Understanding Hedge Fund Fundamentals and Trends

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In this decade, the growth in hedge fund assets has been staggering. Although many investors have their own personal beliefs about hedge funds, those beliefs may not be accurate. Certainly, various reasons can explain the success of hedge funds, but challenges and risks remain ahead of them.

In this presentation, I will start by questioning commonly accepted beliefs about hedge funds to seek a deeper understanding of fundamentals and trends in the hedge fund industry. I will then discuss a few investment opportunities and risks in the hedge fund marketplace today.

Fundamentals

All investors have sets of beliefs about hedge funds—some that are based in fact and others that are not. By starting with some simple hedge fund concepts, I hope to clarify the difference between what many investors believe to be true and what is true—to distinguish between perception and reality. Among these differing beliefs are the definition of a hedge fund, size of the hedge fund market, degree of hedging, fees, and performance measurement.

Beliefs. Some of our beliefs are conscious and overt, and others are subconscious. Conscious beliefs tend to be developed through primary research. Whether this research is proven right or wrong, investors must be mindful of confirmation bias, which is the tendency to do research that supports existing beliefs rather than seek out information that is contrary to the thesis. At the same time, people hold subconscious beliefs that, by definition, may be covert. For example, investors may believe something is true after hearing it from someone they assume conducted conclusive primary research. In investing, investors need to understand the difference between conscious and subconscious beliefs and be self-aware of their drivers. By challenging commonly held beliefs that lie outside of fact, investors can create investment opportunities.

Definition. In the popular press, particularly in the United States, a hedge fund is defined as a "private, secretive pool of capital that caters to the wealthy and to wealthy institutions." Hedge funds are also described as "using high-risk techniques, such as borrowing money and selling short, to make extraordinary capital gains." My friend Paul Isaac at Cadogan Management refers to hedge funds as "a compensation scheme, not an asset class." Paul's definition has some basis in reality. The first definition, however, has little merit because increased regulation as well as the listing of hedge funds in London means hedge funds are no longer secretive or only for the wealthy. Moreover, because hedge funds almost always take less risk than the markets, the second definition also has no merit.

A better definition of hedge funds should include a different perspective. For the institutional asset allocator, hedge funds were once considered an "alternative" investment but today are a "traditional" asset class. The infamous and ever-present "job risk" has shifted from those who invest in hedge funds to those who do not. By structure, a hedge fund is a financial services company that closely resembles the modern investment bank. Similar to a bank, hedge funds engage in proprietary trading and commercial lending. Investors can

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"buy" and "sell" a hedge fund just as they can such publicly traded stock as Goldman Sachs, although hedge funds trade only by periodic appointment and for book value, whereas shares of Goldman Sachs trade nearly every minute for a multiple of book. At the end of each year, hedge funds produce audited financial statements that show a net return to investors that is the same as the growth in the book value of a financial services company.

The definition of a hedge fund I learned from my mentor David Swensen is that it is an investment strategy that skillfully attempts to deliver equity-like expected returns with less risk than the equity markets. These returns are uncorrelated with public market returns and are generated through investments in marketable securities.

Each word in this definition has been carefully selected and encompasses important beliefs. A critical component of this definition is its reference to skill. Skill is a precious resource that is not easy to find. Using the word "skill" as an existing premise in the phrase "skill-based strategies" gives investors the illusion that skill is readily available. Equity-like returns delivered in a smooth fashion are boring. The expected returns for equity markets over the long term are approximately 6 percent real or 8–10 percent nominal, depending on inflation. These expected returns do not change and are not the same as the actual return, which might be 25 percent in one year and 3 percent in another. Hedge funds attempt to deliver the expected long-term equity return in a relatively consistent manner.

Hedge funds are less risky than the equity markets, in which risk is defined as a permanent loss of capital. Risk is not measured by a statistic about volatility, nor is it represented by an occasional high-profile debacle, such as Amaranth. Returns that are generated in an uncorrelated fashion imply a low correlation with any public equity or debt market.

Finally, hedge fund investments are experiencing convergence with private equity strategies and increasingly use nonmarketable securities. So, this aspect of the definition is not as true as it once was.

Market Size. Popular opinion proclaims that approximately 8,000 hedge funds compose the market place. Mark Yusko of Morgan Creek is fond of saying something that seems like the truth to practitioners in the allocation game: "We've met about 8,000 funds, and they all claim to be top-quartile performers, so somewhere out there are another 24,000 that fill the bottom three."

The truth is that the hedge fund market is highly concentrated; only 300 firms manage more than 85 percent of all hedge fund assets. Effectively, that means only 300 hedge funds really matter when investors think of "the market" in the context of aggregate returns, hedge fund indices, regulation, and the impact of hedge funds on global markets. For perspective, the Nikkei 225 makes up 64 percent of the market capitalization of the Japanese market, and investors are comfortable using the Nikkei as a proxy for the entire Japanese market.

Hedging. Because the word "hedge" is used in hedge funds, many assume that hedge funds are hedged. The truth is that most hedge funds retain significant exposure to equity and credit markets. Anecdotally, from a sample survey of some of our most respected peers, we learned that many equity-oriented fund-of-funds portfolios typically retain 40–60 percent net exposure to global equity markets. Additionally, hedge funds have been systematically long credit and short volatility. This allocation is a result of the desire to obtain smooth, positive returns and a consequence of our collective experience of many years of bull market returns. If investors are long credit, they accumulate yield every month, and if they are short volatility, they receive a premium. This design allows a hedge fund to show positive returns.

Fees. A popular belief is that hedge fund fees are too high, and thus, fees must come down in time. This belief has very little basis in fact. It is possible that hedge fund fees are too low. Professor Randolph Cohen at Harvard Business School has made a compelling academic argument that the active component of fees in hedge funds is too low relative to that charged by mutual funds. Although the stated fee in a mutual fund is much lower than that in a hedge fund, hedge funds take significantly more active risk. If the beta component were removed from a mutual fund's returns, the investor would be left paying a very high fee for the mutual fund's active returns.

Another way to think about low hedge fund fees is to consider the expenses of financial services companies with publicly traded stocks that participate in the same types of activities as hedge funds. A typical hedge fund's 2 percent management fee and 20 percent performance fee sound very expensive. But at a 12 percent net rate of return, an investor pays 4.5 percent of net assets as a fee. The average sales and general administrative expense of the six major Wall Street banks in the United States is 11.5 percent of net assets. If the alternative to investing in a hedge fund is to buy stock in Goldman Sachs, one could argue that the investor will pay a much higher fee owning Goldman Sachs than if he or she invested in a hedge fund.

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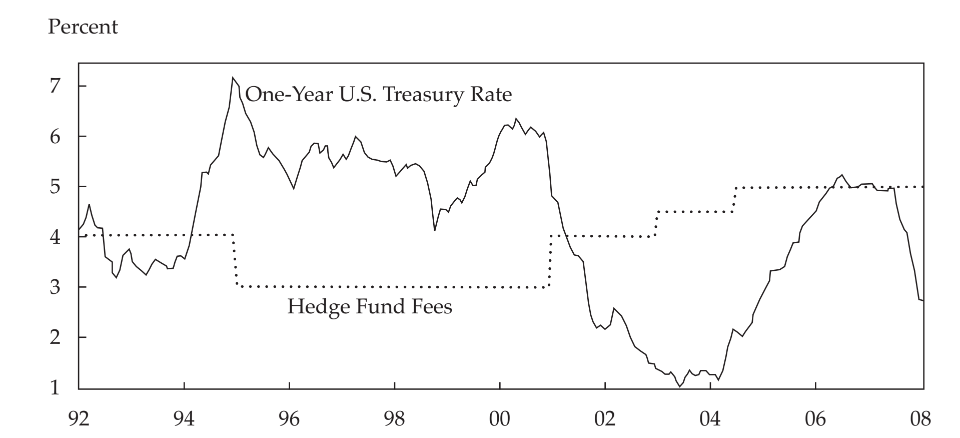
In contrast, the possibility exists that hedge fund fees are too high. Perhaps fees are cyclical, meaning they are not always high and just happen to be high now. The greatest growth in hedge funds occurred in the last 5 to 10 years. **Figure 1** charts hedge fund fees against the one-year U.S. Treasury rate. It shows that in the past, fees decreased after prolonged periods when interest rates were high. The rationale behind the shift was if investors received 8 percent to invest in cash, hedge fund managers would have a hard time justifying a 20 percent carry on such a high cost of capital. It has been a long time since rates have been at levels where investors in hedge funds should care about this free ride, but we do not know what the future holds, and this time may once again come to pass.

In my opinion, fees are never too high or too low. They are governed by the laws of supply and demand, and in the current market, hedge fund managers have the upper hand. In particular, because the aggregate market considers only 300 managers to be talented, tremendous demand exists to invest in a very limited supply of perceived talent. These managers have the ability to charge high fees. Moreover, the fees paid have been justified by the results produced by hedge funds. In aggregate, hedge funds have met the objectives of generating equity-like long-term returns with less risk during almost any historical period. In the 10 years ending 31 December 2007, hedge funds earned about 9 percent after fees with 7 percent volatility, versus a 6 percent return with 15 percent volatility for the S&P 500 Index.

Measuring Performance. Three common beliefs exist about the best way to measure the performance of hedge fund managers: (1) relative benchmarks, in which performance is measured against an equity market or a fixed-income market; (2) peer benchmarks, in which hedge funds are measured against other hedge funds; and (3) risk-adjusted benchmarks, in which performance is adjusted for volatility or some other statistical measure of risk. Many investors believe that these approaches are very important. In my opinion, they are not that critical in achieving any important goal.

- *Relative benchmarks*. The first principle of hedge funds is to deliver equity-like long-term expected returns, such as 8 percent. But in any given year, the market might be up 20 percent or down 10 percent. The return of the market has little effect on what investors are trying to achieve in a hedge fund portfolio, and therefore, it does not make sense to compare the hedge fund return with a market return for any short period of time. The hedge fund return should be a cash rate of return plus a margin, which would produce the alphas—one on the long side and one on the short side.
- *Peer benchmarks*. Hedge fund performance can also be evaluated against the performance of other hedge funds. Peer analysis is very important in assessing the skill of a particular hedge fund manager. But if the reason for investing in hedge funds is to obtain the long-term equity return of about 8 percent, then the performance of other hedge funds has nothing to do with achieving that goal. Peer performance matters if investors are trying to decide whether they are with the right hedge fund manager but does not matter in evaluating the performance of a hedge fund portfolio.

Figure 1. Hedge Fund Fees Compared with the One-Year U.S. Treasury Rate, January 1992–January 2008



■ *Risk-adjusted benchmarks*. Standard deviation is commonly used as a measure of risk in such metrics as the Sharpe ratio, but it is not an appropriate measurement of risk in hedge funds. Another of Paul Isaac's clever aphorisms is "Volatility is only the downside deviation; the upside deviation is called performance." More appropriate measures of risk focus on downside deviation, skewness of returns, and permanent loss of capital.

Industry Trends

Bifurcation, specialization, and institutionalization are three big trends in the hedge fund industry today.

- Bifurcation refers to the accelerating segregation between large and small funds.
- Specialization refers to the tendency for managers to offer products that carve out specific niches.
- Institutionalization refers to hedge fund investing becoming a mainstream business enterprise.

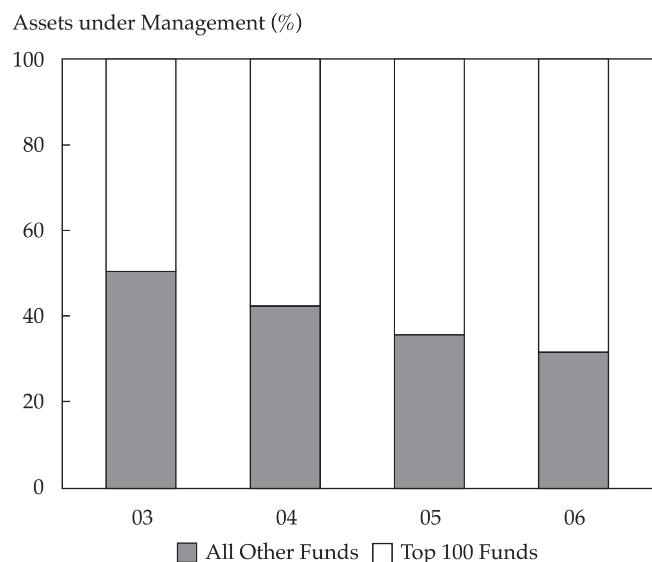
Bifurcation. The aggregate assets in the hedge fund market have been growing at a staggering rate—from $39 billion in 1990 to an estimated $1,870 billion in 2007. Most of the new money, however, is flowing to the biggest funds. **Figure 2** illustrates the market share of the top 100 funds from 2003 to 2006. As of early 2008, the number is approximately 70 percent. But the growth of hedge fund market share from 60 percent to 70 percent has significant implications for where fund flows are invested. The marginal dollar today is being invested in the same 300 hedge fund firms because investors believe those are comparatively safe places to put their money. But they are not thinking about safety in terms of investment risk; they are thinking about safety in numbers.

A result of the big getting bigger is that small-fund managers are losing market share. **Figure 3** compares the difference between the targeted and actual amounts raised from 2004 to 2006 for start-up funds versus new funds offered by existing managers. The gray bars show that in 2004, the shortfall for start-ups was approximately the same as that for existing managers. But in 2005 and 2006, start-ups raised substantially less than anticipated, whereas existing managers extending their brands with new funds were much more successful.

Some advantages to size do exist, and the fact that 300 firms are very large is not all bad. They have tremendous resources to investigate investment opportunities globally. In fact, more money is being spent on research and development than ever before in the history of the asset management industry. As a result, hedge funds have begun to exploit opportunities beyond the public markets that are beneficial for their investors in such activities as direct lending, life insurance, catastrophe bonds, and investment banking activities.

But some disadvantages also exist. As David Swensen says, "Size is the enemy of performance." Large funds lose the flexibility to generate the returns they made in the past. Not only is past performance

Figure 2. Percentage of Market Share Held by the Top 100 Hedge Funds Compared with All Other Funds, 2003–2006



Source: Absolute Return, Alpha, Morgan Stanley.

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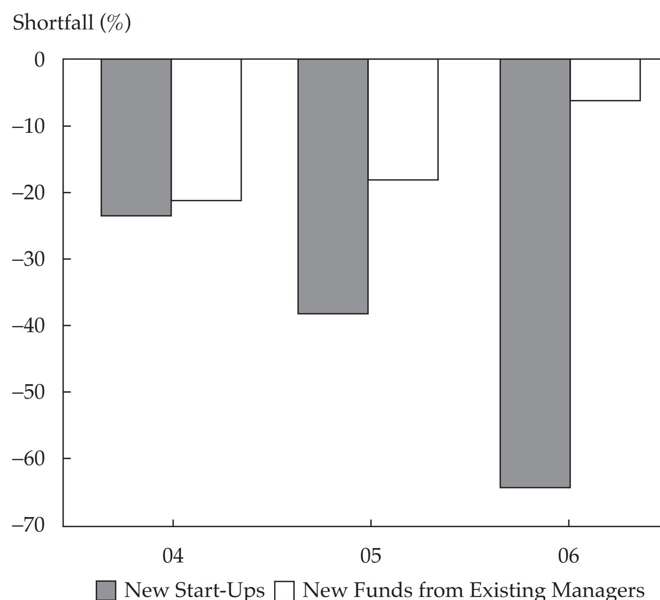
Figure 3. Fund-Raising Shortfalls of Start-Up Hedge Funds Compared with New Funds from Existing Managers, 2004–2006



Source: Morgan Stanley Prime Brokerage.

not indicative of future performance, but the drivers of past performance will be completely different from the drivers of future performance.

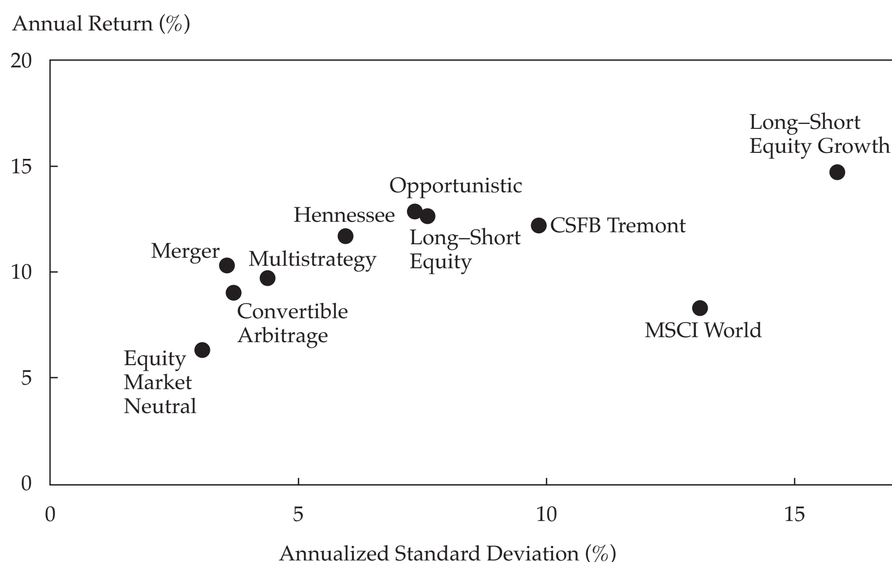
Although it is true that large hedge funds have entered new marketplaces, doing so has been a necessity and has changed the nature of competition. Hedge funds used to be liquidity providers to the market, collecting pennies in diversified merger arbitrage portfolios from long-only investors happy to come out of a successful position. Today, they require liquidity because they collectively constitute a major presence in the markets. Hedge funds used to share information and deals with investment banks. Today, they compete with investment banks. The final notable aspect of bifurcation that investors might not realize is that if they invest in one of the top 300 hedge funds, their money is likely to be invested with a young, unproven manager because senior managers are already at their allocation capacity. In effect, investors who allocate money to the top 300 hedge funds may actually be investing in a start-up fund.

Specialization. The trend toward specialization is a logical response by smaller firms to the first trend of bifurcation. A small firm competes successfully with better-endowed firms by focusing on a narrow area of competitive advantage. Some of the best talent imbedded in large hedge funds may strike out on their own to start a new fund. Because an extensive support network has developed to support small-fund managers, these new funds can focus all their time and effort on developing a particular niche.

Specialization has also affected the fund-of-funds model. **Figure 4** illustrates the hedge fund landscape from 1993 through 2007. On the left are the traditional strategies, such as merger arbitrage and convertible arbitrage, which typically have lower expected returns with lower volatility. On the right are the higher-return, higher-volatility strategies, such as long–short equity. The traditional fund-of-funds model has demonstrated the power of diversification. In the past, fund-of-funds managers could achieve attractive returns by simply diversifying across hedge fund strategies. Because hedge funds provided liquidity to the market and extracted a premium for doing so, nearly all investors succeeded. The most important ingredient for winning was being in the game.

The market today is very different, so the funds of funds have had to adapt. The resulting competition among funds of funds has required an evolution of the industry. Like managers of smaller hedge funds, many fund-of-funds managers are focusing on their areas of expertise and concentrating their resources to add the most value. As a result, funds of funds are being focused by geography, style, and strategy. Sophisticated clients are also creating their own funds of funds by aggregating experts in various strategies. Specifically, they might hire one Asian-focused fund of funds, one European-focused fund of funds, or one that is focused only on long–short equity strategies.

Figure 4. Annual Return and Standard Deviation of Various Types of Hedge Funds, January 1993–September 2007



Note: Period of measurement begins at the inception of the Hennessee Hedge Fund Index.

Source: Henessee Group.

Institutionalization. The last megatrend is the institutionalization of the hedge fund business, which is now starting to mirror the development of the U.S. mutual fund industry. As a result of the massive growth during the past 10 years, two types of models are developing—asset gatherers and investment professionals. Asset gatherers focus as much on the growth of their assets under management as they do on their investment returns, whereas investment professionals focus solely on performance, often at the expense of growing their assets.

As the boutique hedge fund industry has grown to a substantial business, its sophistication has extended from investment strategies to business strategies. Hedge funds are increasingly savvy about the stability of their capital and their techniques to attract and retain talent. On the business side, one of the strategies we are seeing is a trend toward monetization through IPOs. When that happens, it increases the complexity and alignment of incentives between the manager and the investor.

Opportunities and Risks

One opportunity in today's market comes from being properly positioned to seize the megatrends in the industry. That means if investors share my beliefs about industry trends, then they must set objectives that are appropriate for them and not for someone else. Few investors have the same patience and risk tolerance as Yale or Harvard. As a result, the strategies Yale and Harvard pursue might not be appropriate for others. Furthermore, if the average return is not sufficient for an institution, it should focus on finding the very best managers, which may amount to investing in specialist hedge funds or a fund of funds instead of in the largest 300, which by definition will create the average. Conversely, some of the top 300 funds truly derive the benefits of scale and may be structurally better positioned than others to drive returns. Fees matter—although some high fees may be justified, all high fees lower returns. Investors should carefully assess their willingness to pay and search for methods to reduce fees. The last caveat about proper positioning is to remember that volatility in the global investment markets is likely to be higher in the future than it has been. That should be an attractive environment for hedge funds that are truly hedged.

On the risk side, as I mentioned earlier, hedge funds are systematically long credit. The set of conditions that created the subprime problems included a favorable economic environment, an excess of liquidity, increasing acceptance of risk by investors, growing amounts of leverage through structured finance, and a disconnect between those assessing risk and those taking the risk. This set of conditions

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is not isolated to the U.S. subprime mortgage market. A parallel exists between the subprime mortgage market and the high-yield bond market in the United States. In particular, for the high-yield bond market and the leverage created by credit default swaps, collateralized debt obligations may represent the successful innovation in structured finance taken to an extreme. Investors will have to remain vigilant regarding the potential this parallel presents.

Conclusion

I hope this discussion has caused you to rethink the many beliefs you have about hedge funds and return to first principles of investing before you accept what you hear to be true. If you do believe what I have presented, then I encourage you to go back and question my assumptions and conclusions as well.

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Question and Answer Session

Ted Seides, CFA

Question: How can a small pension plan sponsor with limited resources find competent hedge fund managers, or would hiring a gatekeeper help?

Seides: A challenge of investing in hedge funds is the requirement of having the expertise and the resources available to properly evaluate funds and determine which are the above-average performers. A small institution, pension fund, or endowment often does not have the resources and expertise to spend the time sorting through the 8,000 hedge funds in existence.

Part of the reason that 300 funds have effectively become the market, however, is that the market is somewhat efficient. These 300 funds are run by very talented, well-trained managers and generally have been above-average performers, and it is possible they will continue to excel. So, participation by small investors in these large funds may be a sensible strategy because attempting to find managers who generate above-market performance may be beyond their capability.

Furthermore, I wholeheartedly agree with the concept that if evaluating the performance of a hedge fund is difficult, then evaluating the performance of a gatekeeper is equally difficult. I would recommend that institutions be very clear about the objectives they have and the types of managers that either they will look for or instruct their gatekeeper to identify.

One thing to be aware of about investing in hedge funds is that it really is an insider's game. That is, those who have been in the business a long time know who the best managers are and have the relationships to properly monitor the select few. Relationships with insiders can be very helpful in identifying exactly what an institution is looking for.

Question: Will a base fee of zero and a 100 percent performance fee become commonplace?

Seides: A base fee of zero with a 100 percent performance fee is a bit on the aggressive side. But there may be some large managers who have enough assets under management to stabilize their business, so I would sign up for the 0 percent part of the structure without question.

A movement toward reducing the management fee and increasing the incentive fee is a good thing because it aligns the interests of the investors with the managers. The key in the arrangement is figuring out the breakeven gross rate of return and ensuring the structure is sound for the long term.

Question: What is your opinion about the duration of the credit default swap market?

Seides: The most used contract is a five-year CDS. I would assume its duration is between three and four years, which is a reasonable approximation of the duration of the CDS market.

Question: If investors' target rate of return is a stable 8 percent but they, in fact, earn 12 percent, should one be concerned that the hedge fund has taken on too much risk?

Seides: If the manager achieved the 12 percent return in the way the investor expected, the volatility of the result is a good thing. Markets are not stable enough during any short period of time to generate an 8 percent return with little fluctuation. If investors get the good side of the distribution, they should take it while they can.

What is important is understanding the return drivers. A good way to think about hedge fund returns is that investors should earn a cash return plus two alphas, one long and one short. If the cash return in the United States today is 5 percent and an investor does very well, perhaps earning 3 percent on both sides, that would equate to an 11 percent gross return or perhaps 8 percent after fees.

But the concern about too much risk is legitimate and plausible. The key to resolving it is to ask questions and learn what caused the deviation from expectation.

Question: How do you think the relationship between sovereign wealth funds and hedge funds will evolve?

Seides: Sovereign wealth funds are the largest aggregate pool of new capital being invested in markets around the world. At the same time, hedge funds are wonderful businesses for their owners but are inherently capacity constrained as investment strategies. Although sovereign wealth funds have invested in hedge funds and funds of funds and will continue to do so, the more interesting interaction to watch will occur at the ownership level because sovereign wealth funds need to put so much money to work.

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Question: You indicated that average hedge funds are 60 percent net long and also systematically long credit and short volatility. But if hedge funds are truly hedged, then they must take the contrary position. Is that what you are advocating?

Seides: Yes. Many hedge funds do hedge and run, say, 20 percent to 40 percent net long, but few hedge funds are net short. If hedge funds consider investors' return goals, then achieving those goals during long periods of time while being net short has proven difficult because equity markets have risen for a long time. Too many managers believe this trend will continue, which it may or may not; we don't know what the future holds.

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