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HEDGE FUNDS IN THE CURRENT ENVIRONMENT

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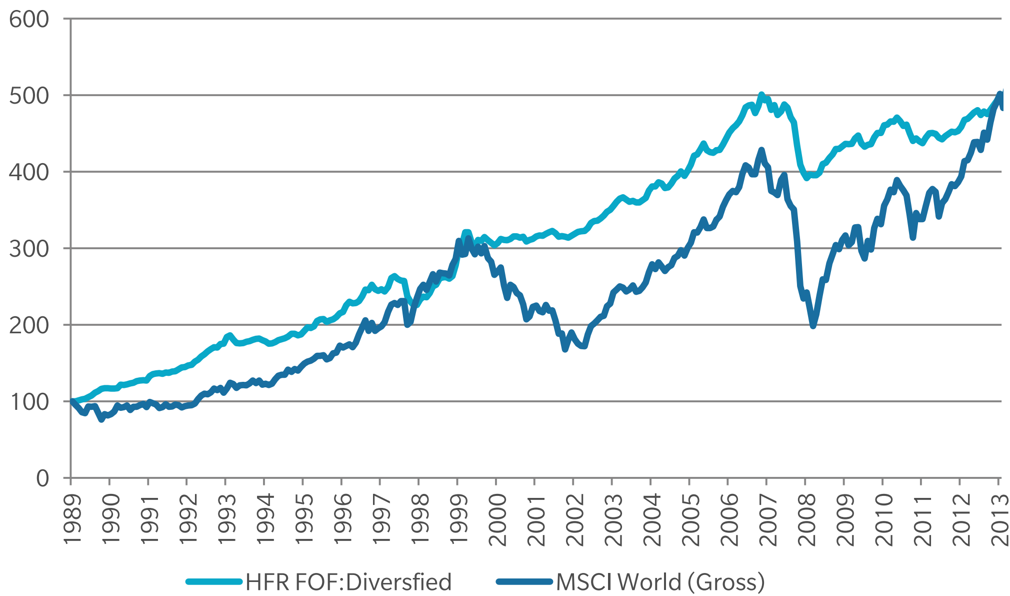
We believe that now is a good time to consider (or reconsider) hedge fund investing. The strategic case remains valid and many current factors are positive for hedge funds. This article explores the case for hedge funds with a focus on the current environment. We also offer some thoughts on choosing the best hedge funds and how to build robust portfolios.

HEDGE FUNDS HAVE DELIVERED THE CLICHÉD "EQUITY-LIKE RETURNS WITH BOND-LIKE VOLATILITY"

Hedge funds can provide both long-term growth and diversification from other asset classes, and can generate these returns with less volatility than public equity markets. This can be achieved through exposure to various types of manager skill and nontraditional risks. Figure 1 on the next page shows the long-term performance of hedge funds compared to equities. We have used what we believe to be the most representative measure of hedge fund performance (the HFRI FOF: Diversified Index), which reflects the average professionally managed hedge fund portfolio and has the least amount of survivorship bias. The gross of fee MSCI World Index is shown for equities. The net of all fees return on hedge funds of 6.9% p.a. almost exactly matches the 7.0% p.a. from equities. By contrast, while equity volatility was 15.4% p.a. over the period, hedge fund volatility was 5.9%, compared with 5.5% achieved by the Barclays Aggregate Global Bond Index.

FIGURE 1

Long-Term Performance of Hedge Funds Compared to Equities



Source: Hedge Fund Research Inc.

Over shorter periods a well-designed portfolio of hedge funds is likely to "come in second place" relative to equities and bonds: lagging in strong bull equity markets and eclipsed by treasuries in times of crisis, even if they can protect capital better than equities do. However, always coming second, when the same asset class is not always coming first, means that the longer-term return profile can be very attractive and potentially result in outperformance over the long term (especially with robust portfolio construction and good manager selection).

Hedge funds have been able to deliver diversifying returns because they are afforded the flexibility to access different return drivers than those accessible through traditional long-only asset classes. This means that hedge funds can help share the burden of growth in investor portfolios. In investor portfolios that are often dominated by equity risk (and to a lesser extent credit risk), hedge funds can contribute by offering access to non-traditional return drivers such as bi-directional security selection and timely variability in beta exposure.

THE CURRENT OPPORTUNITY SET FOR HEDGE FUNDS IS ATTRACTIVE

We see many positive factors for hedge funds including a robust opportunity set. The reward structure of hedge funds continues to attract the best investment talent and, on balance, we believe there are currently stronger tailwinds than headwinds for hedge fund strategies. Importantly, the opportunity cost of investing in hedge funds currently appears low. By this we mean that many traditional asset classes are either over- or fairly valued, so investors in hedge funds are less likely to miss strong bull markets in either equities or credit.

A key change has been a better environment for stock selection and long/short investing. We have seen lower intra stock correlation, a key measure that means security prices are better reflecting their own idiosyncrasies rather than moving in tandem with the market. This creates a favorable opportunity set for hedged security selection, especially when fundamentals are being rewarded and the economic environment is creating clear winners and losers.

Changes in the banking sector, notably bank deleveraging, are continuing to provide opportunities for hedge funds. Many hedge funds are providing liquidity to European banks, as these institutions are incentivized to dispose of non-core assets at prices that imply attractive forward-looking rates of return. The reduced competition from bank proprietary trading also has benefits for hedge funds. First, hedge funds are not competing with these banks for the same trades as they did in the past. Second, they are able to hire those very traders who previously worked at banks onto their staff.

" Changes in the banking sector, notably bank deleveraging, are continuing to provide opportunities for hedge funds."

Event-driven opportunities also abound. These range from restructurings to recapitalizations, to spin-offs, to mergers and acquisitions (M&A). It is worth noting that M&A volumes are currently in excess of the levels last seen in 2007.

For macro traders, monetary and fiscal intervention in markets has been a challenge in recent years especially when policymakers have had such a big impact on markets. But now, while macro risks remain, policymakers' actions are becoming increasingly differentiated as economies diverge, allowing more scope for different market responses. We believe this backdrop should allow skilled managers to profit from macro opportunities resulting from global imbalances.

INVESTING IN HEDGE FUNDS – BUILDING PORTFOLIOS AND PICKING MANAGERS

We refer to "portfolios of hedge funds," rather than individual managers, as our core belief is that accessing this "asset class" is not unlike investing in equities — diversification within a hedge fund portfolio, by manager and strategy, is key to achieving the diversification benefits highlighted earlier. Furthermore, we believe:

- Hedge fund strategies should be rational and managers must have an identifiable edge.
- Hedge fund portfolios should be "hedged".
- No single hedge fund should represent a disproportionate share of the total portfolio.
- But there should be prudent concentration within an allocation.
- Liquidity terms should match the underlying investments.
- There is value in seeking exposure to more cyclical strategies via opportunistic multi-strategy funds.

Picking good hedge fund managers is hard. Quantitative analysis, including past performance, is not necessarily indicative of future results. This is especially true for hedge funds, as their nontraditional nature and general opacity can often mask underlying risks that lie dormant until realized in outsized losses. The hard work must start with detailed due diligence to select managers with an identifiable and repeatable edge.

A key part of hedge fund manager selection is forming an investment thesis on each hedge fund manager. This basis for selecting managers defines their unique role in the hedge fund portfolio and sets the tolerance for risk taking and performance expectations. Effectively defining the investment thesis for each manager is critical, as a break in the investment thesis should be the basis for termination. Successful hedge fund investing is predicated on skillful manager selection. From idea generation to implementation and business management, all elements of an investment strategy and hedge fund organization must continually be assessed and reassessed to ensure the investment thesis remains up-to-date.

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