INVESTMENT>ALTERNATIVE INVESTMENTS

This Is What Clients Want From Hedge Funds

Three strategies to help diversify their portfolios.

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By Joe Burns

Evaluating hedge funds in the context of a diversified portfolio is fundamentally challenging, mainly due to the widely disparate investment strategies, liquidity profiles and distinct risk/return characteristics across different funds. While it is imperative to have access to the highest quality managers investing in various strategies that are complementary to an existing portfolio, the more fundamental question is: what am I looking to solve for in the context of an overall portfolio; specifically, are my clients looking for hedge funds to provide capital preservation, portfolio diversification or enhanced returns?

Capital Preservation

This approach is often focused on larger, established funds that trade in many different markets and dynamically deploy capital among multiple strategies across the capital structure. These funds can offer investors capital protection while still delivering strong risk-adjusted returns over time. A Preqin survey of institutional investors found that almost half (46 percent) of investors use hedge funds to dampen portfolio volatility, with 30 percent citing the mitigation of risks in other areas of their portfolio as a key objective of their hedge fund allocation.

Portfolio Diversification

Investors have grown comfortable with the negative correlation between equities and bonds, such that when equities falter bonds rally in a flight-to-quality scenario. But what happens if or when equities struggle for a protracted period of time, corresponding with rising rates and a declining liquidity environment for fixed income? The value of alternative strategies uncorrelated to both stocks and bonds increases considerably as a primary source of portfolio diversification in such a scenario. Global macro strategies and systematic trading strategies have consistently shown the lowest correlation to traditional markets over the past two decades. Following the recent period of uncommonly strong long-only performance, these strategies have unsurprisingly lagged, but offer an opportunity to diversify clients' risk exposures and introduce new return drivers long-term.

Return Enhancement

There are three primary ways in which an advisor can help clients achieve enhanced returns via hedge funds, and all seek to take advantage of the flexibility that hedge funds have over long-only strategies in traditional markets. The first is where the hedge fund has a specialized focus, either geographic, sectoral or factor-based (e.g. value or small-cap) to generate returns from a long and short perspective. Portfolio returns over time will come from idiosyncratic risk rather than market exposure, driven by a more dynamic portfolio management approach.

Co-investments offer another way of enhancing returns, allowing investors to participate alongside a hedge fund in a single investment idea. Fund managers will occasionally have an exceptionally high conviction idea that is not capacity constrained, but if the position is fully-sized in a portfolio the manager may create a vehicle for investors who wish to get additional exposure to a specific investment. These co-investments are typically a single company or particular theme that has a discrete time horizon (often 1 to 2 years). These structures can also benefit investors by charging lower fees than a typical fund investment.

Finally, advisors seeking to enhance returns for clients should focus on accessing emerging funds that historically have delivered outperformance vs. larger peers. Strategically, these managers tend to focus on fundamentally driven long/short equity and event-driven strategies. These emerging funds can outperform their larger counterparts due to:

- **Broader Opportunity Set:** Emerging managers are less constrained by liquidity and thus can invest across the market capitalization spectrum. This allows them to invest in smaller stocks but also to take larger positions more freely, as liquidity may a limiting risk factor for a large fund looking at the same investment.

- **Talent & Experience:** The best managers often self-select in launching their own firms following years of successful experience at a larger firm.

- **Alignment of Interest:** There are many motivational factors that help drive smaller managers to focus on returns; the limited asset base means the performance fee represents the majority of their personal profit, the entrepreneurial desire to 'make it' can be a driving factor, and the small size of the team means that the founder is more intimately involved with all aspects of the portfolio.

Considering the significant contribution to returns that equities have provided over the past decade, the protection from bonds and the negative correlation between the two asset classes, advisors may feel as though their clients are well-positioned from a returns, risk and portfolio diversification perspective. However, it is difficult to overestimate the impact of monetary stimulus and effect on market structure. As the Federal Reserve's balance sheet contracts, interest rates and volatilities increase, valuations normalize, and correlations shift across markets and asset classes, the need to access new return drivers and risk mitigants rises exponentially. Specific hedge funds, large and small in multiple strategies can provide investors with an opportunity to improve the quality of their portfolios and increase risk-adjusted performance in a new market regime.

Joe Burns is the Managing Director, Head of Hedge Fund Due Diligence, iCapital Network