Current Thoughts About Hedge Fund Investing

Concepts like volatility and correlation can be hard to visualize or grasp intuitively. I sometimes like to think simplistically about complicated matters. The insights gained are often far from simplistic. Hedge funds are unfortunately, a complicated subject, and try as one might, it is difficult to reduce the complexity of the issues.

One of the reasons that hedge funds are an attractive investment is that because they don't spend long spells in decline, they are a useful investment for someone who doesn't know when they might need liquidity and have to sell their investment. A steadily rising NAV provides a useful store of value which can be realized based on ones' needs and liabilities rather than based on the performance of the asset. Nothing is without volatility or risk but hedge funds dampen volatility sufficiently to make the liquidation decision less dependent on the asset performance. With long only, exposure based investments the liquidation and indeed investment decision often depends on an assessment of both the investors' liability requirements as well as the historical, current and prospective asset performance. A simple example is the following. An investor's decision whether to liquidate their position in an S&P 500 index ETF depends not just on whether they need cash or not but whether the S&P500 is expected to rise or fall going forward or on whether the market is cheap or expensive. Investor regret is another psychological factor that complicates the decision. The investor is discouraged from disinvesting if it means crystallizing a loss or if they have recently experienced a large drawdown. Memoryless investing is a difficult ideal.

Low volatility is a useful feature in an investment as it allows the investor to compound their returns. Of course low volatility should be coupled with a positive return. Compounding is one of the most powerful concepts in investing and one often misunderstood even by seasoned investors. If investors understood compounding there might be fewer investors who fail to reinvest their dividends. A cursory survey of the proliferation of dividend paying mutual funds, some even paying out of capital, will illustrate this.

Hedge funds specialize in niche markets and strategies. Even when they invest in broad markets, the successful ones always have unique approach. Often, hedge fund techniques have been honed by years of trading on a prop desk risking bank shareholders' capital allowing the hedge fund manager to learn without fear. Hedge funds excel in 'closed' markets which are not well known by garden variety investors. Their consistent returns are often supplied by itinerant and unfamiliar investors or tourists as they are known euphemistically. A large bond mutual fund manager trafficking in the mortgage backed security market is an example of such tourists. Dedicated MBS traders whose careers have been focused on the MBS market tend to fare much better than their generalist cousins in a game that is not entirely but fairly close to, zero sum. That the MBS market is one of the largest and most liquid in the world is no protection for the unfamiliar. The insularity of that market, the peculiarities of its culture and regulation, make it a difficult place for tourists. Merger arbitrage is another great example of equity investors employing more than just equity valuation and analysis to what are often complex legal and strategic events. The best merger arbitrageurs are those who combine legal expertise with corporate finance, private equity, and equity analysis and an understanding of the options market to employ optimal trade expressions so as to eke out all the available returns in a merger deal. A lacking in any one are puts one at a disadvantage against traders with the full range of skills. The best merger arbitrageurs benefit from the liquidity provided by less well equipped merger arbitrageurs and long only fundamental or speculative investors.

Hedge fund detractors argue that hedge funds have failed to outperform equities. Depending on the time frame hedge funds have either outperformed by a wide margin, 1993-2013, averaging 9.23% p.a. versus 4.86% p.a. for the MSCI World. In the last 10 years, however, hedge funds have done a paltry 6.14% p.a. against 8.55% p.a. for equities. That said, the volatility of hedge funds have tended to be less than 6% whereas equity vols have been about 15%. Practically, what this means is that the amount of risk assumed to obtain a unit of return was much higher for equities than hedge funds. This point is very much related to the first concept we discussed, that investing in equities needs good timing.

When comparing the performance of hedge funds with other investments it is necessary to use some kind of benchmark or index. One should be circumspect about the utility of hedge fund indices. Apart from data and construction issues which are well documented, there is the question of what such an index measures. Mutual funds can easily be benchmarked against market indices. However, while the average mutual fund is, well, average, the average hedge fund is quite poor. Low barriers to entry, light regulation, even as standards are tightened, the absolute return objective, make it hard to excel in a highly competitive industry. An index designed to be representative of the collective, if successful, might reasonably be expected to display lackluster returns.

Hedge fund investing is all about seeking out the best in their respective fields. The successful hedge fund allocator should assemble a portfolio that p
erforms and looks very unlike the index. Hedge funds are not a homogenous group but display significant dispersion of behavior and results. The potential for finding the exceptional is high. The risk of finding the mediocre or the poor is high.

One of the problems with any investment is that with wide acceptance comes correlation. While hedge funds are not homogenous and many have unique strategies, even independent strategies can become correlated through the behavior of their investors and prime brokers. Investors control the source of equity capital available to hedge funds while prime brokers control the leverage available. Herd psychology and cross contamination can lead to group behavior among investors. That prime brokers are almost always leveraged by a multiple or several multiples more than the hedge funds they finance adds to potential instability. Hedge funds with adequate liquidity restrictions can in fact be a strength although very few investors recognize this or accept it; exhibiting a strong liquidity preference. This liquidity comes at a significant cost.

How relevant are hedge funds today? In the post 2008 world, hedge fund indices have indicated a lackluster performance easily eclipsed by equities or corporate credit. Beneath the headline numbers, a group of hedge fund managers have outperformed the market either in absolute terms or in risk adjusted terms. These funds have tended to trade in credit. Some equity funds have managed to excel but these have tended to be merger arbitrage and activists or indeed credit funds extending beyond their normal hunting grounds in the capital structure. Structured credit funds, particularly those involved in mortgage backed securities have also excelled.

The opportunities for making money are ample today. They may be less accessible to long only strategies since markets have recovered strongly from their 2009 lows. The world continues to be a complicated place with a steady stream of tectonic shifts in geopolitics, policy, economic fortunes, regulation and the structure of distribution and allocation of capital. These are very interesting times indeed for investors who seek out and embrace complexity as a source of alpha, or non-market returns.