Hedge funds: A new way

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Willis Towers Watson

Hedge funds: A new way

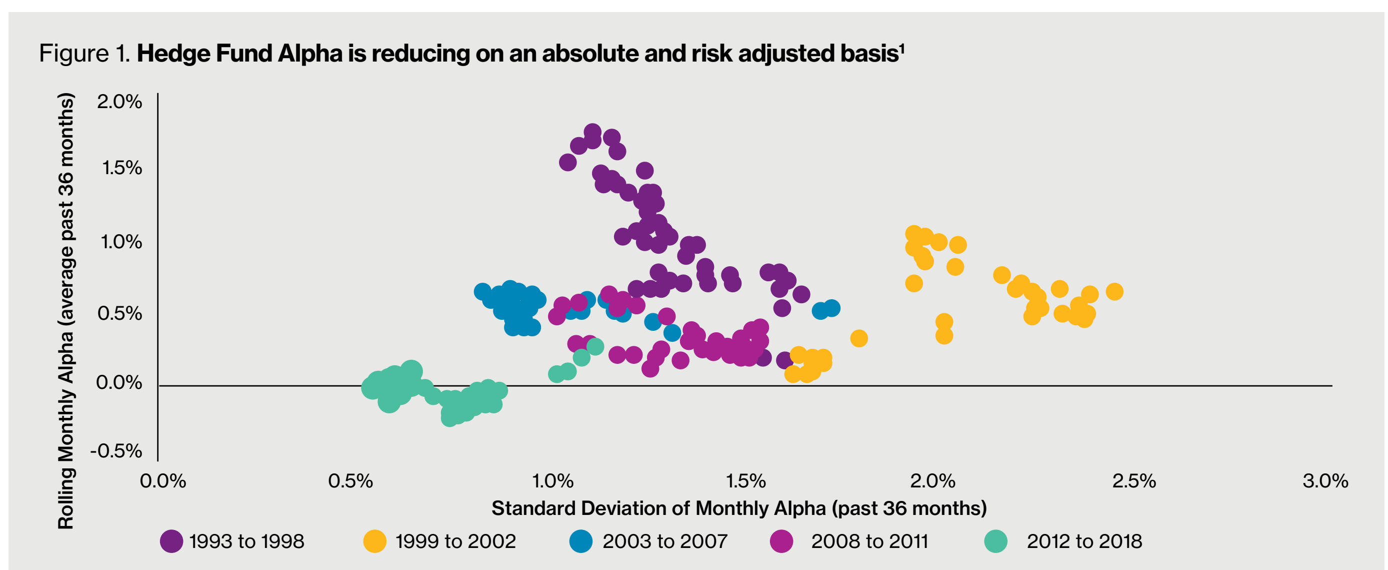
Hedge funds were once praised for extracting superior performance relative to traditional asset managers. More recently, however, we have witnessed a growing tide of negative sentiment directed at them, driven by a lengthy period of lacklustre hedge fund returns coupled with hefty fees. While we have sympathy with the sentiment and believe some of it may be justified, we believe that asset owners contemplating capitulation would be making a mistake. Importantly, we haven't been passive observers of this recent environment and have been working tirelessly to deliver a new and better way for hedge funds; a way to improve portfolio outcomes and shake up the industry to benefit end investors.

In recent years, returns have been distinctly lacklustre

Investors buy hedge funds to access the skill and excess returns the manager is able to generate, often loosely defined as "alpha". *Figure 1* shows the average rolling monthly alpha of hedge funds over various time periods. The green dots represent the last six years, showing that the level of alpha and the volatility of alpha are at their lowest ever.

Given the sustained equity bull market and muted market volatility, the low level of alpha is unsurprising. Worryingly though, this data suggests that hedge funds are not assuming sufficient risk to deliver attractive performance in any environment. And while some of the low levels of alpha can be attributed to central bank quantitative easing and low market volatility, not all can. A full explanation for these outcomes and this behaviour remains unclear. As such, we are forced to pose a simple question – what is going on?

Figure 1. **Hedge Fund Alpha is reducing on an absolute and risk adjusted basis**[1]



1. The monthly alpha is the residual of a rolling regression where the 36 month beta of the HFRI index to the S&P is the beta of the regression. Sources: HFR® and Bloomberg LLP, 30 June 2018.

Past performance is not a reliable indicator of future returns.

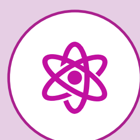
There are a number of structural and market headwinds facing the industry which need to be addressed.

Headwinds

Structural

Management of enterprise risk rather than investment risk

Now a $3tn[2] industry, the scale of hedge funds and the requirement to appease investors has created a trend towards institutionalisation. As the industry has matured, we believe managers have become more concerned about jittery investors redeeming due to poor short-term performance. This has led them to reduce their investment risk appetite in favour of managing 'enterprise risk'. Enterprise risk is the risk that managers spend too much time focusing on the stability of base management fee revenues rather than delivering against performance objectives for clients. This trend will lower expected returns and undermine the competitive advantage of hedge funds – they should be nimbler and less constrained relative to larger and more institutional asset managers.



The rise of alternative beta

Championed by Willis Towers Watson, asset owners are increasingly using specialist alternative beta strategies in their portfolios. These specialists seek to isolate and capture widely recognised behavioural biases and non-traditional risk premiums using a systematic approach. Historically the exclusive domain of hedge funds and active management, these products are attractive to investors as they capture some hedge fund-like returns at a much lower fee. This is essentially crowding the hedge fund opportunity set.

Insufficient value for money

Hedge fund net returns are suppressed by high and poorly structured fee schedules. Additionally, headline fees don't always capture additional expenses which are regularly, to the detriment of asset owners, disregarded by hedge fund investors. We have long been vocal advocates of the need for change and greater transparency across the hedge fund universe.

Market

Unfavourable macro environment

Accommodative monetary policy and coordinated central bank activity, including quantitative easing programmes, have dampened dispersion and volatility. Most hedge fund strategies rely on volatility and dispersion between markets and security valuations to extract alpha. As such, this has genuinely been a challenging environment.

2. Source: Barclayhedge, 30 September 2018.

The structural headwinds will continue to persist. Whilst it is unlikely that market headwinds will persist indefinitely, simply assuming that the macro-economic environment will reverse, and will overwhelm the structural headwinds, is a strategy of hope.

Hedge funds still have a place in client portfolios

We believe hedge funds continue to have distinct competitive advantages, which result from their largely unconstrained investment mandate. They can take greater investment risk, hire the brightest investment talent and should be less influenced by enterprise risk management, relative to larger institutional asset managers. Consequently, a hedge fund portfolio can generate strong performance *and* complement a total portfolio.

Hedge funds continue to warrant inclusion in institutional portfolios as a result of the aforementioned competitive advantages.

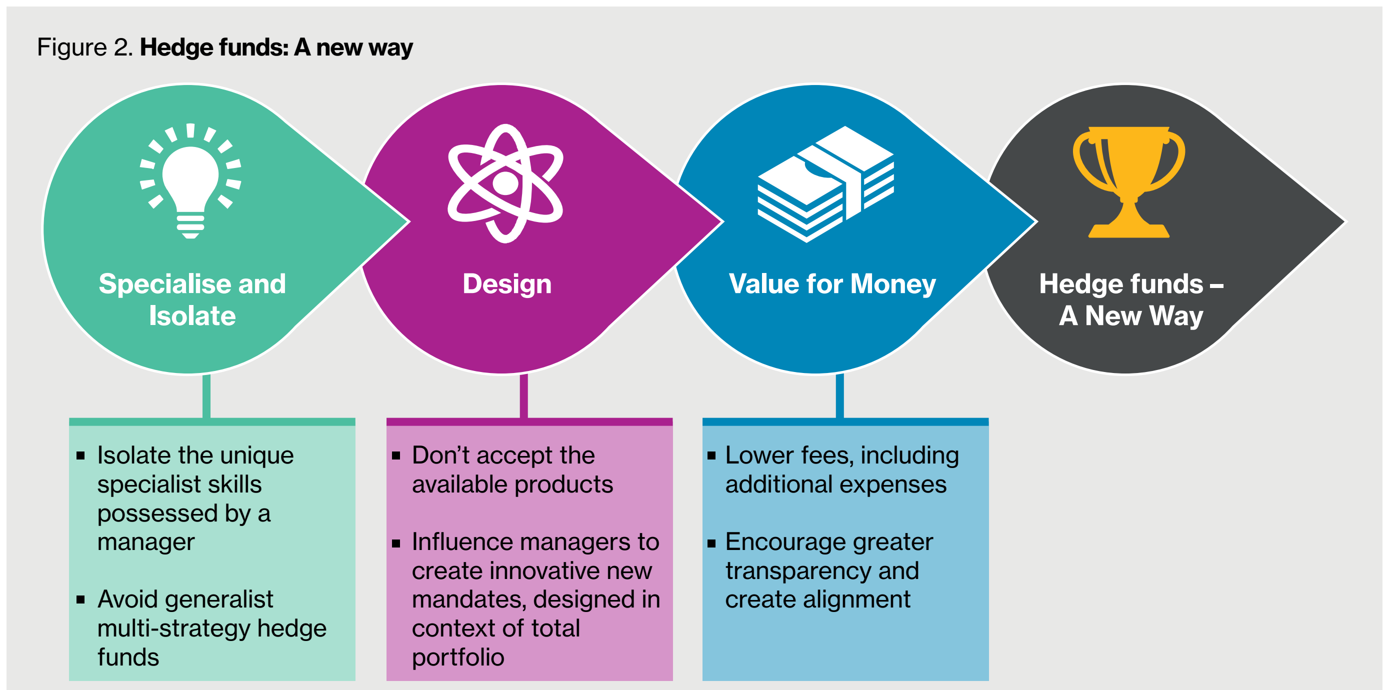
Willis Towers Watson has outperformed the average hedge fund of funds over the past decade supported by our thorough due diligence process – delivering 1.5%[3] per annum outperformance. However, we have not been immune from the headwinds facing the hedge fund industry. We too have observed a fall in alpha and volatility. We have had to evolve to ensure our portfolios deliver sufficient "bang for their buck" for our clients in the future.

Our *new way* has evolved to mitigate against the structural headwinds facing investor portfolios.

3. Notes: Performance data sourced from Willis Towers Watson, BNY Mellon Fund Services (Ireland) Limited, Hedge Fund Research Inc. 'HFRI', and Bloomberg, 30 June 2018. Composite returns are in USD. Figure calculated since inception – November 2007. Benchmark referenced is the Hedge Fund of Funds HFRI Index. The Willis Towers Watson Hedge Fund Composite is an equally weighted composite representing the performance of alternative beta allocations for accounts managed by Willis Towers Watson and its affiliates. Performance is net of manager fees and net of an assumed Willis Towers Watson fee of 0.5% per annum. Accounts included in the composite may be standalone accounts or carve-outs from multi asset class accounts. Please see composite disclosure for further details.

Past performance and simulated past performance are not reliable indicators of future returns.

Figure 2. **Hedge funds: A new way**



Our new vision has involved re-shaping our hedge fund selection process and refining our portfolio construction.

Building better components:

1. **Specialise and Isolate:** Our experience has shown that a manager is rarely best-in-class in multiple disciplines. We select hedge funds that we believe possess a unique competitive advantage in an area and then isolate this specialist skill and/or opportunity set to create a bespoke solution that is concentrated in the best ideas. This can involve carving out the best elements from flagship/multi-strategy vehicles or seeking specialist solutions, free from the lower-conviction 'risk management padding' that can suppress returns, while still retaining the unconstrained investment mind-set and style.

Through our scale, willingness to be innovative and our active role in product design, our flagship alpha driven hedge fund strategy pays less than 1% management fee and less than 15% performance fee on average - this is lower than 99% of institutional hedge fund investors according to a recent survey[5].

2. **Design:** We customise and refine the implementation of the solution to ensure that it is appropriately designed for our hedge fund portfolios. Our engagement goes beyond just fees and terms - we create better structures and new products in order to fill uncovered gaps in the market. By collaborating with managers, we shift their focus from enterprise risk to investment risk so that an appropriate level of risk is targeted. We will use a managed fund platform, where appropriate, to implement our customised solution. The platform, AMX[4], alleviates the operational burden for managers that do not have sufficient scale and allows them to focus on investing, all the while saving the end client money.

3. **Value for Money:** We work to ensure that fee structures are transparent and ensure alignment between the hedge fund manager and the end client. We believe managers should be paid for alpha, but are conscious that fees should reflect the manager's cost structure, the underlying strategy and the risk level. Through our scale, willingness to be innovative and our active role in product design, our flagship alpha driven hedge fund strategy pays less than 1% management fee and less than 15% performance fee on average - this is lower than 99% of institutional hedge fund investors according to a recent survey[5].

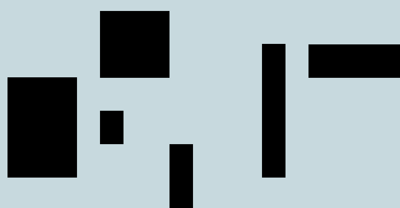
4. AMX: Asset Management Exchange
5. Source: JP Morgan Capital Advisory Group 2017 Institutional Investor Survey

Case Study: Carving out a specialist credit opportunity from a flagship multi-strategy fund

The old way:
We identified a multi-strategy credit hedge fund portfolio with more than five underlying strategies. The fund charged management fees of 1.5% and performance fees of 20%.

We believed the manager to be skilled. The multi-strategy hedge fund achieved **US LIBOR +4.4% p.a.** net of fees since inception. (This was c. 2% higher than the average credit hedge fund.)

However, volatility over the previous five years had fallen to c. 5%[6].



The new way:
Specialise & Isolate: We identified that this manager was particularly skilled in idiosyncratic shorting. The flagship vehicle had a 10-30% allocation to a sub-strategy dominated by idiosyncratic shorting, but was constrained by liquidity, capacity and risk management considerations. We isolated this specialist strategy.

Design: We worked with the manager to launch a strategy in a new vehicle where idiosyncratic shorting would be a dominant driver of returns. By isolating the strategy from the large flagship vehicle, it became less constrained by the liquidity requirements of the flagship vehicle and we secured significant capacity for our clients.

Value for Money: Through negotiation, we reduced the management fees below 0.70% and the performance fees to 15% over a meaningful hurdle.

Outcome: US LIBOR + 8.1% p.a. net of fees with a volatility of 8.9%[7].

Case Study: Investing in a highly-skilled individual

The old way:
We identified that the outlook for (developed market biased) discretionary macro was improving following mediocre returns through the post-crisis, quantitative easing environment. However, the majority of institutional quality funds in the market suffered from over-diversification. Most hedge funds blended multiple portfolio managers in order to benefit from diversification of style and opportunity set, but also to manage enterprise risk, we surmised. This approach generally produces a smooth return profile and good protection against a significant performance loss, but delivers very low levels of volatility and lower absolute performance than desired.

The new way:
Specialise & Isolate: We identified a highly skilled, single portfolio manager with an investment style that could deliver attractive, countercyclical returns. We negotiated a carve-out from the flagship fund, focusing on this one portfolio manager. We isolated this specialist strategy.

Design: We worked with the manager to launch a new vehicle. The mandate was designed to focus on a concentrated number of themes, with these expected to be the dominant driver of returns. By isolating the strategy from the large flagship vehicle, it became less constrained by the liquidity requirements of the flagship vehicle and could deliver an appropriate risk profile. We secured significant capacity for our clients.

Value for Money: We negotiated fees that were competitive given the level of risk that the strategy provides. These fees were more attractive than the flagship vehicle fees.

6. Track record quoted from inception of original multi-strategy credit hedge fund, August 2007.
7. Track record quoted from inception of strategy, August 2014.

Past performance is not a guide to future investment performance.

Building better portfolios:

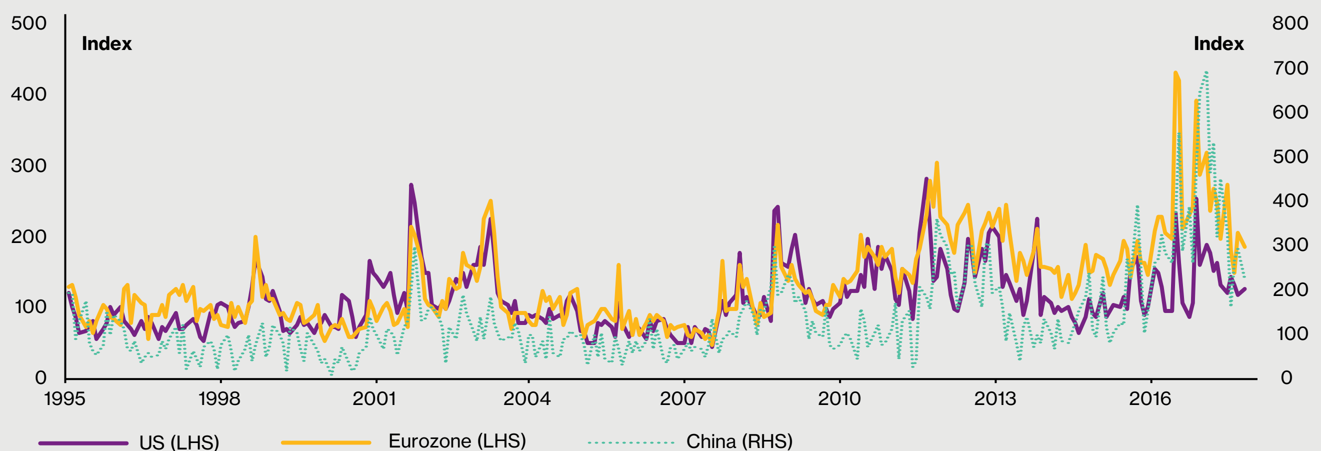
1. **Client Context:** Considering the client's portfolio as a whole is key. As a component of a wider portfolio, the hedge fund portfolio should avoid replicating the traditional equity and credit risk premia that are already accessed by traditional assets. The hedge fund portfolio also needs to contribute an appropriate level of risk and return to have a meaningful impact on the total portfolio. We have designed hedge funds with low macro-economic sensitivity and higher risk levels to ensure that the underlying components add meaningful returns and complement.

2. **Appropriate Diversification:** We consistently challenge the industry's status quo that diversifies risk excessively, rather than managing risk at the portfolio level. Combining a number of 'low return, high Sharpe ratio' hedge funds just results in diluted portfolios with low returns. As alluded to above, we view each individual fund as a building block that should target a suitable level of risk, such that desired returns may be achieved at the total portfolio level. In addition, a hedge fund portfolio should allocate to a concentrated mix of funds (we typically allocate between 10 and 20) and not overly diversify the exposures. If each component is different and playing its role, significant diversification is possible within a concentrated portfolio without sacrificing a higher return.

A more favourable environment is likely

After a few years of disappointing returns, we are optimistic that the market for hedge funds is improving for two reasons; high levels of uncertainty and rising downside risks. *Figure 3* shows how political uncertainty has been increasing and seen more episodic spikes. Elevated levels of uncertainty have historically supported hedge fund strategies that thrive as markets transition to higher volatility levels and investor sentiment diverges.

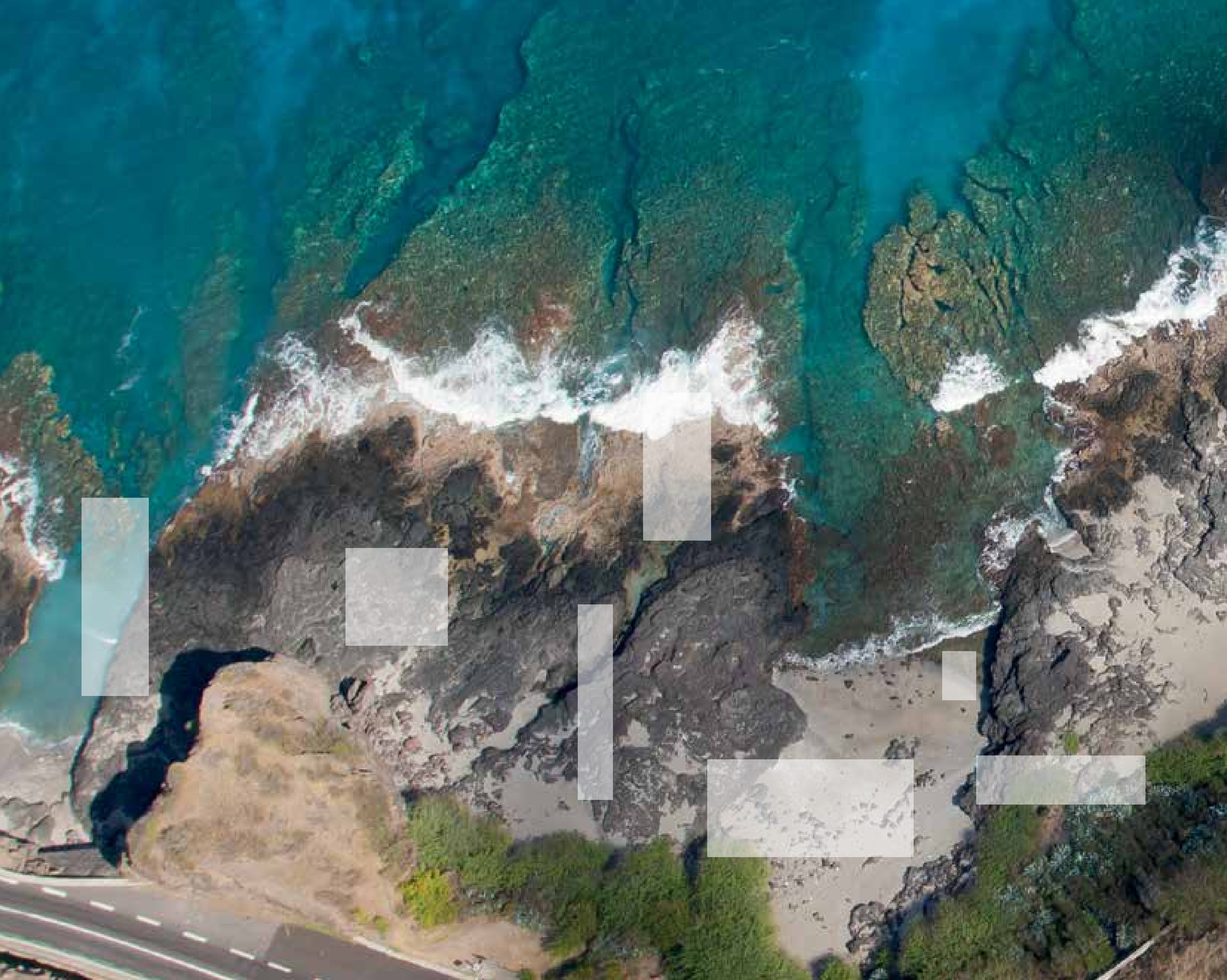
Figure 3. **Political Uncertainty**[8]



Source: "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com, November 2017.

With rising interest rates and the potential for slower global growth, we foresee greater downside risks over the medium term. This would make equity and credit markets vulnerable to price falls, providing a better environment for hedge funds to exploit their unconstrained mandate. We are already witnessing change. Central bank policy divergence has commenced and the correlation between stocks is now at historically low levels, implying a greater level of dispersion and a richer opportunity set. It is also precisely the type of environment where hedge funds can improve the downside protection characteristics of a total portfolio.

8. Source: Bloomberg LLP



Now is the time to act

We urge asset owners to rely on more than just a change in the macro-economic environment and to embrace change in their approach to hedge funds. We have disrupted the status quo to design a new way; a solution that combats the structural headwinds facing the industry by isolating specialist return drivers, designing appropriate solutions to fit in with the wider portfolio and negotiating value for money for clients. We believe that this new way has the potential for our hedge fund portfolio to deliver the returns required. As we continue to demand change from the hedge-fund industry, the old way is likely to fall behind.

Willis Towers Watson has worked with its clients to implement hedge funds in portfolios for many years, leveraging a large team of manager research professionals to deliver differentiated outcomes. We have always avoided viewing hedge funds in isolation, but rather as part of a portfolio, designed to complement, to augment. This philosophy transcends the old and new approaches and has driven the superior downside protection we believe is so important. However, evolving to the new way, to thrive going forward, has been far from a trivial exercise. It has required us to draw on all of our resources. Notably, we have leveraged our scale, infrastructure and resourcing to help identify, design and launch the specialist hedge fund solutions that now comprise our client portfolios, all the while harnessing a culture of innovation. Underpinned by a desire to change the investment industry for the benefit of the end saver, we believe we have created a new and different way and hope weary asset owners will evaluate hedge funds through this different lens.

Disclaimer:

Willis Towers Watson Hedge Fund Composite (the "Composite") represents the performance of hedge fund investments for accounts managed by Willis Towers Watson & Co. and its affiliates. It includes the performance for accounts that are allocated to at least four hedge funds. During the period in which an account is building up their exposure to hedge funds (and as such, have invested in fewer than 4 hedge funds), it will not be included in the Composite. Accounts included in the Composite may be standalone accounts or carve-outs from multi asset class accounts, all of which must meet the Composite criteria described above for inclusion. Additional information regarding the calculation of Composite returns is available upon request.

Investments in Hedge Funds are speculative and involve a high degree of risk. Underlying funds may use leverage and performance may be volatile. The underlying funds fees and expenses may offset profits.

As outlined in the disclaimer, we have relied upon data supplied to us by third parties. Reasonable care has been taken to ensure that the data sourced across all clients is representative of actual experience.

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The performance shown is for the stated time period only; due to market volatility, each accounts' performance may be different.

Timing of transactions and market conditions prevailing at the time of investment may lead to different results. Differences in the methodology used to calculate performance may also lead to different performance results than those shown. The period shown includes the global financial crisis of 2008, a period of significant market stress. The performance shown is compared to HFRI Fund of Funds Composite. The index is designed to be representative of the overall composition of the fund-of-hedge fund universe and includes over 650 constituent funds including both domestic and offshore funds. Only fund of funds with at least $50 million under management or have been actively trading for at least 12 months are included in the index.

The Composite is an equal weighted composite which allows for currency hedging and is comparable with the HFRI FOF Composite which is shown in USD terms.

Inception date is 1 November 2007. Note that figures may not sum due to rounding.

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