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Hedge funds as an asset class

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There are many reasons why smaller institutional asset allocators, such as most UK Pension Schemes and Charities, are currently reticent to consider hedge funds as part of their strategic asset allocation. From an investment perspective, some feel the industry is too risky due to techniques such as leverage and shorting. From an operational perspective, many are concerned by the lack of regulation, the risk of fraud, and the high levels of fees charged by the industry. The 2008 financial crisis and the Bernard Madoff situation have only served to exacerbate these concerns.

Therefore, it is somewhat incongruous that many of the larger Pension Schemes, Insurance Companies and Endowments from around the world consider an allocation to hedge funds to be a key part of the strategic make-up of their assets. Larger institutions typically have the resources to understand and overcome the concerns outlined above and have concluded that, subject to extensive due diligence, the best aspects of the hedge fund industry can substantially improve the risk and return characteristics of their portfolios. In the post-2008 world, the substantial reduction in capital operating at hedge funds and investment banking proprietary trading desks has significantly improved the opportunity set for those funds that remain.

The term 'hedge fund' can be misleading and it holds many negative connotations, especially in recent times. The industry is so diverse in terms of types of business and investment strategies that attempts at homogeneity miss much of the detail, and in that detail one can find the most attractive investment opportunities. We prefer to think of hedge funds as 'unconstrained active managers', in contrast to the constrained (i.e. benchmark driven) active and passive managers that typically make up an institution's strategic asset allocation. These unconstrained active managers trade the same securities as the constrained ones; equities, government bonds, corporate bonds, foreign exchange, commodities etc. Managers typically specialise in one area. Therefore, if an investor is not comfortable with an asset class or a style of investing, they can be avoided.

Historical returns from the hedge fund industry suggest two common characteristics:

- Good hedge fund managers deliver better risk adjusted returns than passive exposure to traditional assets or than active long-only managers
- Hedge fund managers' return streams tend to have low correlation to traditional assets

There are some investors who consider each hedge fund manager to only be at the very active end of a spectrum, including their passive and long-only active allocations. Therefore, an Equity Long-Short hedge fund would sit within their equities allocation. However, a more common approach is to recognise that hedge fund managers are not constrained by a benchmark and that their returns look very different to benchmark-driven managers in similar securities. Hedge funds are thus typically designated as their own asset class within an absolute return, alternative or unconstrained piece of the strategic asset allocation.

However, what of the concerns that hedge funds are risky enterprises and potential frauds? Many large hedge funds are now very well established businesses. A tour of the offices of Brevan Howard, Citadel or SAC Capital Management would be indistinguishable from the trading floor of a Wall Street bank or other asset management institution. Many have hundreds of staff, billions of assets under management and substantial profit and turnover. If anything, the events of 2008 have served to weed out the weaker or riskier hedge funds from the industry, leaving only the most robust organisations.

It is true that most hedge funds will continue to use leverage (ie borrowing to increase the gross market exposure above 100%) but such approaches magnify losses as much as they magnify gains. Therefore, hedge funds who are not skilled at dynamic balance sheet management will have little benefit from leverage. In the current environment, prime brokers are much more careful to set prudent limits on leverage offered to their customers. Thus, the current leverage risks posed by the hedge fund industry are reduced. In addition, all reputable hedge funds disclose their level of leverage, and so those

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operating at uncomfortably high levels of leverage will fail to attract investment. However, for those managers who do have the skill to increase their exposure when the opportunity is strongest and reduce exposure when times are difficult, they have a crucial addition to their set of skills for generating good risk adjusted returns.

A similar case can be made for shorting stocks. Shorting a security (ie borrowing it to sell and buy back at a later date, hopefully when the price has decreased) is a sophisticated skill, with potentially unlimited downside. Therefore, hedge fund managers who use shorting need to have very strong risk management capabilities. Those who don't, or who short stocks recklessly, will lose money and fail to attract investment from investors who conduct thorough due diligence. The current regulatory regime scrutinises short selling activity much more closely. Thus, the risks to the investor of being exposed to irresponsible or illegal shorting are reduced. However, those who are capable of shorting successfully can profit from declines in the price of securities as well as increases, doubling their opportunity set and potentially generate profits in any market environment.

What all this means is that in any rolling three year period of the last ten years, including the TMT crash and the current credit crisis, an asset allocation that included a portfolio of hedge funds (net of all fees) would deliver better returns per unit of risk (ie annualised return divided by annualised risk) than a traditional blend of equities and government bonds (parameters used for this model are given in the footnote[1]). The current environment, with increased regulatory scrutiny, increased prudence from investors and prime brokers and significantly lower levels of competition, makes an investment in the hedge fund asset class now an even more attractive prospect.

However, potential risks have not been eliminated and the hedge fund asset class therefore requires a much higher level of investment and operational due diligence than the traditional asset universe. Of the many thousands of hedge funds operating today, only a small proportion truly offer exceptional investment opportunities, and each of these carries distinct risk characteristics that need to be fully understood before investment. We would encourage new investors in the hedge fund industry to choose a diversified portfolio of funds, to minimise the risk of picking funds that fail to deliver, and to work with an experienced hedge fund due diligence specialist to conduct research and allocate to the asset class.

Given the potential of hedge funds for improving the efficiency of most asset allocations and the attractiveness of the asset class following the shake-out of 2008, smaller institutional asset allocators are strongly encouraged to increase their level of understanding of the hedge fund universe. Going forward, it is likely that the lines will become increasingly blurred between traditional asset managers, such as Fidelity, PIMCO, and Capital International, and hedge fund managers, such as DE Shaw, Bridgewater Associates, and GLG. It is important that schemes are not afraid of this asset class, and that they can understand the potential for efficient, uncorrelated asset managers to improve the risk and return characteristics of their strategic asset allocation.

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[1] Traditional portfolio is 50% MSCI World Free Index LC, 50% JP Morgan Global Government Bonds Index LC, rebalanced monthly. Portfolio including hedge funds is 80% of the Traditional portfolio plus 20% allocation to the actual track record of FRM's flagship portfolio AA Diversified Ltd – USD share class. Analysis conducted from 31 December 1997 to 31 July 2008. Past performance in not indicative of future performance.