THE CASE FOR TRADITIONAL HEDGE FUNDS

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WHAT ARE HEDGE FUNDS?

We do not think of hedge funds as an asset class, rather as a collection of heterogeneous investment strategies that can be used to gain exposure to a variety of nontraditional risks (hedge fund risks). In fact, individual hedge fund managers implementing the same investment strategy often target and generate contrasting risk profiles.

THE HEDGE FUND TOOL BOX

- Long and short investing
- Manager skill
- Absolute return
- Leverage
- Investment flexibility

Hedge funds offer greater flexibility in execution and a broader mandate through fewer constraints.

THREE MAIN TYPES OF HEDGE FUNDS

MULTI-STRATEGY

Expected to produce consistent returns due to diversification across strategies, plus ability to tactically shift allocations between strategies as opportunity set changes

FOCUSED SINGLE STRATEGY

- Long/short equity
- Event-driven
- Global macro
- Credit opportunity

Expected to produce strong returns over full cycle, but with less consistency than multi-strategy funds

HEDGING STRATEGY

- Tail-risk hedging
- Managed futures

Long volatility strategies with potential for diversification against systemic risk

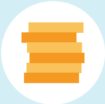
WHY OWN HEDGE FUNDS?

- Improve the risk/reward trade-off
- Diversify traditional equity, credit and interest rate risks that dominate typical asset allocation
- Get exposure to nontraditional return drivers and diversify your portfolio
- Rely less on the direction of capital markets
- Stretch efficient frontier and improve risk-adjusted performance
- Generate attractive risk-adjusted returns relative to global equities over full market cycle
- Develop a well-crafted hedge fund allocation as an attractive component of the growth portfolio toolkit
- Through risk-factor diversification, increase drivers of portfolio growth and reduce risk in absolute sense
- Obtain equity-like returns with significantly less volatility over long term, if well-executed

Of course, hedge funds aren't without risk. Many risks are noncompensating, so diversification is critical. Successful implementation helps achieve desired benefits — manager selection, due diligence, risk monitoring and portfolio construction are critical.

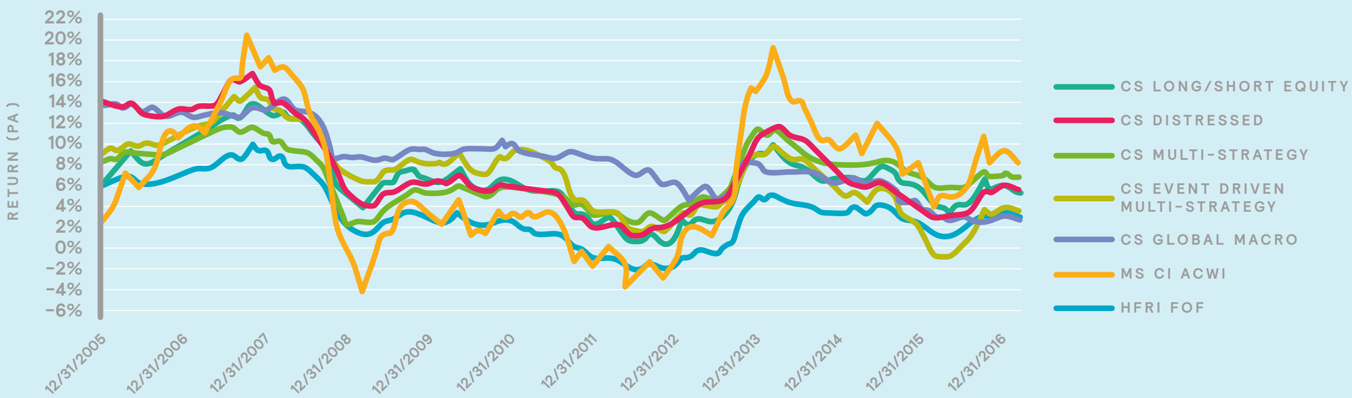
WHY INVEST NOW?

Forward-looking potential for market beta is weak.



Investors increasingly seek greater contribution from “alpha” to capitalise on policy divergence, rising dispersion, continued M&A activity and maturity of credit/default cycle.

POSITIVE BUT MUTED PERFORMANCE IN RECENT YEARS



Source: Thomson Reuters Datastream based on HFRI Fund of Fund Composite, MSCI AC World indices, and Credit Suisse indices from December 2000 to February 2017 showing 5 year rolling period returns.

- The long-term track record of hedge funds broadly has been strong, but performance is strategy-dependent and cyclical, underperforming during strong markets and adding significant value during market dislocations.
- However, hedge funds have provided returns of cash + 2%–3% over the last five years. As a reminder, hedge funds generally focus on absolute returns, are benchmark agnostic, and are not constructed to outperform a benchmark.

LOOKING FOWARD

A Falling (and Low-) Volatility Environment
Volatility has started to increase in a number of markets, which should create a more fertile opportunity set for some hedge fund strategies.

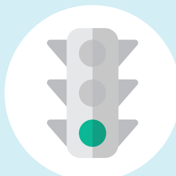
Relatively Little Dispersion Within Markets
Making strong assertions about the likely level of dispersion in markets is difficult, although we are now starting to see decreased intra-asset-class correlation. To the extent that we have already passed the high point in monetary stimulation, more “normal” market dynamics may resume in years ahead.

The Large Number of Hedge Funds
The number of hedge funds is unlikely to fall substantially in the near term. Careful manager selection is therefore critical to success. It remains a dynamic industry — investors entering or exiting the market can create opportunities.

The Low-Interest-Rate Environment
Interest rates are expected to gradually increase over the next few years, which should be a tailwind for absolute-return-focused mandates. It should also create winners and losers within markets as weaker companies no longer survive through cheap financing.

MERCER PHILOSOPHY

Act as risk-reducing component of growth portfolio	Improve total portfolio diversification	Diversify equity risk without introducing interest-rate sensitivity

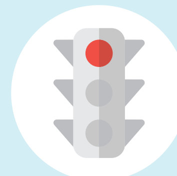


TOOLS WE EMBRACE

Bi-directional investing

Concentration in best ideas

Complex securities/situations



TOOLS WE AVOID

Long-biased investing

Excessive leverage

High-frequency trading

Our hedge fund strategy is to diversify return drivers in the growth portfolio and generate attractive risk-adjusted returns relative to equities over a market cycle.

THREE KEY STEPS TO STRUCTURING A HEDGE FUND ALLOCATION

1. Consider investor's objectives and beliefs; analyze their current investment portfolio
2. Review appropriate hedge fund allocation depending on investor's objectives and constraints
3. Review best way to implement allocation depending on investor type:

'DO IT FOR ME' INVESTOR

- Appreciates value of hedge funds but,
- Lacks investment knowledge and/or time
- Wants professional assistance managing investment exposure over time

An outsourced solution is likely to be most appropriate.

'GUIDE ME' INVESTOR

- Reviews alternatives allocation occasionally
- Wants control over major shifts in allocation
- Limited engagement on implementation, rebalancing and other shorter-term issues

A diversified multi-manager approach is desired, direct or delegated solutions.

'LET ME DO IT' INVESTOR

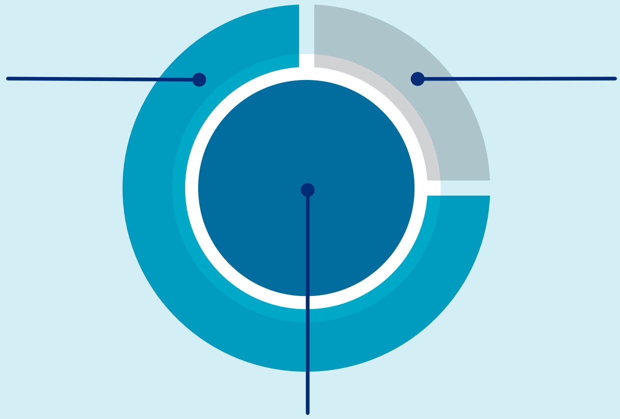
- Frequently reviews alternatives portfolio
- Utilizes full range of investment options
- Controls all key investment allocation decisions

Some investors use hedge funds to round out the portfolio.

BEST-PRACTICE PORTFOLIO CONSTRUCTION

Focused single strategies: expected to generate strong returns over a full cycle (30%-70%)

Global Macro
Long/Short Equity
Relative Value
Insurance Linked



Hedging strategies: useful diversifiers (0%-30%)

Tail Risk Hedging
Managed Futures

Multi-strategy and Alternative Risk Premia: provide diversification with scope to shift allocations as opportunity set changes and to gain exposure to niche/emerging strategies (20%-60%)

ABOUT THE AUTHOR

Jordan Nault is a partner and the global leader of Mercer's Hedge Fund Boutique. She has been with Mercer since 2006 and is based in our Chicago office. Jordan is responsible for leading the Hedge Fund Manager Research team in establishing and monitoring strategic research priorities and ongoing manager research coverage. Jordan has experience as a senior investment consultant and has worked with a wide variety of sophisticated institutional clients on asset allocation, portfolio construction, investment policy, investment manager selection and governance. She served as the chair of the Target Date Fund Strategic Research Team from 2012 to 2015.