

Rocaton

INSIGHTS

*The State of the Hedge Fund
Industry*

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EXECUTIVE SUMMARY

- Hedge fund strategies have faced increased scrutiny post-financial crisis due to underwhelming performance and high fees relative to traditional strategies.
- The increased pressure has led to a number of fund closings, but, despite the headwinds, assets under management across the entire hedge fund industry recently hit an all-time high.
- While hedge fund strategy fees remain high relative to traditional active and passive strategies, there has been a trend towards a reduction of fees.
- When adding hedge fund strategies to a portfolio, we believe investors should focus on a strategy's investment profile (return potential, correlation expectations, drawdown potential, etc.) and range of outcomes before including it in a portfolio.

Introduction

Post-financial crisis, hedge fund strategies have faced increased scrutiny and negative press due to high fees and poor performance relative to public markets. While some high-profile firms have closed and some institutional investors have reduced or abandoned hedge funds, hedge fund strategies still play a role in some investor portfolios. Therefore, we believe it is prudent to remind investors of the considerations which should be understood when utilizing hedge funds. Importantly, we believe investors should focus on a strategy's investment profile (return potential, correlation expectations, drawdown potential, etc.) and range of outcomes when contemplating the addition of hedge funds to their portfolio. The balance of this paper reviews the current state of the hedge fund industry and provides more detail on our preferred approach to using hedge fund strategies within investor portfolios.

Recent Hedge Fund Performance

In recent years, media publications have often labeled hedge fund strategy returns as unequivocally bad. While performance for many hedge fund strategies has failed to keep up with public market asset classes, a more meaningful assessment of the success of hedge fund strategy performance requires greater depth. First, unlike many public market asset classes (e.g. U.S. public equity), the dispersion in returns across strategies within the hedge fund industry can be wide. Further, there are significant flaws in the limited number of hedge fund benchmarks that are available. Hedge fund "indexes" are often peer groups which aggregate performance for underlying strategies. This results in indexes which can suffer from survivorship bias, may not be investible and may not properly resemble the particular hedge fund strategy being analyzed. Despite these shortcomings, we can compare "index" performance across hedge fund strategies (see Figure 1) to various public market asset classes to provide a general sense of results experienced by investors¹.

¹ We have chosen to show performance for the hedge fund industry with the Credit Suisse hedge fund indexes due to data availability. While we do not have a strong preference, we have found that both the Credit Suisse and HFR Hedge Fund Indexes are suitable for performance comparison purposes.

Figure 1:

Total Return Performance for Hedge Fund Strategies

Strategy Type / Asset Class	Trailing Periods Ending July 31, 2017					Calendar Years				
	YTD 2017	1 Year	3 Year	5 Year	10 Year	2016	2015	2014	2013	2012
Hedge Funds (Broad Index)	4.3	6.1	2.1	4.5	3.3	1.2	-0.7	4.1	9.7	7.7
Equity Market Neutral	6.1	4.0	1.0	2.7	-2.9	-4.6	1.7	-1.2	9.3	0.9
Event Driven	5.1	9.0	-0.8	4.7	3.0	2.7	-6.3	1.6	15.5	10.6
Global Macro	-0.2	4.7	1.9	2.6	4.9	3.6	0.2	3.1	4.3	4.6
Long/Short Equity	8.6	9.0	4.0	7.3	4.0	-3.4	3.6	5.5	17.7	8.2
Managed Futures	-3.2	-13.0	2.0	-0.6	2.1	-6.8	-0.9	18.4	-2.6	-2.9
Multi-Strategy	5.9	8.7	5.7	7.3	5.0	4.4	3.8	6.1	11.2	11.2
U.S. Equity	11.6	16.0	10.9	14.8	7.7	12.0	1.4	13.7	32.4	16.0
Non-U.S. Equity	10.8	18.5	7.3	11.6	3.2	7.5	2.3	6.5	20.6	16.9
U.S. Core Fixed Income	2.7	-0.5	2.7	2.0	4.4	2.6	0.5	6.0	-2.0	4.2
U.S. High Yield Fixed Income	6.1	10.9	5.3	6.7	8.2	17.1	-4.5	2.5	7.4	15.8

Returns greater than 1 year are annualized. Hedge fund strategy performance represented by the Credit Suisse Hedge Fund Index series. Public market indexes are the S&P 500, MSCI ACWI ex. U.S., Barclays U.S. Aggregate, and Barclays U.S. High Yield Fixed Income.

Looking at performance relative to public markets, one might reach the conclusion that hedge fund strategies have failed to add value to investor portfolios. The Broad Hedge Fund Index, for example, has underperformed most public asset classes over most trailing and calendar years. However, by definition, hedge funds are expected to have less than 100% market exposure and, therefore, should be expected to underperform traditional strategies during bull markets. To be clear, performance for hedge funds broadly has failed to meet our expectations even when considering the environment we have lived through post-financial crisis. Beyond total returns, we also believe it is also important to review strategy correlations, volatilities and drawdowns. Figure 2 provides additional detail relative to the same public market asset classes.

Figure 2:

Hedge Fund Strategy Volatility, Drawdown and Correlations

Strategy Type / Asset Class	Hedge Funds (Broad)	Equity Market Neutral	Event Driven	Global Macro	Long/Short Equity	Man. Futures	Multi-Strategy	U.S. Equity	Non-U.S. Equity	U.S. Core Fixed Income	U.S. High Yield
Volatility (Last 5 Years)	3.1%	3.9%	4.7%	3.7%	4.5%	10.3%	2.3%	9.5%	9.0%	2.8%	5.2%
Volatility (Last 10 Years)	5.6%	13.7%	6.5%	5.5%	7.7%	10.8%	5.5%	15.1%	14.5%	3.3%	10.6%
Maximum Drawdown (Post-GFC)	-7.0%	-5.6%	-14.3%	-6.2%	-12.6%	-17.8%	-4.3%	-16.3%	-17.6%	-3.7%	-9.7%
Maximum Drawdown (Last 10 Years)	-19.7%	-45.1%	-19.1%	-14.9%	-22.0%	-17.8%	-24.7%	-50.9%	-50.3%	-3.8%	-32.7%
Correlation to S&P 500	0.69	0.18	0.65	0.46	0.74	0.13	0.43	1.00	0.80	-0.05	0.66
Correlation to MSCI ACWI ex. U.S.	0.82	0.12	0.73	0.66	0.75	0.13	0.65	0.80	1.00	0.06	0.71
Correlation to Barclays Aggregate	0.13	-0.05	-0.16	0.15	-0.02	0.57	0.20	-0.05	0.06	1.00	0.31
Correlation to Barclays High Yield	0.58	0.08	0.64	0.37	0.47	-0.02	0.44	0.66	0.71	0.31	1.00

Volatility is annualized. Drawdowns are cumulative. Correlations are over the last five years ending July 2017. Hedge fund strategy performance represented by the Credit Suisse Hedge Fund Index series. Public market indexes are the S&P 500, MSCI ACWI ex. U.S., Barclays U.S. Aggregate, and Barclays U.S. High Yield Fixed Income.

By combining after-fee total returns and other performance statistics, we can better assess recent hedge fund strategy performance. For example, managed futures strategies have generally delivered on their promise of low correlation to traditional asset classes while long/short equity strategies have delivered smaller drawdowns than public equities. This is not to say that all hedge fund strategy performance has been good. We recognize that, in many cases, after-fee total return is most important to many clients. Although an in-depth review of each strategy type is beyond the scope of this paper, we would point to several strategy types which, broadly speaking, are meeting our expectations and several which are not meeting our expectations. Specifically, multi-strategy and long/short equity strategies have generally met our expectations while global macro

and managed futures strategies have not kept up with our expectations. The event driven category has also been mixed, although we have generally been pleased with the results from distressed credit managers, which are often bucketed into “Event Driven” by index providers. Again, it is worth pointing out that there can be wide dispersion of returns within individual strategy types and, as such, individual strategies may have delivered more compelling returns in recent years.

Industry Trends

Given the recent lackluster performance, in general, and the maturation of the industry, hedge fund strategy fees, asset flows and liquidity terms have all come under the spotlight. As we have already highlighted, hedge fund strategy assets under management are currently at record highs, despite the negative press and aforementioned performance challenges. The disappointing performance has been somewhat offset by modest improvements in fees and liquidity terms. Below, we explore each of these topics in more detail.

Assets

Just prior to the global financial crisis, assets in hedge fund strategies were north of \$2 trillion. Following difficult performance and significant outflows, total AUM across hedge fund strategies dipped below \$1.5 trillion. In the years following the global financial crisis, net inflows and positive performance have led AUM to a new record high of \$3.2 trillion. It should be noted that growth in AUM has largely been driven by positive performance rather than meaningful net inflows. In fact, according to Credit Suisse, there were net outflows of \$70 billion across all hedge fund strategies in 2016, the first year with net outflows since 2008. Though this absolute dollar figure appears large, we would point out that these outflows represented only 2% of the total industry assets.

Fees

Although investors typically associate hedge funds as charging fees of “2 and 20” (that is, 2% management fee and a 20% incentive fee), the reality is that fees can vary across strategy types and individual managers. For example, long/short equity strategies typically charge a 1.5-2% management fee and a 15-20% incentive fee. Of course, some strategies are still able to charge 2% and 20%, including funds with capacity constraints and those which have delivered better investment results. We have also seen managers willing to offer lower management and incentive fees in exchange for longer lock-ups and, more recently, a “loyalty discount” on management fees for investors that have been invested with a fund for many years. In addition to lowering management fees, we are seeing more funds offering unique terms to suit their investor base (management fees that contractually reduce as AUM rises, for instance) and more willingness to contemplate a market based hurdle or a higher incentive fee with lower management fee. For example, a large public pension plan recently announced plans to move to a “1 or 30” structure with the objective being to always pay a 1% management fee to the hedge fund, regardless of performance, but to never pay more than 30% of the gross alpha provided annually by the strategy. While these custom fee arrangements are generally positive from an investor’s point of view, there can be difficulty in enacting them broadly given different investor objectives and preferences, as well as some funds’ unwillingness to be more flexible regarding fees.

Vehicle Types / Liquidity Terms

Investors likely remember the gates and lock-ups imposed by a number of hedge funds during the global financial crisis. While gates and lock-ups continue to be a feature of hedge fund terms, since the financial crisis we have increasingly seen these features utilized more often to match strategy assets to funds' capital bases. When used for this purpose, we view such terms as an appropriate mechanism to ensure fund stability and, thus, ultimately beneficial to investors. Investors may have also noticed a rise in mutual fund offerings from firms that have historically only managed hedge fund vehicles.

While these strategies may be appropriate for some investors, in most cases, they are not designed to fully replicate the higher-fee, less-liquid flagship fund offerings. This is often the result of mutual fund requirements (daily liquidity, limits on leverage and derivatives, etc.) which ultimately dilute performance expectations for many strategies. For investors who require a daily liquid strategy or do not meet minimum investment requirements, these offerings may be appropriate.

Rocaton Philosophy on Hedge Funds

Based on recent performance challenges and high fees relative to traditional strategies, investors may be reviewing their use of hedge fund strategies. We believe it is most appropriate to align an investors' portfolio allocation to hedge funds with the underlying market exposure and manager strategy. We also believe investors should develop clear objectives for each individual hedge fund strategy in their portfolio.

Objectives can range from return enhancement, volatility reduction, downside protection with reasonable upside participation, or pure diversification relative to other strategies in the portfolio. Additionally, the liquidity profile of a strategy should match an investor's objectives (i.e., more illiquidity should be acceptable for return enhancing allocations while diversifying allocations that will be a source of funds during market drawdowns should be quite liquid).

Investors should also set realistic long-term objectives for their hedge fund strategies. In particular, investors should not expect hedge funds to keep pace with long-only asset classes during strong up markets. In some cases, benchmarking of individual hedge fund strategies should be considered relative to long-only public market indexes (over the long-term) and hedge fund indexes (over the short-term). However, as we mentioned earlier, hedge fund strategies, by definition, typically have less than 100% market exposure and therefore should be expected to underperform long-only strategies during a strong rising market. Investors should instead seek to have hedge funds meet additional objectives beyond total return. In the case of a long/short equity strategy, a potential goal could include providing downside protection during a market correction or reducing the overall beta of the public equity portfolio. Should an investor choose to add hedge fund strategies to their portfolio, allocations should be large enough that such objectives are achievable. As always, investors should set objectives for hedge fund strategies with after-fee returns in mind and should consider other potential drawbacks (relative to long-only strategies) such as higher fees and less liquidity.

Conclusion

Although the media coverage might lead investors to believe that the hedge fund industry is in decline, current assets in hedge fund strategies remain at an all-time high. We agree that recent performance has been challenged (which, in some ways, should be expected during a lengthy bull market), and fees for most strategies remain stubbornly high. However, in recent years, we have seen gradual improvements in the fee structures and liquidity terms offered by many hedge funds. Additionally, to the extent that traditional equity and fixed income markets go through a sustained drawdown, hedge funds may deliver more favorable performance results. Hedge fund strategies can still make sense for investors provided that the investor has a clearly defined, and realistic, objective for each hedge fund strategy in their portfolio.

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The State of the Hedge Fund Industry

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