

Taming Hedge Funds

Why traditional funds perform better when hedge funds join the asset mix, and how pension managers can determine if hedge funds are right for their portfolios.

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by G.P. Van

During the past five years, investors in George Soros' Quantum Fund have earned net returns of 41% per year. Not bad! In contrast, many investors in David Askin's Granite Fund lost most of the money in 1994 when his fund imploded. Not good!

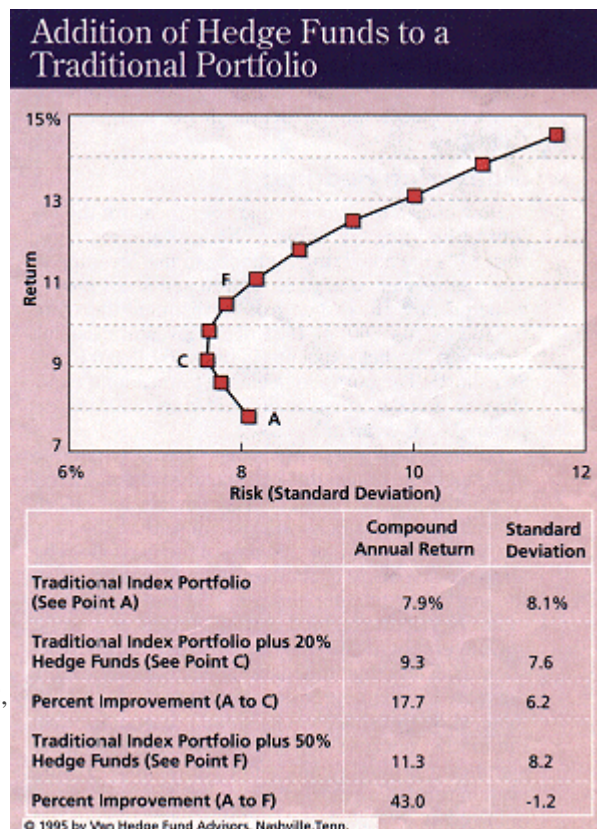
Most hedge fund investors' returns fall between these extremes. This article is intended to help pension managers and advisers decide if hedge funds are appropriate for pension fund portfolios, and if so, how they can achieve results more like Soros'.

Hedge funds offer pension plans two important potential advantages: higher returns than traditional investments and the ability to lower overall portfolio risk through diversification.

In the five years ended 1994, the average U.S. hedge fund provided a net compound annual return of 15.3% vs. 8.7% for the S&P 500. Among the more attractive funds, many have multi-year net annual returns of more than 20%, 25% and even 30%, with correspondingly attractive risk profiles.

Many institutional managers invest in hedge funds because they can diversify their portfolios and lower overall portfolio risk. Our research on hedge funds shows low correlation between traditional portfolios and a number of hedge fund styles. The Efficient Frontier chart (see "Addition of Hedge Funds to a Traditional Portfolio") illustrates the potential enhancement of return and risk of traditional portfolios through the addition of hedge funds. Point A shows the five-year return and standard deviation of a traditional index portfolio composed of 60% S&P 500 equities and 40% Morningstar Average Taxable Fixed Income Fund. Point C is the return and standard deviation of the same portfolio after adding several U.S. Hedge Fund Index styles to it so the combined portfolio now is composed of 20% hedge funds. Point F shows the return of a portfolio with a 50% hedge fund content and approximately the same standard deviation as the traditional portfolio.

The chart illustrates return and standard deviation before and after the addition of the above quantities of hedge funds to the traditional portfolio. At Point C, an 18% improvement in return is accompanied by a 6% reduction in risk. At Point F, there is a 43% improvement in return for approximately the same level of risk.



Hedge Fund Managers

In addition to the potential benefits of higher returns and diversification, some offshore hedge funds can offer plan sponsors a third advantage: tax-free hedge fund investing. This important benefit can eliminate unrelated business taxable income (UBTI) otherwise payable on all gains attributable to the use of leverage.

For example, if a pension fund is invested in a U.S. hedge fund that is leveraged 50%, then one-third of the profit may be taxable (50% divided by 150% invested capital). However, if that same pension fund invests in a qualified offshore fund, there is no UBTI payable. A note of caution: To avoid UBTI, the procedures and structure of offshore funds need to conform to IRS regulations -- and many do. Offshore hedge funds are administered from tax havens such as Bermuda, the Cayman Islands and the Channel Islands. The actual investing decisions for many of these funds are made by U.S.-based managers who run the funds as clones of their U.S.-based funds.

Since establishment of the first hedge fund in the 1950s, the potential of higher returns has motivated investors to seek out hedge fund managers. Today's investor has the advantage of a wide choice of managers. The number of hedge funds has grown tremendously, and it keeps growing at an estimated 20% per year. We also estimate there are now more than 3,000 hedge funds in the United States and fewer offshore. This rapid proliferation of U.S. hedge funds is all the more surprising since the Securities and Exchange Commission (SEC) forbids hedge funds from advertising. Virtually all growth, therefore, has occurred as a result of information spreading by word-of-mouth.

The SEC also limits each fund to 99 investors, affecting a manager's compensation and motivation. He or she cannot gain personally by building a huge fund with thousands of investors, as is often the case with mutual funds or traditional portfolios. Rather, the hedge fund manager must make his or her gains on profits. Typically, the manager receives 20% of all profits. He or she also usually receives a fee of 1% of assets. Thus, the hedge fund manager's interests are closely aligned with those of his or her investors. The manager receives high compensation only if his or her partners earn high profits.

Because hedge fund managers almost always invest in their own funds, they have a second incentive to produce high profits. This also imposes some indirect risk control. The manager's personal investment also loses value when his or her partners lose money.

Measuring Hedging

How does a hedge fund manager measure the extent of hedging? A "typical" hedge fund manager with \$100 in capital might choose to use leverage to buy shares valued at \$120, and to sell short shares valued at \$60. His or her gross investment therefore is \$180 (\$120 + \$60) or 180% of the investors' capital. However, the net exposure is only \$60 (\$120 long-\$60 short). The portfolio is biased toward long exposure, so it is described 60% net long (\$60 "net exposure" divided by \$100 capital).

For long positions, the manager has attempted to pick stocks he or she thinks are undervalued. Therefore, if the market rises and the manager has selected well, the long stocks will rise more than the market, yielding a profit for that part of the portfolio. The short stocks, being overvalued, should rise less than the market, mitigating losses in that part of the portfolio, while the short stocks should drop more than the market because they are overvalued, producing significant profits. Again, a net profit should result, even in this falling market.

In recent years, in addition to going short, many hedge funds *hedge* using basic derivatives such as puts, whether on individual stocks, baskets of stocks or indices.

When used to *speculate*, the same investing latitude that the hedge fund manager exercises to hedge can bring added risk. The hedge fund manager has wide latitude to concentrate his or her bets on a relatively few stocks and to borrow capital to leverage those stocks. If the manager is talented and reasonably prudent, the strategy should work. Indeed, historical hedge fund returns bear this out. However, as always, there are notable exceptions. In most years, a few hedge funds with severe losses close their doors due to investor defections.

Investing Styles

Do hedge fund returns and risk characteristics differ by investing style? While the first hedge fund managers tended to be value investors, today, value investing is only one of the large array of styles, each with its own reward/risk characteristics. Some may appear more attractive than others. For instance, in the five years ended 1994 (see "U.S. Hedge Fund Returns By Style 1990-1994"), the average hedge fund returned 15.3% net compound annual return vs. 8.7% for the S&P 500. However, in the same five years, distressed securities

hedge funds returned 21.4% annually, or more than double the return of the S&P 500 -- and with only one-fifth of the S&P's Risk of Loss.TM This is the probability of having a loss within the last five years.

At the other extreme, as the table demonstrates, short sellers traveled a rocky road in the '90s, with a 3.4% compound annual return and 48.6% risk of loss. And macro funds, like Soros', returned a very respectable shows five-year returns and risk for 14 hedge fund styles.

Beyond the averages, many individual funds achieved outstanding returns. Based on our database sample of 1,250 hedge funds, approximately 37% of all funds have net returns in excess of 15%; 12% of funds have returns in excess of 25%, and more than 5% have returns in excess of 35%.

Instead of investing in individual funds, some investors choose to invest in an existing fund of funds, which reinvests investors' money into a number of stand-alone hedge funds. Thus, for a single relatively low investment of approximately \$500,000, a pension fund can be invested immediately in a number of hedge funds.

This approach offers several advantages, including:

- Instant diversification;
- A known track record; and,
- Outside supervision

Disadvantages of a fund of funds are an extra layer of fees, usually equal to 1% to 2% of assets, plus lack of control over the product. As the table "U.S. Hedge Fund Returns By Style" shows, such funds of funds obtained a five-year net compound annual return of 10.2%, or 17% higher than the S&P 500, for approximately two-thirds the risk of the S&P 500.

If a plan sponsor chooses to assemble its own portfolio of hedge funds, we advise a minimum portfolio size of five diverse hedge funds, preferable 10 or more, to reduce both true risk and volatility. The challenge here is for a plan sponsor to find enough good funds to construct an optimal portfolio. Since hedge funds cannot advertise, most investors know only a few and may use outside experts for help in finding funds or designing hedge fund portfolios.

How to Select Funds

How should the plan sponsor go about selecting funds to achieve favorable results? Obviously, if you start with the largest selection of funds you can find, you will increase your chances of finding what you need. While this sounds simplistic, it is a fact that only a few sources track even 100 U.S. or offshore hedge funds managers.

After identifying a variety of hedge funds, screening is next. The most obvious and useful screening approach is to examine funds' historical returns and volatility. To construct a diversified hedge fund portfolio, finding uncorrelated funds and styles is mandatory.

Which styles should you choose? Beyond looking at the historical returns and risk of each style, you need to consider each style, you need to consider the forecasted business environment. Different hedge fund styles are affected by different components of the business cycle. For instance, merger-arbitrage funds should not be expected to perform optimally if the economy is heading into a long recession. Conversely, distressed securities hedge funds should not be expected to perform well during a long business up-cycle. Stock market cycles affect a number of other styles, including aggressive growth and opportunistic funds, while interest rate cycles affect most styles involving fixed income strategies.

After analyzing proposed funds, considering their past performances and styles, and determining your outlook for the economic environment, the real work begins: on-telephone and on-site due diligence. This process can be exhaustive and exhausting. A comprehensive, closely-typed due diligence checklist for hedge

funds runs at least a dozen pages. But the basics are straightforward, similar to most basic due diligence questions applicable to a traditional money manager:

- Do you believe the returns provided by the manager?
- Is his record audited?
- Do state and federal authorities have any complaints on file?
- What is the manager's reputation among his peers? With his prime broker? With other professionals?

A face-to-face visit with the manager, preferably at his offices, should be mandatory. Are you personally comfortable with the manager and with what he tells you? After a personal meeting, do you continue to be comfortable with his investing strategy and risk control? Do you believe he will stick with his strategy?

	Average 5 Year Compound Annual Return	5 Year Risk of Loss™	Average 5 Year Sharpe Ratio
Aggressive Growth	16.4%	19.8%	0.7
Distressed Securities	21.4	4.4	1.6
Emerging Markets	28.8	19.5	0.7
Fund of Funds	10.2	14.7	0.7
Income	11.2	4.6	0.9
Macro	15.3	14.1	0.8
Market Neutral Arbitrage	11.6	21.1	0.5
Market Neutral-Securities Hedging	17.4	18.9	0.6
Market Timing	19.0	17.2	0.7
Opportunistic	19.1	20.1	0.7
Special Situations	16.2	10.7	0.9
Short Selling	3.4	48.6	-0.1
Several Strategies	15.6	17.8	0.8
Value	14.5	24.7	0.4
VAN U.S. Hedge Fund Index	15.3	19.3	0.7
S&P 500	8.7	22.7	0.3

Warning Signs

As you examine hedge funds, here are some things to be aware of:

- Short track records of less than four years;
- Managers who change investing styles from the style of record;
- Hedge funds that have grown tremendously in asset size;
- Hedge funds that are growing rapidly each year; and
- Managers whose past records are unclear for any one of a variety of reasons, such as having to share credit with others for portfolio returns.

Because of risks in hedge fund investing, use of a knowledgeable industry adviser is recommended. Such an adviser often can add greatly to the number of funds to be studied; he or she also can assist in due diligence. However, regardless of whether an outside expert is used, the plan sponsor is served best if it takes as active a role as possible in the selection and due diligence process.

Given that the return of the average U.S. hedge fund has beaten the S&P 500 by 76% during the past five years with 15% less risk, the effort required to select hedge funds carefully should be well worth it.

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