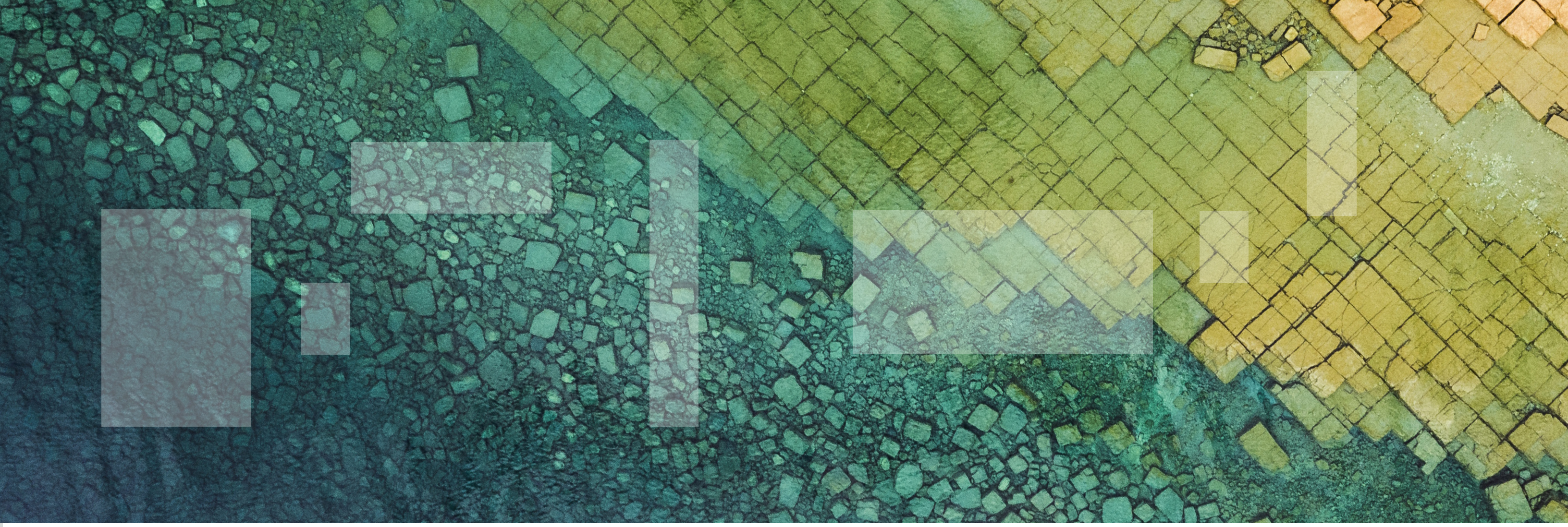
Hedge funds: A new way

For professional clients only

Willis Towers Watson



Hedge funds: A new way

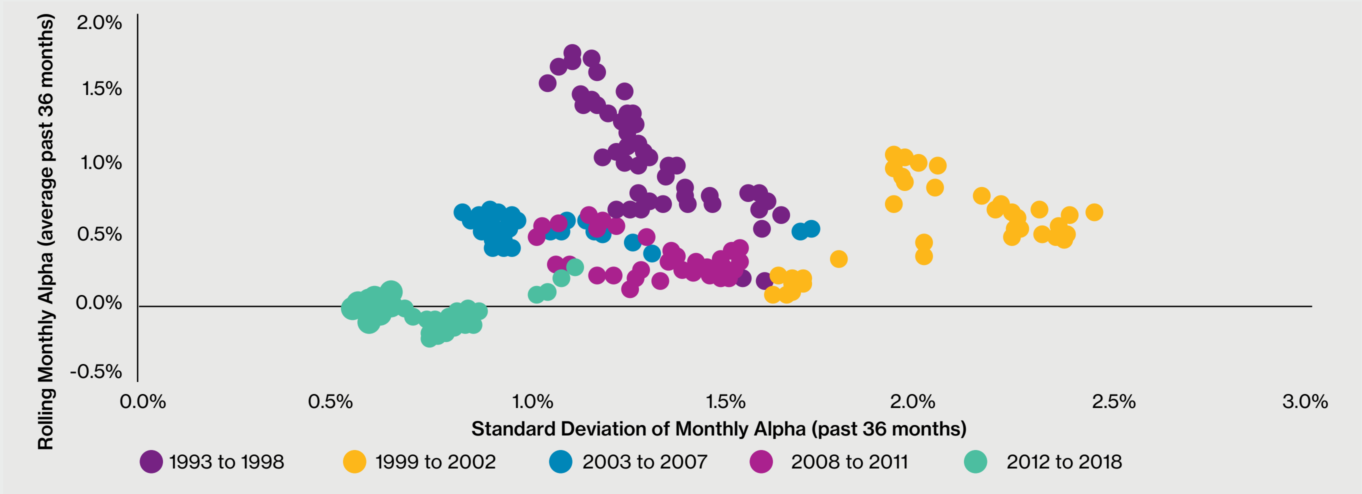
Hedge funds were once praised for extracting superior performance relative to traditional asset managers. More recently, however, we have witnessed a growing tide of negative sentiment directed at them, driven by a lengthy period of lackluster hedge fund returns coupled with hefty fees. While we share this sentiment to an extent 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; instead, we have been working tirelessly to help deliver a new and better way for hedge funds – a way to potentially improve portfolio outcomes and help shake up the industry to benefit end investors.

In recent years, returns have been distinctly lackluster

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, we believe not all can. A full explanation for these outcomes and this behavior 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. Past performance is not indicative of future results.Sources: HFR® and Bloomberg LLP, June 30, 2018.

A number of structural and market headwinds facing the industry need to be addressed.

Headwinds

Structural

Management of enterprise risk rather than investment risk

The scale of hedge funds, now a $3 trillion[2] industry, and the requirement to appease investors we believe has created a trend towards institutionalization. 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 favor 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 can 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 recognized behavioral biases and nontraditional risk premiums using a systematic approach. Historically the exclusive domain of hedge funds and active management, these products are attractive to investors as they look to 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

Unfavorable macro environment

Accommodative monetary policy and coordinated central bank activity, including quantitative easing programs, 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, September 30, 2018.

The structural headwinds will continue to persist. While we believe 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.

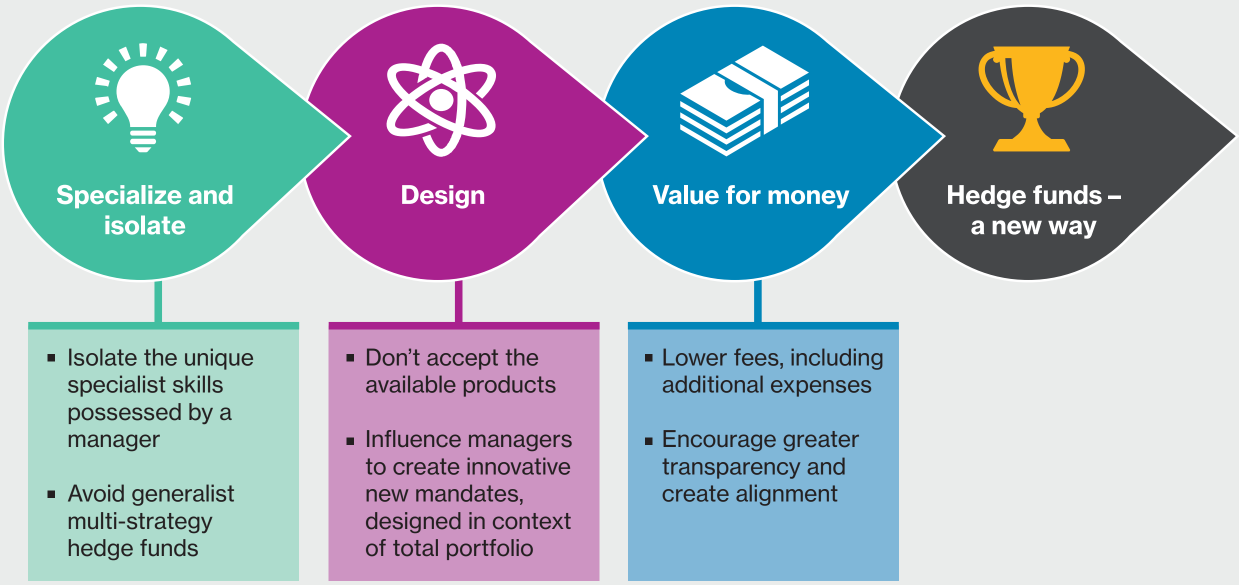
Hedge funds still have a place in client portfolios

We believe hedge funds continue to have distinct competitive advantages, which result from their largely unconstrained investment mandate. They can take greater investment risk, can 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 potentially 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.

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

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



Our new vision has involved reshaping our hedge fund selection process and refining our portfolio construction.

Building better components:

1. **Specialize 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 mindset and style.

2. **Design:** We customize 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 look to create better structures and new products in order to help 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 customized solution.

3. **Value for money:** We work to ensure that fee structures are transparent and to ensure alignment between the hedge fund manager and the end client. We believe managers should be paid for alpha, but we are conscious that fees should reflect the manager's cost structure, the underlying strategy and the risk level.

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 new way:
Specialize and isolate: We identified that this manager was particularly skilled in idiosyncratic shorting. The flagship vehicle had an allocation to a substrategy 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 and the performance fees over a meaningful hurdle.

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, we felt the majority of institutional quality funds in the market suffered from over-diversification. Most hedge funds blended multiple portfolio managers in order to not only benefit from diversification of style and opportunity set but also to manage enterprise risk, we surmised. We feel this approach is more likely to produce 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:
Specialize and 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. This is a sample representation of our work with an investment manager. Reduced fees may be attributed to other factors besides our buying power, including asset allocations to lower fee asset classes or passive management. Outcomes will vary and there is no guarantee that we can achieve savings with any particular manager in any particular asset class.

Building better portfolios

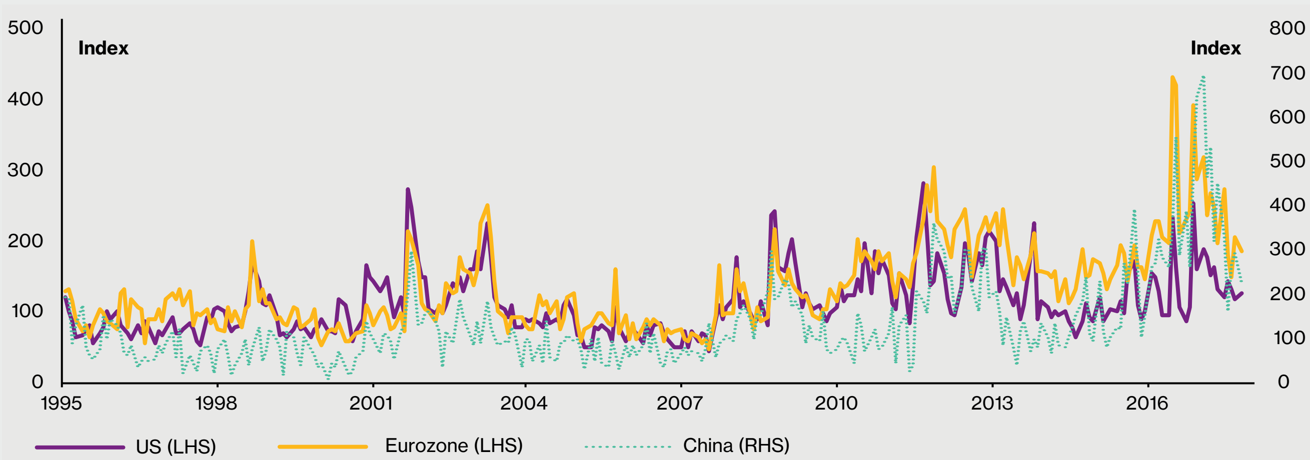
1. **Client context:** Considering the client's portfolio as a whole is key. As a component of a wider portfolio, we believe the hedge fund portfolio should avoid replicating the traditional equity and credit risk premia that are already accessed by traditional assets. The hedge fund portfolio also needs to contribute an appropriate level of risk and return to have a meaningful impact on the total portfolio. We have worked with clients to design hedge fund programs that target low macroeconomic sensitivity and higher risk levels to seek 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 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 favorable 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.

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 potentially exploit their unconstrained mandate. We are already witnessing change. Central bank policy divergence has begun 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.

Figure 3. **Monthly economic policy uncertainty index**



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

Now is the time to act

We urge asset owners to rely on more than just a change in the macroeconomic 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 seeks to combat 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 approach to deliver the returns required. As we continue to demand change from the hedge fund industry, we believe 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 and to augment. This philosophy transcends the old and new approaches and has aimed to drive the 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 compose 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.

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