ACG Atlanta Consulting Group

ACG Insights: Hedge Funds

Introduction

Hedge funds have been grabbing headlines in recent years, and not necessarily in a good way. For the fifth straight year, 2019 experienced more hedge fund closures than launches[1]. Closures have come from newer, smaller funds that never really got traction in fundraising and from funds run by industry veterans like Louis Bacon and Jeffrey Vinik. What's causing this? It is primarily due to two factors: (1) investors have become impatient with hedge funds as they have, in general, underperformed equity markets since the global financial crisis (which will be discussed later in this piece), resulting in investors moving capital away from the space, and (2) the value proposition for hedge fund portfolio managers has changed as the industry has seen fee compression. With respect to point 2, it is no longer a sustainable notion for most hedge funds to charge investors the classic 2% management fee and 20% incentive fee. Investors have demanded lower fees, resulting in portfolio managers earning less income. For those managers who have already amassed significant wealth, they may be less inclined to continue answering to investors and some have chosen to return external capital in favor of continuing to solely manage their own wealth.

These closures are likely an overall positive for investors who want exposure to hedge funds. Lower average fees across the industry (although still higher than traditional asset classes) add to the investor's bottom line. Additionally, those portfolio managers who have shifted with the times do so because they want to continue managing capital and likely are very much engaged in the process, also good news for investors.

What is a hedge fund?

In short, hedge funds are the most unconstrained form of investing. They are not an asset class in and of themselves, but rather they can invest across asset classes – equities, debt, currencies, commodities, and rates using a range of financial instruments. They can invest long and short and many have the ability to use leverage. It is important to note that hedge funds are not monolithic investments, revealing the importance for investors to know the purpose of having hedge funds in a portfolio, and selecting the right hedge funds to serve that purpose.

[1] Source: Hedge Fund Research

Investors in hedge funds, due to their unconstrained nature and less regulation compared to a mutual fund, must meet minimum requirements to be considered an accredited investor. In the United States, to be considered an accredited investor as an individual, an investor must have a net worth of at least $1 million, not including the value of a primary residence, or they must have income of at least $200 thousand for each of the last two years with the expectation to earn the same in the current year. For institutional investors, an organization must have total investable assets in excess of $5 million.

What are the differentiating factors among hedge funds?

Broadly speaking, some of the characteristics that differentiate hedge funds from one another include whether the portfolio is constructed top down based on macroeconomic factors or bottom-up through security selection, the asset classes in which the portfolio manager invests, geographic exposure, market exposure – measured by long and short exposure and market beta (a measure of how exposed the portfolio is to moves in the market), and use of leverage.

As described below, there are four general categories of hedge funds, however there are many more sub-strategies within these broad categorizations.

Equity Long/Short

Equity long/short (or equity hedge) managers invest by buying stock of companies they believe are undervalued in the market and selling (or shorting) companies that they believe are overvalued by the market. Managers can vary their equity market beta over time and can adjust their net exposure over time, sometimes even positioning their portfolios net short.

Event Driven

Event driven investing is just as it sounds, portfolio managers are investing based on events they believe to be accretive to the value of a security. Some common sub-strategies within event driven include merger arbitrage, convertible arbitrage, and distressed credit. Multi-strategy event driven managers may employ various sub-strategies depending on the relative attractiveness of the opportunity set.

Relative Value

Relative value hedge funds trade securities in pairs based on the relative valuation between two companies, industries, or sectors. In most cases, relative value portfolio managers construct their portfolios to be market neutral. Typically, relative value managers employ more leverage than other hedge fund strategies in order to extract additional value from the spreads between the securities they are trading long and short.

Global Macro

Global Macro strategies employ a top-down approach to investing. Rather than choosing individual securities through fundamental analysis, portfolio managers take a view on the directionality of broad market moves. Global Macro portfolio managers can trade equities, fixed income, rates, currencies, and commodities through a discretionary or quantitative approach.

Why invest in hedge funds?

The primary reason to include hedge funds in a portfolio is to provide portfolio diversification. Hedge funds tend to have low correlation to traditional asset classes (equity and fixed income). The correlation matrix below shows the correlation between a number of different market indices and hedge fund indices.

Figure 1: Correlation Matrix (January 1, 2001 – September 30, 2019)[2]

	1	2	3	4	5	6	7	8	9	10
1 S&P 500	1.00	0.87	0.77	-0.11	0.67	0.03	0.65	0.85	0.76	0.60
2 MSCI EAFE	0.87	1.00	0.86	-0.01	0.70	0.24	0.73	0.89	0.80	0.67
3 MSCI Emerging Markets	0.77	0.86	1.00	0.04	0.71	0.20	0.74	0.89	0.80	0.64
4 BBgBarc US Aggregate Bond	-0.11	-0.01	0.04	1.00	0.19	0.68	-0.02	-0.09	-0.09	-0.07
5 ICE BofAML US High Yield	0.67	0.70	0.71	0.19	1.00	0.15	0.62	0.73	0.78	0.72
6 FTSE WGBI	0.03	0.24	0.20	0.68	0.15	1.00	0.04	0.06	0.02	0.04
7 HFRI FoF Diversified	0.65	0.73	0.74	-0.02	0.62	0.04	1.00	0.88	0.87	0.81
8 HFRI Equity Hedge	0.85	0.89	0.89	-0.09	0.73	0.06	0.88	1.00	0.92	0.79
9 HFRI Event-Driven	0.76	0.80	0.80	-0.09	0.78	0.02	0.87	0.92	1.00	0.91
10 HFRI ED: Distressed/Restructuring	0.60	0.67	0.64	-0.07	0.72	0.04	0.81	0.79	0.91	1.00

One potential benefit of diversification is lowering portfolio volatility relative to a portfolio of long-only equities and bonds. As shown in the table below, the absolute volatility for hedge funds is lower than that of equities and the Sharpe ratio (a measure of return per unit of risk) is higher for hedge funds than for equities. This combined with the low correlation to both equities and fixed income (as shown in Figure 1), results in overall lower portfolio volatility when hedge funds are added to a traditional equity and fixed income portfolio.

Figure 2: Risk/Return Characteristics (January 1, 2001 – September 30, 2019)[3]

	Return	Std Dev	Sharpe Ratio
1 S&P 500	6.5%	14.4%	0.34
2 MSCI EAFE	4.0%	16.5%	0.15
3 MSCI Emerging Markets	8.6%	21.5%	0.33
4 BBgBarc US Aggregate Bond	4.8%	3.4%	0.94
5 ICE BofAML US High Yield	7.6%	9.1%	0.66
6 FTSE WGBI	4.4%	6.7%	0.44
7 HFRI FoF Diversified	3.3%	4.5%	0.40
8 HFRI Equity Hedge	4.6%	7.7%	0.39
9 HFRI Event-Driven	6.3%	6.1%	0.78
10 HFRI ED: Distressed/Restructuring	7.1%	6.0%	0.92

A well-diversified portfolio may result in less severe portfolio drawdowns during times of market stress. As exhibited in Figure 3 below, hedge funds tend to have smaller and shorter drawdown periods relative to equity markets and relative to portfolios which consist solely of long-only equity and fixed income. This is due to the hedge funds' ability to go short, and thus have some parts of the portfolio that benefit in a negative market.

[2] Source: Morningstar Direct
[3] Source: Morningstar Direct

Figure 3: Drawdown Characteristics (January 1, 2001 – September 30, 2019)[4]

	Max Drawdown	Max Drawdown Valley Date	Max Drawdown Recovery # of Months
1 S&P 500	-51.0%	Feb-09	37
2 MSCI EAFE	-56.7%	Feb-09	64
3 MSCI Emerging Markets	-61.6%	Feb-09	101
7 HFRI FoF Diversified	-21.8%	Dec-08	62
8 HFRI Equity Hedge	-30.6%	Feb-09	24
9 HFRI Event-Driven	-24.8%	Feb-09	14
10 HFRI ED: Distressed/Restructuring	-27.4%	Mar-09	13

While hedge funds may provide positive diversification benefits which are typically most apparent during times of market stress, low correlation and low beta to equities can mean that hedge funds underperform in periods of strong market rallies like the past decade. When this happens, it's important to remember that hedge funds are not meant to exceed the market over the short term, but rather to provide portfolio diversification benefits over a full market cycle.

Risks of investing in hedge funds

While hedge funds have the potential to provide benefits to a portfolio, they also come with risks. Evaluating these risks is paramount when choosing a hedge fund in which to invest. This makes transparency provided by the managers vital. If a manager is reluctant to provide an investor with adequate levels of information about their strategy, risk management, portfolio exposures, etc., that should eliminate that fund from consideration.

Hedge funds' risk management practices should be disciplined and consistent. When evaluating a hedge fund, it is important to look at past examples where a portfolio manager bypassed any internal risk limits and what led to that decision. This could be a red flag for an undisciplined risk management process.

Hedge funds have the ability to invest in illiquid securities. Due to the unconstrained nature of hedge fund investing, they are not subject to the same liquidity rules as a mutual fund. This can work in investors' favor when the illiquid investments result in an illiquidity premium, adding to fund returns. Liquidity management is an important part of portfolio management in a hedge fund to ensure that if the fund faces redemptions from investors, the portfolio manager can meet these redemptions without having to sell investments at steep discounts, disadvantaging all investors. The first thing to consider when evaluating the liquidity profile of a hedge fund is to determine what liquidity is being offered to investors. Hedge funds allow investors to redeem their investments at set intervals from monthly to bi-annually or even longer in some cases. Some of these liquidity terms may be subject to investor level or fund level gates. Due diligence on liquidity should determine how the liquidity of the underlying investments matches with the capital that is available for redemption. For example, a manager that has bi-annual liquidity can invest more of their portfolio in illiquid or less liquid securities compared to a manager that offers investors monthly liquidity with no gates.

[4] Source: Morningstar Direct

Certain strategies can employ significant levels of leverage. There are different ways to lever a portfolio, the one we are concerned with here is when a portfolio manager uses a loan to invest more capital than he or she has received from investors. As mentioned previously, relative value strategies use pair trades to exploit a mispricing between two similar securities. Sometimes this mispricing spread is narrow and leverage can enhance the returns of each individual pairing. When the markets are behaving rationally and financing liquidity is readily available, this is not an issue. However, defaults can happen when portfolio performance is poor and liquidity is scarce. The most well-known collapse of a hedge fund that used significant leverage is Long Term Capital Management in 1998. When evaluating the leverage employed in a portfolio, understanding the terms managers have with their lenders and the fund's risk management processes is important. Is there potential for financing to be taken away quickly, causing significant issues for the management of the portfolio? Does the manager have stop losses that force them to systematically decrease risk and liquidate positions that are losing money? Is the amount of risk being taken through leverage worth the potential gains from using that leverage? These are all questions to be considered during the due diligence process.

Strategy drift is a third risk of investing in hedge funds. This is where ongoing monitoring of the hedge funds to which an investor has exposure is important. Given the flexibility hedge funds have to invest, at initial due diligence, the hedge fund may be chosen to serve a specific purpose in the portfolio, but over time the strategy may change and the risk profile and drivers of future returns may look very different than at initial investment. For example, an equity long-short hedge fund may have a historical average beta of 0.5 to the S&P 500, but if that low beta causes investors to become impatient during an historically long equity bull market (like the market since the global financial crisis), the portfolio manager may be tempted to increase beta exposure in order to capture more of the rising tide in the market. This may present more risk in the overall portfolio than originally intended. Other examples of style drift are a manager employing sub-strategies or investing in securities outside their area of expertise, increasing exposure to illiquid investments, or using more leverage.

Conclusion

The risks noted above are just a few of the risks that must be evaluated on an initial and ongoing basis when choosing to invest in hedge funds. Few organizations or individuals have the expertise for the depth of evaluation required for these investments. This highlights the importance of choosing the right investment consultant. We at Atlanta Consulting Group would be happy to discuss our investment consulting capabilities, particularly as it relates to our experience with alternative investments.

Disclosure

Investing is subject to a high degree of investment risk, including the possible loss of the entire amount of an investment. You should carefully read and review all information provided by The Atlanta Consulting Group Advisors, LLC ("ACG"), including ACG's Form ADV, Part 2A brochure and all supplements thereto, before making an investment.

The information contained herein reflects the opinions and projections of the ACG as of the date of publication, which are subject to change without notice at any time subsequent to the date of issue. All information provided is for informational purposes only and should not be deemed as investment advice or a recommendation to purchase or sell any specific security. While the information presented herein is believed to be reliable, no representation or warranty is made concerning the accuracy of any data presented. You should not treat these materials as advice in relation to legal, taxation, or investment matters.

Various indices, including, but not limited to the S&P 500 Index, the FTSE 3-Month Treasury Bill Index, and the Russell 2000 index (each, an "Index") are unmanaged indices of securities that are used as general measures of market performance, and their performance is not reflective of the performance of any specific investment. The Index comparisons are provided for informational purposes only and should not be used as the basis for making an investment decision.

Statements herein that reflect projections or expectations of future financial or economic performance of the Fund are forward-looking statements. Such "forward-looking" statements are based on various assumptions, which assumptions may not prove to be correct. Accordingly, there can be no assurance that such assumptions and statements will accurately predict future events or ACG's actual performance. No representation or warranty can be given that the estimates, opinions or assumptions made herein will prove to be accurate. Any projections and forward-looking statements included herein should be considered speculative and are qualified in their entirety by the information and risks disclosed in the confidential offering document. Actual results for any period may or may not approximate such forward-looking statements. You are advised to consult with your independent tax and business advisors concerning the validity and reasonableness of the factual, accounting and tax assumptions. No representations or warranties whatsoever are made by ACG any other person or entity as to the future profitability of investments recommended by ACG.