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Hedge Funds: The Misunderstood Asset Class

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As hedge funds have matured as an alternative asset class they have been increasingly embraced by institutional investors of all sizes, as well as high net worth investors. Their very success or perceived non success may also be creating confusion for some investors. This issue is more important than ever before due to the changing landscape of hedge fund investing that has shifted from predominantly an asset class filled with high net worth investors, to now being dominated by major institutional investors.

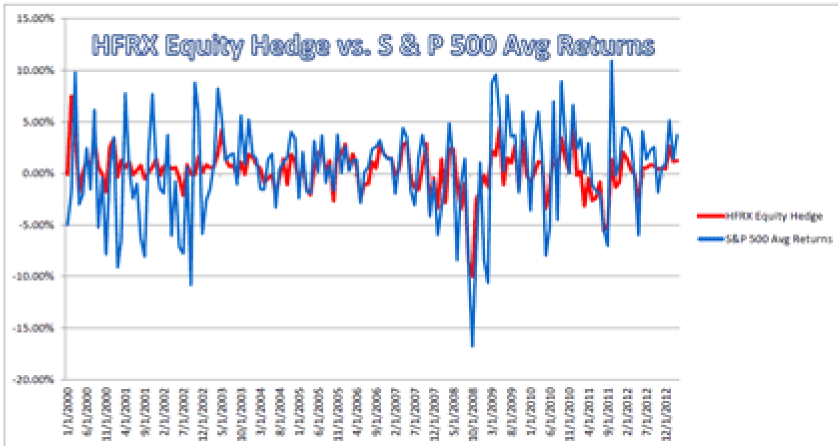
A recent hedge fund research paper written by JPMorgan shows that institutional investors made up an estimated 25% of fund allocations in 2003, with these percentages growing to 43% in 2007 and by 2012 to 85% according to data provided by Preqin.

The growing dependence on hedge fund returns by institutional investors to provide alpha and downside risk mitigation versus traditional long only assets makes it more important than ever to properly indentify, understand and employ the proper hedge fund to meet the specific return, risk and liquidity objectives of the institutional investors. Over many years and now decades, we believe that hedge funds have been a misunderstood asset class due to investors and advisors alike grouping hedge funds into a single melting pot and believing any hedge fund should be able to accomplish what the client needs. We will attempt to clear up some of these misconceptions about hedge funds, by first identifying what are some of the primary factors affecting hedging risks and returns, and by providing guidance as to the hedge fund strategies that would best match the particular investment objectives for different investors.

Over the years a number of excellent academic studies by Bussiere, Hoerova and Klaus (2012) and Khandani and Lo (2007) have provided insights into the risk and return drivers for hedge funds. In these studies through Principal Component Analysis, the authors have identified factors such as equity exposure, volatility and liquidity as being primary determinants of hedge funds returns. Armed with this knowledge, we would like to illustrate on a practical basis how hedge fund returns are actually affected by these factors. To accomplish this we will simply break down how the trend in equity prices, levels of volatility and level of interest rates affect the typical Long/Short Equity Strategy’s return over time. Please note that in general other hedge fund strategies will have risk and return factors that may be similar or inherently different over time.

Long/Short Equity vs. S&P 500

Long/Short Equity is a strategy where the investment manager takes a long or short position in equity securities that are deemed to be undervalued or overvalued. Managers depending upon their risk/return objectives can run portfolios with various ranges of gross and net exposures, typically net long but in the oft occasion can be net short as well. The net exposures tend to be in the range of +10 to +40% net, which explains why these strategies do well in ascending markets. The chart below shows the positive relationship of returns between the HFR Long/Short Equity Index and the S&P 500.



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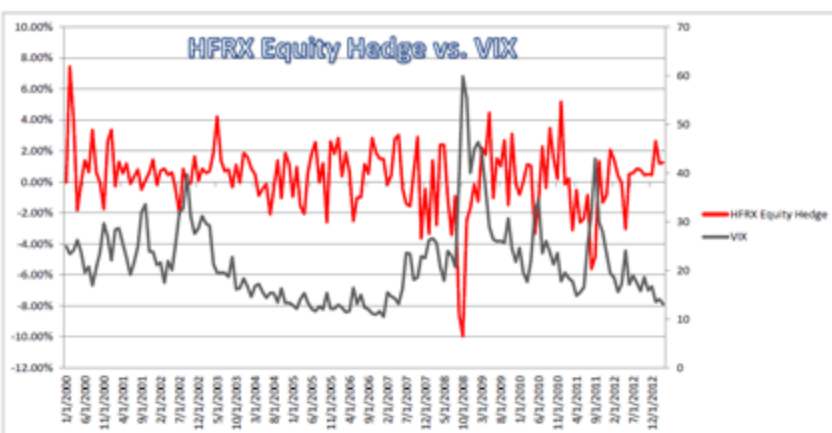
Implications of Market Volatility

In the chart below we find the return of Long/Short Equity is also affected by levels of volatility. These types of hedge fund strategies need a consistent level of rational volatility in order to generate alpha, as they profit from the price dispersion between stocks on a regional, sector and intra-market basis. The price dispersion in order to be additive to performance must be driven by fundamental factors, thus we term these markets to have rational levels of volatility as measured by the Chicago Board of Options Exchange (CBOE) Volatility Index (VIX) that is associated with the S&P 500 Index options, which normally range from the 15% to 25% level. These levels of VIX volatility attempt to predict the potential price movement of the S&P 500 up or down by the percentage level over the next 30 days. During the market debacle of 2008 when the levels of VIX rose to irrational levels, equity prices tend to be driven by global economic and macro factors as opposed to fundamentals, thus volatility in these times will detract from the performance of Long/Short Equity strategies.



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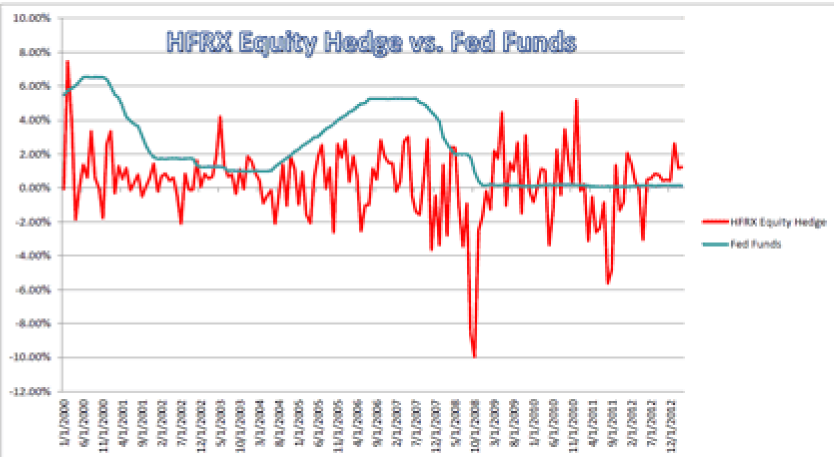
Affect of Interest Rates

In analyzing the affect interest rates have on Long/Short Equity returns, we need to understand the concept of the "short rebate." When a portfolio of short equities is established, equities are sold creating a cash balance in the manager's portfolio account. The cash that is generated earns interest in the form of a "short rebate" which is paid by the brokerage firm where the manager' account is domiciled. The level of interest paid on the account is typically tied to short term interest rates as defined by the broker call of fed funds rates. The affect on hedge fund returns in an environment when interest rates are high can be substantial. As illustrated in the chart below during the time periods in 2000, 2005 and 2006 when fed fund rates were in the 4% to 6% range, a Long/Short manager would have that level of interest income to supplement the returns generated from the equity holdings. It is much easier to generate a 10% annual rate of return if you begin with a solid return from interest income.



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Implications for Investors

With a better understanding of some of the factors that affect hedge fund strategies, we can try to clear up some of the misconceptions in the marketplace of hedge fund performance, expectations in regards to risk, return and correlation, and how they should be employed within a client's portfolio.

As the institutional investor's foot print in hedge funds has grown dramatically over the past several years, many of these investors may need to reassess and educate themselves on how hedge funds as a whole fit into their portfolio versus their investment goals. We believe the drive into hedge funds by institutions has been prompted by their desire for diversification, bond like volatility and low correlation to traditional long only assets. In the current time period when a majority of institutions are either underfunded or stretching to meet their annual spending needs, the ability to generate bond like consistent rates of return to meet their financial obligations would be optimal. To accomplish this, investors should seek out those strategies that employ modest gross and net exposures, moderate to no leverage and have proper diversification in regards to percent of assets within a particular asset class, industry group, and individual positions. Hedge funds that typically have these characteristics are Long/Short Market Neutral Equity and Multi-Strategy Funds.

Institutional investors seeking higher returns, such as competing with and outperforming the S&P 500, should gravitate towards funds that can run with high gross and net exposures, will take directional positions and can employ various levels of leverage. Strategies fitting this model include Long/Short Equity Hedge, Distressed/High Yield Debt and Macro/CTA. The different risk/return characteristic of hedge funds can be seen in the graph below which shows the upside and downside capture versus the S&P 500 index from 2009 to 2012.

	Market Up	Market Down		
Strategies	**Avg Ret%**	**Avg Ret%**	**% Captured**	**% Captured**
HFRI Composite	1.6%	-1.3%	41%	29%
Equity Hedge	2.1%	-2.1%	54%	48%
Event Driven	1.8%	-1.0%	46%	23%
Macro	0.6%	-0.6%	14%	13%
Relative Value	1.4%	0.0%	36%	0%
Short Bias	-3.4%	2.9%	-88%	-64%
Sys Diversified	0.3%	-0.4%	8%	10%
Distressed	1.7%	-0.7%	45%	15%
Merger Arbitrage	0.7%	-0.2%	19%	4%
Convertible Arbitrage	2.2%	-0.4%	58%	10%
Equity Neutral	0.5%	-0.6%	12%	14%
S&P	**3.8%**	**-4.5%**	**32%**	**15%**

Source: Hedge Fund Research, Bloomberg

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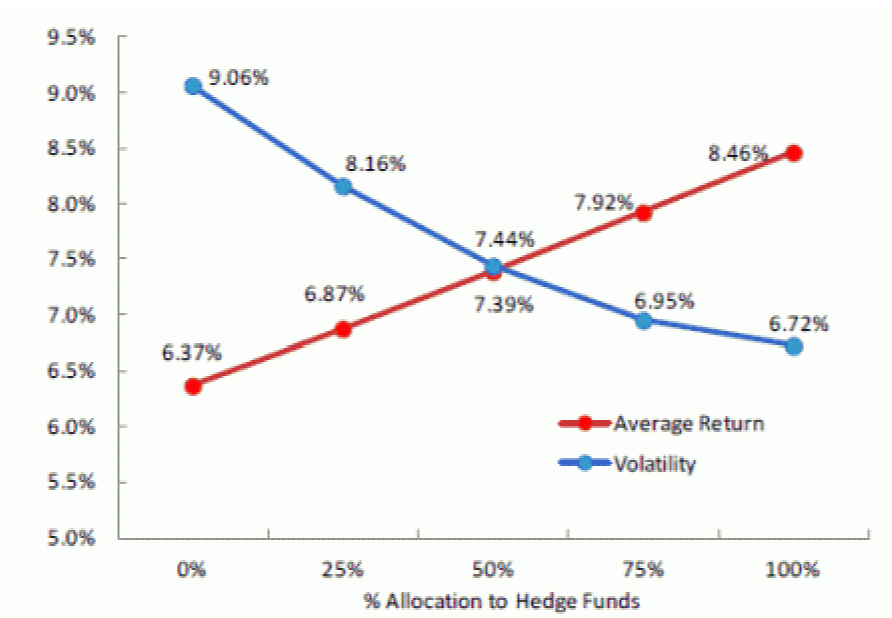
In the current market environment with equity markets trading at historical highs and fixed income markets providing historically low yields, we believe the proper selection and allocation of hedge funds to an institution's portfolio can provide them with a better risk-adjusted return solution to meet the liabilities of a pension fund and the spending rate of an endowment or foundation. Over time we have found that the addition of hedge funds to a traditional long only equity and fixed income portfolio can reduce the downside variability of return, while increasing the probability of the institution meeting its annual return objective by effectively reducing the left tail risk of the portfolio. We are comfortable at recommending upwards of a 20% allocation to hedge funds to achieve this goal. The chart below shows the efficacy of hedge funds as a volatility dampener for a long only traditional portfolio.



Source: Hedge Fund Research, Bloomberg

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Conclusion

Institutional investors today are confronted with achieving acceptable rates of return and the need to mitigate downside risk. Pension funds in this low interest rate environment are seeing their underfunding status worsen, and endowments are needing to find other means with which to meet their annual spending needs. Therefore it is important for institutions to ferret out and employ investments that can meet their targeted rates of return without taking on an inordinate amount of risk. The choice of the appropriate hedge fund to either provide risk/adjusted alpha versus equities or a moderate fixed income like return can help institutions to reduce their volatility and enhance returns over time. Lower volatility and smaller potential portfolio draw-downs lead to a greater wealth effect and compounding of return for the institution. The consistent compounding of returns will permit institutions to better meet their liabilities and spending needs.

Tim Ng *is a Managing Director and Head of Research at Clearbrook Global Advisors, a privately held, independent investment management firm. His responsibilities include global macro and manager research, portfolio analysis, and risk management. Tim serves on the firm's investment committee and is a board member of Clearbrook and the Florida Alternative Investment Association. Prior to joining Clearbrook, he was president and chief investment officer of Structured Investments Group, LLC. Tim began his career in 1982 and has served as an alternative investment and hedge fund advisor in numerous capacities. With more than 25 years investment experience, Tim has had oversight of more than $5 billion of investor capital on behalf of corporations, pension funds, endowments and foundations, banks, investment advisory firms, and family offices. He has been a holder of securities licenses Series 3, 7, 24, 63, and 65. Tim received a BA in Economics from Stony Brook University and an MBA with honors from Long Island University.*

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