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HEDGE FUNDS: DO THEY REALLY HEDGE?

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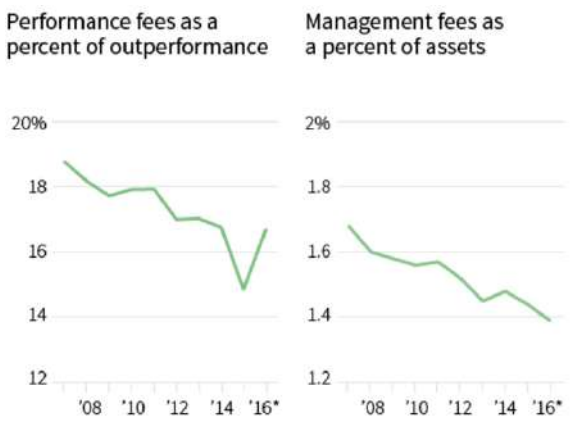
INTRODUCTION

Hedge funds are investment vehicles that invest capital from qualified investors in a variety of asset classes, using a wide range of techniques. As they only accept capital from qualified investors, they are not capped by the same regulatory constraints as are mutual funds, allowing them to use riskier tools such as leverage and short selling. Hedge funds are usually structured as open-end funds and allow for withdrawals or additions by their investors.

One of the most characteristic features of the hedge funds is their fee structure, colloquially known as '2 and 20', which means a fixed annual management fee of the 2% of the fund's assets under management, and an additional performance fee equivalent to the 20% of the increase in the fund's net asset value. That fee structure, together with the usual co-investment of the managers (they invest their own capital in the fund) serves to align the interest of the managers and the investors. In the recent years, there has been a tendency to reduce the traditional '2 and 20' fees:



Source: Reuters

Hedge funds fees remain under extreme pressure across the industry. This negative trend is driven by declining return expectations from investors, increased competition across the industry, and an increasing share of industry assets controlled by large institutional investors.

In fact, in the past all investors generally paid the same fee, regardless of allocation size. Today, most funds will provide a significant fee discount to large allocators. Even though the definition of 'large' allocation varies by firm, it typically starts in the range of $25-100 million. Few hedge funds have instead reduced their fees for current or future investors allocating $25 million or less. While those investors have seen a slight decrease in fees, very large allocators (over $100 million) have seen fees decline as much as 25% to 50 %. Allocation size has caused a large divergence in the range of fees paid by investors and is responsible for a vast majority of the decline in revenue at the industry level.

HISTORICAL ROOTS

The first hedge fund structure was created in 1949 by Alfred Winslow Jones, an Australian sociologist. He originally called his fund "hedged fund", because it was supposed to be hedged against market risk. He achieved the hedge by using short selling: He shorted as many stocks as he bought, so he was not exposed to the movements of the market as a whole; he did not care whether the market was bullish or bearish, he only cared about buying and selling the right stocks. He created what today is known as Long/Short Equity, the most popular strategy in the hedge fund industry, amounting to approx. $800B assets under management.

This strategy, as most hedge fund's strategies nowadays, aims to obtain an absolute return, which means to achieve a positive return regardless of the behaviour of the market. This contrasts with the relative return measures used by mutual funds, that use a benchmark to track and evaluate their performance.

But Alfred W. Jones's legacy in the industry is even greater: He also created the 20% performance fee, he used leverage to increase his profits, he created a measure called 'velocity' (what we know today as 'Beta'), and he only accepted capital from a reduced number of partners, thus bypassing restrictive regulations. Those inventions worked really well for him: during his 34 years as a manager, he lost money in only 3 of them, in contrast to the S&P 500, that was down 9 years during the same period. There are no exact records of his performance year by year, but in his first 10 years, he made a 670% gain, while the leading mutual fund at the moment, Dreyfus Fund, made 358%.

CLASSIFICATION AND OBJECTIVE

The great performance of Alfred Winslow Jones' hedge fund attracted attention and interest, and the industry grew and evolved enormously until our days. Now the hedge fund industry as a whole manages approximately $3,000B and offers a variety of strategies. The main families of strategies include:

- Long/Short Equity: Take long and short positions in equity and equity derivative securities;
- Global Macro: Take positions in shares, bonds or currencies trying to anticipate global macroeconomic trends/events;
- Relative Value Arbitrage: Take positions in different securities in order to profit from discrepancies in prices;
- Event Driven: Take advantage of price inflation/deflation as a response to corporate events.

All of those strategies are used in order to generate an absolute return, meaning that they should over-perform the market during bearish periods. However, that has a B-side: they can underperform during prolonged bull markets, like the one that have just ended. From March 2009 until January 2020, the financial markets experienced the longest bullish market in history. During this period, the hedge fund industry as a whole underperformed against the S&P 500. That, in conjunction with their 'generous' fee structure led to an increasing amount of criticism. Why should they get a 20% of the profit if they are not even over-performing the main indexes? A passive investor could achieve higher gross returns and lower fees by investing in mutual funds or ETFs.

But those that are so critic with the industry are omitting a basic point: The purpose of the hedge funds is to create absolute return, not to over-perform a benchmark; and this, in a period when the Federal Reserve and the European Central Bank are committed to artificially maintain the market at all-time highs, can be really troubling. Especially in US, we have just experienced the biggest economic rescue package in its history, made of more than $2tn to help American families and businesses to make it through the Coronavirus pandemic.

Source: Yadeni Research

PERFORMANCE

It is crucial to assess whether hedge funds really over-perform the market during bearish periods or not. The best way to do so is to compare different Hedge Fund industry indices from a well stablished company, such as Hedge Fund Research Inc. against the S&P 500.

In the graph below, we can compare the performance of the S&P 500 against that of four indices representing the main four hedge fund industry segments during the last four bear periods.

Source: Hedge Fund Research Inc.

It is clear that hedge funds really deliver better results during bear markets. During the bear market from Marc 2000 until September 2002, where the S&P 500 lost nearly 50% of its value, all of the hedge fund indices were up, in some cases more than a 20%.

If we also pay attention to the performance during bull periods, we can see that it has been decent, and

in some cases even better than the S&P 500. However, if we look at the last bull market, from March 2009 to January 2020, hedge funds have heavily underperformed the S&P 500.

Source: Hedge Fund Research Inc.

CONCLUSION

In conclusion, it is clear that hedge funds, in average, serve their purpose, that is, to deliver good absolute returns. The problem is that they may not be the optimal option in prolonged bullish markets. After the longest lasting bullish market in history, fuelled by the central banks, their image and credibility has been seriously damaged. However, investors, as well as the public in general should remember that their purpose is not to deliver relative results, but to deliver good results in any market condition.

According to data group HFR, nvestors pulled $33bn from hedge funds in the first three months of the year. This marked the industry's fourth-largest quarterly outflow in its history, and the highest since the second quarter of 2009 when clients yanked $42bn. The overall value of the industry dropped by $333bn during the first three months of 2020, bringing the total value of the industry to less than $3tn for the first time since 2016.

Looking at the type, macro hedge funds suffered the biggest outflows, accounting for about two-thirds of the total outflow despite being among the best-performing strategies. Investors largely withdrew cash from computer-driven and trend-following macro strategies, and redirected $3.8bn to active managers. On the other hand, distressed and credit specialist funds, which have been aggressively fundraising to seize on opportunities that have emerged from the sell-off, also saw inflows of about $1.5bn.