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The Long and Short of Hedge Funds

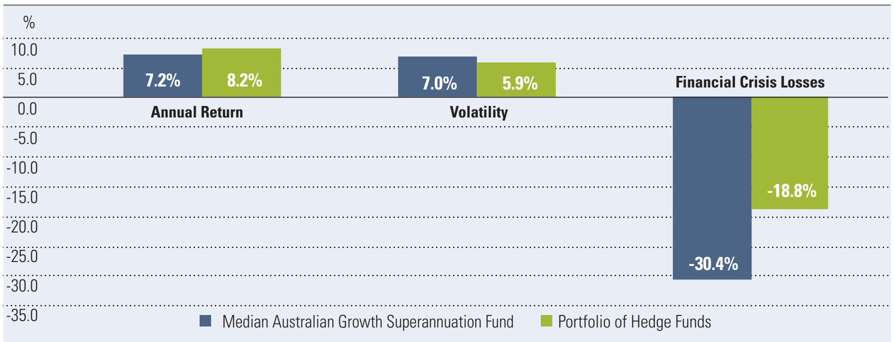
Craig Stanford
Head of Hedge Funds

Investing in hedge funds is one of the more polarising topics in the investment world. There are strongly-held views at each end of the spectrum, with little in-between. The advocates of hedge fund investing paint a rosy picture without acknowledging the negative aspects, while the critics paint the opposing view without acknowledging the potential benefits. In this Ibbotson Insight, Ibbotson Associates Australia Head of Hedge Funds Craig Stanford highlights the potential benefits and addresses some common concerns about investing in hedge funds.

As active hedge fund investors, we regularly have to address issues such as alignment of interests, higher fees, less liquidity, less transparency, and implementation. However, we know that if we can manage these issues successfully, we're able to take advantage of the associated benefits, which include improved portfolio risk/return characteristics, a reduction in the severity and frequency of losses, as well as access to new and otherwise unavailable return streams.

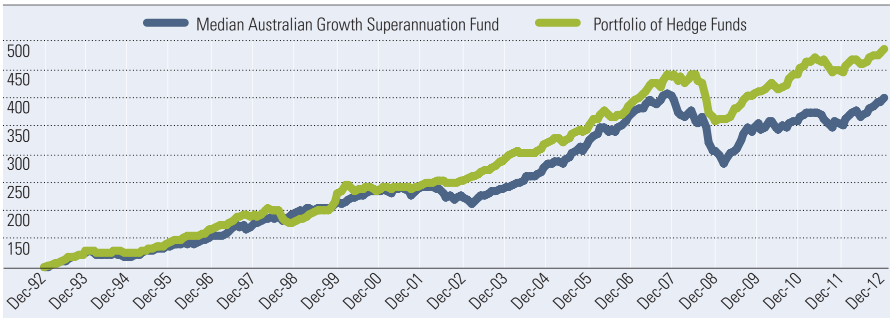
The accompanying graphs show a range of these benefits, by comparing various performance metrics for a typical portfolio of hedge funds to the median Australian growth superannuation fund over the last 20 years. The portfolio of hedge funds is represented by the HFRI Fund of Fund Composite Index, hedged into Australian dollars. This should be a fair representation of most investors' experience, because it includes all fees and eliminates some of the bias in other indices.

Figure 1. Returns, Volatility, Maximum Losses During Global Financial Crisis for Portfolio of Hedge Funds and Median Australian Growth Superannuation Fund, 31 December 1992 – 31 December 2012.



Sources: Morningstar Australian Superannuation Survey, Hedge Fund Research, Inc., Ibbotson Associates Australia.

Figure 2. Value of A$100 Invested in Portfolio of Hedge Funds and Median Australian Growth Superannuation Fund, 31 December 1992 – 31 December 2012.

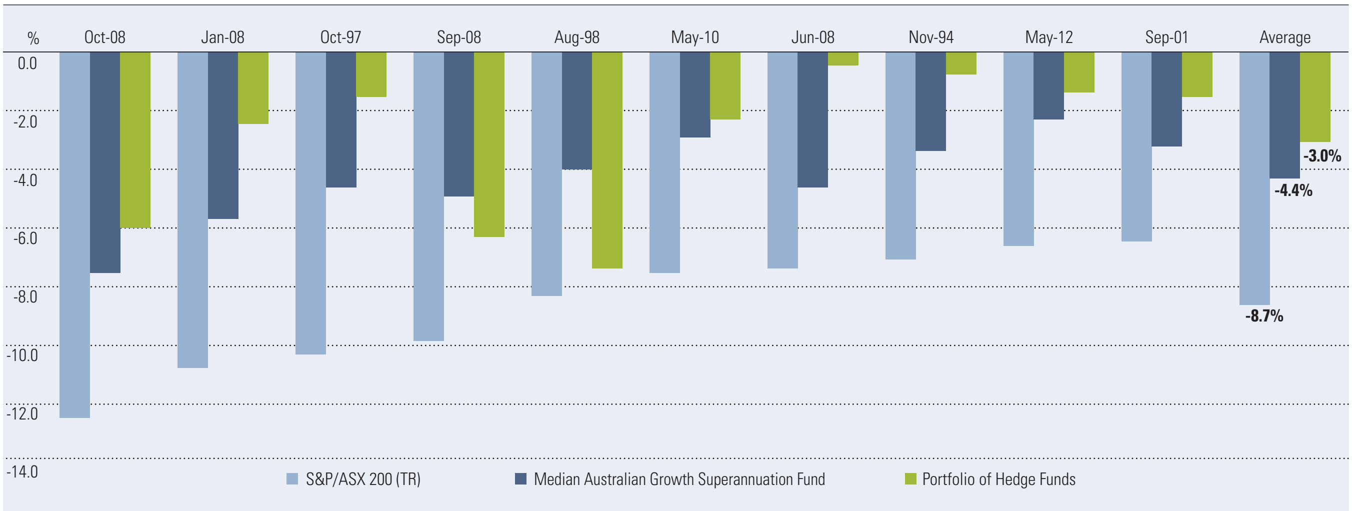


Sources: Morningstar Australian Superannuation Survey, Hedge Fund Research, Inc., Ibbotson Associates Australia.

The median Australian growth superannuation fund is taken from the Morningstar® Australian Superannuation Survey – Multisector Growth universe, and draws on all funds in the survey which have a history dating back to 31 December 1992, a universe of 12 underlying funds.

Figure 1 shows that over this period, the return from the portfolio of hedge funds has been one percent per annum higher (8.20 percent compared to 7.20 percent), with a volatility level one percent lower than that of the median superfund (5.90 percent compared to 7.0 percent). As Figure 1 shows, the median

Figure 3. Monthly Returns of Portfolio of Hedge Funds, Median Australian Growth Superannuation Fund, and S&P/ASX200 Total Return Index During 10 Worst Months of Sharemarket Performance over 20 Years to 31 December 2012.



Sources: Morningstar, Hedge Fund Research, Inc., Ibbotson Associates Australia.

superfund also sustained losses 50.0 percent greater during the recent financial crisis (-30.40 percent compared to the portfolio of hedge funds' -18.80 percent). As a result, the median superfund is still below its pre-crisis value, while the portfolio of hedge funds is well above its pre-crisis value (Figure 2).

An initial issue to address is the poor general perception of hedge funds. The press frequently portrays hedge funds as speculators that are determined to destabilise markets, and media accounts of hedge funds losing money are common. Our experience of investing in hedge funds is that these characterisations are inaccurate. This is not to deny that certain investors have experienced losses from investing in hedge funds. However, we believe that in most cases, these losses could have been avoided or contained with a well-structured due diligence and portfolio management process. This highlights the importance of due diligence, which we regard as a critical part of the investment process in order to avoid investing in hedge funds where there may be catastrophic trading losses or fraud.

In the following paragraphs we detail some of the potential benefits of investing in hedge funds, before addressing some of the common concerns.

Potential Benefits

Ability to Reduce Losses

One of the key benefits of investing in hedge funds is their ability to reduce losses during sharemarket selloffs. This is illustrated in Figure 3, which compares the performance of the median Australian growth superfund to a portfolio of hedge funds during the worst 10 months for the S&P/ASX200 Index over the 20 years to 31 December 2012. During these months, the portfolio of hedge funds lost an average of three percent, although the loss for the median superfund was almost 50.0 percent higher (-4.40 percent), and the loss from the sharemarket was almost three times higher (-8.70 percent). This improvement in downside protection is an important part of improving a portfolio's risk/return profile, and it's clear that hedge funds have been successful at reducing losses during sharemarket selloffs.

Capital Preservation

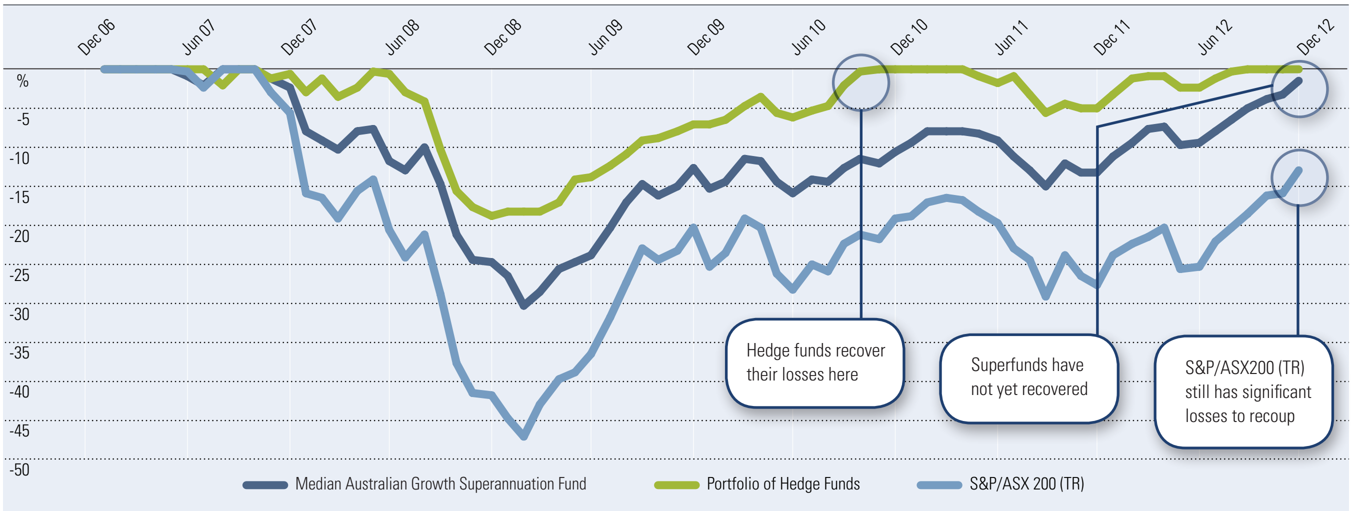
Hedge fund managers think about risk in terms of loss of capital, and actively manage risk to try and limit their losses. A traditional fund manager, by contrast, tends to think about risk in terms of performance deviation from a benchmark, and will generally lose as much as the market does in difficult times.

Figure 4 shows why we think investing in hedge funds makes sense from a capital preservation perspective. The graph shows the loss that each index experienced from 31 December 2006. This was the worst example of hedge fund losses that we could find, and shows that the hedge fund portfolio lost around 19.0 percent over a period when the median Australian growth superannuation fund lost over 30.0 percent and the Australian sharemarket fell more than 45.0 percent. The graph also shows that the portfolio of hedge funds recovered from its initial losses by November 2010, although by December 2012 neither the superfunds nor the ASX had fully-recovered their losses.

Diversification

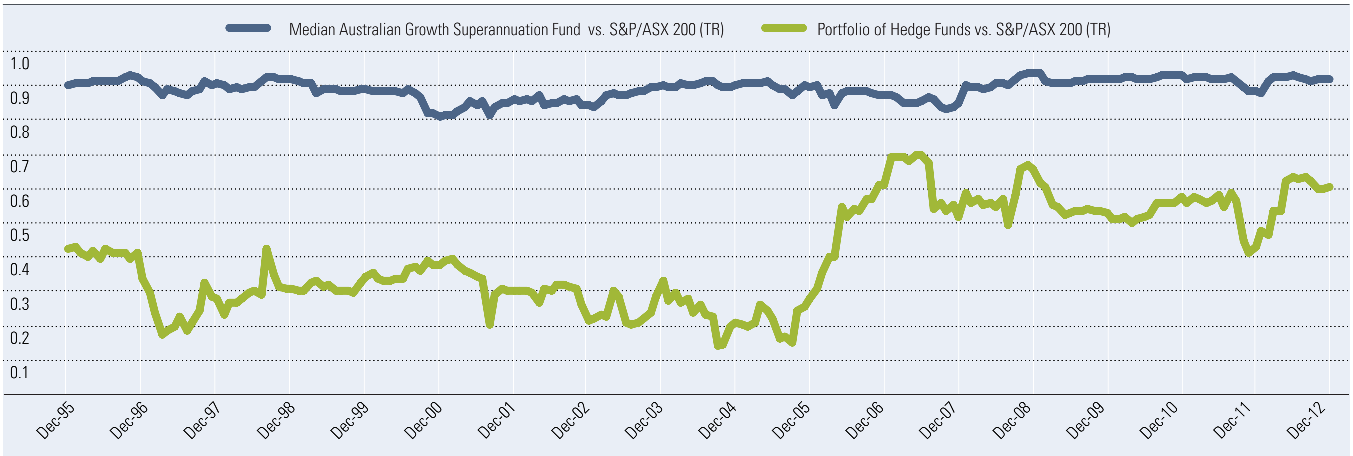
By reducing exposure to general market movements and only targeting specific risks, a hedge fund can produce a return stream that has a low level of correlation with, and a lower level of downside volatility than general risk assets like equities. This has valuable benefits in portfolio construction, and can lead to a more consistent return profile in a diversified portfolio. It pays to be careful when interpreting correlation statistics, because correlation is not the same as causation, but with this in mind Figure 5 shows a measure of correlation using a statistic called R^2. This is defined as the percentage of the movement in one index that can be explained by the movement in

Figure 4. Portfolio of Hedge Funds, Median Australian Growth Superannuation Fund, S&P/ASX200 Total Return Index, Losses from 31 December 2006 – 31 December 2012.



Sources: Morningstar, Hedge Fund Research, Inc., Ibbotson Associates Australia.

Figure 5. Rolling Three-Year R^2 Ratios for Portfolio of Hedge Funds and Median Australian Growth Superannuation Fund, Relative to S&P/ASX200 Total Return Index, 31 December 1995 – 31 December 2012.



Sources: Morningstar, Hedge Fund Research, Inc., Ibbotson Associates Australia.

another index. What Figure 5 shows is that approximately 90.0 percent of the variation in the returns of the median growth superfund can be explained by movements in the Australian sharemarket, whereas this only explains 60.0 percent of the variation in returns of the portfolio of hedge funds. The graph shows that the portfolio of hedge funds displays a variable and consistently lower R^2, while the typical growth superfund displays a consistently high R^2 relative to the ASX. The implication of this is that equities are a much stronger driver of returns for superfunds than is commonly appreciated, and that a portfolio of hedge funds can be a useful diversifier for a superannuation fund.

Targeted Risk-Taking

Another key advantage of hedge funds is the ability to target specific risks and hedge unwanted risks (in a similar manner to a person 'hedging their bets'). An example would be a hedge fund which holds a portfolio of favoured stocks but at the same time wants to protect the portfolio from a general fall in sharemarkets. This allows the hedge fund to target risk-taking to the areas where the manager's expertise is strongest.

New Return Streams

Hedge funds are also able to provide exposure to return streams that are generally not available from traditional funds. Hedge funds can invest in assets or strategies whose returns are driven by different factors to those that drive bond and equity returns. An example is investing in companies that are being liquidated, where the returns are driven by a fairly well-defined legal process. Another example would be having exposure to strategies that may require arbitrage or other relative value techniques beyond the reach of traditional funds.

Benchmark-Unaware

Hedge funds do not generally use index benchmarks, so the concept of tracking error does not constrain them as it does with a traditional manager. Being benchmark-unaware, hedge funds are free to invest in their best ideas and to avoid assets with a poor outlook. Contrast this with a traditional benchmark-aware fund which is compelled to hold overvalued assets that are part of the benchmark index.

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But Not All Are Equal

Notwithstanding the positive attributes just mentioned, we also believe that not all hedge funds are created equal, and we do not advocate investing in them simply for the sake of it. Although the hedge fund business attracts some of the most talented investment professionals, it also attracts a far greater number of less capable investors, and it is important to be able to differentiate between them. Because of this, the due diligence process for selecting hedge funds is typically a lengthy one, best left to experienced, competent professionals. Although the entire process is too complex to summarise in this paper, the following discussion outlines some of the most important factors to consider when undertaking due diligence on a potential hedge fund investment.

The first is an understanding of the hedge fund manager's advantage, expertise, and ability. It's important to be able to understand why a particular manager is able to execute a strategy better than competitors, and determine how durable any advantage may be.

Another key factor is integrity, probably best summarised by Warren Buffett when he commented: "Somebody once said that in looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if you don't have the first, the other two will kill you. You think about it; it's true. If you hire somebody without (integrity), you really want them to be dumb and lazy."

Alignment of interests is also important. Hedge funds generally charge a performance fee, which allows the manager to earn a significant percentage of any gains without having to give back a similar percentage of any losses. This asymmetric fee structure means that there is always the risk that the manager may be tempted to act in their own best interests, instead of those of the investor. Among other factors, we like to see a significant co-investment from a manager to give us some comfort on this point.

A final key aspect of hedge fund assessment is operational capability. A number of hedge fund failures can be traced to deficiencies on the operational side of the business, so an institutional-grade infrastructure and competence in operational due diligence are critical to helping minimise this risk.

Potential Hurdles

No discussion of hedge fund investing would be complete without an analysis of the potential hurdles. In the following paragraphs, we outline some of the common constraints and how we address them.

Fees

The high fees charged by hedge funds are often cited as a reason not to use them, to the point where the risk-adjusted returns after fees are not even considered. Although we agree that fees matter, we think that this narrow view is a mistake. Because the goal is to improve risk-adjusted returns, we try to avoid looking at fees in isolation, and instead gauge the level of cost in relation to the expected value that the investment might add.

This leads us to conclude that there are a small number of hedge funds that are worth paying higher fees for, although we also recognise that the vast majority will not generate returns that justify their higher fees. As an example, it's worth considering the relationship between fees paid and value added by traditional investment managers. Many studies have shown that equity managers as a group tend to underperform their benchmark on an after-fee basis, so that any value added tends to be offset by the investment manager's fees.
What this means for the investor is that the fees paid exceed the amount of value added. Contrast this to a good hedge fund where the fees, although higher, only consume a portion of the value added, and the ratio of fees to value added is far more favourable for the investor.
(A good source of discussion for this topic is 'The ABCs of Hedge Funds: Alphas, Betas, and Costs', published by current and former Ibbotson/Morningstar Investment Management staff Peng Chen, Roger G. Ibbotson, and Kevin X. Xhu in *Financial Analysts Journal* 67, No. 1, January 2011.)

Because the goal is to improve risk-adjusted returns, we try to avoid looking at fees in isolation, and instead gauge the level of cost in relation to the expected value that the investment might add.

We don't think that paying higher fees is necessarily a bad idea if it results in a better investment outcome (higher net returns), and it makes little sense to make fee minimisation the focus of an investment program at the expense of a good investment outcome – what seems cheap initially could be very expensive in the long run.

Liquidity

There are two aspects to liquidity worth considering. The first is the liquidity offered through a fund's normal redemption cycle. The second and more problematic aspect is the ability or willingness of a fund to abide by its normal redemption terms during stress environments such as 2008.

We don't think of the normal redemption terms as a constraint, since they're known in advance and can generally be planned for, although we expect to earn a return premium for the lower level of liquidity. In any case, the majority of investments in diversified portfolios offer daily liquidity, so having a small portion that offers monthly or quarterly liquidity should have little noticeable impact on total portfolio liquidity.

The second aspect, however, of not abiding by the normal redemption terms is a concern, and was extremely poorly-handled by a number of hedge funds in 2008 when they used various methods to prevent clients from redeeming. To manage this risk, we compare the redemption terms of each hedge fund to the liquidity of its underlying investments and ensure that these are appropriate. We also consider the liquidity of each fund as well as the whole portfolio during both normal and stress environments, to ensure that this is kept at an appropriate level relative to the liquidity that we offer to our investors.

Transparency

Portfolio transparency can be considered on a number of levels, but the key for most investors is the need to understand how the fund's portfolio is constructed, and what it contains.

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Interestingly, despite some investors' negative experiences, we have not found transparency to be an issue. Most hedge fund managers we have encountered are comfortable discussing their portfolio and distributing useful summaries of the portfolio's salient features on a regular basis. This information can also be cross-referenced with the fund's audited accounts and administrator.

One touted solution to the transparency issue is the use of separately managed accounts (SMAs), although we believe that these come with both advantages and disadvantages. Use of an SMA gives an investor greater security, because the investor owns the underlying assets directly and appoints an investment manager to manage the assets on their behalf. Contrast this with a traditional co-mingled structure where the investor owns units, along with other investors, in a vehicle over which the investment manager has far greater control. One of the key disadvantages we find with SMAs is that the better managers do not offer them, so the choice of funds will be curtailed and the performance outcome could be affected.

Implementation

This is absolutely critical to a good outcome, but is also an area where we have seen corners cut which have resulted in a poor outcome. An unfortunate by-product is that hedge funds are often blamed for the poor outcome, when it was really the investor's implementation that was flawed.

An example would be when constraints were placed on the investor so that their investable universe was severely curtailed from the outset. This could include using inexperienced staff instead of experienced hedge fund professionals to implement the hedge fund program, along with unrealistically low limits on fees and liquidity. While this may seem like a good idea, it can limit the number and quality of hedge funds available for investment. Under these conditions, it's not that surprising that the outcome was less than ideal, but it is not correct to blame that outcome on hedge funds, as it had more to do with poor implementation.

Experience tells us that the better hedge funds do not offer daily liquidity and do not have the lowest fees. Some lower their fees and offer daily liquidity to raise assets, but finding a great fund with low fees and daily liquidity is rare. Another example would include using leverage to invest in the underlying hedge funds. This was particularly popular in Australia, but investors seemed to forget that leverage can increase losses as well as profits. Perhaps an even more important lesson is that when leverage and illiquid assets are combined, the outcome can be disastrous. Once again, it would be incorrect to blame this outcome on hedge funds – this was a simple case of poor implementation.

When considering an investment in hedge funds, it's important to use suitably-qualified personnel and to have realistic fee and liquidity budgets. The majority of investors do not have these resources and are best advised to draw on the services of an experienced external provider.

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High Investor Losses

A perceived high level of investor losses due to poor trading or fraud is sometimes seen as a reason to avoid hedge funds, but in our experience both are rare. This is not to say that losses and frauds don't happen – they do, but it seems that there have been a small number of highly-publicised cases that are poorly-understood.

In the case of hedge fund frauds, there were often a number of red flags which were ignored, or exceptions to the due diligence process were made. The best defence against a fraudulent fund, as we have alluded to previously, is a strong due diligence process implemented by experienced professional investors.

Experiencing trading losses is an unavoidable part of investing, and George Soros perhaps put it best when he said: "It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong." At Ibbotson we accept that we have to be able to stomach occasional trading losses, but we try to avoid a permanent impairment of capital. For this reason, it's important to understand how each hedge fund manager thinks about and manages risk, in order to gauge how much they may lose if they're wrong.

In any case, most of the commonly-mentioned examples of hedge fund losses should not have unduly affected a diversified portfolio, and a proper due diligence and portfolio management process should have enabled an investor to avoid or contain these losses.

How Much Should Be Invested?

The question of how much of a portfolio should be invested in hedge funds depends on the specifics of each situation, in particular the initial structure of the portfolio as well as the investor's goals and competing opportunities. It's worth repeating that we don't recommend an allocation to hedge funds for the sake of it, and similarly, are not advocates of large allocations to hedge fund replication strategies. We have spent a lot of time and effort building a portfolio of hedge funds that complements diversified portfolios and provides exposure that we expect to be both additive to returns and diversifying. That said, for most portfolios, we think it makes sense to start with an allocation of between five and 20.0 percent.

Conclusion

The aim of this Ibbotson Insight was to illustrate the rationale for allocating capital to a carefully-chosen portfolio of hedge funds.

One of the key tenets of our investment philosophy is that generating and preserving wealth over time depends on the ability to compound wealth steadily and avoid large losses. With this in mind, we think that it makes sense to allocate capital to hedge funds that are active risk managers with the ability to protect capital in negative market environments. From a portfolio construction sense, it also helps if the hedge fund's returns are driven by factors that are different to the drivers of return in most diversified portfolios – in particular, traditional equities and fixed income investments.

We think that investing in a carefully-chosen portfolio of hedge funds will result in more attractive risk-adjusted returns. We also think that an unconstrained approach which allows the broadest opportunity set to be considered is best. Operational due diligence is paramount, and the return after fees is more important than the fees themselves. Hedge fund programs implemented on this basis have yielded superior results to the median Australian growth superannuation fund, and we believe should be a serious consideration for any diversified portfolio that aims to generate superior risk-adjusted returns over the long term. i

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ibbotson
a Morningstar company

Level 36, Australia Square
264 George Street
Sydney NSW 2000

Locked Bag 25
Royal Exchange
Sydney NSW 1225

Tel: +61 2 9276 4550
Fax: +61 2 9276 4545
AUDistribution@ibbotson.com

www.ibbotson.com.au