

# The Future of Hedge funds in an Advisory Context

Stephen Brawn.

This brief paper sets out to address the issue of hedge funds and how they fit into the current investment universe, to dispel a few market myths, and to put a personal perspective on their relevance to institutional investors, pension funds, wealth managers, and their advisers.

## So, what are hedge funds?

The spectrum of the alternative investment arena is very broad indeed, typically encompassing all investment strategies beyond traditional bond and equity investments. The term 'hedge fund' is somewhat inappropriate as it was originally based on the ability to hedge, or reduce risk; in adverse down moves in the broader equity market using short positions. Nowadays many strategies have emerged where that description is perhaps not appropriate, but is still the term of choice.

Hedge funds and their managers do make investments in assets that can be invested in by traditional long only funds but also in what might be described as 'alternative' assets like volatility and commodities. It is the manner in which hedge funds invest and the instruments used amongst other things, which typically set hedge funds apart from their less complicated cousins.

## Why invest in hedge funds?

Traditional investment portfolios, mutual funds, stocks, and bonds, demonstrate traditional risks, with their returns reflecting a high degree of correlation with the underlying markets in which they invest.

Hedge funds use a large variety of different financial instruments and products that dramatically increase investment opportunities. Well-chosen hedge funds typically offer less correlated sources of return that are independent of traditional asset classes, and are driven by absolute, not relative, performance. It is fair therefore to consider that well-chosen hedge funds are complimentary to traditional investment portfolios.

Market professionals and research papers from numerous sources verify that the addition of hedge funds to a traditional investment portfolio dramatically improves the risk/return balance reflected in volatility of returns, and as judged by various mathematical measures, including the value at risk (VAR), and the Sharpe Ratio.

*Edhec Business School performed research (December 2005) based on the effect of adding hedge funds to an optimal pension portfolio consisting of equities and bonds. The school found that the probability of a 25% shortfall (assets versus liabilities) decreased by 27% by allocating just 12% to hedge funds on a time horizon of 10 years.*

*What the salesperson won't know to tell you:* It is worth noting that although hedge funds are sold on the manager's ability to produce absolute returns, in reality only

Europe's least popular and misunderstood investment style, managed futures, achieve a particularly low correlation with the underlying assets that are traded.

In essence a hedge fund's return consists of both beta and alpha components. On average around half the return is derived from traditional beta (Gehin and Vaissie 2006) and varies by investment strategy. Not surprisingly managed futures or CTA funds have the lowest proportion of returns from beta and long/short Equity the highest. The alpha returns being the total of hedge fund beta (returns from non-traditional sources like volatility) plus pure alpha generated from the managers skill.

### **Hedge funds have had bad press, is it justified?**

Thorough due diligence and a detailed understanding of the hedge fund arena eliminates many risks, as with any other investment process.

Unlike traditional funds, the hedge fund industry derives most revenue via performance fees, and therefore earns far less during periods of poor performance. Traditional asset managers typically earn the same fees regardless of performance and have little financial incentive to consistently make money.

The following text is extracted from the government's Myners report in 2001 'Institutional Investment in the United Kingdom A Review'

*"Hedge funds tend to target significantly higher returns than funds managed in a more conventional manner"*

Many investors have avoided investing in hedge funds because they are concerned with making large losses. In the past few years in fact, hedge funds have typically outperformed both equities and bonds with lower volatility. One of the key reasons for investing in hedge funds is to preserve capital, particularly when the markets are difficult for traditional assets.

*"There has been limited understanding of the different styles of hedge funds and the risk diversification and return enhancement potential they can provide"*

The typical pay structure of hedge funds and the perceived lack of transparency to outside parties make the hedge fund industry an easy target to fill newspaper column inches. The lack of expertise in the media only enables commentators to create impact headlines without ever having to address the underlying issues.

### **Hedge fund portfolios, does size matter?**

Many large funds of fund providers have adapted their own corporate structure to suit the requirements of advisers and their institutional clients. The size of assets under management in many cases has become highly restrictive. They are forced to look at larger single strategy managers and often ignore the 70% or so of funds with assets under \$1 billion, compromising portfolio returns in the process.

*Inevitably the bigger funds of fund returns simply mimic those of hedge fund indices but at a higher price to the investor.*

Those market practitioners that choose not to adopt a 'junior scout' structure using inexperienced researchers so often favoured by large multi-manager funds, are typically more able to find good funds with the potential to be successful over a sustained peak period of perhaps two to five years, during their 'emerging' phase.

Numerous studies have indicated that larger more established fund managers tend to generate lower returns than new funds which may have an 'edge' over the peer group for the first few years of operation. Equally allocation of capital to some unique strategy at a large fund may well have little impact on the return of a large portfolio. Emerging fund managers are normally highly motivated to generate good returns simply to earn a living from a much smaller asset base, at the same time as managing a start-up business.

From a fund of hedge fund perspective when looking at costs, it is not surprising that the younger funds are often overlooked. Staffing issues aside, the cost of fully researching a single fund has been estimated at around \$50,000 and is difficult to justify when it will only result in a relatively modest allocation.

A single manager fund with a larger asset base is forced to deploy capital regardless of the cost to alpha generation. The agility of a large fund is often decreased too, with the strategy often being both transparent to direct competitors, and obvious to the liquidity providers in the market.

Experience tells us that investing in funds with large assets under management does not necessarily offer greater capital protection than investing in their smaller neighbours or a greater return on invested capital.

### **Hedge Fund Selection**

The most important part of creating a hedge fund portfolio is the avoidance of poor manager selection, a qualitative process best performed by those with appropriate market experience. Unlike investing in traditional funds and assets, the dispersion of performance in the hedge fund world is quite high and getting higher, so fund selection is particularly critical.

The Myners report refers directly to the importance of fund selection:

*"Investment in one or more hedge funds (or a carefully constructed fund of funds) can therefore generate superior risk-adjusted returns, which are uncorrelated with the remainder of a typical institutional investors portfolio. However, the selection of funds is crucial, and must take place on the basis of careful research"*

Market note: Edhec Business School's European Alternative Diversification Practices Survey (2005), when referring to the largest publicised hedge fund failures stated:

*"In 8 out of 10 cases, operational weaknesses are the root cause of the failure or have prevented a fund from managing a crisis situation appropriately in an unexpected financial context"*

The process of selection typically consists of quantitative filtering and qualitative selection by interview. It is easy to over emphasise the quantitative aspect simply

because it is the least time consuming, and has no barrier to entry. It can be achieved by buying into a readily available database where the quality of the data is not guaranteed and not particularly meaningful. There are currently over seven thousand funds and a myriad of strategies.

In reality there is no replacement for direct contact with fund managers where a more detailed assessment of the risks can take place, with most managers uninterested in meeting unless it potentially results in a suitable allocation.

Many commentators suggest that the hedge fund industry has grown too quickly creating capacity issues that in turn have reduced the hedge fund returns reflected in various indices like HFR, Tremont, and Edhec. In 2000 it was estimated by various sources that some £300 billion was held in hedge fund assets that has since more than trebled and heading towards £1 trillion. There is however little empirical evidence to suggest that capacity issues are currently big enough to present a real threat to the hedge fund industry. The fact that hedge fund returns are on average lower is a function of several unrelated issues.

In 1990 a typical hedge fund was a macro style proprietary trading vehicle that basically took long and short positions in highly liquid markets and instruments. The core skill of the hedge fund manager was that of market timing, i.e. gauging when to enter and exit from a position in an asset, and managing the market risk. The returns were correlated to market opportunity; i.e. sustained market trends, distinct over valuation of an asset, distinct undervaluation of an asset, and market volatility.

Today macro funds account for a much smaller slice of the hedge fund universe, perhaps only 10% of assets, which is reflected in the risk/return profile of the industry as a whole. Notwithstanding this, two thirds of hedge funds are still broadly directional, regardless of the underlying asset class. These funds rely on markets trending with a reasonable degree of volatility.

*The requirement for some volatility is particularly obvious as higher volatility implies an increased chance of a making more money (from the correct decision) using the same amount of capital.*

Since the summer of 2003 the S&P market volatility as measured by the CBOE VIX contract has dropped from a peak of around 40% to a current level of just over 10%. A manifestation of a perceived drop in financial market risk by market participants, which is reflected in other assets like, fixed income, credit, and foreign exchange.

The new 'styles' of funds to emerge in the past few years like asset backed lending, and structured credit amongst others, are less reliant on pure directional trading. They can generate low volatility return profiles that attract institutional investors and portfolio managers, but have contributed to a downward drift in the average returns of the industry. They are however, not without their own unique risks.

As the hedge fund universe grows the process of selection becomes increasingly important and much more complicated, moving out of reach of the traditional fund manager into the hands of specialist providers.

## **Hedge Funds in Wealth Management versus Institutional Investment**

The original investors in hedge funds and the general providers of capital were wealthy individuals and offices that ran family money traditionally comfortable investing in equities.

Many well established wealth management firms also carry the baggage of having stock broking antecedents. This 'one track' equity investment model worked well during periods of strong equity markets, the shortcomings becoming only too clear from 2000 onwards when far less friendly conditions prevailed. The revolution in the development of electronic trading platforms has also undermined the traditional model where the price of execution between providers became transparent.

Hedge funds now form an established part of a product set offered by Wealth Management firms. The process of client facing within the industry is now more about giving advice than product provision and generation, the larger firms typically having product divisions responsible for their 'manufacture'.

New entrants in the wealth management field plus the more progressive incumbents have spearheaded expansion by offering a holistic approach to wealth management.

To be successful these firms will require the processes to make full use of a much larger universe of asset classes beyond the traditional bonds, equities, and cash, to include alternative fund products, hedge funds, and associated structured products.

It is not unusual to see alternative asset allocations up to 25% of a discretionary portfolio in private banks and family offices.

The minimum investment in a single strategy hedge fund varies but can as high as \$5million for some established funds and strategies; typical capital amounts required to create a well-balanced hedge fund portfolio are therefore substantial. A fund of hedge funds over comes many of these issues and typically have much smaller minimum investment thresholds, thus enabling investors to achieve a level of diversification that could not be achieved with the same capital outside the fund. Both private banks and wealth management companies have been the drivers in delivering such investment opportunities to their clients.

The successful integration of investment services and delivery processes has presented a major opportunity to external advisers and consultants. Also, given the uncertainty that currently exists within the Global economy and hence most asset classes, suiting those with legal or accounting expertise, where financial risk mitigation is one of, if not the, primary driver.

As investing in hedge funds has become more widespread institutions and pension funds have played a more important role both in dictating the type of funds that receive capital, encouraging banks and investment firms to create cost efficient structures to meet their demands.

In the Edhec (2005) Institutional Investor Survey 51% of European institutions already used hedge funds in their portfolios, with only 3% firmly opposed to adding

them in the near future. For those invested, hedge funds accounting for around 7% of their overall portfolios.

Such surveys perhaps give the impression that a high degree of expertise and comfort exists within the institutional investment community, but in fact on further examination these numbers flatter. In the same survey it is clear that many are not aware of the risks they are exposed to by investing in hedge fund strategies with some 15% of institutions acknowledging this fact, and some 25% refusing to commit on their own risk management ability.

*When European institutions were asked “In the area of risk, do you consider that you are capable of carrying out risk analysis on the investments independently from that provided by your manager?” Only 29% answered yes.*

A full 71% of European institutions surveyed did not feel capable of assessing risk of hedge fund portfolios and yet over half of them still invested, one hopes with the help of external specialist advisers.

It is important for institutional investors to understand that tools used to analyse traditional asset portfolios exhibiting linear returns, are simply not applicable to the non-linear hedge fund universe. The return profile of a hedge fund portfolio is naturally a function of the various assets and instruments traded at manager level and therefore likely to be outside the skill set of traditional asset managers.

The current trend in the institutional arena, not so much in wealth management because of the scale required to be viable, is the separation of alpha and beta generating streams using derivatives. This structuring of ‘portable alpha’ portfolios makes sense for larger investors and asset/liability managers where a distinction between passive and active investing is required. The interest in this area is growing as institutions see it as a cost effective way of generating superior longer-term returns.

A primary level of understanding of strategies and tools to build alternative portfolios is simply not enough. Creating isolated multi-strategy hedge fund portfolios or bespoke portfolios to sit alongside specific weightings in traditional assets, requires specialist skills.

It is clear that the appetite to invest in hedge funds in Europe is often greater than the knowledge required within institutions to do so effectively. They have little choice but to seek external help, either by buying into the intellectual capital if they have the resources and framework to do so, or by retaining specialist advisers and consultants.

## Conclusion

Hedge funds and issues behind hedge fund investing have a far greater media profile than is perhaps justified purely from an allocation perspective. Depending on which assets are chosen as being traditional (and allowing for error) the money invested in hedge funds Globally accounts for anywhere between 2% and 5% of the traditional assets under management. It is not so much about the absolute size of assets in hedge funds therefore, as the rate of asset growth, the driver behind the success of many service providers.

A successful single manager hedge fund able to produce regular returns in the 10% to 15% per annum range for investors, will make a multiple of the fees charged by a traditional benchmarked fund running similar capital. So indeed fees available to service providers from hedge funds and other successful 'alternative' investment funds, are disproportionate when compared to the broader investment universe. Prime brokers, banks, lawyers, accountants, IT and compliance consultants, have all benefited in recent years because of the sustained growth.

One of the most relevant issues for all participants in the hedge fund arena of course is the sustainability of demand. Recent consulting reports in the USA show that institutional interest in hedge fund assets is likely to continue for some time with growth set to be very strong until at least 2010; I believe a valid assumption whilst the industry continues to evolve and generate attractive risk adjusted returns, and without capital saturation in the non-traditional asset classes.

Europe will continue to be a profitable arena for advisory firms offering a broad array of services and solutions to a fast growing client universe for many years. The environment is competitive with major players necessarily adding business units such as wealth management, and pension consulting, to complement existing services.

*Stephen Brawn is Principal of Locus Capital Consulting and also Head of Alternative Investments at Voltrex Limited, a City based financial services boutique. He advises trustees, family offices, and high net worth individuals, on hedge fund allocation and portfolio construction.*

*He left investment banking in 2002 as Executive Director of Sanwa International, where he was responsible for Global volatility trading. He graduated with an honours degree in Physics from London University in 1985 and with a Management Science Masters degree from Cranfield University in 1987.*