Mercer

Investing in hedge funds

Why hedge funds?

Introduction

Continuing our four-part series on hedge funds, this second installment expands on the strategic benefits of an allocation. In our view, the core benefits of a well-constructed allocation include diversification, asymmetry/convexity and a compelling return profile. These benefits can provide resiliency and ballast to a portfolio. As highlighted in our previous paper, despite the 2010s being a challenging performance environment, we believe that the benefits of an allocation remain true and that the environment may be improving as headwinds shift to tailwinds — or at the very least, decline to a soft breeze.

The third article in this series will focus on considerations for building and managing a hedge fund allocation. The final installment will focus on how to implement diversifying alternatives as a constrained investor.

The role of hedge funds

It is critical to note that hedge funds are not an asset class. Rather, hedge funds are a collection of heterogeneous investment strategies implemented across asset classes, markets and instruments. At Mercer, we group hedge funds within a category we label “diversifying alternatives.” The label explicitly seeks to encompass the core value proposition itself and the role diversifying alternatives can serve within a portfolio — alternative sources of diversification. Within diversifying alternatives, we distinguish between unconstrained approaches and constrained approaches. This paper focuses on unconstrained hedge funds, which in our experience, offer attractive chances for success to capitalize on the unconstrained framework while at the same time, delivering on their, risk reduction role within a portfolio, as we describe it below.

These strategies seek to capture returns from alternative risk factors while limiting traditional risk influence. Across the hedge fund landscape, individual strategies tend to have highly disparate risk/return profiles. This has numerous implications for implementing a hedge fund portfolio and the role hedge funds play in the traditional asset-allocation framework. Long-term success is achievable for an allocation but requires clearly defined objectives and often an entire market cycle to highlight the strategic benefits.

The very unconstrained nature of hedge funds and dispersion of risk profiles across the universe means these strategies can be positioned to serve nearly any role across the risk/reward spectrum. Regardless of the application, we believe hedge funds can offer three core benefits:

1. Diversification
2. Asymmetry/convexity
3. A high-quality return profile

> Hedge fund benefits
>
> Diversification: Alternative risk and return sources.
>
> Asymmetry/convexity: Pursue results that favor the upside regardless of market environments.
>
> Quality return: Return that compensates for the risks taken and is efficient, as illustrated through measures such as the Sharpe ratio.

Despite the term “hedge fund,” by and large, we are not referencing direct hedges to market risk. Instead, we are talking about risk-controlled exposure to a diversified collection of non-traditional return streams that diversify traditional portfolios (in particular, equity risk and interest rate risk).

Through the addition of these alternative return drivers, the portfolio relies less on the direction of capital markets, resulting in "hedging" properties and a potentially lower-risk portfolio.

For nearly 20 years, we have held the view that a carefully constructed portfolio of hedge funds best serves as a risk-reducing element of the growth portfolio, and our view has not changed. However, investing in hedge funds is not necessarily risk-reducing; risk-reduction is pursued through a disciplined, calculated and informed approach to manager selection and portfolio construction.

As mentioned, hedge funds can be positioned in a variety of ways. For instance, if executed effectively, we believe risk-reducing hedge fund portfolios have the potential to achieve cash plus 3%–4% per annum over a full market cycle, with less of equity volatility, lower sensitivity and moderate correlation to both traditional equity and fixed income measures and a muted downside capture. Importantly, this does not necessarily come at the cost of lower expected returns,[1] making hedge funds a compelling investment opportunity. Further, we expect an allocation of 10% or more to result in an improved risk/reward profile for a total portfolio while subsequently allowing for a more efficient portfolio over the long term.

We believe, given their clear and defined mandate, hedge funds are worthy of a dedicated allocation to deliver on the objectives and benefits collectively.

Input — sources of value add

Hedge funds serve two critical roles by capturing opportunities that fall across and between public and private markets while, at times, capitalizing and facilitating asset transfers among market participants who may be constrained by mandate restrictions.

Most market participants cite "alpha," or return that is not attributable to market risk, as the primary reason to invest in hedge funds. We agree with this premise, as alpha is an important diversifier. We believe a combination of skill, non-traditional risk factors and an expanded toolkit supports the investment thesis for hedge funds. The multitude of strategy classifications and the subjectivity thereof can create confusion for investors. That said, regardless of label, the value proposition is rooted in two basic concepts: unique tools used to implement and harvest unique sources of returns.

Tools of the trade

The unconstrained toolkit affords a skilled manager the ability to not only harvest alternative premiums, but also tailor-make individual position and portfolio risk/reward while allowing for a more robust risk management framework. Figure 1 highlights some of the key tools at a hedge fund manager's disposal.

[1] Relative to the sources of capital — typically, some sort of stock and bond combination.

Figure 1. Hedge fund manager tool kit

Tools	Application
Short selling	Generate absolute returns or alpha through security selection expressing a negative view
Active hedging	Remove or dampen unwanted risk or isolate targeted risks
Leverage	Adjust position or portfolio asymmetry profile/improve capital efficiency
Dynamic risk management	Actively adjust positions or portfolio directionality and sensitivity to reflect micro or macro views
Concentration	Though not exclusive to hedge funds, express conviction through position sizing in a benchmark-agnostic approach
Engagement	Engage with management teams or stakeholders to effect change and unlock value; some hedge fund strategies may own majority stakes, allowing them to exert significant influence at the company
Litigation	Invoke creditor or shareholder rights and claims through negotiations and legal proceedings

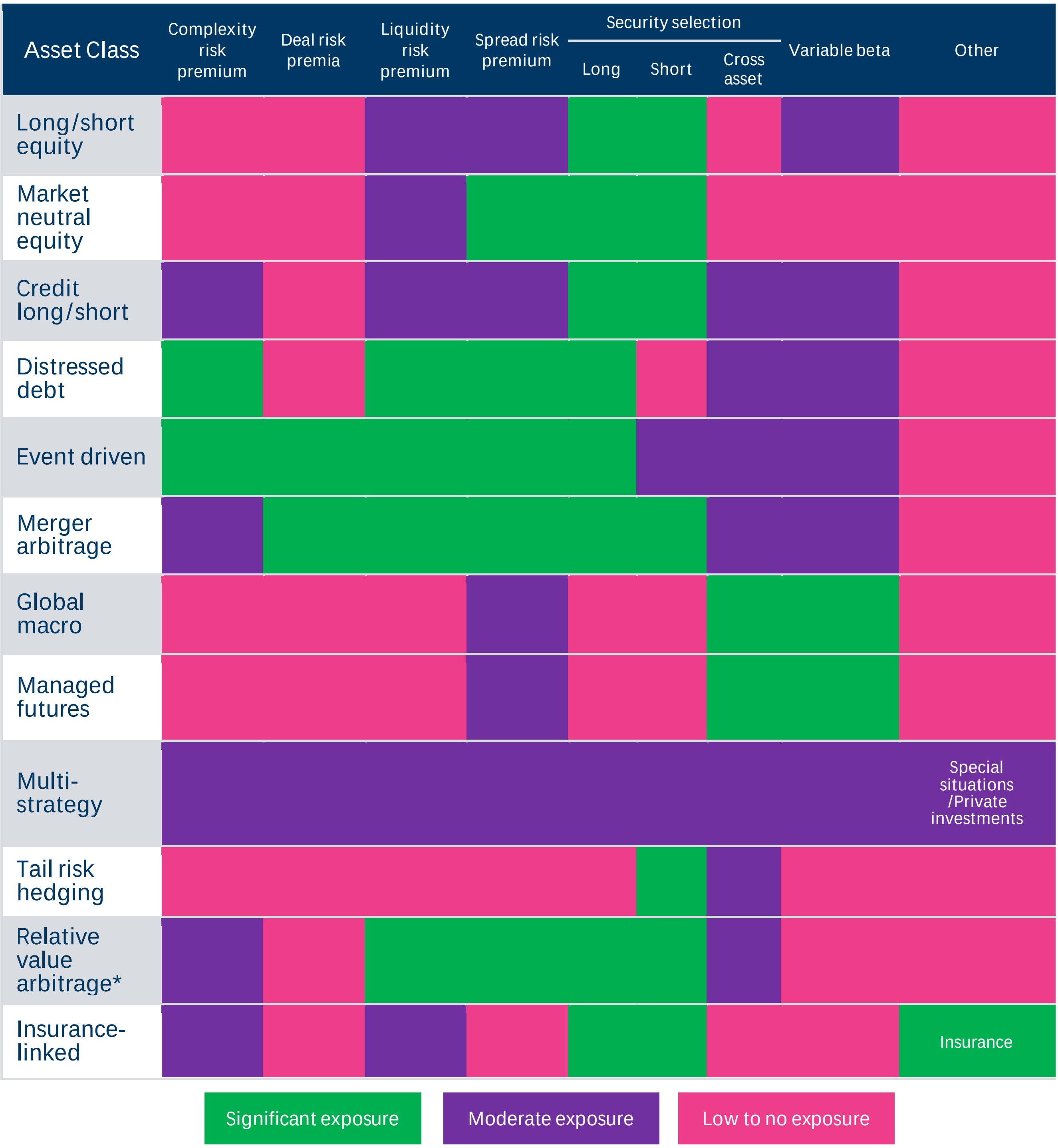
Fishing in a different pond

Further, the tools and techniques in Figure 1 can help capture and enhance the alternative sources of return detailed in Figure 2, and thereby alpha or exposure to idiosyncratic risks as opposed to market risk.

Figure 2. Description of alternative return sources

Alternative return sources	Description
Bi-directional security selection	Profiting from both price appreciation and depreciation, or, more practically, the excess returns of long positions over short positions. Common application often involves secular changes by identifying those firms that have or are establishing competitive moats relative to those that may be disadvantaged.
Deal risk premium	Capturing deal spreads and value catalysts; examples include merger arbitrage, spin-offs, split-offs, buybacks, activism, etc.
Complexity premium	Capturing returns created by complex situations and instruments, including credit covenants, litigation, bankruptcy proceedings and structured finance, among others
Liquidity/time horizon premium	Seeking to capitalize on forced sellers across assets often created due to stressed liquidity and captured by employing a longer time horizon, including liquidations, trade claims
Spread risk premium	Capturing the differences or mispricing in relationships through long and short positions across securities, capital structures, sectors, industries, geographies or term structures
Variable beta	Tilting the portfolio and risk in either the long or short direction in an effort to profit from the decision of when to accept market risk and when to avoid it
Macro trends/changes	Taking trading-oriented approaches that seek to deliver uncorrelated returns by trading broad global markets across equity, fixed income, currency and commodities based on macro views and factors

Figure 3. Use of alternative risk sources by hedge fund type (hedge fund diversity)



Includes volatility and arbitrage strategies (including convertible arbitrage)

The combination of asset classes, instruments, financing, risk factors and portfolio levers only expands the opportunity set available to hedge fund managers. Effective implementation can deliver a return profile that cannot be achieved otherwise. That said, these elements alone do not necessarily lead to success. Given the same investment universe, philosophy and approach, two managers are likely to deliver different results over the same period. Long-term success hinges on identifying those managers best equipped to keep pace through varying market environments and regime shifts.

Output

Isolating and measuring individual input contributions is challenging, as the risk-taking and execution are interconnected and dynamic over time. In the analysis below, we attempt to quantify hedge fund benefits and the primary areas investors should consider in selecting individual strategies and managers. We have chosen the broadest set of indices to capture the universe as reported by Hedge Fund Research, Inc. We caution that generalizations across the universe or within it are prone to error.

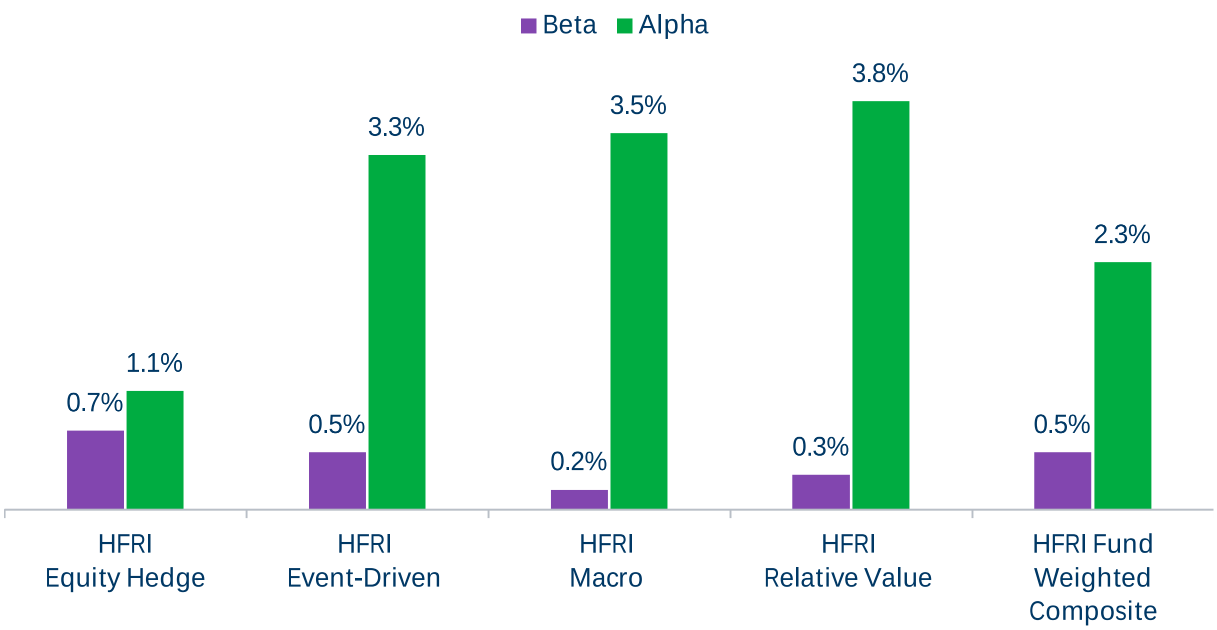
This point on generalizations is critically important and often underappreciated or ignored as labels, characteristics, descriptors and, ultimately, results are a function of a manager's approach, risk-taking tactics and acumen. Still, we think the inputs above provide for three key outputs that help deliver on the objectives outlined earlier: (1) diversification, (2) asymmetry and (3) return quality. We detail each below.

Diversification

Traditional portfolios are dominated by two systemic risks: equity beta[2] and interest rate risk. As previously mentioned, hedge funds can be used to diversify from these traditional risks and also add alpha.[3] Over the past 20 years, hedge funds have delivered 1.1%–3.8% of annualized alpha on average, net of fees after accounting for beta exposure to a combined 60/40 portfolio (60% equities, 40% bonds)[4]. We argue the prior 10 years, in particular, have been a challenging alpha environment. We believe a reversion to higher alpha in the near to medium term could range between 2%–5% annualized on average across the landscape, with potential improvements possible through manager selection.

Figure 4 shows the levels of market sensitivity and idiosyncratic returns from different hedge fund categories. From a perspective of blending a hedge fund portfolio with other investments, an attractive result is a low beta and a high alpha.

Figure 4. 20-year annualized beta and alpha to 60/40 portfolio



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). Data is 20 years to December 31, 2020.

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[2] Beta is a sensitivity. For example, if a portfolio had a sensitivity of 0.7 to equities over a particular time period, all else equal, we would have observed a roughly 7% rise in the portfolio if equities had risen 10%. A lower beta means that the category is less responsive to market risk, delivering diversification, which is unsurprising as hedge funds emphasize idiosyncratic risks.

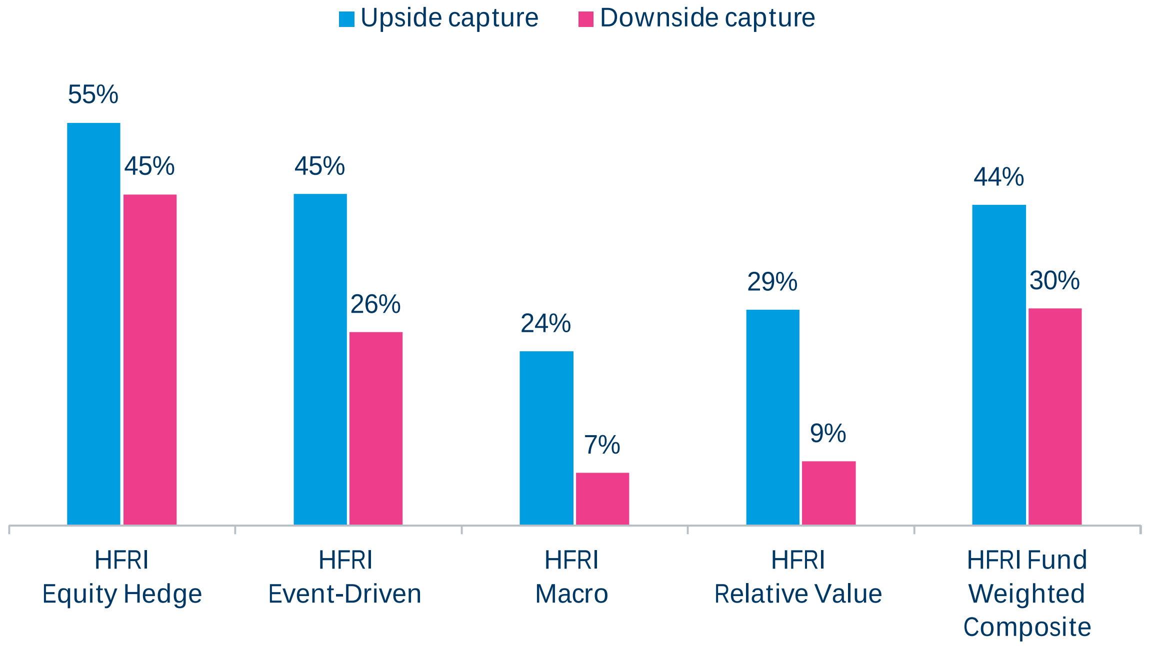
[3] In a simple linear regression, alpha is the residual return after accounting for market risk (portfolio return = alpha + beta*[index return]). Positive alpha is often equated with manager skill, although a component can be other systematic risk factors.

[4] 60% MSCI AC World Total Return Index (USD) and 40% Bloomberg Barclays Global Aggregate Total Return Index (USD).

Asymmetry

The key to delivering on the risk-reduction characteristics is achieving a certain level of positive asymmetry in results (also known as positive convexity). We believe the expanded toolkit of the unconstrained approach helps deliver on that asymmetry. Typically, we seek approximately a 2:1 up/down capture relative to equity risk; for instance, 40% of the upside and 20% of the downside, though in practice this can be tailored. Dampening or reducing drawdowns allows more consistent compounding, which is key to long-term portfolio growth.

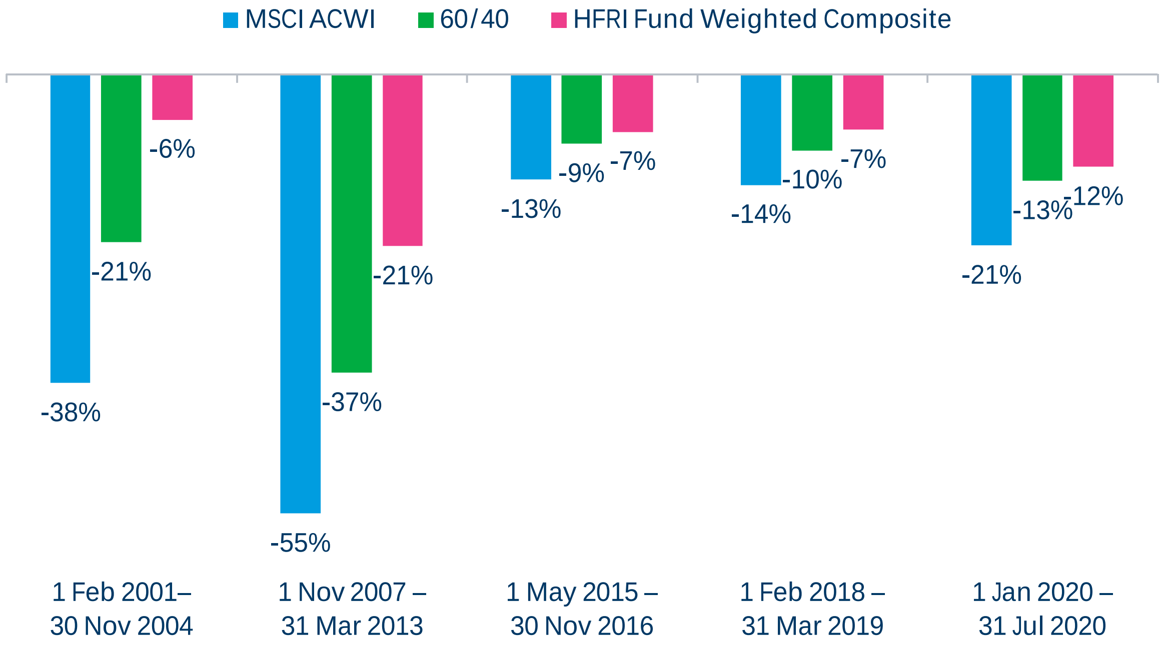
Figure 5. Global equity capture – 20 years ending 2020



Source: Thomson Reuters Datastream, Bloomberg and Mercer calculations. Global equity is represented by the MSCI AC World Total Return Index (USD), using monthly return calculations. Data is 20 years to December 31, 2020. Capture is calculated as the average monthly return of the hedge fund index divided by the average monthly return of the MSCI ACWI index (considering months when the MSCI ACWI is positive for upside capture, and negative for downside capture).

Figure 5 illustrates the average monthly upside and downside capture relative to global equities for certain hedge fund categories, showing that hedge funds broadly exhibit favorable asymmetry. We recognize the magnitude of asymmetry is non-constant and most effective during deeper and protracted market drawdown periods, as illustrated in Figure 6.

Figure 6. Maximum drawdown over the last 20 years where global equities have fallen substantially



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).

During the past 10 years, the equity market has largely moved up, resulting in few deep and protracted market drawdowns — in part, we believe, due to government intervention since the global financial crisis (GFC). The lack of deeper market downturns optically distorts hedge fund diversification benefits since the GFC. It might lead some to inadvertently extrapolate the asymmetry properties of the recent past with the expected future. As detailed earlier in this paper and our performance review paper, the diversification properties remain consistent in the beta and alpha profiles but have been suppressed post-GFC. We believe future policy responses will have a declining marginal utility. With interest rates near zero or negative across many developed markets, the ability and impact of additional monetary stimulus are likely to be weaker. Fiscal stimulus may partially bridge the gap, but the effects have been varied and only partially linked to risk incentives.

As we have witnessed more recently, the continued efforts are beginning to raise fears and concerns on macro risks such as inflation, debt burdens and currency. We believe we are entering a new volatility regime that is partially out of control from central banks. Further, the return-free risk now offered by a large portion of government debt means investors will need to pursue alternatives for diversification and return potential. Hedge funds are positioned to deliver this alternative exposure given their lower betas to equities and bonds.

Return quality

Using the Sharpe ratio as a quality measure, over the past 20 years, hedge funds have provided an equal or higher-quality return relative to equities, as well as a 60/40 blend of equities and bonds.

Figure 7. Return quality comparison of different hedge fund strategies

Trailing 20 years ending December 31, 2020	HFRI Equity Hedge (Total) Index	HFRI Event-Driven (Total) Index	HFRI Macro (Total) Index	HFRI Relative Value (Total) Index	HFRI Fund Weighted Hedge Fund Index	HFR FoF Index	MSCI ACWI Index	BBg Barc Agg Index	60/40
Annualized return	5.4%	6.5%	4.6%	5.7%	5.6%	3.7%	6.1%	4.8%	6.0%
Standard deviation (±)	8.5%	6.9%	4.8%	4.6%	6.3%	5.1%	15.9%	3.4%	9.6%
Sharpe ratio	0.5	0.7	0.7	0.9	0.7	0.5	0.3	1.0	0.5
Worst drawdown	-30.6%	-24.8%	-8.0%	-18.0%	-21.4%	-22.2%	-54.9%	-3.8%	-35.7%
Positive months	64%	68%	57%	77%	67%	66%	61%	67%	64%

Source: Thomson Reuters Datastream, monthly calculations, USD

Even after applying haircuts to the results to account for some well-known biases with hedge fund indices, the broad universes have mostly outperformed global equities, global bonds and the standard 60/40 portfolio with lower volatility (excluding bonds).

Within each universe is a wide variety of sub-categories, and within each sub-category, a variety of styles and approaches resulting in significant dispersion across the universe. Furthermore, investors should understand what is behind the statistics. It bears repeating: The greatest value (or quality) is often delivered in down markets at the sacrifice of upside participation.

Adding constraints

As mentioned earlier, seeking success requires clearly defined objectives and reasonable expectations relative to the prevailing environment. The historical results and benefits illustrated above, along with Mercer's forward-looking expectations, assume a relatively unconstrained approach to building a hedge fund allocation. Importantly, this unconstrained framework serves to promote and enhance the core benefits: diversification, asymmetry and quality return profile. Historical evidence suggests the incorporation of constraints (fees, liquidity, etc.) can have material impacts both individually and collectively that can adversely affect desired outcomes. Expectations should be adjusted accordingly to any applied constraints. We explore this concept further in our final paper of this series. Similarly, using hedge funds in applications other than the "risk-reducing" role described above requires different expectations and implementation.

Why now?

Clearly, with hindsight, diversification has not been rewarded over the past 10 years. In our previous paper reviewing hedge fund performance, we offer explanations for the reduced benefits to hedge funds in the post-GFC decade.

Anecdotally and intuitively, the environment appears to be improving for alpha, as cited in our previous article, "2020: Hedge Funds' Phoenix Moment?."[5] Successful investing involves being on the right side of change. We see significant change occurring within and across sectors and regions both at the micro and macro levels.

At the micro-level, COVID-19 accelerated many of the secular trends already in place. From an equity perspective, these include cloud computing, remote working, e-commerce, payments, electric vehicles, the gig economy, ESG,[6] telehealth and digital streaming. In credit markets, certain sectors have seen stress and bifurcation due to COVID-19 and secular change.

At the macro level, current political and regulatory pressures have increased. Further, while central banks are responding similarly to the COVID-19 crisis as they did to the GFC, we believe policies will diverge. From a geopolitical perspective, we are likely entering a period when the world becomes less globally interconnected, not more, in part because the pandemic has highlighted vulnerabilities.

All of this suggests to us that uncertainty and disruption and, as a result, volatility, correlation and dispersion are more likely to provide a better opportunity set for unconstrained mandates from now on. Indeed, beginning late last year and before COVID-19, we saw signs that some headwinds mentioned earlier were starting to turn into tailwinds for hedge funds, broadly. This continued through 2020 despite the challenging and dynamic environment, with hedge funds delivering some of the best performance and alpha in the last decade.

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[5] Mercer. "2020: Hedge Funds' Phoenix Moment?" March 5, 2021, available at www.mercer.com/our-thinking/wealth/2020-hedge-funds.html.

[6] Environmental, social and governance considerations.

Closing remarks

Through a diversified collection of alternative risks and a disciplined risk-management approach, well-constructed hedge fund allocations have historically proven to inject resiliency into growth portfolios. We continue to expect that will be the case. The pursuit of alpha requires investor patience and a long-term horizon. For portfolios that currently exclude an allocation, this may be a good opportunity to diversify. For those portfolios that presently include a hedge fund allocation, we encourage staying the course. While we hope the role of hedge funds is clear, the building blocks to success are less obvious. Managing an allocation is part art and part science and far less prescriptive than many desire.

In our next article, we will review managing an allocation for success.

John Jackson, CFA
Head of Diversifying Alternatives Research

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May 2021