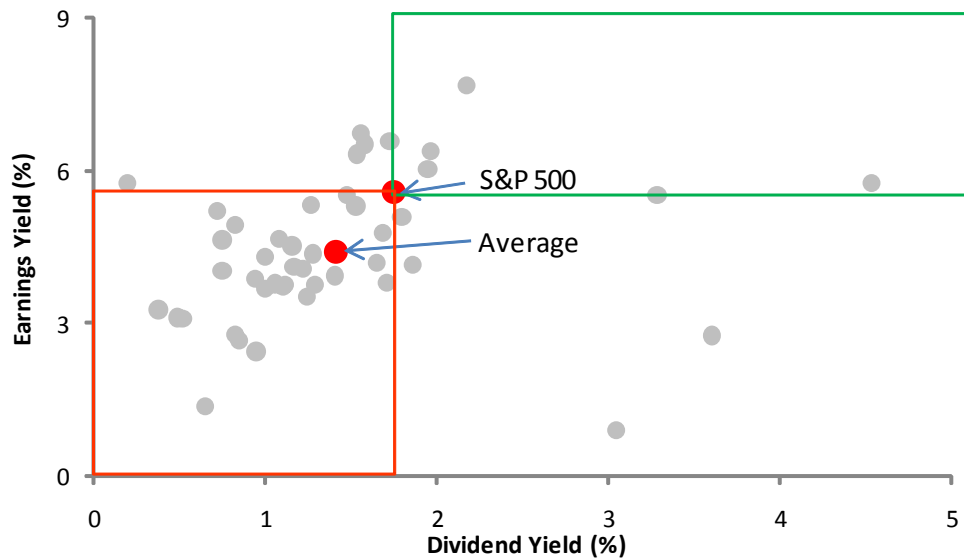
Source: Bespoke Investment Group, Bloomberg

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Hedge Fund Fundamentals

When we analyzed the fundamental and valuation metrics of our large hedge fund universe, we found that in aggregate, hedge funds are holding stocks that pay smaller dividends and have higher P/E ratios (lower earnings yield) than the S&P 500. For both dividends and earnings, only 20% of the funds we monitored had a higher yield than the S&P 500. Combining the two, there were only four funds (AQR, Atticus, Lazard, and Kinetics) that had dividend and earnings yields greater than the S&P 500.

Largest Hedge Funds: Earnings Yield vs Dividend Yield

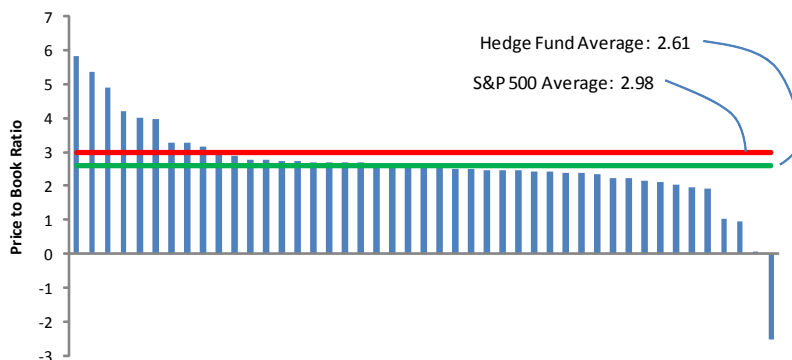


Source: Bespoke Investment Group, Bloomberg

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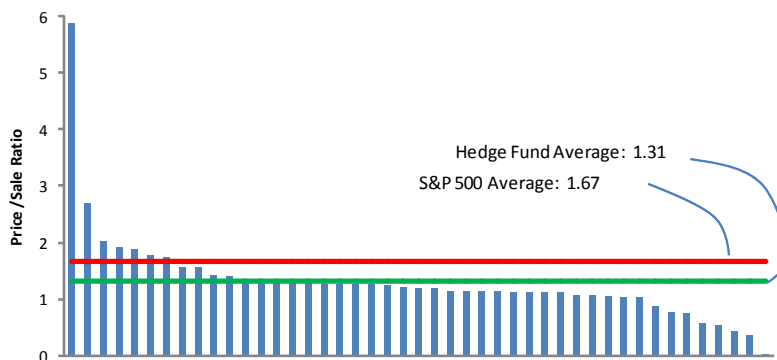
While the preceding chart would imply that most of the funds in our universe are more focused on growth versus value, based on other measures such as Price to Book and Price to Sales, their holdings are actually cheaper than the market. This implies that hedge fund managers are seeking out companies in order to unlock value. The companies already have the assets and sales, but they have trouble converting these to the bottom line.

Price/Book Ratio of Individual Funds



Source: Bespoke Investment Group, Bloomberg

Price/Sales Ratio of Individual Funds



Source: Bespoke Investment Group, Bloomberg

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Finally, we looked at the individual stock holdings of the various funds. For the sake of space, we analyzed the top three increases and decreases in positions for each fund. It appears as though the number one reason for a fund adding to a position was the result of a corporate action. The top three names which were added in the quarter were CVS, FCX, and HAL (CVS and FCX both made major acquisitions while HAL spun off its KBR unit).

Companies which found themselves most often in a fund's top three additions list outperformed the S&P 500 by over 500 basis points in Q1 (the quarter in which they were added). Since the end of Q2 however, they are outperforming by less than 150 basis points. So rather than anticipating a catalyst for a stock, it appears as though the hedge funds were either causing the move themselves or jumping in after the move had been made.

The tables below highlight the stocks which made the top three add or subtract lists of at least two funds in Q1. We also compared each stock's performance in Q1 and so far in Q2.

Stocks Most Often in Top Three of Most Adds in Q1

Ticker	Dollar Value Added (\$, mln)	Number of Funds	Performance (%)	
			Q1	Q2 (5/21)
CVS	1,958	8	10.4	10.7
FCX	1,410	3	18.8	9.4
HAL	616	3	2.2	15.7
IBM	456	3	-3.0	13.6
ABT	300	2	14.6	5.1
ADM	142	2	14.8	0.3
CCU	373	2	-1.4	8.6
ESRX	436	2	12.7	22.1
GE	240	2	-5.0	4.9
GS	288	2	3.7	10.9
H	340	2	-2.3	<i>acquired</i>
JPM	174	2	0.2	8.6
LSI	342	2	16.0	-20.6
MEL	267	2	2.3	-0.4
MIR	118	2	28.2	18.5
MO	413	2	2.3	7.5
MSFT	422	2	-6.7	11.4
NOK	506	2	12.8	17.7
TWX	303	2	-9.5	10.3
TXT	401	2	-4.2	17.6
TYC	306	2	3.8	2.0
		Average	5.3	8.7
		S&P 500	0.2	7.3

Source: Bespoke Investment Group

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As far as stocks which most often made the top three subtractions list, we found that while they underperformed the market during Q1, their margin of underperformance since the start of Q2 has picked up.

Stocks Most Often in Top Three of Most Subtracted in Q1

Ticker	Dollar Value		Performance (%)	
	Subtracted (\$, mln)	Number of Funds	Q1	Q2 (5/21)
TWX	693	3	-9.5	10.3
GSF	147	2	4.9	11.1
HPQ	659	2	-2.5	12.7
IBM	422	2	-3.0	13.6
JPM	108	2	0.2	8.6
LEH	280	2	-10.3	4.6
LGND	113	2	-7.9	-34.9
MO	168	2	2.3	7.5
MU	317	2	-13.5	-5.2
PLD	159	2	6.8	-3.1
SHLD	496	2	7.3	-0.3
SLM	731	2	-16.1	35.2
SUNW	147	2	10.9	-10.3
TGT	168	2	3.9	-1.9
WM	162	2	-11.2	6.4
YHOO	192	2	22.5	-6.2
		Average	-1.0	3.0
		S&P 500	0.2	7.3

Source: Bespoke Investment Group

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