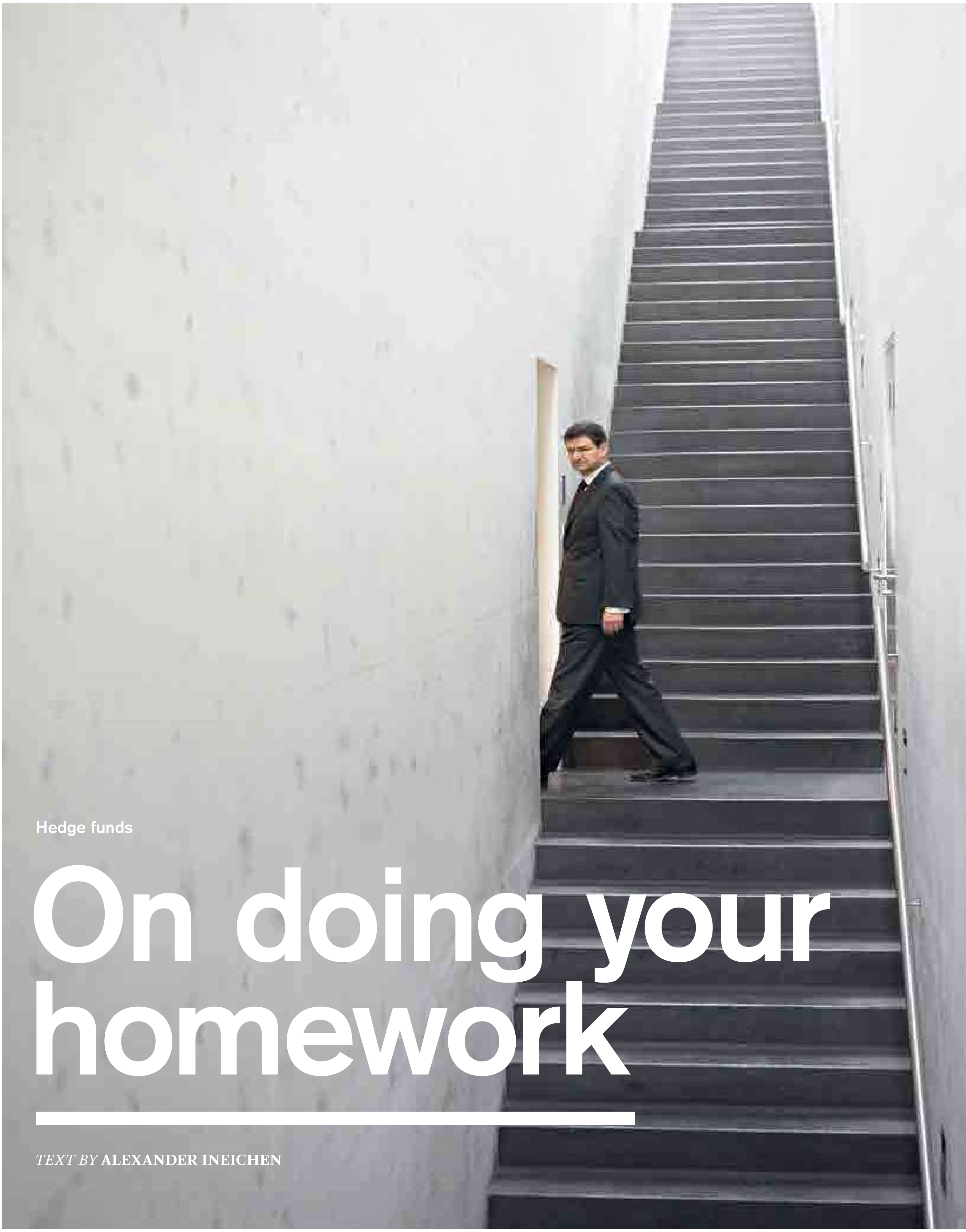

Hedge funds

On doing your homework

TEXT BY **ALEXANDER INEICHEN**

Photo: Gerry Amstutz

Recent skeptical reports in the press about hedge funds, and a high-profile divestment or two, have prompted speculation that hedge fund returns are in “structural” decline. Not so fast, says Alexander Ineichen. For investors willing to get off the couch, a careful study of hedge funds shows that they actually deliver higher-end returns than US equities do, with less volatility.

Many seasoned investment professionals argue that liquidity is an illusion. It is something you think you have, and can measure in good times, but it vanishes immediately during a perfect storm. It is a bit like your path toward the emergency exit in a concert hall: under normal circumstances you can run toward the exit within seconds; when fire breaks out, you cannot. Liquidity is something everyone seems to require at the same time. The financial crisis of 2008 is a good example. Markets literally disappeared for a while. So-called market makers would delete their prices on their screens and not pick up the phone, even in markets that were considered liquid prior to the market disturbance. Another example is the more recent decision by the Swiss National Bank to drop its quasi-peg to the euro in January 2015. For a short time, the foreign exchange market – considered as the most liquid market in the world – stopped functioning properly.

Hedge funds – a “quasi-liquid,” superior return profile

In his 2000 book “Pioneering Portfolio Management”, David Swenson, the CIO of Yale University’s endowment fund, distinguishes between liquid and illiquid. But, for hedge funds, he creates something in between that he calls “quasi-liquid.” This is a very elegant turn of phrase. Hedge funds are indeed not as liquid as US large-cap stocks, but are also not as illiquid as, say, private equity or real estate.

In the last couple of years the gloss has come off hedge funds. Earlier, the high returns had turned a niche product into a flourishing industry. For example, an investment of USD 100 in the S&P 500 Index at the beginning of 2000 was at USD 89 (–11%) five years later, including full reinvestment of the dividends. The same investment of USD 100 in an average hedge fund portfolio, after all the fees everyone complains about, stood at USD 141 (+41%) five years later. This is a big difference.

Hedge funds did well in the second part of the last decade too. In the five years to December 2009, a long-only investment in the S&P 500 went from USD 100 to USD 102 (+2%), whereas an investment >

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of USD 100 in the average hedge fund portfolio went to USD 132 (+32%). This is still a big difference, but it had gotten smaller. In the five years to December 2014, a USD 100 investment in US equities more than doubled to USD 205 (+105%). However, USD 100 in the average hedge funds portfolio "only" rose to USD 125 (+25%). As an investor, which sequence do you prefer: –11%/+2%/+105% or +41%/+32%/+25%? The second sequence is superior in two ways: higher-end return with less volatility. I like to think of the first sequence of returns as "nature." That is what you get if you do not apply risk management: moderate overall return with high volatility. Hedge funds can improve this sequence with active risk management. The second sequence does not appear in nature, it is man-made. Hence the fees.

Challenges big and small

The biggest challenges hedge funds face today are linked to the smaller managers. First, they find it very difficult to raise capital because the financial crisis and the Madoff incident caused private investors to more or less disappear. They are coming back only very slowly. This means the main source of capital comes from institutional investors who have a more sophisticated decision-making process. They expect a hedge fund to have at least USD 100–150 million under management and three years of proven real returns. Furthermore, institutional investors conduct due diligence with their managers, because a lack of it was one of the sources of disappointment in 2008. Institutional investors also expect various layers of operational excellence, adding to the cost base of hedge fund operators. This means that the barriers for smaller, less-established managers have risen. Finally, regulation has intensified. Large hedge funds can deal with the added bureaucracy more efficiently than smaller managers.

But large hedge funds also face challenges, and one of them is related to regulation. The financial crisis, and the regulation wrath that it triggered, resulted in investment banks downsizing their trading operations. Liquidity in many markets went down. Because of the winner-takes-all effect that resulted in large hedge funds getting larger and larger, these growing hedge funds see dwindling liquidity as a challenge. A less liquid market means diminished opportunity and is more prone to gap risk.

Are hedge funds a good/bad investment?

I always recommended to everyone willing to listen that they move up the learning curve with respect to risk management, absolute returns and hedge funds. Knowledge beats ignorance every time. An educated investment is better than an uneducated investment. And education compounds. At the end of the day, an investment decision is binary: either a position is established or it is not. This means the various trade-offs, the pros and cons, need to be carefully weighed against each other. This requires an effort, i.e. learning. Whether a nice chap recommends hedge funds is not that relevant for most investors. An investor needs to reach a level of comfort before investing, and a conviction once acquired requires ongoing reconfirmation. Both are a function of learning and effort.

The late Peter Bernstein, author of one of the best books on the history of risk, once wrote that "liquidity is a function of laziness." What he meant is that liquidity is an inverse function of the amount of research required to understand the characteristics of an investment. As he put it: "The less research we are required to perform, the more liquid the instrument." An investment in US Treasuries requires less research than an investment in US equities. An investment in US equities requires less research than an investment in hedge funds and so forth. In sum, hedge funds are not for the lazy.

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Why I want hedge funds in my portfolio

Hedge funds originally marketed themselves as absolute return products that deliver positive performance in any market environment. Now, in the wake of the financial crisis, hedge funds focus on their diversification benefits and risk-adjusted performance. A portfolio of hedge funds does not obviate any alternative or "classical" way of portfolio construction. However, hedge funds have properties that you do not find in other areas of finance. For example, trend-following managers have had a positive return in 17 out of 19 major corrections in the equity market since 1980. This is unique. There is nothing else in finance that has such favorable correlation characteristics. Among other asset classes, measured low correlation more often than not turns into an illusion when it is most needed, somewhat akin to perceived liquidity.

Over the last decade or so, the conceptual arguments for investing in hedge funds have not changed much. However, the market place has changed. For example: hedge funds as a group are larger; the largest funds are larger; some trades are more crowded; liquidity in some market areas is lower due to Dodd-Frank; yields are lower and IT is more important. But again, conceptually, an intelligently structured portfolio comprising independent returns and cash flows is as worth considering by every thoughtful and diligent investor as it was in 1949, when the first hedge fund was launched. If you know the future, invest in what goes up the most. If you do not, construct a portfolio where the source of returns and cash flows are well balanced and the risk is actively managed, while not forgetting that perceived liquidity can turn into an illusion. ●