Hedge Funds: Reasons to Love Them, Reasons to Hate Them:

The hedge fund industry has come under a lot of fire in the last 12 months. They have been blamed for falling markets, failing banks, rising costs of credit, bad weather, you name it. But while it is easy to target an industry where a hedge fund manager can earn millions in a year, what do we really love them for and what do we really hate them for? We know that they are clearly not responsible for the troubles in the banking industry. The weather is another matter…

While I have defended the performance and relevance of hedge funds, there are areas where hedge funds have been deficient.

Why we hate hedge funds:

Style drift is a major major complaint. Style drift is when your equity long short manager starts trading credit, or fixed income or starts buying unlisted private companies. Style drift is, however, hard to define and hard to police. Is an equity manager with a very fundamental bottom up process guilty of style drift if he chooses to express his view on a company by buying preferred shares? Or the bonds issued by the same company? Blatant style drift is rare and easy to detect if you know what you are doing, but even experienced due diligence people can be eluded or deluded by more subtle types of style drift. Is someone who trades convertible bonds for their volatility characteristics guilty of style drift if they start trading distressed convertibles where the volatility element of the bond is dwarfed by the credit risk of the bond? How about an equity manager who normally takes a long term view but becomes successful at trading in a more volatile market? What if they become successful at their deviation? Would an investor cry foul and redeem?

Not doing what one says they will do is very much related to style drift. Actually, its more related to misrepresentation. The risk arb manager who suddenly decides to operate a long only distressed debt strategy. A public listed equity hedge fund that decides to buy an unlisted resort in Bali. A distressed debt manager who decides to take a punt on some equities (non post reorg equity). These types of style drift are misrepresentation. The regulation of these products falls not under the FSA or the SEC. They fall under the concept of misrepresentation in Contract Law. Offering documents are currently drafted in such a way that a hedge fund manager could do pretty much whatever they liked. This has to change. For contract law to take hold, the level of definition in prospectuses has to be improved. Investors will want to know precisely what hedge fund managers are allowed to do, and not allowed to do, and they will want it in ink.

Hedge fund fees do not reflect proper alignment of interest between managers and investors. Performance fees are a great idea, but what about negative performance? Like any business activity, a workman deserves his wages. Paying performance fees for performance is fine. It is even acceptable that fund managers don’t have negative performance fees (that is pay out when they lose money symmetrically as they charge fees when they make money, lets grant them this latitude). But the current design of performance fees encourages short termism and does not encourage optimal behaviour over multiple periods. A private equity fund style holdback with clawback quickly (though imperfectly) addresses this. Management fees. The raison d’etre for management fees in a hedge fund which already charges performance fees is that it covers costs and overheads. In that case, charge expenses and costs to the fund and do away with management fees. Or cap the management fee in absolute dollar amount so that the fees fall as the fund size increases. Costs and expenses do not rise linearly with assets under management.

Gates. These are the things that hedge fund managers use to keep investors from pulling their capital out. There is a purpose and a use for gates, but the way they were used in 2008 is a negative example. Gates should be used as a last resort. Gates should be structured so that there are clear guidelines to when they can or cannot be invoked. The blanket rights of the fund’s board of directors to impose gates should be re-examined. A fund should be structured properly so that its redemption terms are appropriate to the liquidity of the strategy and market it trades. If done appropriately, the need for gates is greatly diminished. Invoking gates because the manager had more illiquid assets than he was representing and was therefore caught off guard by the volume of redemptions is not a good excuse. Worse still is the tendency to invoke gates since (in 2008), everyone else was doing it and the stigma associated with it seemed to have diminished is downright disingenuous.

Side pockets. These are share classes issued to track illiquid investments and to make sure that investors are equitably treated with respect to their allocation of these illiquid investments. There is a proper use for them, but often they are misused. I can see side pockets used when an investment is illiquid and the valuation is conservative and the true value is likely to be known only upon realization. In any case, side pockets should only be used for new investments and never for legacy ones. Investors don’t like retroactive side pockets. They are more like back pockets.

Terms which are inappropriate for the strategy or market traded. When hedge funds were doing well and the industry was in rapid expansion, hedge fund managers were able to command whatever terms the market would bear. A star manager trading a liquid strategy in liquid markets could demand long lock ups, account level gates, fund level gates, exit fees, high management and performance fees, modified high water mark fees and other features that had no bearing on the strategy. Smaller managers, start ups, less visible or fashionable managers who struggled to raise assets would provide more liquidity than their portfolios could bear, offer discounts so that they would be less viable businesses. Don’t promise more than you can deliver. Don’t ask for more than you need.

Investor management is poor. Apart from willful misconstruction of the fund vehicles, the investor side of the equation, the capital base, was often left as an afterthought, delegated as a part time job to one of the portfolio managers, the CFO, a junior marketer and was generally not well managed. Banks have an army of personnel to manage the deposit base so as to build stability. Banks with an over-reliance on wholesale funding have found themselves in deep trouble lately. A hedge fund which gave little thought to its investor base and had too much concentration from particular types of investors, notably wholesale intermediaries like funds of funds, were precisely analogous to wholesale funded banks.

Transparency is often poor. Many hedge funds do not provide sufficient transparency because they underrate the value of transparency to investors, don’t care if its important to investors or are simply very secretive. Reference the point above about poor investor management. Transparency is part of investor management and investor retention. Investors want to know what the hedge fund manager is up to. Transparency is also required by investors to monitor potential style drift. Transparency, however, takes different forms. Position level reports are useful to an extent but they are more relevant to some strategies than others. The trading behaviour of a manager can create risk exposures that a snapshot picture in time cannot reveal. Risk reports are often more useful, aggregating exposures to specific relevant risk factors. Receiving these reports from the independent administrator is of course far more useful than if it is sent by the manager themselves. Transparency can also take the form of communications with the manager. Of course the traders and portfolio managers time is best served trading and managing money. Well informed investor relations personnel with relevant experience can be a very powerful investor management resource. Alas, some managers think of these resources as costs rather than as investments.

Not reasons we hate hedge funds:

Strategies are too complex. Hedge fund strategies can run from the simple to the complex. Behind every simple strategy, is a complex thought process. A simple strategy with a simple thought process and a simple execution will not obtain much alpha. Investors do not shy away from complexity, they price it. The more complex a strategy is, the safer it must be for a given return, or, the higher must be the return for a given level of risk.

Fees are too high. Its not how high the fees are, it’s the design of the fees. See my previous article about fees: Hedge Fund Fees. Its not the magnitude but the design.

Hedge funds have long lock ups. We don’t have a blanket aversion to long lock ups. We have an acute aversion to liquidity mismatches. See my article dated Feb 2007 about the Asset Liability Management of a Hedge Fund.

Hedge funds are all beta and leverage and little else. It is true that the large majority of hedge funds are not of the highest quality. Barriers to entry into this lightly regulated industry has allowed fund managers who have no business running a hedge fund to run a hedge fund. At the aggregate level it is certainly true that leverage and beta have been the main drivers of returns. The solution to the problem is to be selective. The definition of beta alone is a subject of a long discussion and we won’t get into it here. The appropriate level of leverage similarly is a complicated issue. Being selective is not a complicated issue. It is a difficult problem to crack, but the concept is simple.

Why we like hedge funds:

They actually work. Mutual funds and long only funds lost 40% to 50% in 2008. Hedge funds lost only half that. And many of those losses were due to the collapse of the infrastructure surrounding them and the misguided policies of regulators in response to the crisis. The shorting ban of 2008 for example was a major impediment to hedge fund strategies. In spite of these constraints, hedge funds lost on average 20% in 2008, roughly a quarter of them made money in 2008, and roughly a third of them underperformed long only funds (bear in mind that the performances are not uniform with respect to strategy or size.)

Hedge funds are less volatile. On average over the last 8 years, hedge funds had a volatility of 12% while long only funds had a volatility of 25%. The risk reward properties of hedge funds is also attractive. In the last 8 years, equities have lost 5% while hedge funds have made 5%. A comparison of Sharpe Ratios quickly recommends hedge fund over passive long only strategies.

Market efficiency: As a group, hedge funds represent unconstrained investing. I say as a group because you do not want to be investing with a single manager who is totally unconstrained. Do you? But as an unconstrained investor, the hedge fund industry brings price efficiency to the market, allocating capital efficiently to businesses, sectors, countries and asset classes.

Hedge funds offer diversification benefits. **And more.** This is an interesting area. Depending on how you measure correlation, that is over what length of time and with what frequency, hedge fund correlation to the MSCI World Equity Index can range from 60% to 95%. What is interesting, however, is that in recent years, investors had complained that correlation between hedge funds and equity markets had risen, and they were right. Throughout 2006 and 2007, correlations ran at over 90%. But correlations have fallen since the middle of 2007 from 90% to 70% in Feb 2009. Just when you needed the decoupling, you got it. In the middle of the bull market, correlations ran high. In the throes of a bear market, correlations fell. Not an entirely undesirable quality.