Overview of Hedge Funds

February 2021
Hedge Funds have Two Defining Characteristics

- Attempt to avoid or HEDGE conventional market risks
  - Generic equity and bond market exposures can be obtained cheaply and easily
  - Investors who take on the hassle and expense of investing in hedge funds expect something different

- Invest in an UNCONSTRAINED manner
  - Find attractive risk/reward opportunities that other investors overlook or avoid
  - Take advantage of the ability to react quickly to temporary market dislocations
The Hedge Fund Industry Has Grown and Institutionalized

Source: Hedge Fund Research Inc.
Hedge Fund Returns in the 1990s Were Spectacular

Source: Hedge Fund Research Inc., Paris

<table>
<thead>
<tr>
<th>Year</th>
<th>HFRI FWC</th>
<th>MSCI ACWI</th>
<th>BarCap Global Agg</th>
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</thead>
<tbody>
<tr>
<td>1990-1999</td>
<td>18.3%</td>
<td>11.4%</td>
<td>7.9%</td>
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</tbody>
</table>

Average Return 18.3% 11.4% 7.9%
Correl. to HFR FWC 1 0.66 -0.1
Hedge Fund Returns from 2000 through 2008 Were Attractive

Source: Hedge Fund Research Inc., Paris
Hedge Fund Returns Post Financial Crisis Have Been Subdued

Source: Hedge Fund Research Inc., Paris

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<th>HFRI FWC</th>
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<tr>
<td>2009-2019</td>
<td>5.4%</td>
<td>10.9%</td>
<td>2.9%</td>
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<tr>
<td>Average Return</td>
<td>5.4%</td>
<td>10.9%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Corr. to HFR FWC</td>
<td>1</td>
<td>0.91</td>
<td>0.36</td>
</tr>
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Source: Hedge Fund Research Inc., Paris
What Should We Expect from Hedge Funds Going Forward?

- Hedge funds provide access to different return drivers from stocks and bonds.

- On average hedge funds have protected capital in down months for global equities.

- Historically hedge funds have outperformed during periods of rising rates.

What do HFs Do That Long Only Equities and Bonds Do Not?

- Hedge funds provide access to different return drivers from stocks and bonds

- These low correlation strategies improve the overall portfolio’s risk and return

- Flexible mandates allow the funds to be tactical, taking advantage of market dislocations
Is There Too Much Money In Hedge Funds?

- Hedge fund assets have reached record highs but are still small relative to markets

- Hedge funds have evolved and developed new strategies to increase capacity
  - Bank Regulatory Capital Relief
  - Alternative Risk Premia
  - Insurance Linked Securities

Source: S&P Dow Jones, MSCI, SIFMA, HFR
Hedge Funds Have Outgrown Some Of Their Former Markets

Some strategies are no longer available to many funds and investors

Source: Morgan Stanley, Hedge Fund Research Inc., BarclayHedge, Deutsche Bank
What Strategies Can Be Considered?

Hedge funds come in a wide range of flavors

- **Niche Strategies**
- **Low Cost**
- **Conservative**
- **Diversifying**
- **Straight Forward**

**Size**
- Institutional Firms
- Expensive

**Fees**
- Aggressive

**Risk Profile**
- Return Enhancing
- Complicated

**Return Stream**
- Complexity

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Hedge Funds: Separate Allocation or Integrated Into Existing Structure?

- Long-Short Equities
- Event Driven
- Credit Relative Value
- Structured Credit
- Mortgage Arbitrage
- Insurance Linked Securities
- Discretionary and Systematic Macro
- Opportunistic Investments
**Hedge Fund Strategy Types**

**Relative Value**
- Profits from price discrepancies across related securities
  - Equity L/S
  - Credit L/S
  - Structured Credit

**Macro**
- Takes positions based on macro-economic or top-down views on markets
  - Discretionary Macro
  - Managed Futures

**Opportunistic**
- Investments based on events or market dislocations
  - Merger Arbitrage
  - Distressed / Activist
  - Drawdown Funds

**Orthogonal**
- Strategies that are fundamentally uncorrelated to financial markets
  - Insurance Linked Securities
  - Volatility Arbitrage

Source: Reference for this data

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Are Hedge Funds Worth Their (High) Fees?

- Some Alt Risk Premia funds are available for as low as 70bp flat
  - Very high capacity strategy
  - Moderate return expectations
  - Lots of competing funds

- A few hedge funds still charge 2% and 20% or more
  - Limited capacity
  - High return potential
  - Unique strategies

Hedge fund fees are governed by the laws of supply and demand and lately they have been **falling** - see our recent [blog post](#)
Can Hedge Fund Blow-Ups Be Avoided?

Hedge funds have suffered two types of Blow-Ups:

- **Fraud** – the manager stole/spent/lost the money and tried to cover it up
  - This risk can be minimized with thorough Operational Due Diligence

- **Poor Returns** – the investments lose money
  - Investment Due Diligence should define clear risk and return expectations, including the extremes
Public Fund Usage of Hedge Funds

Public Funds began allocating to Hedge Funds in the early 2000s
  – In recent years, the average allocation to hedge funds across public DB Plans has hovered around 4%

*Greenwich Associates – Market Dynamics Reports
Should We Invest in Hedge Funds?

Hedge funds can add value to virtually any portfolio; however, investors must be willing to bear certain characteristics inherent in hedge funds:

- **Complexity** – hedge fund strategies tend to be more complicated than those employed by most stock or bond funds
- **Fees** – hedge fund fees are higher than long-only equity and bond funds so net returns must be compelling
- **Monitoring** – tracking these more complex strategies is more difficult in part because hedge funds are private investments and do not generally report to databases
- **Benchmarking** – judging short term returns is difficult as true hedge fund indices do not exist and peer group returns are an imperfect benchmark
How Are Hedge Funds Incorporated into Public Plan Portfolios?

- **Role** – What is the objective of the allocation
  - Diversification/risk reduction
  - Return enhancement

- **Bucketing** – how do they fit in the overall asset allocation scheme
  - Discrete hedge fund allocation
  - Incorporate strategies into other buckets as appropriate
    - Return enhancers in Growth portfolio
    - FI alternatives in Bond portfolio
    - L/S equity in Equity portfolio
  - Opportunistic allocation
The CALPERS Experience

- **Size:** HF strategies are generally capacity constrained
  - HF allocation of $4b out of $298b or 1.3% at the time of exit
  - 30 HF investments - $130mm average allocation

- **Expectations:** how do they fit in the overall portfolio
  - Wanted an offset to equities in a market crash

- **Political Pressure:**
  - HFIs are complex and have high fees
  - Turnover in investment leadership

- **Tail Hedge Experience:**
  - Cut one of two tail hedge funds in Feb 2020 that was up 3,600% in March (the other was up 929%)
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