Mercer

Investing in hedge funds

A historical view of performance

© 2021 Mercer LLC. All rights reserved.

Introduction

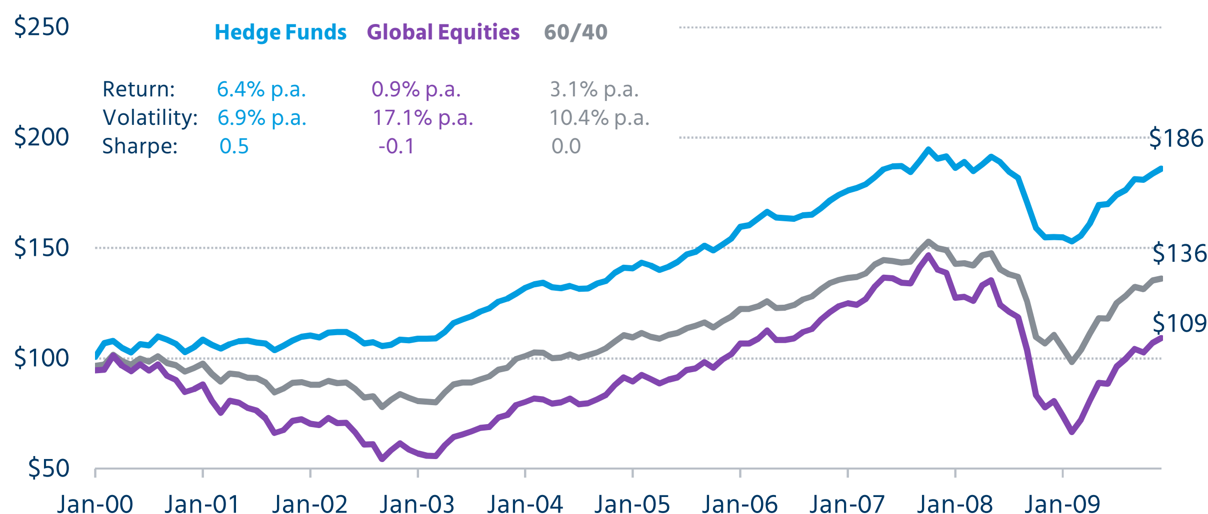
The debate around hedge funds is often polarizing and features strong views, opinions, conjectures and criticisms that can leave one with little clarity or understanding. While recent levels of risk-adjusted returns have been in line with history, the absolute level of performance has been suppressed (as indicated by industry benchmarks). Understandably, this has led to some criticisms growing louder with increased concerns on the cost/benefits. We believe a good portion of the suppression is related to the corresponding market regime, one that has been significantly influenced by policy and regulation. We would also remind readers that the potential success achievable through manager selection and portfolio construction is often lost in the industry averages, the most recent period included. We believe manager selection and portfolio construction are crucial to success and investor experience during any period.

This article is the first of a four-part series answering critical questions related to hedge fund investing. In this article, we review hedge fund performance over the prior two decades. The next two papers focus on the unconstrained hedge fund approach — the why and the how. The last installment will focus on the constrained family of liquid alternatives.

Recent performance

The past 20 years encompass two distinct decades of market and hedge fund performance. The most recent period, during which hedge fund index averages did not meet some expectations, is the reason for this review.

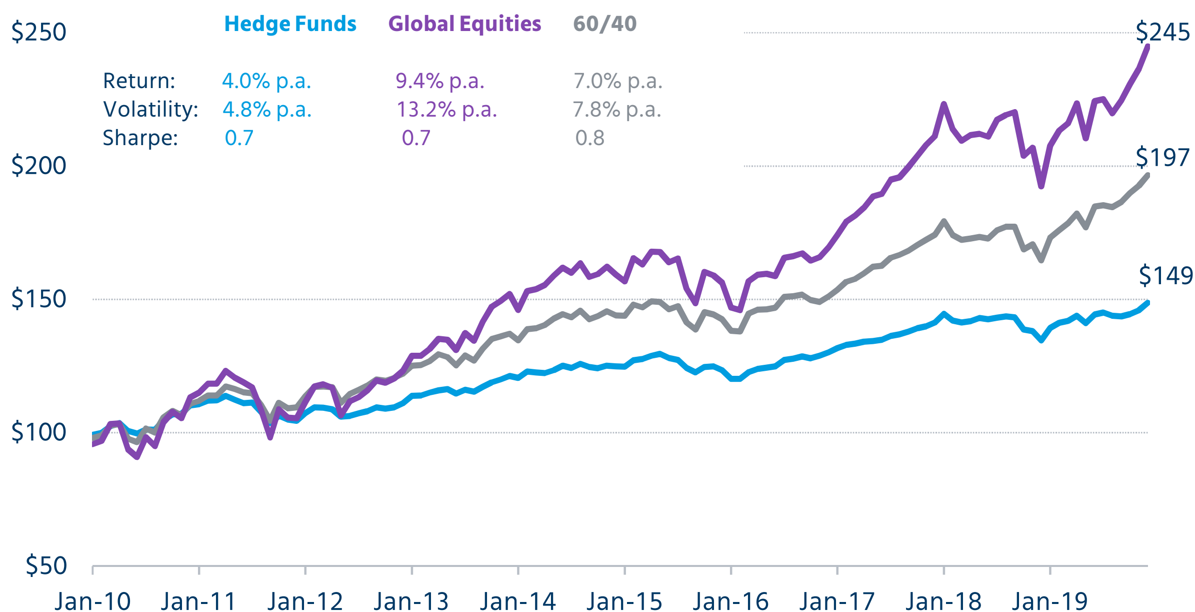
Figure 1. Performance comparison 2000–2009 - growth of $100



Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations. Hedge funds are represented by the HFRI Fund Weighted Hedge Fund (USD) Index, global equities are represented by the MSCI AC World Total Return Index (USD), and the 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

© 2021 Mercer LLC. All rights reserved.

Figure 2. Performance comparison 2010–2019 - growth of $100

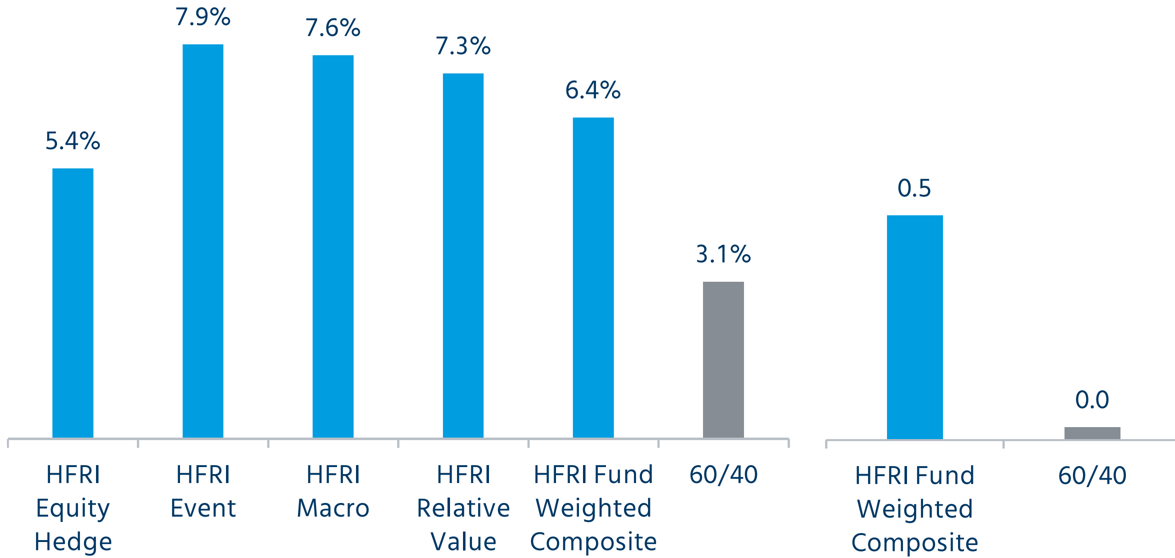


Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations. Hedge funds are represented by the HFRI Fund Weighted Hedge Fund (USD) Index, global equities are represented by the MSCI AC World Total Return Index (USD), and the 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

The period between 2000 and 2009 was bookended by the dot-com bubble and the global financial crisis (GFC), respectively, and proved to be one of the worst decades for equities in history. The decade that followed was one of the longest and strongest bull markets in history. Hedge funds performed very well from 2000–09, benefiting from their alternative risk exposures and low beta. During the 2010–19 period, a stellar time for stock and bond returns, the lower beta of hedge funds proved to be a headwind, as did broader diversification in general. We would argue this is somewhat within expectations as hedge funds serve to deliver value during periods when beta is not overwhelmingly rewarded.

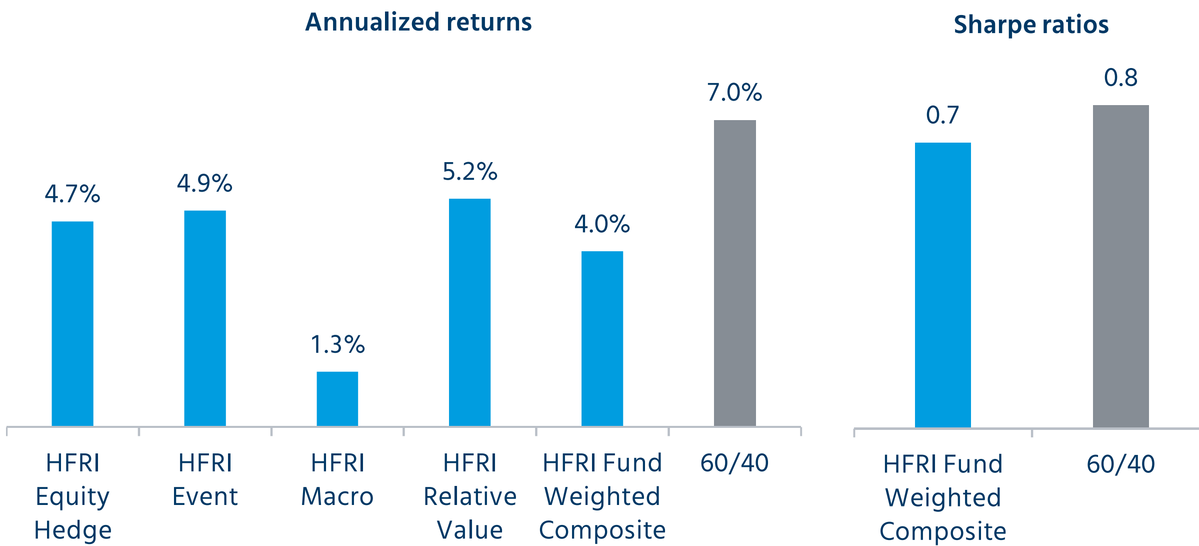
© 2021 Mercer LLC. All rights reserved.

Figure 3. Annualized returns and Sharpe ratios, 2000–2009



Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations. The 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

Figure 4. Annualized returns and sharpe ratios, 2010–2019



Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations. The 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

© 2021 Mercer LLC. All rights reserved.

Hedge funds largely avoided the herd mentality that drove the dot-com bubble and burst, adding significant value over this period. For the 2010–19 period, however, the annualized returns were lower than the previous decade, with the most significant decline in global macro strategies.

This is further supported in the asymmetry of returns, measured below as the ratio of equity upside capture to downside capture. As can be seen, the asymmetry has been compressed over the most recent period and, in most cases, significantly so. An aspect of hedge funds' asymmetric performance profile historically is that the strongest alpha is delivered in down markets. The lack of down markets over the most recent decade affects results.

Figure 5. Ratio of upside capture to downside capture

HFRI strategies	2000–09	2010–19
HFRI Equity Hedge (Total) Index	1.5	1.0
HFRI Event-Driven (Total) Index	2.5	1.3
HFRI Macro (Total) Index	8.0	1.0
HFRI Relative Value (Total) Index	39.7	2.7
HFRI Fund-Weighted Composite Index	1.9	1.1

Source: Thomson Reuters Datastream

Alpha impacted by multiple factors

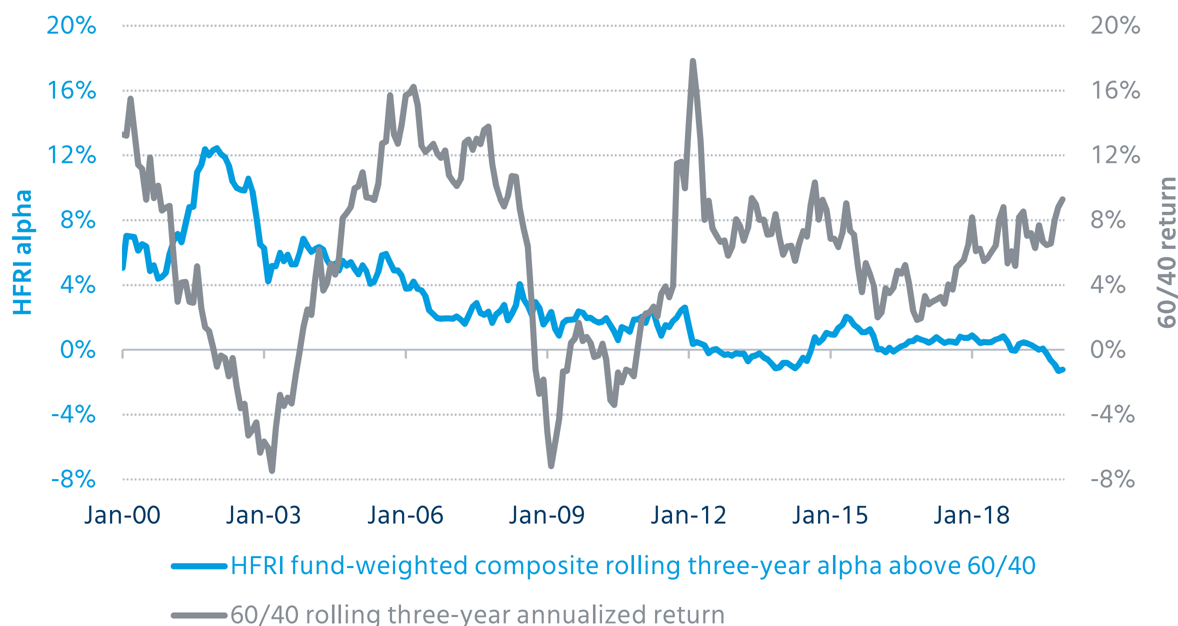
However, results also are a function of hedge fund alpha, which was far stronger between 2000 and 2009 than it was from 2010 to 2019.

Hedge fund alpha faced two significant challenges over the last decade:

- Increased competition
- Government intervention resulting in:
  - High inter- and intra-asset correlations
  - Suppressed volatility

© 2021 Mercer LLC. All rights reserved.

Figure 6. Rolling three-year performance comparison



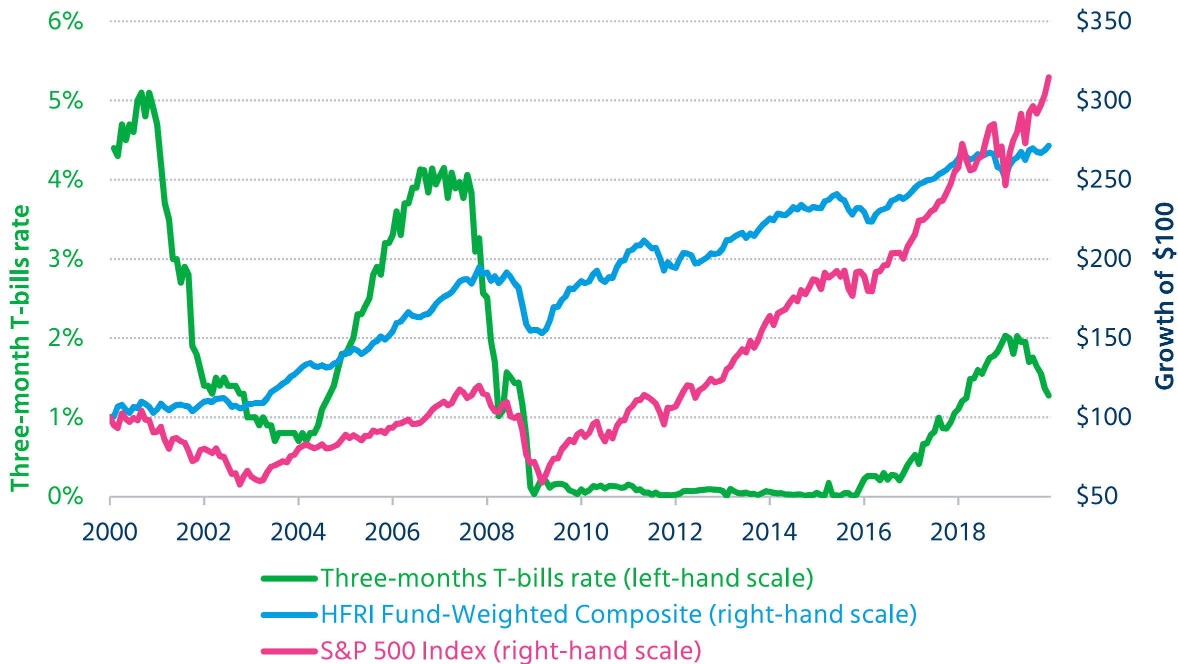
Source: Thomson Reuters Datastream, Bloomberg. Data as at December 31, 2019. The 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

It is natural to assume the decline in alpha from hedge funds is a function of an increased asset base chasing fewer alpha opportunities, or that alpha opportunities have not expanded at the same pace as the level of assets. There is some merit to this premise, particularly following the dot-com bubble and the "institutionalization" phase in the industry's life cycle. However, this premise is given far more weight than it probably deserves. Hedge fund industry growth has not been evenly distributed, yet the peer-group index (Hedge Fund Research) data suggests broad-based alpha compression, particularly post-GFC.

On a related note, the market cap of hedge funds has been proportionately consistent with the global market cap over this period. We see the extraordinarily stable and sustained period of elevated performance for a traditional balanced portfolio beginning in 2012. The risk-on incentives are evident during this period, the magnitude of which dampened alpha potential.

© 2021 Mercer LLC. All rights reserved.

Figure 7. Cumulative growth and cash rates, 2000–2019



Source: Thomson Reuters Datastream. Data as at December 31, 2019.

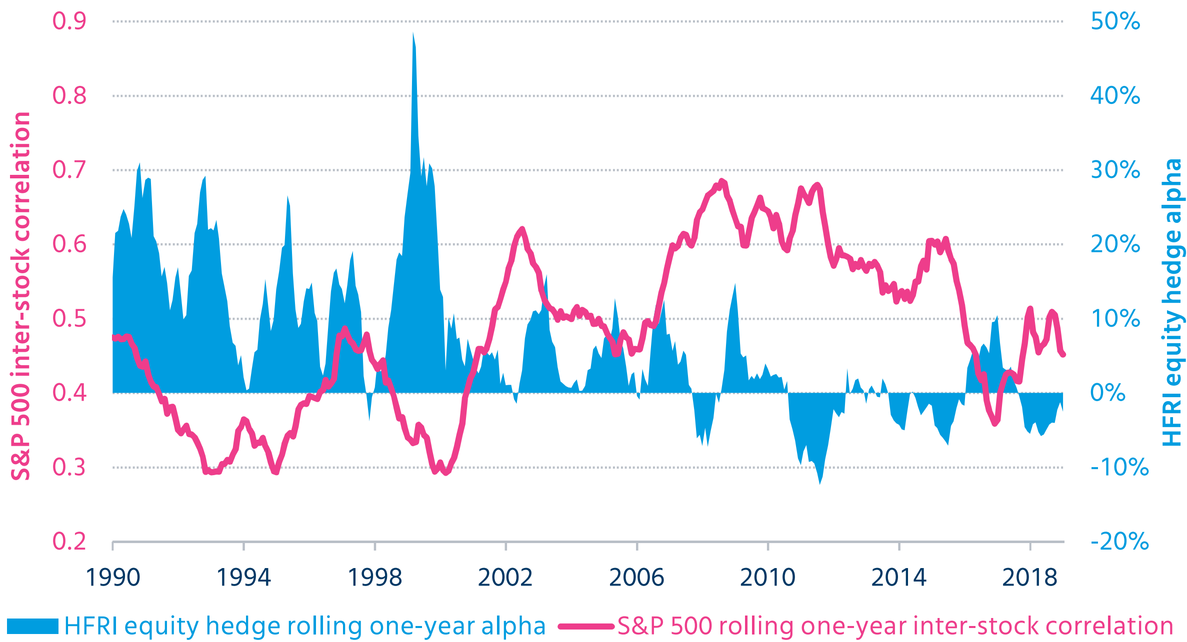
As seen in Figure 7, the near parabolic rise in equities coincides with the impact of government response to the GFC. The most meaningful impact, in our view, has been global monetary policy post-GFC that has been extremely accommodating and coordinated on a breadth and scale not seen before. The net effect drove interest rates to near zero (now negative for some) across much of the developed world. At higher interest rates, investors have options to pursue risk and reward across the spectrum; however, at near-zero rates, those decisions are in part made for them. The secondary effects have altered the risk landscape, with higher levels of correlations and lower levels of resulting volatility.

Whether it is inter- or intra-**correlations**, hedge fund alpha levels are generally higher with lower levels of correlations. A skilled stock picker, for example, seeks to isolate idiosyncratic business risk by identifying value and/or catalysts ahead of the pack that will drive valuations up or down depending on the position taken. If correlations are high, the ability to isolate idiosyncratic risk and alpha is diminished.

Spikes in correlation, as well as sustained levels of high correlation (>0.5), correspond with lower alpha in general. Figure 8 shows the elevated correlations evident within the S&P 500 Index during this period and the associated HFRI Equity Hedge Index alpha levels. This is just one example of the environment seen across and between multiple asset classes during this period.

© 2021 Mercer LLC. All rights reserved.

Figure 8. Inter-correlations and alpha environments



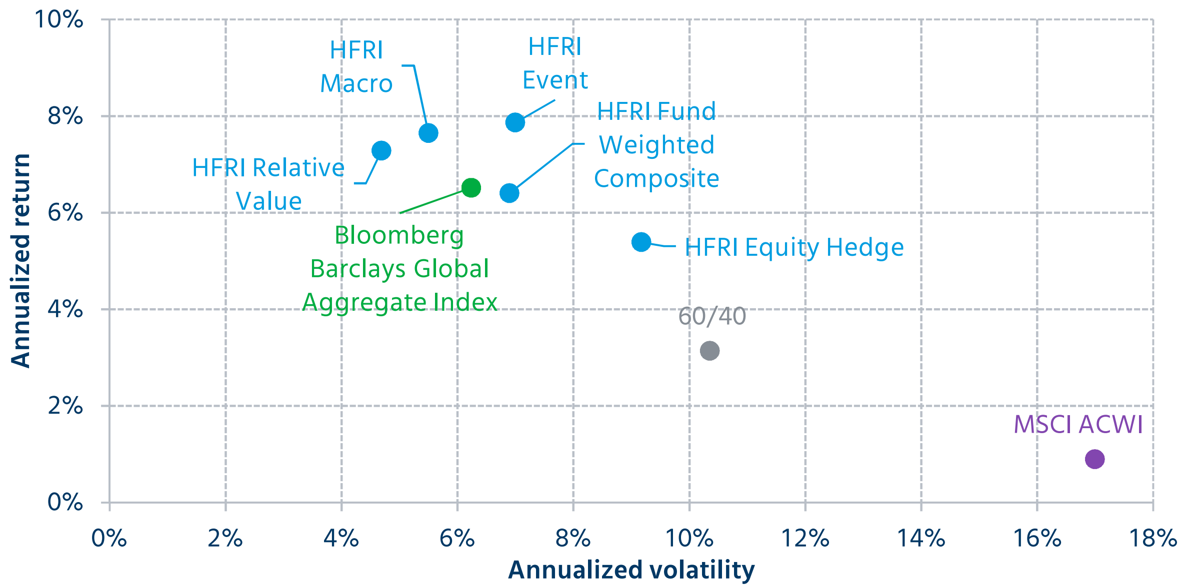
Source: Bloomberg and Thomson Reuters Datastream. Data as at December 31, 2019.

Volatility adds another dimension. Hedge fund alpha is highest when correlations are low and volatility is high, as in the early 2000s, a time when fundamental investing was rewarded. Conditions are worse for alpha when correlations are high and volatility is low, such as in the most recent decade.

Figures 9 and 10 illustrate risk/reward over the two decades in question. In the 2000–09 period, realized annual equity volatility averaged 17%. This volatility benefited hedge fund alpha and performance, while global equities suffered. From 2010 to 2019, realized volatility has been suppressed, averaging 13% annually.

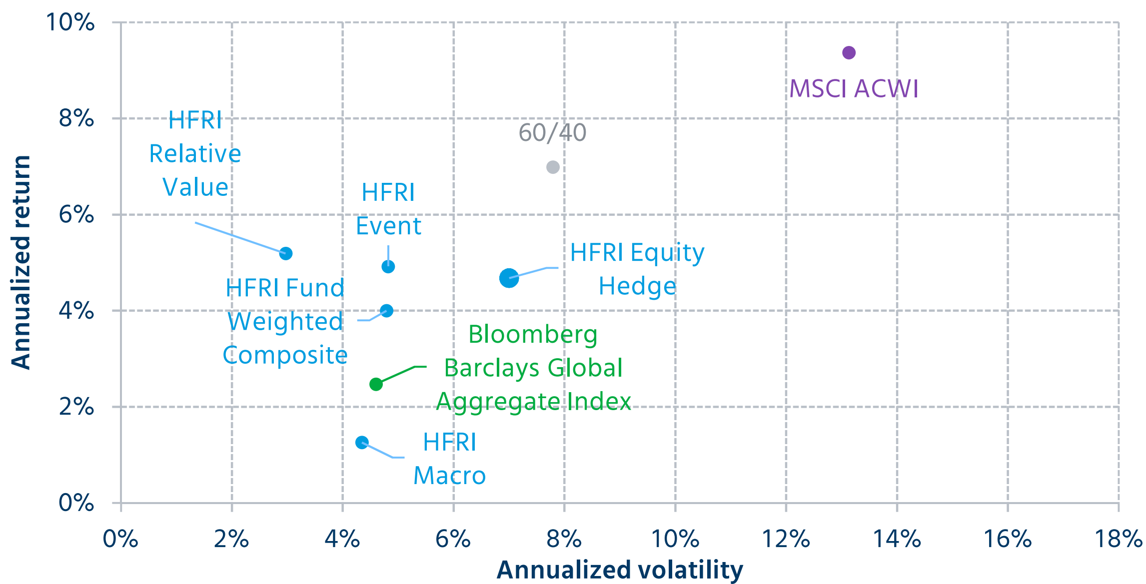
© 2021 Mercer LLC. All rights reserved.

Figure 9. Risk/reward profile, 2000–2009



Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations. The 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

Figure 10. Risk/reward profile, 2010–2019



Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations. The 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

© 2021 Mercer LLC. All rights reserved.

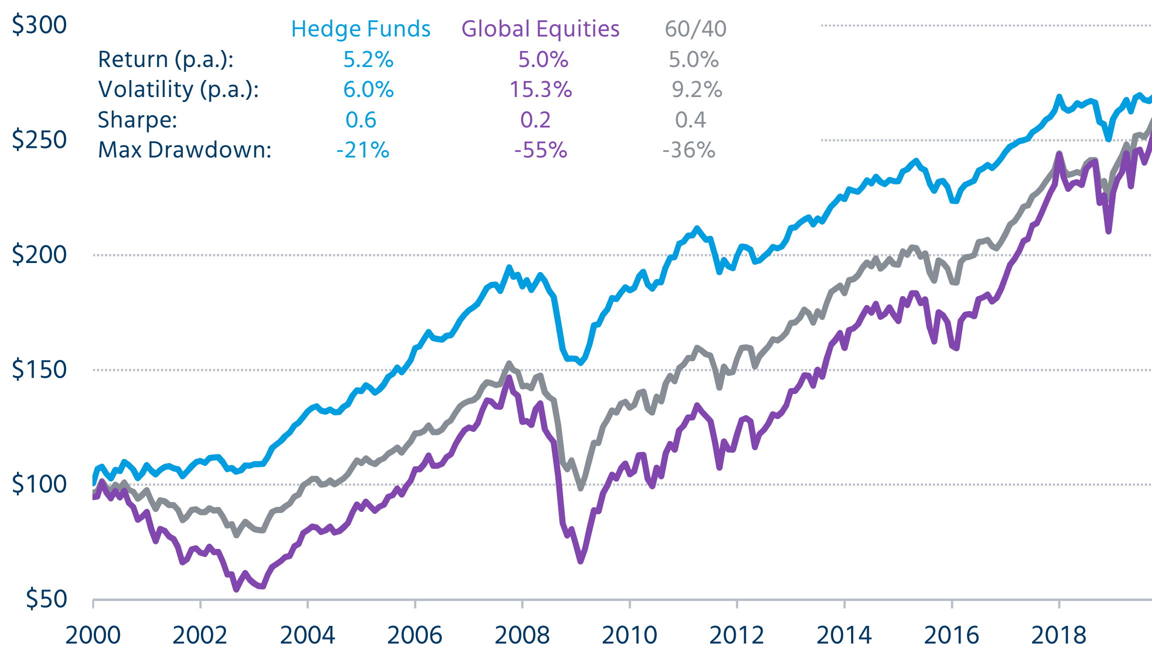
Again, to the credit of central bankers, this was designed to incentivize risk-taking, capital expenditures and economic growth coming out of the GFC. While hedge fund alpha and risk-adjusted performance has been positive, the absolute level of returns has been at lower levels than the prior decade, and the risk diversification benefits less obvious.

Overall, the prevailing macroeconomic environment undermined the hedge fund alpha toolkit while providing extraordinary support for equities. For hedge funds to keep pace with this growth would have required greater risk-taking either in the form of added leverage, directionality, increased beta or some combination. These are measures we prefer hedge funds to avoid.

Long-term results

Despite the challenges and increasing volume of criticisms, we would be remiss if we did not mention that over the 20 years from 2000–19, hedge funds collectively outperformed global equities and the naive 60/40 blend with lower volatility, as did nearly every major hedge fund category. We should point out these hedge fund results are net of fees and over both an almost unabated bull market in fixed income and one of the strongest equity bull markets ever post-GFC.

Figure 11. Performance comparison – growth of $100



Source: Thomson Reuters Datastream, Bloomberg. Data as at December 31, 2019. Hedge funds are represented by the HFRI Fund Weighted Hedge Fund (USD) Index, global equities are represented by the MSCI AC World Total Return Index (USD), and the 60/40 portfolio is 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

© 2021 Mercer LLC. All rights reserved.

Importantly, hedge funds broadly have delivered on two key value propositions over both periods in question — diversification and return quality (as illustrated by the low beta and attractive sharpe measures in figure 12). And they delivered them over both periods, regardless of relative absolute performance strength.

Figure 12. Equity betas and Sharpe ratios

	HFRI Equity Hedge (Total) Index	HFRI Event-Driven (Total) Index	HFRI Macro (Total) Index	HFRI Relative Value (Total) Index	HFRI Fund Weighted Hedge Fund
Equity beta (2000–2009)	0.4	0.3	0.1	0.2	0.3
Equity beta (2010–2019)	0.5	0.3	0.1	0.2	0.3
Sharpe ratio (2000–2009)	0.3	0.7	0.9	1.0	0.5
Sharpe ratio (2010–2019)	0.6	0.9	0.2	1.5	0.7

Source: Thomson Reuters Datastream.

Lastly, we maintain the view that the performance of the **average** hedge fund, as represented by the peer group indices, leaves much to be desired; successful hedge fund investing depends upon avoiding the average manager and identifying the finite best. Alpha, of course, is not evenly distributed across the universe, and the index results are now more diluted because of new entrants. We believe that using Mercer's A-rated selections combined with thoughtful portfolio construction can lead to better than average outcomes, including in the most recent period.

Closing remarks

In our view, average hedge fund returns have been muted during the past decade because their low beta, bi-directional and hedged profiles served as a headwind in a market environment that rewarded beta (long only equities and bonds). There were few deep and sustained market declines that rewarded lower beta strategies and downside risk management. In addition, accommodative monetary policy globally resulted in high correlations of securities prices and diminished volatility, which negatively affected alpha opportunities. Just as the 2010–19 period was unlike the preceding decade, we believe that the next decade will be different — as well and likely more rewarding — for hedge funds.

© 2021 Mercer LLC. All rights reserved.

Regardless of the environment, past, present or future, we continue to see the complementary benefits of a hedge fund allocation, even if those benefits are at non-constant levels over time. Any amount of positive alpha is additive to portfolios. In our next paper, we revisit the long-term strategic benefits of a hedge fund allocation and the complementary role they serve within a portfolio.

John Jackson, CFA
Head of Diversifying Alternatives Research

© 2021 Mercer LLC. All rights reserved.

Important notices

© 2021 Mercer LLC. All rights reserved.

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

This does not constitute an offer to purchase or sell any securities.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

Past performance does not guarantee future results. Mercer's ratings do not constitute individualized investment advice. The value of investments can go down as well as up, and you may not get back the amount you have invested. Investments denominated in a foreign currency will fluctuate with the value of the currency. Certain investments, such as securities issued by small capitalization, foreign and emerging market issuers, real property, and illiquid, leveraged or high-yield funds, carry additional risks that should be considered before choosing an investment manager or making an investment decision.

Private funds are for sophisticated investors only who are accredited investors or qualified purchasers. Funds of private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequentially, higher risk. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action. An investor could lose all or a substantial amount of his or her investment. There are restrictions on transferring interests in private capital funds. Funds of private capital funds' fees and expenses may offset private capital funds' profits. Funds of private capital funds are not required to provide periodic pricing or valuation information to investors. Funds of private capital funds may involve complex tax structures and delays in distributing important tax information. Funds of private capital funds are not subject to the same regulatory requirements as mutual funds. Fund offering may only be made through a Private Placement Memorandum (PPM).

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary and actual results may differ materially.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see http://www.mercer.com/conflictsofinterest.

Information contained herein has been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.

Investment management and advisory services for US clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business a s "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, New Jersey, North Carolina, Oklahoma, Pennsylvania, Texas and West Virginia; as "Mercer Investments LLC (Delaware)" in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Mercer Investments is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Mercer Investments' Form ADV Parts 2A and 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited and Mercer Limited. Mercer Global Investments Europe Limited and Mercer Limited are regulated by the Central Bank of Ireland under the European Union (Markets in Financial Instruments) Regulation 2017, as an investment firm. Registered officer: Charlotte House, Charlemont Street, Dublin 2, Ireland. Registered in Ireland No. 416688. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU.

Investment management services for Canadian investors are provided by Mercer Global Investments Canada Limited. Investment consulting services for Canadian investors are provided by Mercer (Canada) Limited.

April 2021

© 2021 Mercer LLC. All rights reserved.