Hedge Funds off Steroids

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Introduction

Please allow me to share a few personal observations. I spent fourteen of the past fifteen years analyzing and investing with hedge fund managers. I was a firm disciple of the premise that the very best and most talented investment professionals would prefer to work at hedge funds, owing to their inherent investment flexibility and attractive incentive fee structure. However as an absolute return investor at heart, I always felt it unfair that these strategies have only been available to "accredited investors" and thus off limits to the general investing public.

Recent events have led me to reevaluate the premise that quality liquid absolute return investing is the exclusive domain of hedge funds. In setting up my own investment advisory practice, I am finding more opportunities for absolute return-type investing within the mutual fund and ETF spaces. This does not preclude investing with hedge funds, but does allow for more selectivity.

Components of Hedge Fund Returns

There are three primary elements to a hedge fund's performance

1. Market beta – the element that may be explained by the direction of the overall markets (or a specific asset class or sector).

2. Hedge fund beta – a subset of beta that reflects the returns embedded in various non-traditional asset classes, irrespective of manager skill.

3. Alpha – the return that is due to manager skill alone.

In a perfect world one would only pay incentive fees for alpha. However, most hedge funds charge high fees while providing investors with healthy doses of both market and hedge fund beta (and often very little alpha).

Quantitative liquid hedge fund replication strategies contain a very large cash component – so if one believes these to be a proxy for the hedge fund universe, investors in multi-manager portfolios may be paying very high fees for unwanted money market exposure. With many hedge fund managers claiming to be pure alpha generators, in order to justify 20% performance fees, we reach the illogical conclusion regarding hedge funds' performance as an "asset class" or index that

Total Alpha equals 0.8-times Hedge Fund Beta

Additionally, hedge funds must generate 25% higher gross returns than mutual funds in order to generate similar net performance.

Many hedge fund managers come from the institutional or retail long-only space. Thus we ask, do former mutual funds managers suddenly become markedly more skillful after they re-locate from downtown Boston down the I-95 highway to the office parks of Greenwich, Connecticut?

What has Changed?

Markets have become deeper and more diverse - offering more alternatives to the traditional stock and bond portfolios. There is an ever growing number of mutual funds and ETF's offering non-traditional exposure. More and more, we are seeing Hedge Fund beta being offered via regulated investment vehicles. Mutual fund structures provide some important advantages

1. They are regulated ('40 Act)
2. All have daily liquidity
3. One can invest or redeem fairly anonymously
4. There are no incentive fees

In contrast, hedge funds are often not regulated and generally offer poor liquidity relative to the alpha spread they may provide. Moreover, one cannot sell out of a hedge fund anonymously. And no aspiring hedge fund of fund analyst wants to incur the wrath of a successful hedge fund manager by informing him of an impending removal of capital (lest he or she be branded as "hot-money investors, and not be allowed to invest in the next "must-have" fund launch).

Hedge Funds off Steroids

Absolute return mutual funds come in many flavors, and do not always represent classic hedge fund strategies. They are "off steroids", as there are stricter limits on leverage. Hence the return goals are often more modest compared levered hedge funds run in similar fashion. Mutual funds have daily liquidity - gates and side pockets are unheard of. We classify them into four general categories,

1. **Absolute Return Fixed Income:** relatively conservative non-correlated return targets in fixed income and currencies, be they directional or market-neutral.
2. **Directional Alternatives:** hedge fund strategies with a capital appreciation focus, such as global macro, managed futures, equity long-short and distressed debt.
3. **Absolute Return Equity:** long-only funds that do not follow a benchmark, and are differentiated from run-of-the-mill diversified equity funds.
4. **Other:** The goal is retain the real value of cash-plus allocations.

Some Examples of Differentiated Mutual Funds

These are not your everyday benchmarked mutual fund. They generally do not use any internal or external leverage, are liquid, and as such are "hedge funds off steroids".

1. An absolute return credit fund, which invests in performing high yield bonds, bank debt, debtor in possession (DIP) and other financing, and some bankruptcies.
2. A global macro fund, that varies its debt and equity exposures and is currently long equities and short some fixed income.
3. Another conservative macro strategy focused on long and short fixed income and currencies.
4. A relative value fund, run by a former hedge fund analyst, which invests in capital structure arbitrage, convertible arbitrage and pairs trading. There is also a small directional credit element.
5. A managed futures fund, focusing on short-term trend, longer-term trend, and counter-trend strategies.
6. An opportunistic absolute return fixed-income fund, run by another former hedge fund manager who invests everywhere in the corporate capital structure, both long and short.
7. A quantitative relative value fund focusing on merger arbitrage, convertible arbitrage and similar strategies.
8. An absolute return long-only equity manager, who runs a concentrated portfolio of beaten-up, unloved names, who will occasionally buy debt, and does not care about benchmarks.

Interestingly, the one area where we have yet to see opportunity is in equity long-short or "market-neutral", although some funds do exist.

Portfolio Construction Issues

Many studies advocate adding hedge funds to traditional portfolios in order to improve the overall risk-reward profile. This argument is misleading, at least with regards to its implied exclusive nature. Any asset class with a differentiated positive return stream will provide diversification, be it merger arbitrage, or an investible index linked to the returns of 19th century rare stamps.

Good alternative mutual funds should also diversify traditional portfolios, especially in the current low-rate environment. We are comfortable placing a larger allocation of client portfolios in these funds, relative to how we would size hedge fund positions. Some of the more conservative allocations replace traditional bond positions.

We evaluate every alternative mutual fund from a risk perspective, and allocate according to either fixed-income or equity-type risk buckets, from a volatility perspective. Thereby we extend the typical 60:40 or 70:30 models to include more asset classes and exposures.

Summary

Talent is where you find it, and there are some interesting managers running absolute return mutual funds. While not all may eventually live up to expectations, all do provide daily liquidity. No need to worry about annual redemption deadlines or liquidity gates, as per hedge funds.

The rout of 2008 proved that the allure of healthy incentive fees did not prevent many hedge funds from losing large sums of investor capital. Some of the culprits were in sectors where mutual funds may not invest owing to high leverage or illiquidity. We are not advocating abandoning investing in hedge funds; rather one may consider exercising a higher standard of scrutiny for incentive-fee based partnerships. Moreover, while we are yet to witness a wave of outstanding hedge fund-style mutual funds, there are now enough good managers and interesting strategies to diversify a traditional long-only portfolio.

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