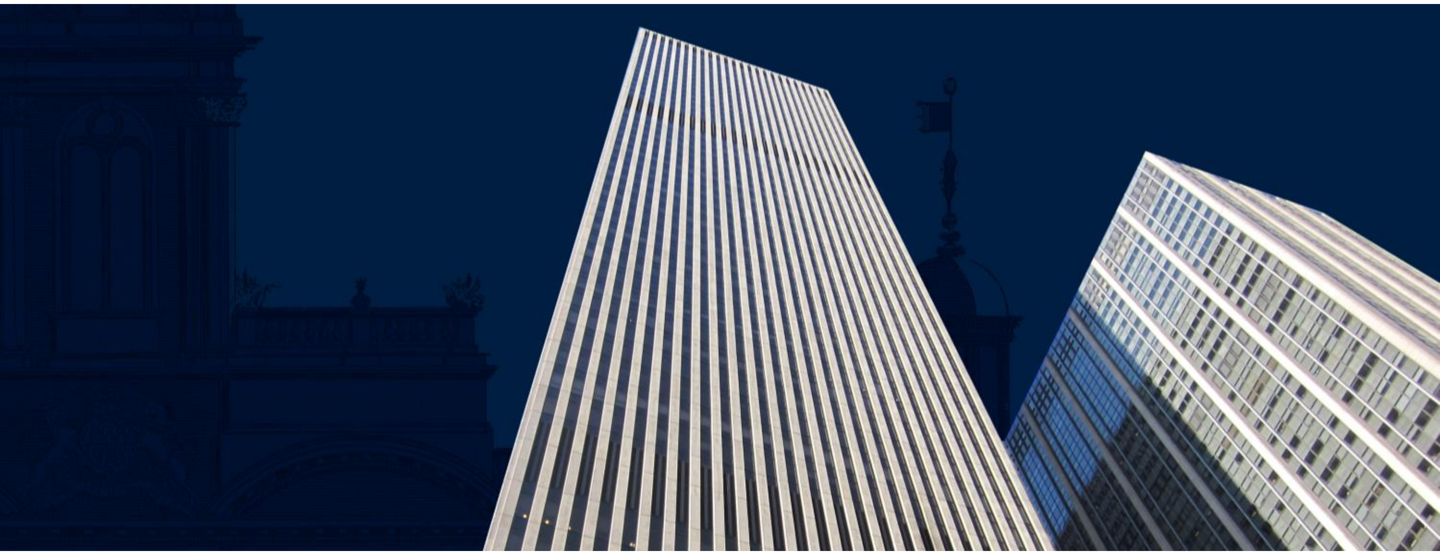
Alternatives Strategies in the USA

Are Hedge Funds Still Relevant?



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Mr. Riaz is based in New York and helps build, manage and implement investment solutions specializing in alternative investments with a focus on alternative income, loss-sharing, lower fees and tax-mitigating strategies designed to enhance yield, minimize volatility, and improve after-tax returns.

Given the current level of equity markets, the low probability of interest rates declining further, and the lack of returns from holding cash, an alternative portfolio of hedge funds offers investors an attractive option for at least a small part of their investment holdings. When incorporated strategically, these alternative portfolios may provide an expected return of 6% to 8% above the risk-free rate, with a similar level of volatility.

However, there is a growing disconnect between the relative attractiveness of alternative strategies in the current market environment and investors' perception of the value of alternatives in their portfolios. Several studies predict net redemptions from the hedge fund industry this year and these findings are further evidenced by NYC Pension Fund's recent announcement of redeeming all $1.5 billion of its hedge fund program.

All is not lost, however. By addressing investors' concerns and returning to their original value proposition, hedge funds can restore trust and play a prominent role in investors' portfolios.

Value proposition	What is the value proposition of the hedge fund model?	**Industry reactions**	How are Hedge Funds responding to investors' concerns?
Investors' concerns	What are Investors' issues with the model today?	**Potential solutions**	What can investors do to address and solve these issues?

Hedge Funds' Original Value Proposition

The hedge fund industry was built around a pay for performance culture which aligned the interests of the investor with the incentives of the manager. Managers could only get rich if the client got even richer. The managers were so confident in their ability to consistently extract value from the markets that they were willing to own an option on themselves via the performance fee, with the management fee merely subsidizing the overhead expenses of running a business.

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Asset Management

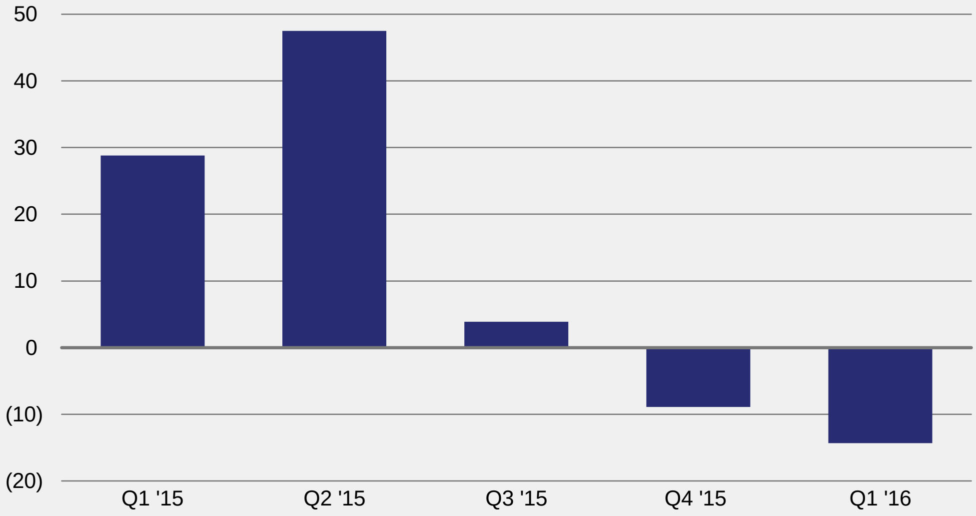
Contrary to popular belief, hedge funds are not an asset class, rather, vehicles for investment strategies that use sharper tools than those available to traditional investors. Shorting, leverage, and derivatives increase the stakes by offering the chance to magnify both profits and losses. Armed with these techniques, not only can a hedge fund improve risk adjusted returns, but also provide value diversification to the traditional holdings in most clients' portfolios.

Investors' Concerns with Hedge Funds

Today, the increasing disillusionment with hedge funds is essentially rooted in the growing belief that investors' interests are less aligned with the managers' interests today than they once were. For example, management fees were never meant to become a profit center for managers, yet as assets flowed in and hedge funds gained economies of scale, the savings were not passed onto investors. This was tolerated when returns were higher, but as returns declined, the impact of fees became hard to overlook.

There is also an increasing perception that the current 2-and-20 fee structure may be overpaying, particularly in cases where a significant portion of returns may have been derived from the market's beta rather than the manager's alpha. This increased misalignment of interests was signaled in the market by CALPERS total redemption of its hedge fund portfolio in 2014.

Total Hedge Fund Industry Asset Flows ($bn)



Source: Preqin Hedge Fund Online

Investors also recognize that the promised diversification of alternative portfolios could disappear in stressed market conditions, precisely when it is needed most. While these highlight some of investors' most pressing concerns, they are hardly a complete list. Additional concerns over enterprise and operation risks, transparency, and liquidity mismatches also became more pronounced in the aftermath of the 2008 crisis.

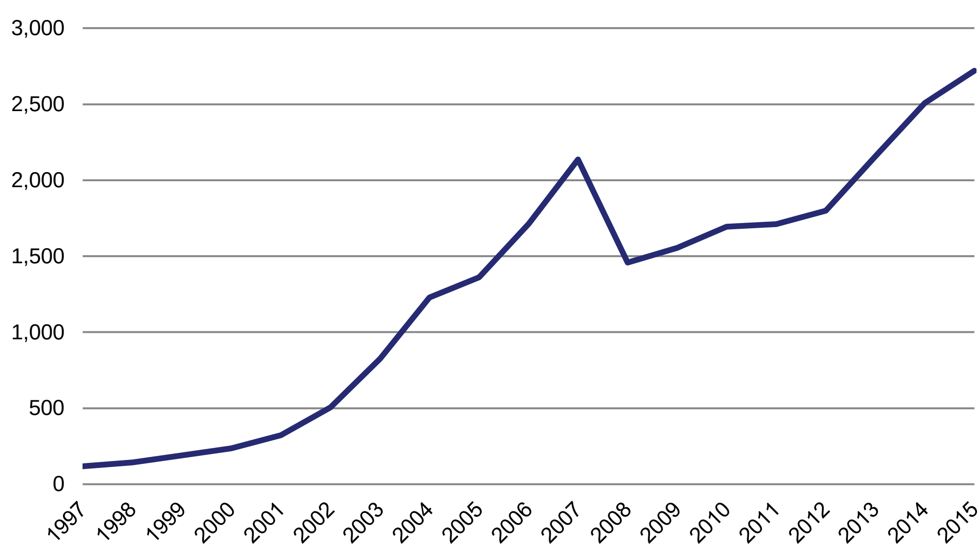
Hedge Funds Respond

While market conditions should make hedge funds attractive choices for investors looking to build an alternative portfolio, it is clear that investors have legitimate gripes with the industry. The real uncertainty is whether managers will come to terms with this shift in perceptions or whether they continue to assert that the traditional business structure is set in stone.

Co-founder of the Carlyle Group, David Rubenstein, recently asserted that managers have "an obligation to explain to the community what the hedge fund and private equity companies do that is useful."[1] Others confronted the liquidity problems in the industry and discussed thoughtful ways to circumvent the issue. A survey by the data company Preqin revealed that the majority of managers are aware of growing negative perceptions from investors of the hedge fund industry and managers affirmed that soothing investors' apprehensions is a pressing matter. The survey also stated that almost half of industry managers did not reach their performance expectations and only 15% of managers surpassed them.[2]

On the reverse side, some industry leaders placed the blame on government policies and regulations for dampening profits. Whether these criticisms are valid or not, they will hardly be satisfactory answers for investors wanting an explanation on why more than half of hedge funds lost money in 2015. It also will not stop the flow of funds out of the industry as the majority of investors plan to reduce their hedge fund allocation. A second survey from Preqin shows that 32% of investors plan to cut back on hedge fund investments while only 25% of investors plan to increase exposure to the industry.[3]

Hedge Fund Industry AUM ($bn)



Source: Barclay Hedge

Notes
1 Barron's, "Hedge Fund Managers Are on the Defensive at SALT", May 14, 2016
2 Financial News, "Hedge funds suffer worst half since crisis", July 18, 2016
3 Preqin, "2016 Preqin Global Hedge Fund Report"

The Path Ahead

Barring a major rebound of returns in 2016, managers may feel the pressure to change their structures in the near future, if they haven't already. Investors are increasingly focused on realigning their interests with those of managers by using a variety of new and old methods. Addressing the problem of outsized management fees, there is an increased use of fee structures where the management fee percentage declines as assets increase. Additionally, becoming more popular are the use of hurdle rates, clawback of fees, and significant manager co-investment.

Along with these, investors are going to increasingly demand managed account structures which allow customization of fees and mandates, while simultaneously improving control, liquidity, and transparency. A final route for investors to take is the utilization of loss-sharing arrangements: instead of a free option on the investor's capital, managers are actually allocated all the trading losses up to a pre-agreed percentage, in exchange for a higher share of the upside.

Other data suggests that while investors may be frustrated with their current managers, they aren't giving up on the industry entirely. According to a Credit Suisse survey, most institutions that withdrew assets from hedge funds plan to reallocate their investments into different hedge funds. Of those, 56% plan to invest in a variety of new and old hedge funds, and 19% plan to invest into new hedge funds.[4] This underscores the shifts within the industry and is evidence of investors' evolving expectations and demands.

The Next Evolution of Hedge Funds

As hedge funds evolve and respond to investors demands they will continue to play a key role in the alternative investments sphere. Warts and all, hedge funds still can play a critical role in investors' portfolios. Given geopolitical risks and current valuation levels, investors should be prepared to tolerate a higher level of volatility to generate the same expected return. Hedge funds can provide one way to control this higher level of necessary volatility to meet portfolio return targets. Hybrid portfolios which take advantage of the convergence of traditional and alternative approaches can help to rationalize the fee structures associated with higher alpha approaches.

Additionally, hedge funds may be particularly relevant to investors for a different reason. Given the current low level of global interest rates and the general expectation that rates could stay low for many years, investors need an "alternative" to the fixed income component of their traditional portfolios. A thoughtfully constructed portfolio of hedge fund strategies can act as a fixed income surrogate without the relative downside of bonds in a rising rate scenario.

Hedge funds must also innovate and deliver truly unique sources of return, rather than relying on a single trade highly correlated to markets or interest rates. A mid to high single-digit return target over the risk-free rate, based on past performance of hedge fund strategies, should be the most investors should expect to earn in the current environment. If that return target can be achieved with bond-like volatility, it can provide a powerful argument for including hedge funds in investors' portfolios.

Notes:

4 Pensions & Investments, "Credit Suisse: Performance, style drift called chief reasons for hedge fund exits", July 12, 2016