Hedge Funds: The industry strikes back

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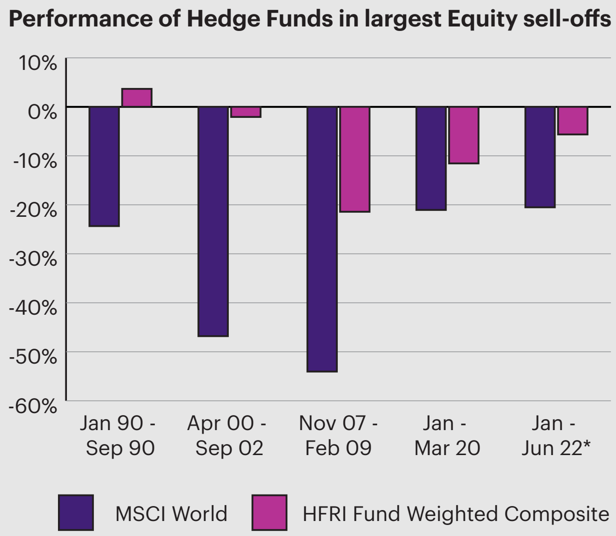
The hedge fund industry continues to grab headlines, but all too frequently in a negative light.

Unfortunately, a majority of this negativity is warranted - there are inevitably performance blow-ups, but also fraud, the flaunting of enormous wealth, to name a few topics. What is less frequently captured in headlines is the strong performance of hedge funds (the HFRI Fund Weighted Composite returned more than 10% each year in 2019, 2020 and 2021 – three very different market environments) and a pleasing evolution in segments of the industry in terms of transparency, delivering better value and help to address emerging important issues for asset owners.

We wrote a paper in 2019 ("Hedge funds: A new way") lauding the benefits of hedge funds, if invested in the correct way. While we were taking a contrarian view at the time (perhaps at the peak of hedge fund unpopularity), we are pleased to see that the portfolios of hedge funds we have constructed in "a new way" have consistently added value. Not only have they generated stronger absolute returns than we've seen in the past decade or two, but they have provided significant protection when investors have really needed it. Figure 1 illustrates the hedge fund industry performance through periods of challenging equity market performance, such as the first quarter of 2020 and through the market turmoil in the first half of 2022. And while the industry performance is one of less downside rather than full capital protection, through (successful) active selection and portfolio construction there has been scope to build hedge fund portfolios delivering positive performance through these challenging periods.

We are excited by a number of encouraging trends in the industry which we explore in this paper, including innovation, momentum in sustainable investing best-practices, better value for money and improving returns and alpha. However, at the same time, we observe tentative signs of a return towards prior behaviours, for example a failure to engage on Inclusion and Diversity by all participants, in addition to the emergence of fee/costs structures that are egregious and create limited alignment with the end saver. These are particularly prevalent in a type of hedge fund structure often referred to as "platform solutions" where the asset owner bears all of the costs rather than the more typical fixed base fee plus performance fee model. Is the industry striking back towards the darker days of the past? At a moment of significant uncertainty in geopolitics, macroeconomics and policy, we believe hedge funds are well placed to contribute strongly to institutional investors' portfolios. If the industry can avoid a lurch backwards in terms of client value proposition and persist with the new way, it can capitalize on the progress made over the last 5 years and see broader adoption by asset owners.

Figure 1: Downside protection[1]



[1] Figure 1 shows the five largest drawdowns in the MSCI World since 1990, and how the HFRI Fund Weighted Composite performed during this period. *The MSCI World sell-off which started in January 2022 is still ongoing. Sources: HFR and MSCI.

Let us now examine the positives and the negative changes in the industry since 2019.

Positives:

1. Innovation

Our 2019 paper called for innovation from hedge funds, not just in terms of better client solutions, but also for investment opportunities. Hedge funds used to be at the "cutting edge" of finance, drawing the best talent and generating alpha through skill, however this reputation had started to wane as performance and alpha dropped. We are seeing this trend take a turn as we see hedge funds branching into new investment areas ripe for exploitation, such as digital assets and carbon credits, full of volatility, expert knowledge and requiring investment skill. We are greatly excited by these developments and look forward to where these avenues lead to.

2. Momentum in sustainable investing best practices

We have been campaigning for better incorporation of sustainable investing practices in hedge funds for many years, but it has been resisted due to a "returns-only focus", a lack of clarity on what the right way of doing things is, and how to measure this (with an added excuse that some investors don't care). Some of the issues which hedge funds continue to grapple with are highlighted in Figure 2.

Figure 2: Challenges in sustainable investing when investing in hedge funds

Shorting	How do you account for this exposure?
Indirect Investments	If you're trading derivatives, such as futures or options, you're not directly impacting the underlying asset, so how do you capture the effects?
Time Horizon	For strategies that trade with short time horizons, is ESG applicable?

Happily, in recent years, changing requirements by regulators and changing preferences of asset owners are helping to put more pressure on managers and create positive momentum, particularly with respect to climate risks. There is a growing acceptance that ESG factors do influence asset prices and thus return outcomes, and while the signal will be strongest over the long-term these factors can impact strategies with a shorter time horizon. In essence, the challenges in Figure 2 which historically represented impediments to progress are beginning to be addressed.

Some years ago, we asked equity hedge funds to take their responsibilities as shareholders more seriously, voting when appropriate, making their own assessments of relevant corporate activities and recording when they have done so. We believe Stewardship is a critical and under-utilised tool in helping to bring about a just transition towards a net zero economy. Our expectations continue to evolve, moving significantly beyond this simple task. Today we are requiring the reporting of a large number of portfolio metrics, and for managers to incorporate considerations on the environment, society and governance into the idea generation and implementation processes. We set ourselves the same standard in our 2020 UK Stewardship Code.

Frameworks are emerging to create a standardised approach, such as the IIGCC, which recommends reporting short and long exposure separately, along with reporting exposure that includes and excludes derivatives. As the data and analytics in the climate space are rapidly evolving and there is not a single definite measure for the impact of climate change, WTW recommends a balanced scorecard that considers the multiple dimensions of "success", as highlighted in our 2022 Sustainable Investment Report.

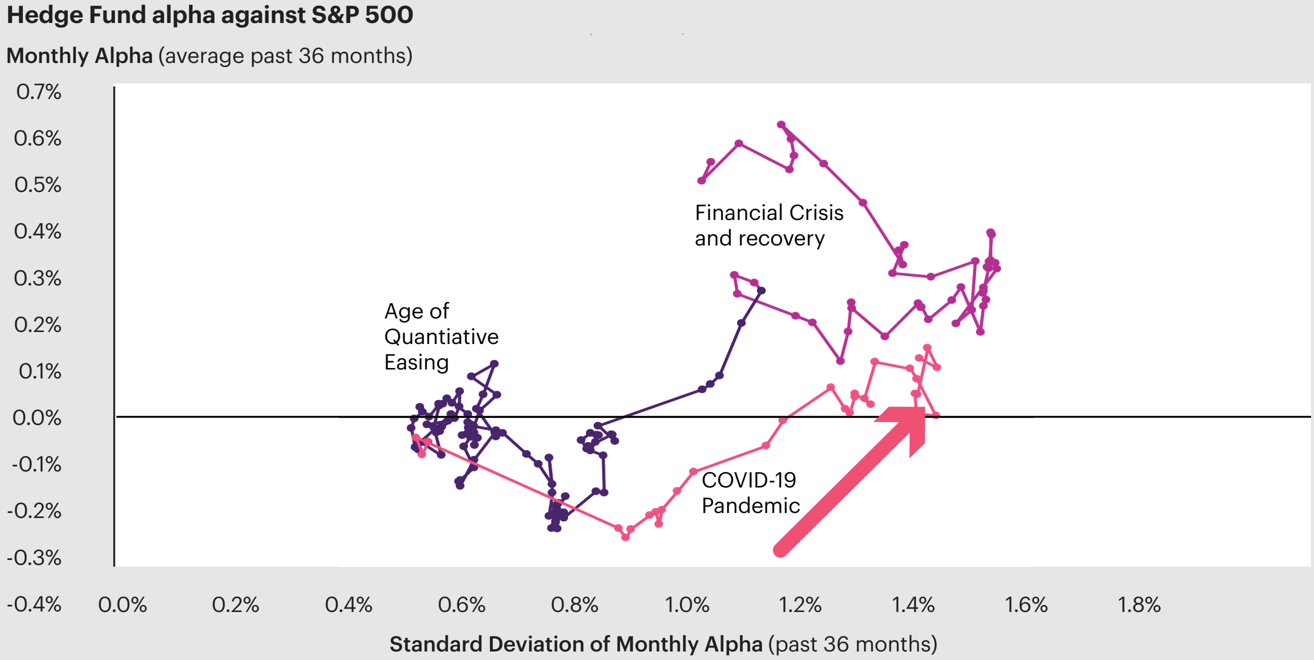
With a growing number of asset owners signing up to Net Zero goals by 2050 (or earlier), all asset managers selected, including hedge funds, will be required to engage and report on this key area.

3. Better value for money

We are pleased to observe better value for money in the hedge fund industry, with headline fees reducing (aside from at large platforms – we will come to that later). There is a wider recognition that there needs to be demonstration of sustainable sources of skill and alpha for managers to demand high fees and that the level of fees should align with the type of the hedge fund strategy and the expected alpha. We are pleased to see that 2% management and 20% performance fees are no longer the norm, as highlighted by numerous third-party surveys over recent years.

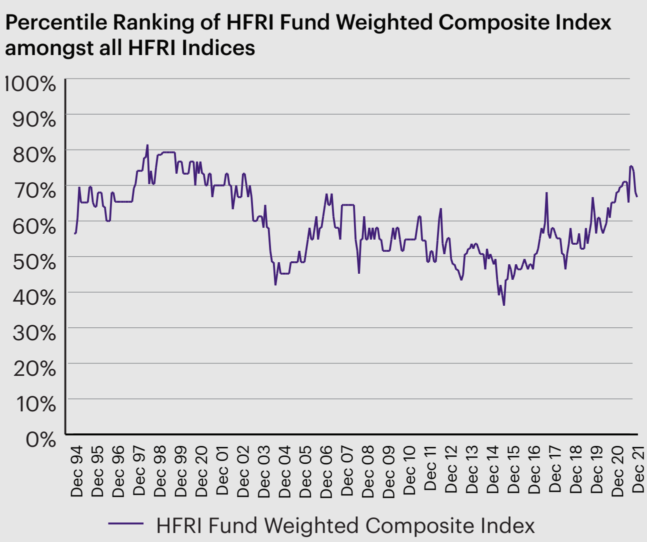
We are proud that our intense focus on fees and expenses has resulted in significant improvement in the value for money. Beyond just the general movement of the industry, the reduction in fees has helped justify the position of hedge funds in a multi-asset portfolio, particularly given the downside protection delivered during periods of challenging performance for traditional asset classes. Historically, our clients have enjoyed attractive management and performance fees on average. This is an encouraging trend, and we would call for the industry to continue to provide better alignment of fees, expenses and terms with investors.

Figure 3: Hedge fund alpha on an improving trend[3]



[3]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 Blomberg LLP, June 30, 2022.

Figure 4: Diversification benefit within hedge funds[4]



[4]Figure 4 shows where the HFRI Fund Weighted Composite, the composite of all hedge funds in the HFRI universe, ranks versus the full universe of single hedge funds. Where the line is above 50%, a diversified portfolio of hedge funds was more likely to have outperformed a more concentrated portfolio, or single hedge fund strategy. Source: HFR.

4. Seeking to improve returns and alpha

The level of "alpha" in the industry has been lackluster during the age of Quantitative Easing. Figure 3 shows the rolling monthly alpha of hedge funds over time and provides a simplistic measure of hedge fund industry alpha. With the withdrawal of Quantitative Easing and increased central bank policy divergence in recent times, markets have become more volatile and now offer a richer opportunity set for skilled managers. Our analysis indicates that this is beginning to come through at the industry level, as shown by the pink line and arrow.

Investors should also consider that there is no segment of the hedge fund opportunity set which has consistently performed. One demonstration of this is in Figure 4, which shows how a diversified, "industry" portfolio has generally ranked in the top half of the full hedge funds universe in performance terms. This supports diversification of a hedge fund program across skilled managers and strategies. But that alone doesn't guarantee results. Portfolio construction and creating solutions – considering the client's portfolio holistically are also key to ensuring that the underlying components add meaningful and complementary return potential.

Negatives:

1. A failure to engage on Inclusion and Diversity

The routes to entering the hedge fund industry today are markedly different to what they were two or three decades ago. Before, the talent funnel was extremely narrow, with the vast majority of hedge fund investment professionals coming from bank analyst programs and bank proprietary teams (see Figure 5). This resulted in highly competitive, heavily male-dominated investment teams, with limited gender diversity, reduced scope for and insufficient focus on cognitive diversity, and a general disregard for equity and inclusion. Unfortunately, concepts such as flexible working, mental well-being and embracing differences received insufficient focus.

Today, entry into hedge funds is through more diversified routes; the Global Financial crisis led to a dramatic reduction of the size of bank proprietary trading desks and forced hedge funds to find talent elsewhere. Some larger hedge funds have started their own graduate training programs while others offer internships. However, entry remains extremely difficult. There are potentially more appealing career paths for juniors and graduates emerging in other areas of asset management, and in external industries such as the technology sector. Here, possibilities for wealth creation seem to be coupled with a better work-life balance and a more inclusive and equitable workplace (although, we acknowledge there are examples of technology companies getting it wrong); hedge funds are faced with a worrying trend of diminishing talent in their pipelines.

Hedge funds are also faced with the even more immediate challenge of retaining their existing talent. We are witnessing concerns from managers across the globe about the number of members of their teams who are being poached by platforms, offering extreme compensation packages.

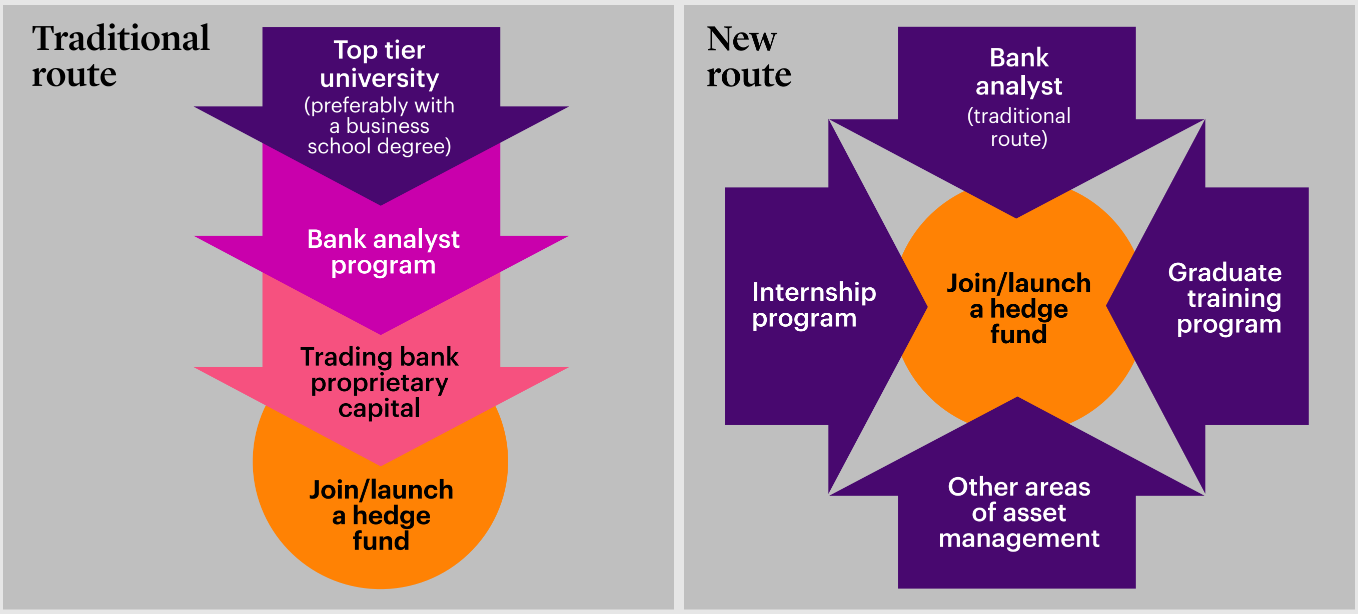
We worry this is a return to a model with limited direct focus on the client value proposition for investors and imperfect alignment of interest, with an unhealthy focus on short-term performance.

We have been very active in engaging with hedge funds to help them plan a better Inclusion and Diversity policy and practice. Some areas we have focused on, mentioned in our 2020 study of Diversity in the Asset Management Industry:

- Adapting compensation structures to equitably reward different work styles
- Rewarding positive behaviours and not just short-term performance
- Hiring plans that are long-term with training opportunities
- Hiring through initiatives such as “returners”
- Fostering a more inclusive culture that supports and celebrates all lenses of diversity
- Improving work-life balance with an eye on mental well-being

We believe an improvement of Inclusion and Diversity should be an urgent and high priority for every hedge fund in order to attract and retain talent, align horizons, and ultimately keep the industry at its best for investors. Furthermore, we increasingly see asset owners voting with their feet, requiring transparency and commitment to evolve in this area.

Figure 5: An evolution in approach to sourcing diverse talent



2. Re-emergence of excessive fees/ costs structures

As far back as our 2012 paper "Hedge Fund Investing – Opportunities and Challenges" we have been vocal advocates of the need for greater transparency around fee structures and expenses. Headline fees usually do not capture additional expenses and we have expended notable resources in our manager research process to sifting through all expenses in fund accounts and excluding elements we do not consider to be fair.

While we welcome regulations in Europe and Australia focusing more on costs and expenses, we still witness resistance from the asset management community. More worryingly, we have started to see some upward pressure from hedge funds on fees, and there is growing diffusion of a fee structure in the industry that we are very concerned about: hedge funds that are set-up as expense pass-through platforms.

In principle these structures sound great: investors pay what it costs to run the fund, plus a performance fee when good performance is delivered. In the event of a challenging performance period, costs are still covered, giving investors confidence in the stability of the firms trusted to look after their assets. However, there is a material misalignment of interest: how can the costs be controlled and what is the incentive to do so?

For example, platforms hire portfolio managers and their entire teams, pay them whatever is needed and allow them to spend whatever they want to generate returns. But this does not guarantee results. If a team does not generate performance immediately, their allocation within the fund is quickly cut, and if this continues, they are fired. All associated costs are charged to investors.

In many cases, investors have no idea how much the bill is. We see fees that exceed 8% per annum, with the performance fee on top. We worry about the detrimental impact on outcomes over the medium-term that could derive from this extreme focus on short-term performance. Furthermore, we fear the disruption caused by team instability in periods of challenging performance, threatened by the lack of the attachment between the portfolio managers and the platform.

For the sake of completeness, the arguments of the large hedge funds utilising a platform model is usually two-fold:

Paying for the cutting-edge technology, large datasets and the very best talent costs a lot.

We argue that investors should be aware of how their money is being spent, including the platforms' expensive marketing campaigns, and staff bonuses, which should be aligned with and come out of performance fee revenue.

Investors should look at net returns and not worry about the costs.

We argue that this is a departure from the value for money mindset of the end saver. Furthermore, we caution against placing too much emphasis on past performance: future alpha, its reliability and the risks used to generate it are what matters. Past performance is a poor indicator of any of these.

Due to relatively good performance and strong marketing efforts, some of these hedge funds platforms are currently enjoying massive growth in assets under management. This success is enticing more hedge funds to switch to this business model.

We believe this would be a backward step for the industry.

We would encourage the investors allocating to these hedge funds utilising the expense pass-through model to question whether they are getting value for money, the effectiveness of the alignment of interest and the longer-term longevity and stability of this model.

Conclusion

Our desire to change the investment industry for the benefit of the end saver led us to create a new way for hedge funds. We are encouraged by the value added by those hedge funds which have embraced this new way and by the emerging positive trends we have explored in the papers. We believe that in the current environment, hedge funds are well positioned to contribute strongly to institutional investors' portfolios.

There is a risk that the recent improvement in performance outcomes catalyses a backward step; the industry strikes back. We hope not.

We will continue to use our scale, infrastructure, and resources to challenge the behaviours that threaten the ability of the industry to keep moving forward. We are calling for broader engagement on sustainability, and Inclusion and Diversity, and for fee structures and compensation frameworks that represent strong value propositions for investors and create appropriate alignment.

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