

The First Step to Regaining Credibility

As equity indices romped higher throughout most of the last ten years, the long-short hedge fund industry increasingly came under attack. As we have written, much of the furore was unwarranted. Truly uncorrelated, zero-beta hedge funds were never meant to be a replacement for the S&P 500 (or the MSCI Europe, or whatever market proxy you use).

Describing such a hedge fund as a lousy rip-off simply because it underperformed a 100% equity benchmark is preposterously naïve; and this foolishness has been particularly rampant here toward the latter end of what has been a tremendous decade for equities.

In this piece, however, we are going to visit, and take, the *other* side of the argument. Our view is that many purportedly long-short hedge funds implicitly encouraged this faulty comparison to equity benchmarks. For them, the comeuppance is much deserved.



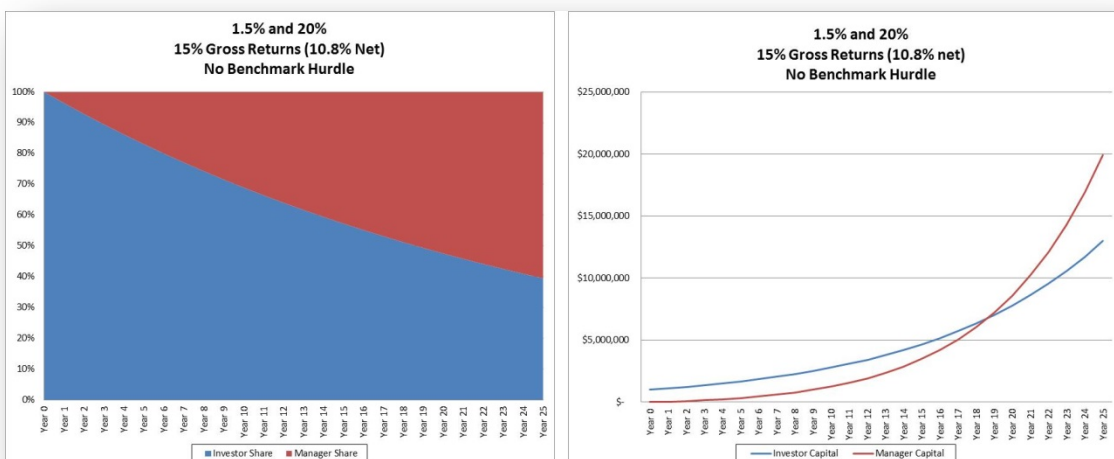
He got it back.

For those hedge funds running a net long exposure during a raging bull market, even if the returns appeared optically reasonable, or at least satisfactory, they were anything but. There is nothing special about running a 50% net long hedge fund portfolio, generating a 25% gross return over some period when the market is up 50%. That's what the average skill-less dart-thrower would have achieved.

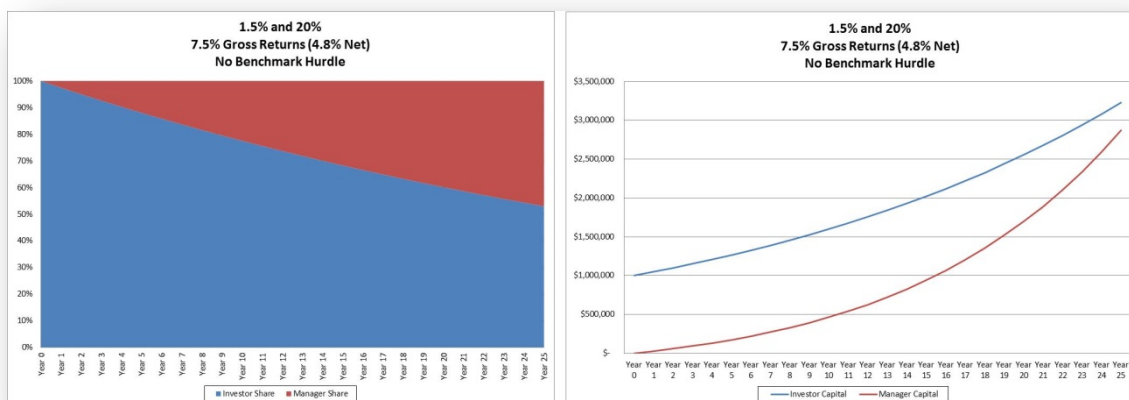
And there is something very un-special about that same net long hedge fund charging a full performance fee on those 25% absolute returns, rather than on a beta-adjusted relative return. In other words, a lot of hedge funds were charging performance fees when there was no alpha at all. There were also many charging performance fees even when the alpha was negative. **This, we believe, is why the overall industry is broadly frowned upon these days, and finds itself in this predicament.**

To illustrate the problem here, let's take it to somewhat extreme, but not crazy, levels. Imagine an investor earning a 10.8% net return from a 1.5% and 20% hedge fund, annualized, over 25 years. And then imagine his fund manager investing all of his fee proceeds into his own fund, and letting it compound with no fees over the remaining years.

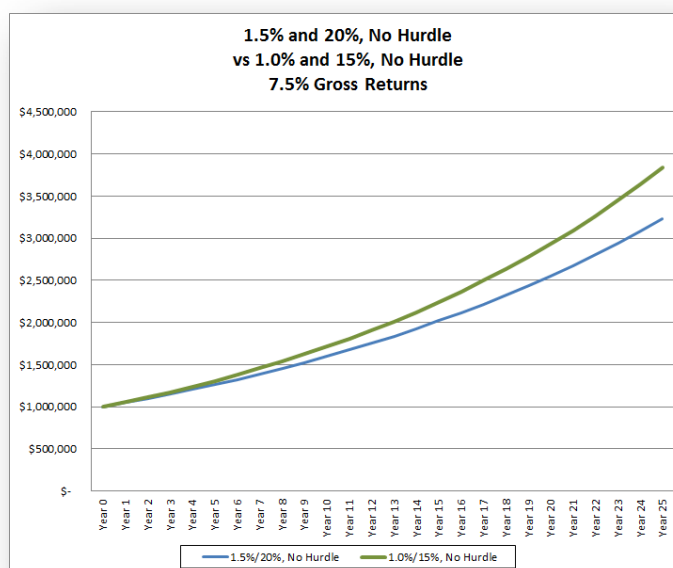
By year 19 – under this fee structure – the manager has more money than the investor.



Even in a world with 4.8% net returns, the wealth transfer from investor to manager is tremendous.



As happens in free markets, the industry is waking up a bit, on both the manager and investor side, and is now easing up on both management and performance fees. This is a step in the right direction. Here is the same 7.5% gross return fund compared to a more reasonable 1% and 15% fee structure.

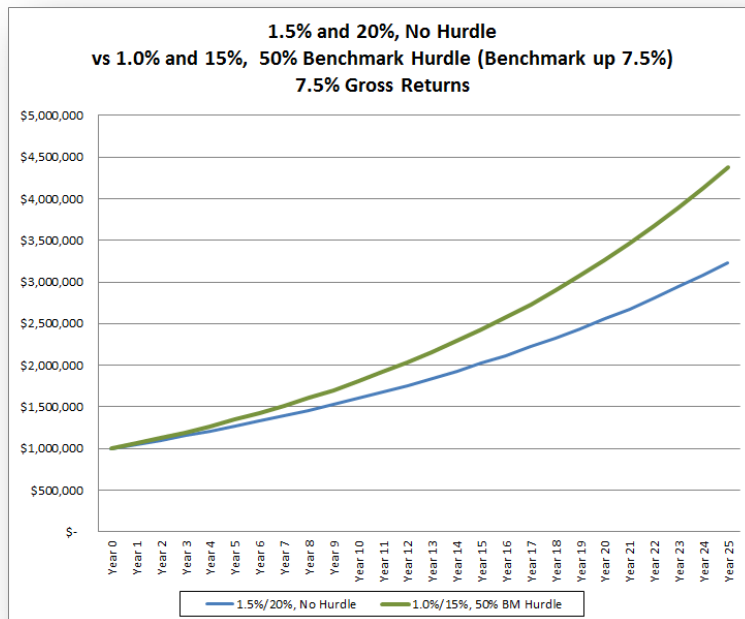


The difference over the first few years is barely noticeable, and certainly not noticeable to folks (on both the investor and manager side) that are focused on short-term returns. But when you stretch it out to 25 years, which certainly is closer to the actual time horizon of institutional investors, there is a \$600K difference on what was initially a \$1 million investment. Sure, that difference may be 25 years down the road, but it's the difference between having \$3.2 million, or 19% more than \$3.2 million.

But even this isn't reasonable yet, because we aren't yet taking into account any appearance (or not) of skill. There is no consideration of alpha generation in this absolute return paradigm. Sure, if the L/S manager is truly running with a beta of zero¹ and 100% of his excess return is due to some special skill, then fine. But for the manager that is running 50% long, he should have a performance fee hurdle that reflects that.

¹ And this argument could be made not just vs. the market factor, but against other known factor exposures known to systematically generate long-term excess returns, including momentum, value, quality, BAB/Low-vol, and in some cases, size.

Here is the comparison to a more aligned fee structure, with lower management and performance fees, and a hurdle based on the hedge-fund’s beta (or net exposure).



Here, I believe, we have arrived at a fee structure which gets closer to what is fair. It gets closer to aligning interests while maintaining incentives. It gets closer to paying for skill, if skill exists. And the end result for the institutional investor is nearly 36% better performance than under the old, one day vestigial, paradigm of high performance fees without regard to alpha.

This is where the industry should go.

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