Hedge Funds Ever More Relevant Today

Hedge funds are now more useful than ever now that many investors have given up on them.

Since the trauma of 2008 when some funds gated redemptions, side pocketed their ugly skeletons of illiquid securities, suspended NAVs altogether, only US institutional investors have resumed investing in any scale. European investors who were significant investors in hedge funds never quite recovered from the Madoff scandal and the general disappointment of what they thought was a bullet proof investments. And yet, hedge funds, even on average, and one should never invest in the average hedge fund, did well relative to equity investments. On a risk adjusted basis, over a multi decade period, they've outperformed a balanced portfolio of equities and bonds. Yet Europe turned its attention towards regulated hedge funds, or UCITS III funds, there is now a UCITS 4 directive that extends the already convoluted UCITS III rules… These have also disappointed as me too managers jumped on the bandwagon in the hope of gathering assets. The higher quality managers simply dove underground, eschewed UCITS and me too investors and went about managing partners' capital. It was a return to the old days. Asia, a late adopter of hedge funds, whose investors had a net negative return in the asset class all told, have simply given up. They turn to real estate and private equity, moving up the risk scale by seeking directs instead of funds, and applying as much leverage as their relationship banks will give them. Given the asset inflationary efforts of the central banks, these investments have worked, thus far. Its not clear if these investors are aware of the levered beta exposure they have assumed. Indeed its not clear the leverage providers are aware of the same. Doomsayers are sidelined as naysayers, who will one day publish their memoirs or tell them in bars.

The hedge funds that have found capital tend to be the larger brand name funds with a strong recent track record. Beware. A strong track record is the confluence of skill and luck and discerning the relative contributions of each is not easy. The risk arbitrageur who suddenly gets lucky in mortgages can generate such a remarkably strong track record that investors throw money at them, which they subsequently halve in their attempt to reinvent themselves as global macro managers. Investors still chase returns, fall for the institutional pitch, the legions of staff, the bold offices, the glossy presentations, and the references of old investors for whom the trade is already done.

As a whole, the hedge fund industry has done a poor job. At least that’s what the HFRI indices indicate. But this was always going to be the case. In an unregulated industry seeking absolute returns, not benchmarked relative returns, more will fail than succeed. Hedge fund detractors claim that hedge funds don’t add value, and they are right. The average hedge fund doesn’t add value, it quite definitely detracts from value, especially with the high fees. There is no question that in this highly talent dependent industry, the average is decidedly poor. The good managers are decidedly good, and decidedly in an acute and elusive minority. How do you find them?

It is not entirely useful to try to pick outperforming strategies. The winds of fortune come and go for each strategy. There will be times when a particular anomaly arises which presents glaring arbitrage opportunities. However, when such opportunities have been harvested, what is an investor to do? Redeeming his investment would not be an unreasonable reaction. The talented hedge fund manager weathers all conditions, except the catastrophic ones. Beware managers who survive catastrophes but are otherwise unspectacular, this is a warning sign of good luck, something the investor is well advised to avoid.

Picking outstanding managers is not easy either but it is much more useful. The dispersion of returns of hedge funds around their peer index is significantly higher than one will find for mutual funds, and understandably so. There is no clustering around a benchmark, no place to hide. Successful managers are expected to make money all of the time. It is therefore important to identify these talented managers and to distinguish between skill and luck.

Of the managers in the portfolio, 7 out of the 10 managers have done significantly better than their peers, and generated strong returns. Year to date August, the merger arbitrageur is up 18%, the credit alternatives fund is up 12%, the credit long short is up 7.5%, the event equity fund is up over 16%, the multi strategy capital structure arb is up over 13%, the Asian carve out by the same manager is up over 7% and finally the credit and converts fund is up 5.9%. Slightly discouraging were the fixed income arb fund at -0.06%, the fixed income relative value and macro fund at 0.13% and the Asian multi asset at 3.58%. The HFRI Index has only managed 3.52% year to August. The portfolio as a whole is up 9.29% gross year to August and 8.63% net.

None of the managers is a megasized brand name manager. All of them were found after extensive research, analysis and due diligence.