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# Hedge Funds are NOT an asset class.

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## 1. Introduction

Mystery and fear surround the world of hedge funds in the public debate. The list of evil traits of hedge funds is long: opaque, excessive manager remuneration, short termism, casino mandates, star-players without responsibilities, etc.
No wonder that the institutional and pension fund world has long kept hedge funds at a certain distance.

Through the financial crisis many of the surviving hedge funds have redeemed themselves by continuing to deliver positive returns whilst delivering significantly lower risk profiles and volatility. This has brought a new interest in hedge funds - including from the pension fund sector. The size of the hedge fund sector is frequently discussed. Many guestimates circulate, but it seems reasonable to assume that it is currently bigger than $2 trillion.

This note deals with a central issue in many current debates on hedge fund investing. In a world where yields of lower-risk investments have fallen so dramatically, the search for more attractive returns is extending to sectors which were no-go areas until recently.

One of the main characteristics of these debates is the approach many take in treating hedge funds as a separate asset class.

We will argue that hedge funds are not a separate asset class. They are a method of investing in traditional asset classes such as equity, debt, commodities, property, etc.

## 2. What are hedge funds?

Hedge funds are pooled investment vehicles that pursue absolute returns through the taking of either long or short positions, and the active use of risk protection through "hedging" certain risks. Hence the wide terminology "hedge funds".

As a result, they tend to exhibit low correlation to traditional market indices. The strategies employed by hedge funds are based on investment concepts that were originally developed by A.W. Jones in the late 1940's.

While myriad strategies are available to hedge fund investors today, an important distinction lies in the fact that hedge fund strategies are skill-based: they do not rely solely on price appreciation to generate returns. Hedge funds allow managers to employ highly flexible investment approaches that involve both long and short portfolio exposures; therefore, they can generate returns in down markets and they can profit from the relative performance of securities against each other.

While traditional mutual funds tend to generate returns based solely on equity and fixed income price appreciation, hedge funds can tap other potential return sources, such as the performance of large cap equities vs. small cap equities, changes in the term structure of interest rates, and derivative pricing anomalies that occur due to disparate views on future volatility.

## 3. Hedge fund Strategies

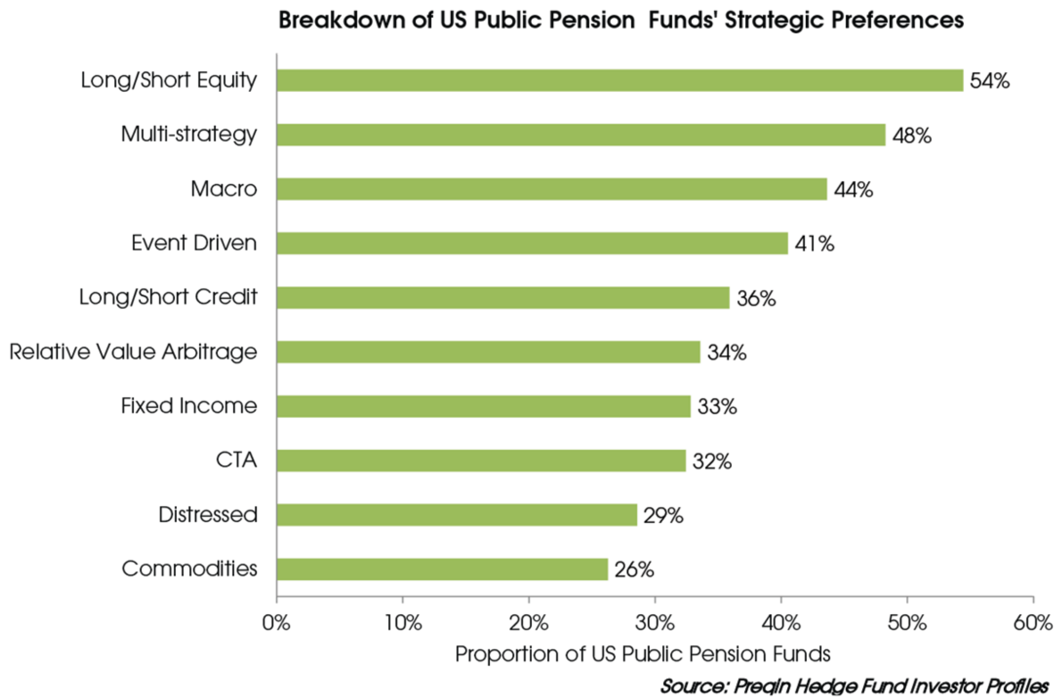
It follows from the above definition that the term "hedge fund" encompasses a wide variety of investment strategies. It covers many investment activities which differ greatly in terms of objective, focus, and asset class.

The quest to identify common themes among different hedge funds has led to their grouping into investment strategies such as:

- Equity Long/Short;
- Global Macro;
- Event Driven including Distressed;
- Credit or Fixed Income;
- Relative Value;
- Commodity;
- Managed Futures/CTAs; and
- Diversified/Multi Strategy.

Annex I presents a brief description of these strategies.

The graph below shows that the amount of institutional money invested in these different strategies varies significantly, with Equity Long/Short being the most popular strategy.




Hedge funds, through their different strategies, invest in traditional asset classes: equity, debt, property, commodities and cash. It is **the way they invest** in these asset classes that differentiates them from traditional long-only investing. The use of leverage through derivatives and short positions, coupled with the manager's extensive discretionary flexibility differentiates hedge funds from classic mutual funds.

In our view, this does not mean that they are a different asset class. Hedge funds can be more accurately described as pooled investment vehicles. Pooled investment vehicles like mutual funds offer investors access to diversified, professionally managed investment portfolios. They do not have, **in themselves**, a specific diversification benefit.

The table below mixes and matches the traditional asset classes with the various ways investors can seek to take positions in them. For example, in the credit/fixed income area investors can buy listed bonds, invest through mutual credit funds, subscribe to private debt deals, buy structured products such as ABS or MBS or finally take credit exposure through hedge funds (see hedge fund credit strategies in Annex).

Each of these methods has different characteristics (see the next chapter) but the table below tries to clarify that hedge fund investing is, in our view, a way of investing in different asset classes and not an asset class on its own.

| | Listed securities | Mid/small cap | Structured Products | Private Equity/debt | Hedge funds |
|---|---|---|---|---|---|
| Equity | *shares* | *shares* | *funds* | *participations* | *long/short, relative value* |
| Debt | *bonds* | *high yield* | *ABS, MBS* | *private debt* | *arbitrage, distressed* |
| Property | *shares* | *holdings* | *shares* | *participations* | *market discrepancies* |
| Commodities | *ETFs* | *shares* | *funds* | *physical holdings* | *speculative* |

## 4. Characteristics of hedge fund investing

According to Preqin, the global leader in alternative assets data, US public pension funds are now the biggest source of institutional capital for hedge funds. They account for approximately 16% of the total institutional capital allocated to hedge funds, and year-on-year increases in mean hedge fund allocations rose from 7.2% at the end of 2010 to 8.8% at present. It seems that the current debate in Europe is edging in the same direction with major pension funds such as ABP and PFZW of the Netherlands, already investing more than 5% of total assets through hedge funds.

For the investor, hedge fund investing characterizes itself through a number of distinct aspects such as:

- Significant manager freedom to take positions
- Use of leverage
- Remuneration linked to performance
- Reduced liquidity

Investors, and in particular institutional investors such as pension funds, need to be fully aware of these characteristics. They need to be comfortable with this level of mandating in view of their fiduciary duties. For example, investing in liquid markets such as listed securities results in very different risk, return, and liquidity profiles from investing in private equity or hedge funds. The freedom managers require while implementing investment mandates is usually very limited with listed securities or mutual funds in listed equities or bonds – especially given the trend towards passive investing – contrary to investing in private equity or hedge funds. This means at the same time that the direct control investors have over equity fund mandates is much greater than the control that can be exercised on hedge funds or private equity managers.

The table below illustrates some of the issues investors are facing when choosing among the various investment opportunities on offer.

|  | **Listed securities** | **Mid/small cap** | **Structured products** | **Private equity** | **Hedge funds** |
|---|---|---|---|---|---|
| Liquidity | *high* | *medium* | *limited* | *very low* | *low* |
| Managers leeway | *limited* | *limited* | *defined* | *defined* | *great* |
| Use of leverage | *none* | *none* | *limited* | *yes* | *major* |
| Costs | *low* | *low* | *enhanced* | *high* | *high* |

This schedule shows us that investing directly in listed securities allows for high liquidity with managers under strict control, no leverage and low costs, contrary to investing in hedge funds or private equity.

The way hedge funds invest aims to achieve steady returns and low volatility, which makes them a worthwhile element in an investment portfolio. However, their mandates allow for significant discretionary freedom for managers, and thus reduced controls from the investor point of view.

This is very important for boards and trustees of institutional investors to appreciate. It is also an issue for supervisors in the pension fund sector, as they need to decide whether allowing discretionary mandates with significant manager freedom sits well with the Prudent Person Principle of pension fund trustee boards as caretakers for the pension fund participants. In cases where hedge fund investing is allowed, supervisors require substantial knowledge at the trustee level in order to ensure close and effective monitoring.

## 5. Conclusion

Investing in hedge funds has long been a no-go area for major institutional investors such as pension funds.

Many reasons have been fielded for this, such as:

- Reduced liquidity levels
- The use of leverage which could be seen as being in
- conflict with basic funding rules for pension funds
- Significantly higher levels of manager remuneration in a world where costs are tightly monitored
- Significant levels of discretionary freedom for managers and thus reduced levels of direct investors' control

In the current climate, the search for yield has forced pension funds and other institutional investors to look beyond traditional asset allocation.

Whereas in the past traditional asset managers have always been dependent on directional moves in the underlying markets (beta exposure) for their performance, they now need to enhance their investment skills to generate outperformance - and investment skill is the defining and competitive element of hedge funds.

As we are probably entering a period of higher volatility, alternative investments, as described earlier, may play an increasingly important role.

Some alternative strategies will allow a manager to add value irrespective of the directional moves of the underlying market.

A greater degree of interest in hedge funds from the institutional sector may benefit private investors as well, as the hedge fund sector will likely become more mature and transparent and, importantly, also less expensive.

## Annex I Defining hedge fund strategies

**Equity Long/Short –** The Equity Long/Short strategy was developed in 1949 when Alfred Winslow Jones launched the first "hedged" fund, which was designed to capture idiosyncratic market opportunities by taking both long and short positions. Jones' objective was to neutralize market risk by maintaining equal exposure on the long and short sides, while generating profits based on stock selection.

Equity Long/Short exposure can be measured in terms of various market betas (sensitivity to changes in a market index), industry exposure biases, regional exposure biases, etc., but the most widely used measures are gross exposure (long exposure + short exposure) and net exposure (long exposure – short exposure).

Gross exposure shows the degree to which a hedge fund manager has used leverage to increase portfolio risk and return, and net exposure shows the degree of market exposure. Net exposure can be used to compare one fund's market exposure against another, or how a fund's market exposure changes over time. A net exposure of 0% does not mean that the fund has no market exposure. Market exposure can be influenced by numerous biases and mismatches: a zero net exposure portfolio might be long high beta stocks and short low beta stocks, or long emerging market stocks and short developed market stocks.

**Global Macro –** Global Macro strategies can be discretionary (based on human judgment) or systematic (based on computer models) in nature, and seek to generate returns in the currency, fixed income, equity, and commodities markets based on macroeconomic factors. Such factors include capital flows between countries and the interest and foreign exchange rate effects of differences in the outlooks for global economic growth and inflation.

Global Macro managers use macroeconomic valuation measures such as interest rate parity and purchasing power parity to take directional and relative value exposures, typically via liquid futures markets. They tend to perform best in directional markets where disparate fiscal and monetary policies can cause imbalances to occur. However, unlike managed futures managers, they may choose to bet that a trend will reverse, or a new trend will develop in the future. As a result, they can be either long or short volatility, so their returns may or may not correlate with relative value and managed futures strategies.

**Event Driven –** Event Driven strategies generate returns by investing in the securities of corporations that are undergoing significant change. Managers tend to specialize in event driven trades like mergers, spin-offs, and turnarounds, or credit driven trades in the investment grade, high yield, or distressed markets. Many trades involve a combination of the two.

**Credit –** Credit strategies are typically divided into sub-classifications based on the degree to which they are dependent on income (carry) or capital gains (valuation). Carry-based Credit strategies involve the purchase of high yielding securities, and hedging out market exposure via short bond or derivative positions. High yield carry trades generate positive cash flow, or "carry," because the interest received on the long position is greater than the interest paid on the short position. They can also generate positive capital gains when the interest rate differential between the long and short holdings shrinks because the long position increases in value relative to the short position, and vice versa.

Valuation-based Credit strategies are more focused on valuation than carry. These strategies may even take positions that have zero or negative carry (short position that yields more than long position), but this is uncommon due to the negative interest cost that must be paid while the manager waits for valuations to move in line with expectations.

**Managed Futures (CTAs) –** Managed Futures managers are sometimes referred to as Commodity Trading Advisors (CTAs), and the terms can be used interchangeably. Managed Futures strategies employ computer modelling techniques to identify short-, medium-, and long-term upward or downward trends in security prices, especially in the futures markets. As a trend develops, the model will increase the portfolio's long or short exposure based on the expectation that the trend is likely to continue.

The rebalancing frequencies employed by Managed Futures strategies can be long-, medium-, or short-term in nature. Long-term trend followers tend to move in and out of positions slowly. They have both higher expected return and higher risk profiles because they are exposed to short-term reversals within long-term trends. On the other hand, since short-term managers rebalance quickly, they can miss major trends due to the presence of short-term reversals. Given the strengths and weaknesses associated with various rebalancing frequencies, investors typically diversify their exposures.

**Commodities –** While Managed Futures managers use computer models to capture trends in the price movements of various commodities and financial instruments, Commodity managers differ in several important aspects. Although they invest based on expected future movements in commodity prices, and the asset price changes that will likely develop, their strategies are based mostly on fundamental macroeconomic and security valuation research rather than on technical analysis of security price trends.

**Relative Value** – Relative Value funds capitalize on value discrepancies between securities in order to generate returns. Discrepancies can be both market specific and company specific. Relative Value managers often invest across the corporate capital structure in both equity and debt instruments to achieve their return objectives. Other types of relative value strategies involve taking positions that isolate the values of the call options that are embedded in structured securities such as convertible bonds and mortgage-backed securities. Statistical and market neutral arbitrage strategies are also typically classified as Relative Value.

**Diversified / Multi-Strategy** – Diversified funds, also known as Multi-Strategy funds, can utilize any or all of the other hedge fund strategies to achieve their objectives.

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