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Hedge fund survey: Finding five exceptional hedge funds

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Investors in hedge funds seem to agree with U2

"But I still haven't found what I'm looking for"

Pop group U2's refrain may be an apt description of how those running alternative investments at Calpers, the largest US pension fund, felt last year when they decided to pull the plug on their long experiment with hedge funds. Ted Eliopoulos, the fund's chief investment officer, said too much effort was expended for too little exposure for a $300bn fund.

But if management believes in hedge funds, why not commit more resources to the search and boost asset exposure to produce performance?

That is the issue explored in this year's annual industry review.

Calpers is not alone in its retreat from hedge funds. The UK's £20bn Railways Pension Scheme wants to reduce its £1bn exposure. The same is true for the £39.6bn BT Pension Scheme and the third-largest pension fund in the Netherlands, PMT, with €55bn.

Such institutional rumblings should not come as a surprise. Last year's survey revealed the paradox of rising net flows into an industry delivering lacklustre performance while stocks continued to shine for a fifth straight year.

Fidelity Investments' institutional arm, Pyramis Global Advisors, which manages more than $200bn, recently reported that nearly one-third of US institutional investors felt hedge funds fell short of expectations. According to Stephen Benjamin, vice-president of market and business intelligence at Pyramis, this contrasts with the more benign sentiment investors expressed in 2008, when hedge fund losses were about half that of the market's.

Mr Benjamin says: "When Calpers announced it was withdrawing from the space, almost every US institutional investor hit the pause button to re-evaluate its hedge fund investments." Meaning: hedge fund exposure is no longer a given.

Calpers' $4bn sell-off does not mean there will be a rush out of the asset class. But Mr Benjamin does feel there is more palpable risk in the sector now than in recent years.

BarclayHedge reports hedge fund asset growth in 2014 is set to accelerate past the 8.35 per cent annual expansion rate witnessed since 2008. This is occurring despite hedge funds continuing to underperform the S&P 500 for the sixth straight year. In the year to November, the average fund was up 3.5 per cent while US stocks rose nearly 14 per cent. The MSCI World Index in dollars was up over 7 per cent.

However, pure long-only stock portfolios are volatile, with exposure to chunky drawdowns over the long term. These concerns have been driving institutional investors into hedge funds.

Citi Investor Services reported that 12 years ago, 80 per cent of hedge fund investors were wealthy individuals and family offices. Parity with institutions was reached in 2007 as market fears were building. Now, two-thirds of hedge fund dollars are owned by pension and sovereign wealth funds, endowments and foundations. Sandy Kaul, US head of business advisory at Citi Prime Finance, expects that figure will jump to nearly three-quarters of the industry's anticipated $4.8tn assets by 2018.

"Institutionalisation of hedge funds makes market outperformance less likely," says Jeffrey Willardson, a managing director at Paamco, which runs $10bn in hedge funds of funds. "Protection from downside volatility typically means lagging performance when stocks take off," he says.

With large investors still ploughing in, allocations are getting bigger. This favours larger funds that have the capacity to accommodate bigger flows. Industry tracker HFR says more than 80 per cent of hedge fund assets are now concentrated in fewer than 7 per cent of all funds, whose assets each exceed $1bn.

To generate better net returns, the industry has two basic options: one, increase focus on proven smaller funds that have delivered superior returns due to their scale and flexibility; and two, adopt progressive fees and strategy-adjusted hurdles.

The second point requires a realistic benchmark against which to measure hedge fund performance. Because hedge fund strategies rely on various asset classes, the most balanced gauge arguably blends 60 per cent exposure to the S&P 500 and 40 per cent in the Barclays US Aggregate Bond index. Hedge funds on average have underperformed this benchmark by slightly more than 1 percentage point a year over the past decade.

Assume for this discussion that funds running less than several hundred million dollars require a 2 per cent management and 20 per cent performance fee to function securely.

Jon Hansen, director of hedge funds at C/A Capital Management, which has nearly $10bn in assets under management, thinks management fees should be progressively reduced to at least 1.5 per cent as funds get larger. "This reflects growing operational efficiency that comes with scale," he says, "and a belief that management fees should not be profit centres."

There is also mounting consensus that 20 per cent performance fees are too rich as funds grow into multibillion-dollar operations, suggesting a progressive reduction in this fee should be considered too as funds get larger.

Establishing hard strategy-specific hurdles would further boost net performance. For example, a long/short fund should generate more than 4 per cent before realising a performance fee on profits that exceed the hurdle.

Mr Hansen believes a rethink about fees would boost returns beyond the blended benchmark, discourage underperforming managers from staying in business and better align investor and manager interests.

Returning to the first point: many reports have found smaller funds deliver higher and more consistent returns than bigger funds. But Bailey McCann, senior editor at Opalesque, the industry tracker, explains large institutions are not in the former because of "headline risk, the fear of making news by being the only large public investor caught in a smaller, lesser-known manager that badly trips up".

The much safer and easier road, she says, is simply making a few larger allocations to big, well-known managers that are fiduciarily sound and a lot easier to get approved by pension fund chief investment officers and boards of directors.

But therein lies the cause of industry dissatisfaction.

The cost of vetting sub-$1bn funds should not undermine their potential return advantages. "Institutions would discover a number of smaller funds have been able to generate double-digit returns with muted downside volatility and drawdowns, while not compromising operational standards," says Bruce Amlicke, chief investment officer of UBS's A&Q Hedge Fund Solutions.

Even when excluding one of the five selected funds, whose numbers would skew averages to the upside excessively, this year's selection, whose average AUM is less than $400m, has generated five-year annualised returns of 14.6 per cent through June 2014, with annualised volatility of 8.1 per cent, and an average worst drawdown of 11.1 per cent.

Several common traits help explain these funds' compelling numbers, features that Paamco's Mr Willardson says he also targets: creative search for asset mispricing, especially due to non-economic factors; disciplined buying and selling; concentrated portfolios that demonstrate a high conviction in research; the confidence to alter net exposure to exploit opportunities or to become more market neutral ; a willingness to raise cash levels to preserve capital; managers keeping a significant portion of their wealth in their funds; and set asset capacity to help sustain performance.

We are not recommending these funds, and past performance does not assure their forward behaviour. But this perennial review does show what investors can turn up by digging into various strategies and asset classes.

Tom Williams, chief investment officer of FRM Pine Grove, believes adding proven, well-vetted and diverse managers can smooth performance over the long term, and that is what investors should be looking for from hedge funds.

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