‘Hedge fund lite’: all the taste but none of the calories?

Diversified growth funds have attracted a great deal of interest from investors. But are DGFs operating as de facto hedge funds without being placed under the same amount of scrutiny? Nicola Ralston, FSIP, examines the asset class.

Even amongst many professional investors, mention of hedge funds is liable to prompt a tirade against egregious fees, followed perhaps by disparaging comments about lacklustre performance and short termism. At the same time, though, there has been a boom in UK mutual funds using many classic hedge fund strategies. In this article I consider this development, and some implications for investors and asset managers.

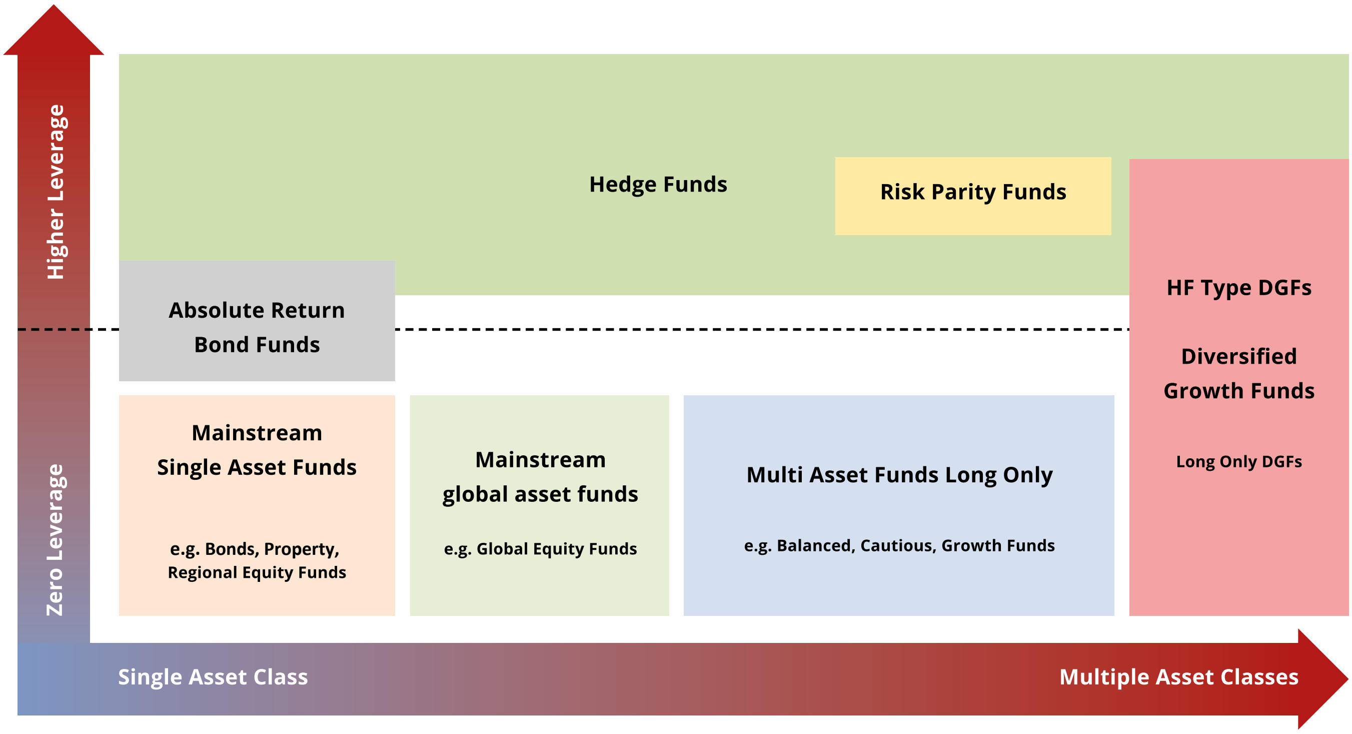
WHAT TYPES OF FUNDS ARE USING 'HEDGE FUND' STRATEGIES?

Figure 1 below shows a range of fund types in stylised form, including traditional long-only funds, offshore hedge funds, and funds which do not fall neatly into either category. The Y axis measures the degree of leverage, with long-only funds sitting in the lower, ‘No Net Leverage’ segment; hedge funds, and other types of funds which use net leverage, are in the upper segment. The X axis shows the degree of diversification, with a single asset class focus on the left, while those to the right are multi-strategy/multi-asset.

Executive summary

- While the nature of Diversied Growth Fund strategies varies by manager, ‘hedge fund type’ DGF funds share an objective of generating a significant element of their return from manager skill, utilising leverage and derivatives to achieve this.
- DGF funds underperformed in 2016, which may prompt a review by some investors as to whether they fully understand the characteristics and risks of their investment.
- Investors do not always undertake the same type of investment due diligence considered essential for a hedge fund investment. Yet DGF managers should have nothing to fear from intensive analysis.

Figure 1. Schematic stylised representation of fund types and use of net leverage



It is not always straightforward to identify which funds depend for their returns on long-only, market exposures (whether active or passive) and which depend to a significant degree on non-directional, 'skill-based' strategies. Most fixed income funds use some types of derivative strategies historically associated with hedge funds; however Absolute Return Bond Funds, where net duration can be positive, negative or neutral is a category of 'single asset' funds which employs net leverage; I show these funds to be straddling the zero leverage line in Figure 1. Moving to the far right-hand side of Figure 1, many multi asset funds have absolute return targets, either versus a cash benchmark, or an inflation measure; some of these 'Diversified Growth Funds' (DGFs) make extensive use of net and gross leverage, while other DGFs do not. The DGF market is a significant one: specific definitions vary, but even a narrow definition comprises more than twenty large funds with assets in aggregate of over £80 billion at end 2016.

CHECKLIST

- Use of leverage, either gross or net
- Risk management techniques other than simple asset diversification*
- Significant use of relative value techniques including long/short strategies
- Asset allocation shown as 'risk weightings' without explanation; asset classes may be poorly defined, e.g. 'diversifying assets'
- Most, sometimes all, positions implemented via derivatives
- Little or no use of 'traditional' active stock selection strategies
- Little or no use of third party funds.

*Excluded occasional use of options to protect against a market downturn

While the nature of the strategies varies by manager, these 'hedge fund type' DGFs funds share an objective of generating a significant element of their return from manager skill, utilising leverage and derivatives to achieve this. The following extracts from the Standard Life Investments Global Absolute Returns Strategies Fund Guide serves as an example. *"[GARS Fund Managers] can ... use advanced investment strategies that are not always available to traditional investment funds in order to gain additional returns or guard against market falls" and in respect of derivatives, "In implementing advanced investment strategies, absolute return managers often use derivatives…In the past, derivatives have been associated with hedge funds".*

I estimate that just over half of the assets of the DGF sector display several of the Checklist characteristics outlined above, and depend materially on hedge fund strategies. Continued interest in these approaches is also demonstrated by the fact that around half the DGFs launched in the last five years also fit into this category.

WHY HAVE THESE STRATEGIES PROVED SO POPULAR?

The first fund to gain a serious foothold in the mainstream market using these types of strategies was the Standard Life Investments Global Absolute Return Strategies fund, which was launched in January 2008. By February 2010 it had reached £2.7 billion in assets and £25.7 billion at the end of 2016. The success of this fund seems to have been one of the elements in establishing a market for other funds marketed by traditional asset managers seeking to use these types of strategies. But there have been a number of factors leading to much greater interest by investors in this type of DGF.

REASONS INCLUDE:

- Investors are keen to diversify away from a perceived over-dependence on equities, but government bonds – the traditional diversifying asset - are not seen as attractive in the current, ultra-low interest rate environment;
- For Defined Benefit pension funds in particular, while burgeoning deficits increase required returns, they also result in a focus on the path of returns, and hence on the management of risk;
- Although not generally an explicit objective, such funds are seen as having the capability to provide equity-like returns over the long run with significantly lower risk than an equity portfolio;
- More broadly, investors have been increasingly keen to avoid paying high fees simply for market beta; use of skill-based, relative value strategies sidesteps the debate on closet indexing in equities, and indeed in other mainstream markets;
- Fees are typically as low or lower than other multi asset funds, especially on a look through basis; very limited use of third party funds (often used by long-only DGFs, for example to gain exposure to property or infrastructure) helps to keep fees competitive.

HOW HAVE DGFS PERFORMED?

The table below compares the performance of a long-only portfolio split 60:40 between global equities (50% Unhedged, 50% Hedged) and UK Corporate Bonds (All Maturities) with two types of DGFs. The DGFs have been split between those using hedge fund type strategies to a material extent, and those which do not.

It is clear that this has been a challenging environment for all DGFs, given the strength of both equity and bond markets. Up to 2016, the performance of DGFs with significant use of hedge fund strategies was as a group broadly similar to the remainder of the DGF sector – in fact, in the four years 2012-

2015 it was slightly better. However, this position changed dramatically in 2016; with continued strong returns from both equities and bonds, boosted for unhedged sterling investors by the weakness of sterling following the vote to leave the EU, funds focused on relative value rather than market exposure struggled to earn returns above cash rates. Some funds did not manage even this, and saw losses in absolute terms. Nonetheless, over the five-year period, the HF Type DGFs displayed lower risk than other DGFs, and hence as a group achieved a higher Sharpe Ratio (see Figure 4 below).

It is too early to determine the impact of poor 2016 performance on fund flows for the hedge fund type DGFs, but the stark divergence of performance in 2016, continued into the first quarter of 2017, seems likely to have some impact on the allocation of assets to these funds. It may also prompt a review by some investors as to whether they fully understand the characteristics and risks of their investment.

ARE THEY AN ALTERNATIVE TO 'TRUE' HEDGE FUNDS?

It is interesting that DGFs using hedge fund investment techniques extensively are rarely seen as direct alternatives to investing a portfolio of hedge funds. Perhaps nomenclature plays a part; i.e. part of their appeal is that they are not called, or marketed as, hedge funds. Yet, in comparison with hedge funds, they typically offer:

- Better liquidity - either daily or weekly
- Much lower fees, with no performance element
- More robust infrastructure, typically supported by established, well-resourced firms
- Stronger internal governance
- Lower risk of fraud, and greater likelihood of compensation in the event of loss of assets.

Investing in DGFs employing hedge fund strategies cannot be considered as a like-for-like alternative to investing in a portfolio of hedge funds. Setting aside the important differences in the regulatory structure, one key difference is that DGFs – as their name makes clear – are by their nature multi asset, whereas many hedge fund explicitly specialise in one or a limited number of strategies only. Perhaps, though, DGFs which use hedge fund type strategies may be thought of as 'Hedge Fund Lite' investments in that they share similar absolute return objectives and investment strategies with hedge funds, but without the disadvantages associated with the hedge fund wrapper and fee structure.

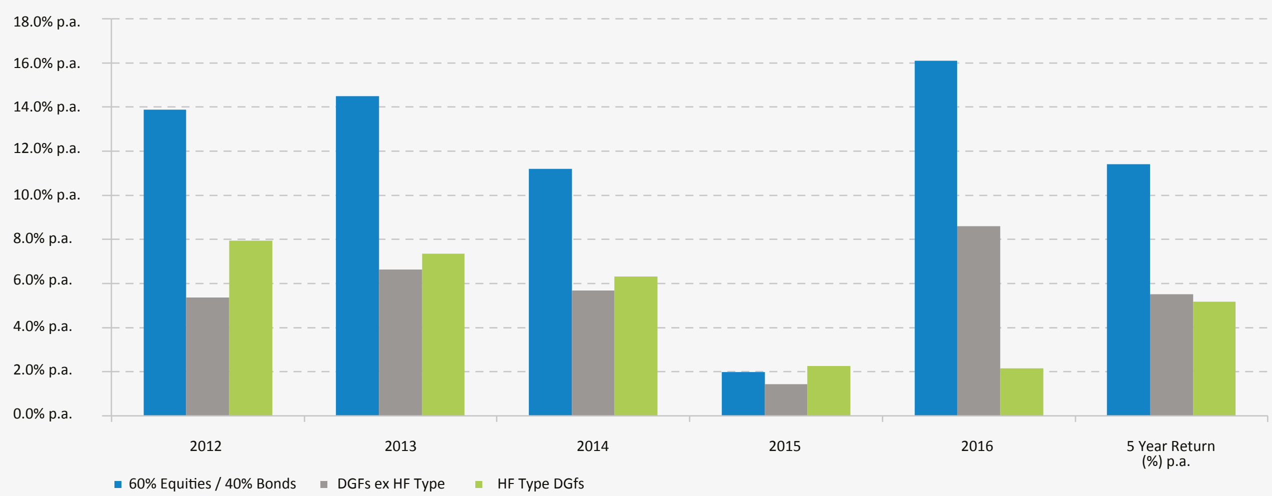
Figures 3 and 4 overleaf compare the performance of DGFs using hedge fund strategies versus hedge funds. I have selected Hedge Fund Research (HFRI) as it is one of the established global leaders in the indexation, analysis and research of the hedge fund industry, with index history of over 20 years. Overall, I believe the HFR statistics are representative of the type of returns hedge funds have achieved for investors (both individual hedge funds and funds of hedge funds), although given the extreme heterogeneity of this asset class there is a large degree of dispersion.

Over the period of analysis, hedge fund returns - as represented by the HFRI overall fund composite and the HFRI fund of fund composite - failed to keep pace with the average 'hedge fund type' DGF, and also displayed lower Sharpe ratios.

HEDGE FUND WORLD LESSONS

If we can conclude that 'Hedge Fund Lite' DGFs have as much in common with 'true' hedge funds as they do with other DGFs, there are some lessons we can take from the hedge fund world.

Figure 2. Performance of a '60:40' Index and Diversified Growth Funds. Period 2012-2016



Source: PiRho, Reuters Datastream
60% Equities - FTSE All World TR (50% Unhedged, 50% Hedged) / 40% Bonds - iBoxx GBP Non-Gilts TR DGFs ex HF Type (16 funds at the end of 2016) and HF Type DGFs (6 funds at the end of 2016); returns are an unweighted average, and net of fees on the lowest fee share class

- Investors do not always undertake the same type of investment due diligence considered essential for a hedge fund investment. Yet DGF managers should have nothing to fear from intensive analysis, and should not seek to hide behind the sometimes bland and vague descriptions of investment process, poorly explained references to risk management, and use of internal asset class definitions, which cannot be properly understood even by professional investors.
- Investors should think more about diversification of manager risk when investing in hedge fund-type DGFs; one approach may be to use such funds as a complement to, rather than a substitute for, long-only strategies.
- Watch out for survivorship bias. The lifespan of a hedge fund historically has been assessed at an average of around five years, with high risk of failure in stressed markets. Closures of large hedge funds have often been accompanied by huge media focus. The mainstream market buries its dead more quietly, for example with a switch of mandate or a fund merger.

Biography

NICOLA RALSTON

Nicola Ralston has over thirty-five years' investment experience as an analyst, portfolio manager, investment consultant, board member and investment adviser. She is a director and co-founder of PiRho Investment Consulting, which offers bespoke investment advice to institutional investors. Nicola spent 22 years at Schroders, where she became Head of Investment, and was subsequently Head of Global Investment Consulting at Aon Hewitt. Other current roles include Chairman of Henderson EuroTrust and the Investment Committee of the British Heart Foundation. Nicola has received the Distinguished Friend of Oxford award and is a member of the Somerville Development Board.

Figure 4. Sharpe ratio and risk-adjusted returns PA Period 2012-2016

	5-year Annualised Return p.a.	5-year Annualised Volatility p.a.	Sharpe Ratio (rfr = 0.5%)
60% Equities / 40% Bonds	11.4%	6.3%	1.74
HF Type DGFs	5.2%	3.9%	1.22
HFRI All Funds Composite	4.5%	4.3%	0.93
HFRI Fund of Hedge Funds Composite	3.4%	4.0%	0.73

Source: PiRho, Reuters Datastream; see Figure 3 for details of portfolios/indices

Figure 3. Performance of Hedge Funds and DGFs using hedge fund strategies. Period 2012-2016