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Hedge Funds: When You Find Alpha

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It has become quite popular to degrade hedge fund managers of late. Since 2008, the hedge fund index has not been able to beat the S&P500. Instead, in the rising markets environment of the last few years, a simple use of ETFs became a popular way to invest. After all, who wants to pay hedge fund fees if you can just be long the market or a sector? And how many hedge fund managers generated 30% return in 2013 like the S&P500 did?

A Timing Call

While I agree that passive investing has cost and liquidity advantages over active managers, I would like to note that, by being long an index, an investor is making a timing call on the market, and, as we all know, this is a very difficult task. It is not only the entry point to the trade, but also the exit point. For example, an investor that bought the QQQ (ETF that monitors the Nasdaq) in March of 2000, when the index was trading at his all-time high of around 5,000 points, would still be, almost 14 years later, DOWN on that investment. Similarly, the investor that bought the SPY (S&P500 ETF) in the beginning of 2000 saw the first decade of this century pass by while his investment in the ETF generated ZERO return, including a down 38% year in 2008.

No one said it is easy to make money in the markets, and hedge funds are certainly not perfect. The following may be some of the reasons why the hedge fund industry's performance in the last few years has lagged the overall market. First, the number of hedge fund managers has increased dramatically over the last 15 years. There is a very simple reason why most investors want to have a hedge fund: the fee structure. Who would not want to get paid a 2% annual management fee and another 20% performance fee? Although I believe the best money managers work at a hedge fund, it cannot be the case that all 10,000 hedge fund managers out there can beat the market. Statistically, it is not possible. Second, the leverage in the system is lower than it was before 2008. Third, the current low interest rate environment means that, when a manager shorts a stock, the cash that he receives in return "seats" in a cash account that does not pay any interest, even though it might have paid 5% in the past. Lastly, the macro environment of the last few years, from the great recession in the US to scares about systematic risks to the Euro zone, has been difficult.

Despite the industry underperformance, I believe there are several reasons to include hedge funds in your clients' portfolios. To begin with, there are certain investment strategies, such as global macro for example, that cannot be replicated via ETF or mutual fund. Second, certain asset classes, like structured credit, that trade Residential Mortgage Backed Securities are not available to trade via a broker or even a more sophisticated family office structure. Third, while the overall market is supposed to be efficient, certain parts of it, such as small cap equities, are not due to lack of coverage by Wall Street analysts. This creates opportunity for good, smart, buy-side analysts to do proper research work and come up with profitable trading ideas on both the long and short sides.

Not a Simple Task

There still are a few hedge funds out there that are able to generate alpha and beat the markets on both an absolute and a risk-adjusted basis. I can think of one long-short equity manager, focused on the financial sector, that has generated around 25% annualized returns since 2008, has never had a down year and has approximately half of the exposure to the market. Another long-short equity manager, focused on the healthcare sector, has annualized returns of 21% since 2005 while having only 50% exposure to the market. The point is: there ARE great managers out there who can beat the market, and there are investors that are happy to pay their higher fees. But one cannot find them by merely looking at their track record, past performance is only a guarantee for past performance.

When one identifies a potential manager, proper due diligence on both the front and back offices should take place before making any investment allocation decisions. I believe a portfolio of managers should be comprised of 15 hedge funds; these should be your best managers. In an industry that is growing in assets and managers, it is not an easy task to find them. But once you do, you want to keep them for the long haul.

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