Evoke Insights: Hedge Funds That Hedge

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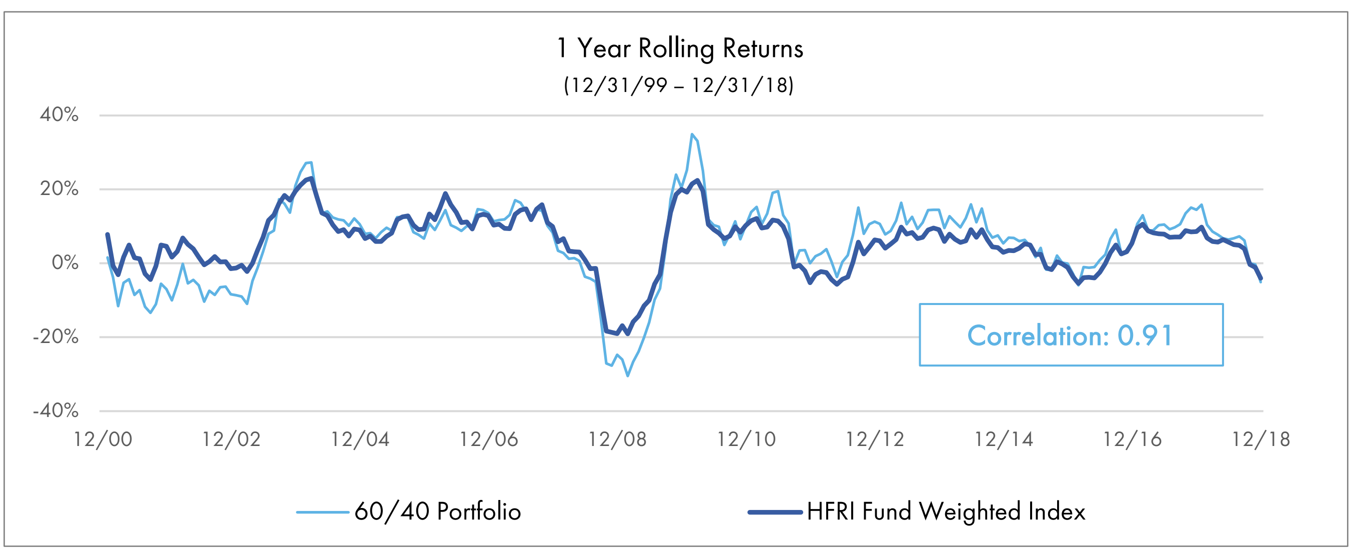
2018 was a difficult year for most investors as stock market volatility increased and nearly all markets lost money. The economy is exhibiting early signs of slowing, as the tailwind of monetary and fiscal stimulus gradually shifts to a headwind for the first time in a decade. Despite the bounce in early 2019, the recent market jolt may be a mere prelude for rough seas ahead as opposed to a temporary blip in the upward trend to which investors have become accustomed. Naturally, a portfolio strategy that can perform well during a challenging environment for traditional asset classes, characterized by higher risk and lower potential returns, is of great interest at the moment.

Hedge funds <u>that actually hedge</u> may offer a potential solution. This statement may come as a surprise given the negative headlines and generally disappointing results associated with the hedge fund industry. Broad hedge fund indices have produced underwhelming returns since 2008 (HFRI Fund Weighted Index returned just 2.5%, on average each year), posting losing years in 2008, 2011, 2015 and 2018 when investors hoped to see some diversification benefit.[1]

Let's begin with the fact that hedge funds are not an asset class but rather a type of investment vehicle (much like a mutual fund or an exchange traded fund). You would never say that exchange traded funds have performed poorly because there are too many different strategies for such an assertion to make sense. The same logic holds for hedge funds. One advantage that hedge funds have over other vehicles is the availability of an expanded menu of tools to hedge. Within this context you may categorize hedge funds into two broad groups: 1) those that don't or only partially hedge and 2) those that fully hedge. Since traditional markets tend to rise over the long run, it is far easier to earn positive returns by maintaining market exposure with limited hedging. For this reason, the vast majority of hedge funds fall into the first category. Chart 1 compares the returns of the broad hedge fund index to a traditional 60/40 mix, clearly demonstrating the highly correlated nature of the return stream. The two lines are nearly identical!

Chart 1: Hedge Fund Universe is Highly Correlated



[1] Source: Bloomberg. The HFRI Fund Weighted Composite Index (HFRIFWI) returned 2.5% annualized for the period from 12/31/07 – 12/31/18.

60/40 Portfolio represents a 60% allocation to global equities (MSCI World Index) and a 40% allocation to US bonds (BB Barclays US Agg. Bond Index).

Given the results above, it is not surprising that investors are frustrated. Most hedge funds are simply not worth the high fees charged by fund managers. That said, there are a small percentage of managers that fall into the second group (that actually hedge) and have been able to deliver respectable net-of-fees returns. These funds produce reliably uncorrelated net returns that can be valuable to a portfolio, particularly in today's risky environment.

The question that we have been repeatedly asked is how can a manager generate a truly uncorrelated return? There are two simple ways a skilled manager can produce a return that is reliably uncorrelated:

1. **Structure the portfolio to be market neutral.** A strategy that invests the same amount in long and short positions, leaving a net market exposure of zero, will be uncorrelated to the underlying market in which it invests. For instance, a manager buys $100 of technology stocks she favors and shorts $100 of companies in the same industry that she believes are over-valued. In this case, her net market exposure is zero, leaving her agnostic on overall market direction. Instead, her return will be determined by how well her long positions performed relative to her shorts.

2. **Have no bias to being long or short over time (i.e., zero average market exposure).** Some funds opportunistically go long or short specific markets at a point in time, but maintain an average exposure of zero over time, meaning they are equally likely to be long or short. Since these managers have no persistent market exposure, returns are uncorrelated over the long run. For example, a manager may expect rising interest rates and a strong stock market, so he buys the S&P 500 and shorts the bond market. Later, as the economy slows down, he takes the opposite positions by shorting stocks and going long bonds. The average exposure to stocks and bonds was zero over the full period and the total return earned will be a function of his timing rather than the overall return of the stock and bond markets.

Hedge funds that fully hedge (as described above) should reliably earn uncorrelated returns while those that hedge less will be more correlated. There is no magic here: anyone can earn uncorrelated returns as correlation is highly influenced by average market exposure. The hard part is to earn attractive net-of-fees returns while maintaining an average market exposure close to zero. Those that are able to accomplish this task over the long run and through multiple market cycles are rare but do exist.

Managers A and B represent two examples of large, reputable firms that have successfully earned attractive, uncorrelated long-term returns (we have labeled them anonymously because industry regulations do not permit us to "market" these firms). Manager A, which is market neutral, has earned about 10% net per year since its inception in 2004. Manager B has maintained zero average market exposure since it started managing money in 1991 and has returned approximately 9% net per annum. Both funds have achieved these results with a correlation to stocks and bonds of close to zero.

In Table 1, we present both managers' since inception net-of-fees returns as well as their calendar year net returns during periods of negative equity market performance. A compelling way to demonstrate the uncorrelated nature of the returns is to compare their since inception performance to their average returns in down equity markets. Remarkably, these numbers are nearly identical. Manager A's average return during down markets was 11% versus 10% during all periods, and Manager B's 10% versus 12%. Clearly, whether the market was up or down had nothing to do with these managers' ability to generate solid performance.

Table 1: Historical Net Returns During Negative Equity Markets

	Global Stocks (MSCI World Index)	Manager A (market neutral)	Manager B (zero average market exposure)
Inception Date	December 1991	April 2004	December 1991
Inception to Date Net Return	7%	10%	9%

Average Net Return in Down Market	-16%	11%	8%
2000	-13%	–	-3%
2001	-17%	–	6%
2002	-20%	–	14%
2008	-41%	8%	9%
2011	-6%	9%	16%
2015	-1%	13%	3%
2018	-9%	12%	10%

Performance for Manager A and Manager B is representative of actual net-of-fees returns as reported by the managers, without independent verification from ARIS.

We have an extensive process that has been refined over many years to uncover managers that we believe can achieve reasonable uncorrelated returns over a full market cycle. As volatility picks up and we move closer to the next bear market in equities, we encourage investors to consider adding lowly correlated funds that can help to improve returns and reduce the risk in their portfolios.

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