Five Myths of Hedge Fund Investing

2022 was the worst year since 2008 for the traditional 60/40 equity/bond portfolio, as rising interest rates negatively impacted traditional asset classes.

By contrast, hedge funds provided much needed diversification and capital preservation, outperforming public equity, investment grade bonds, and other listed asset classes, in a banner year for hedge funds.[1]

Looking ahead, higher macro volatility and asset class return dispersion looks set to continue.[2] Hedge Funds tend to generate attractive alpha-driven returns during periods when these factors are present.[3]

Investors new to hedge funds may be considering their merits. To help investors navigate hedge funds we'll consider 5 commonly held beliefs and explore whether these are true or should be debunked.

Join our WTW experts as we explore:

What are the Myths vs the Truths of hedge fund investing?

How best can pitfalls be avoided?

"Hedge funds are very risky"

As their name suggests, hedge funds more typically employ hedged, so-called 'relative value', positions which exploit market price inconsistencies rather than taking outright bets on the direction of market prices. History shows that hedge fund returns are less volatile than traditional assets classes. For the 3 years to January 2023, hedge fund performance volatility was 5.5%, versus 20-25% across global equity indices, and 7.7% for global bonds.[1]

Myth gauge:

Our expert view:

"**Do your due diligence! All managers are passed through a rigorous process. They must demonstrate risk management and wider governance. What's more, their portfolio must complement our overall risk target.**"

Victoria Vodololazschi
Hedge Fund Research,
North America

"Hedge Fund performance has disappointed"

It is true that hedge fund returns lagged passive equity returns in the decade to 2021. Quantitative easing drove a period of low volatility and low cash returns which, compounded by significant market intervention by central banks, helped to contribute to lagging hedge fund returns.

However, with a focus on absolute returns, hedge funds are typically prized for their diversification potential. Downside protection was broadly demonstrated in 2022, a year when traditional asset classes performed badly.

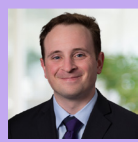
The high dispersion of hedge fund returns demonstrates the value of manager selection and portfolio construction to help deliver desired outcomes.

Myth gauge:

Our expert view:

> "We will only accept high-conviction talent, and will re-structure the product to our needs. Each year our Research team scours the universe of hedge fund managers to isolate differentiated, genuine alpha which compliments a client's wider portfolio.
> No segment of hedge fund alpha has consistently performed, so we focus on a portfolio approach of a concentrated selection of uncorrelated diversifying alpha sources."

John Delaney
Portfolio Manager,
North Amercia



"Hedge funds are secretive and opaque"

Hedge funds are often protective of their intellectual property. After all, their individual approach is what drives the differentiated returns and alpha generation we seek. However, this must be balanced with almost 92% of investors highlighting the need for more transparency.[4]

We believe what matters is that managers are willing to be transparent around their aggregate portfolio risks and that they are sharing their hard-earned returns fairly with their investor partners.

Myth gauge:

Our expert view:

> "WTW have been at the forefront of driving improvements in transparency for years. We insist our managers report to both our proprietary database and risk engine for ongoing monitoring at both the manager and overall portfolio level."

Sara Rejal
Head of Liquid Diversifying
Strategies Manager Research

Hedge Funds are expensive

Delivering alpha requires skill, and we appreciate there is a premium to pay. As a long and vocal advocate of improving value to investors, we have been pleased to observe hedge fund fees declining, albeit more recently at a slower pace. Average hedge fund management fees are 1.55% in 2022, down from 1.7% a decade ago.[5]

However, we are concerned that the ‘pass-through’ fee model employed by an increasing number of Multi-Manager funds does not appropriately incentivize managers to control costs for investors. Some estimates equate to management fees of up to 7%, with 20% performance fee on top.[6] Many of these managers are ‘hard closed’ (effectively full and not open to new capital) and therefore have little incentive to offer investors transparency or flexibility around their fee model.[8]

Myth gauge:

Our expert view:

We believe the fees managers charge should be fair and aligned with investor interests. We only work with managers with a transparent fee model. With the added weight offered by our scale means our average manager fees paid are 51% of the wider market.[7] However, our overall focus is on the value hedge fund managers can bring to to client portfolios, and direct our fee budget accordingly.

Sara Rejal
Head of Liquid Diversifying Strategies Manager Research

Hedge Funds don’t care about sustainability

While hedge funds were initially behind the curve versus mainstream managers on ESG matters, the industry has been playing catch up. This is particularly the case within equity and credit strategies where relevant data is available and where corporate engagement models have become more structured.

In 2022 an estimated two thirds of hedge fund managers integrated ESG/SRI within their investment process, up from a quarter in 2020.[9]

Influence matters: we believe this was driven by investors, including ourselves, insisting on progress.

Myth gauge:

Our expert view:

All our managers are required to have an ESG policy, with applicability to their investment process. We also seek thematic managers, for example in Energy Transition and Carbon Credits, where the investment outcomes are favourable. Furthermore, we expect managers to demonstrate progress of their culture and diversity.

Victoria Vodololazschi
Hedge Fund Research, North America

Are you ready?

We believe hedge funds and a wider universe of liquid diversifying strategies deserve consideration by investors. They also require skill and experience to dispel common myths and manage risks for clients.

At WTW, we use a unique approach to building liquid diversifying solutions for our clients. Contact us to hear more.

Specialise & Isolate > Customise & Design > Align Investor Values

Want to read more?

[Hedge funds: A new way]

[Hedge funds: The industry strikes back]

[Liquid Diversifiers Solutions]

Contact us

Sara Rejal
Head of Liquid Diversifying Research
sara.rejal@wtwco.com

Victoria Vodolazschi
Director of Investments and Hedge Fund Research
victoria.vodolazschi@wtwco.com

Holly Murnieks
Senior Director of Investments
holly.murnieks@wtwco.com

Erin Gallagher
Portfolio Specialist, Investments
erin.gallagher@wtwco.com

Sources:

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