The Fading Masters of the Universe and Their Liquid Alt Heirs

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Hedge funds are facing an investor stampede for the exits amid poor relative performance against long-only stock and bond funds, high fees, and growing competition from much cheaper "liquid alternative" mutual funds. Yet years of strong returns from stocks and bonds have lifted valuations to rich levels. It may be exactly the wrong time for investors with plenty of long exposure to reduce or eliminate shock-absorbing hedge and liquid alt funds in their portfolios, given broad expectations for volatile markets ahead. The diversification and risk mitigation offered by hedge and liquid alternatives remain as crucial as ever to sensible portfolio allocation.

Executive Summary

- Many investors are pulling the plug on hedge funds given poor performance, high fees, limited liquidity, and a competitive threat from liquid alternative mutual funds. Hedge fund closures are growing and launches of new funds are declining.
- Valuations of U.S. large-cap stocks are well above historical averages, while credit market spreads are compressed amid a 10-year Treasury yield that remains well below its longer-term average. Frothy valuations and expectations for two to three U.S. benchmark interest-rate hikes this year imply volatile markets ahead.
- The performance of long/short equity funds should be less volatile than that of the index in up- and down-trending markets, given both their long and short stock exposures. Returns dispersion in the long/short equity mutual fund category is extensive. As in active management generally, investors would be well advised to look at individual long/short equity mutual fund performance, not the category average.

As the S&P 500 Index ended 2016, its eighth year of a bull market yielding a stellar annualized total return of more than 14%, and the Bloomberg Barclays U.S. Universal Index capped the year with a near 4% total gain, the headlines on the demise of hedge funds became rampant. "The Golden Era of Hedge Funds Draws to a Close with Clients in Revolt," Bloomberg reported toward the end of December. It was quite a shift from mid-2015, when Bloomberg published "Masters of the Universe Return as Hedge Funds Rebound."

The rebound proved short-lived. There's little doubt the hedge fund industry is under intensifying pressure from lackluster performance, sky-high fees, opaqueness, redemption restrictions, and, increasingly, the growing competitive threat of liquid alternative mutual funds. The industry has evolved rapidly over the years, as hedge fund categories proliferated amid an expanding variety of leveraged, if not always liquid, investments in increasingly diverse markets. Complex portfolio construction and intricate risk management strategies also haven't lent themselves to transparency. Strong returns in plain vanilla U.S. stock and bond markets since the financial crisis have left hedge fund investors wondering why they should allocate to the space at all.

As the more recent Bloomberg article points out, while several years of mediocre returns are clearly problematic, another big part of the problem are exorbitant fees: the private or limited partnership (LP) structures of most hedge funds customarily net out close to 2% management and 20% performance fees. The arrangement effectively leaves hedge fund managers with most of any returns and their clients with more of the investment risks. But even some institutional and individual investors in "liquid alts," as this relatively new breed of much lower cost hedge funds in '40 Act mutual fund wrappers are called, have been disappointed with poor relative performance.

Many investors in both LP hedge and liquid alt funds, which usually charge a flat management fee of well under 2%, are pulling the plug, perhaps at precisely the wrong time. After years of strong runs in both stocks and bonds, U.S. equity and fixed income valuations are generally frothy. Investors would be well advised to seek uncorrelated returns and to mitigate potential volatility if markets start trending down, as they inevitably do. Diversification and risk mitigation may well be more important today for appropriate portfolio allocation than they have been for some time.

Caution: Interest Rate, Reflation Pressures Ahead

As in previous years, strategists at virtually all the major investment wirehouses are calling for growing market volatility in 2017—notwithstanding the recent low Chicago Board of Options Volatility Index (VIX) levels—and recommend that investors curb their expectations for returns. Unlike previous years, though, markets are no longer discounting U.S. Federal Reserve benchmark interest rate projections, given current trends in U.S. inflation, employment and wage data, not to mention the "reflation" prospects that Donald Trump's vows to cut taxes and regulation and to boost infrastructure spending have created. In mid-February, the yield on the 10-year U.S. Treasury was trading around 110 basis points above its 1.36% record low just seven months before, creating big rate differentials with rock-bottom and even negative sovereign yields in other developed markets and narrowing the rate differentials with emerging markets.

The U.S. economic expansion since the 2008 recession, while hardly robust, has been among the longer running on record. Thanks in no small measure to years of Fed-driven low interest rates and asset purchases, equity market valuations are hardly compelling. The trailing 12-month price/earnings ratio of the S&P 500 Index in early 2017 stood at 21 times, far above the 10-year average of 16 times. The bond market is similarly pricey, with the Bloomberg Barclays U.S. Universal Index having posted an annualized return of 4.6% from the end of 2008 through 2016. The bond market may have considerably more downside than upside if U.S. economic growth does accelerate as expected, pressuring inflation and interest rates. Moreover, the U.S. 10-year Treasury yield is still far closer to its record low than its 6% average since the 1981 record high.

Challenged Performance, Fewer Debuts, More Liquidations

In contrast to the long, strong runs in U.S. stocks and bonds, the returns of private hedge funds in the $3 trillion accredited institutional segment have been relatively poor. The HFRI Fund Weighted Composite Index hit a record high by the end of 2016, bringing its annual return to 5.5%. Not bad, but for many investors it wasn't enough after years of uneven and sub-par performance versus long-only funds. Moreover, the dispersion of returns was extensive. While most HFRI Event Driven strategy indices posted low double-digit gains last year, with the exception of the Activist Index, their longer-run annualized performance wasn't nearly as strong. At the other end of the spectrum, macro-oriented hedge funds performed poorly, with the HFRI Macro (Total) Index gaining 1.4% last year, when market positioning for "secular stagnation" in the first half was upended in the second as the rotation to "reflation" exposures took hold. Given last year's sharp swings in commodities, foreign exchange rates and fixed income yields, they should have done better.

Unsurprisingly, smaller hedge funds outperformed those with assets under management (AUM) north of $1 billion, as it's easier to be nimble in putting on and taking off trades that are smaller in size. HFRI also reported that average industry fees have been falling, with the management fee ebbing to 1.49% in the third quarter and the incentive fee dropping 10 basis points to 17.5%.

Nonetheless, even launches of slightly cheaper LP hedge funds, which usually don't start out AUM heavy, have been falling. During the third quarter of last year, 170 hedge funds debuted, the fewest since the first three months of 2009, according to HFRI. Meanwhile, private hedge fund liquidations rose in the third quarter of 2016 to 252 from 239 in the second quarter. That brought the number of liquidations over the first nine months of the year to 782, "which is on pace for the highest number of liquidations since the Financial Crisis," HFRI noted. "The total number of hedge funds, including fund of hedge funds, declined to 9,925, falling below 10,000 funds for the first time since 2014." The average life-span of private hedge funds nowadays is just five years.

The Alternative in Liquid Alternatives

Life isn't as precarious among liquid alternative mutual funds, which effectively offer many of the same investment strategies, and not just at much lower fees. Liquid alts also come without six- or seven-figure minimum investment requirements and restrictive redemption guidelines. Although they've been increasing in number, liquid alts remain a fraction of the private hedge fund universe. At the end of 2016, Morningstar tracked 550 liquid alternative funds, up some four-fold over the last decade. AUM through December 2016 amounted to $167.53 billion, up from $80.97 billion at end of 2011.

To be sure, some investors in liquid alts have also been losing confidence in the asset class. Monthly flows into the category turned negative last May, and through the end of January 2017 the net outflows totaled $10.7 billion.

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If back in the day hedge funds were meant to hit the ball out of the park for high-net worth accredited individuals, today both private hedge and liquid alt funds are often pinch-hitters meant to mitigate volatility usually by going long on securities managers expect to go up in value as well as going short, or betting against, those they think will lose value.

The Long and the Short of Risk Mitigation

In a long/short equity fund, for example, performance may be less volatile than that of the index, given both the long exposures in up-trending markets and short exposures in down-trending markets. But when the equity market trends upward for years, as we've seen since the financial crisis, long/short equity funds will likely lag long-only portfolio returns. When the trend shifts, however, and a downturn ensues, their short positions should help long/short funds outperform long-only portfolios. Hence, they work best over a full market cycle.

But the risk characteristics of long/short equity portfolios can still be appreciated despite the extended rise in U.S. stocks: the five-year annualized standard deviation of U.S. long/short equity funds tracked by Morningstar stood at 8.35% at the end 2016, versus 10.37% for the S&P 500 Index. That may be cold comfort to investors in those funds looking at five-year annualized returns amounting to 5.71%, versus 14.66% for the S&P 500 Index at the end of last year. Reams of academic studies in behavioral finance aren't needed to understand why investors would want to redeem their investments in long/short equity funds.

Yet they may want to think twice. Quite apart from the annual Dalbar analysis on how the average mutual fund investor poorly times buy and sell decisions, the outlook for U.S. interest rates and currently high equity market valuations suggest it may not be the best time to cut and run from U.S. long/short equity funds.

Eye Performance Dispersion, Not the Average Performance

Rather, investors should examine performance of individual funds, whatever the category. "When it comes to alternative fund categories...the averages can be deceiving, owing to the high degree of dispersion within many of the fund groupings," Morningstar's Josh Charlson noted in a recent article entitled "The Year in Alternative Funds: A Bumpy Road with Some Bright Spots." Returns from the beginning of 2016 to mid-December in the long/short equity category, for example, ranged from 25% to negative 18%. Just as the "average" actively managed equity fund has had a hard time in recent years outperforming index-tracking passive investments, a minority of truly active managers has added value over longer measurement periods.

Of course, it is far harder for the "2 and 20" LP hedge fund managers to do so, net of their fees. But for disciplined investors looking for low-cost, low-correlation portfolio stabilizers over market cycles, liquid alts are a welcome alternative to the aged hedge fund masters. ■

Important Information

The views expressed by Mr. Roth reflect his professional opinions and are subject to change. Under no circumstances does the information contained within represent a recommendation to buy or sell any security.

Basis Point (bp) – A unit equal to 1/100th of 1%. 1% = 100 basis points (bps).

P/E – Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share. Forecasted P/E is not intended to be a forecast of the fund's future performance.

Sovereign Debt – Government debt that has been issued in a foreign currency.

Standard Deviation – A measurement of dispersion around an average which, for a mutual fund, depicts how widely the returns varied over a certain time period. Higher standard deviation of returns indicates greater volatility.

VIX – The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts.

The Bloomberg Barclays US Universal Bond Index represents the union of the U.S. Aggregate Index, U.S. Corporate High-Yield, Investment Grade 144A Index, Eurodollar Index, U.S. Emerging Markets Index, and the non-ERISA eligible portion of the CMBS Index. The index covers USD denominated, taxable bonds that are rated either investment-grade or below investment-grade.

HFRI Event-Driven (ED) Strategy Indices are composed of hedge fund managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities.

The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager hedge funds that report to HFR Database. Constituent funds report monthly net of all fees performance in U.S. Dollars and have a minimum of $50 million under management or a twelve-month track record of active performance.

HFRI Macro (Total) Index includes hedge fund managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

Investments carry risks, including possible loss of principal. Additional risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity, volatility, and political and economic risks. Investments in small- and mid-capitalization companies may increase the risk of greater price fluctuations. A short position will lose value as the security's price increases. Theoretically, the loss on a short sale can be unlimited. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Non-diversified funds can be more volatile than diversified funds. Investments in the Fund are not FDIC insured, nor are they bank deposits or guaranteed by a bank or any other entity.

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