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ASSET CLASS

HEDGE FUNDS

No longer out of reach

OUTLOOK

CARLO SVALUTO MOREOLO

Hedge funds have become more investor-friendly since the global financial crisis but there is still room for improvement

KEY POINTS

- **Transparency has improved across the industry, with position-level data now available in most cases**
- **However, such data is often not sufficient to evaluate hedge funds**
- **Liquidity terms have improved and liquidity mismatches seem less likely**
- **There is a widespread debate on fees and alignment of interest**

Hedge funds remain a difficult investment proposition for many institutional investors. Part of the reason is the collective memory of several iconic cases where hedge fund managers fell short of their fiduciary duty. Of course, the image of hedge funds as masters of a dark art is a stereotype. But how has the hedge fund community responded to requests for more transparency and general investor-friendliness?

There is clear evidence that fund managers have changed their business models to suit the evolving needs of investors over the years. However, they need to work harder to become accessible to a wider range of institutional investors.

Transparency, liquidity and cost are the three main areas investors will be assessing when considering whether to invest in a hedge fund, regardless of the risk-return profile. Most managers have made improvements on each front since the financial crisis.

The first one has perhaps been the biggest concern for investors. But there is no doubt that getting detailed information on the workings of a hedge fund strategy is much easier than a decade ago.

Patrick Ghali, co-founder of hedge fund advisory business Sussex Partners, says: "Transparency has changed a lot since 2008. Managers understand they have fiduciary responsibility towards their investors, and that investors cannot just put money in something they do not understand. Funds have become a lot more transparent as a result."

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Better transparency has been achieved step by step. First, hedge funds started offering risk management data to third-party risk-analysis providers such as RiskMetrics. This saved funds having to provide information directly to clients, which sometimes goes against the philosophy and nature of hedge funds.

The next step is position-level transparency. Today, it has become more common for managers to provide this kind of data, particularly when institutions require it for regulatory reasons.

"There are still a few managers that have not got the message, but I think they are struggling to keep their investors on board. We certainly have rejected funds on the basis that

we were promised certain standards of transparency that never materialised. If we are not able to understand where the money goes, there is no way we can recommend the fund," adds Ghali.

Managers have been reluctant to disclose information about their portfolio, fearing that investors can replicate their strategy, but Ghali says: "There is no reason not to provide the information. In most cases, a manager is good not because of the book he has today, but because of the ability to change that book around actively."

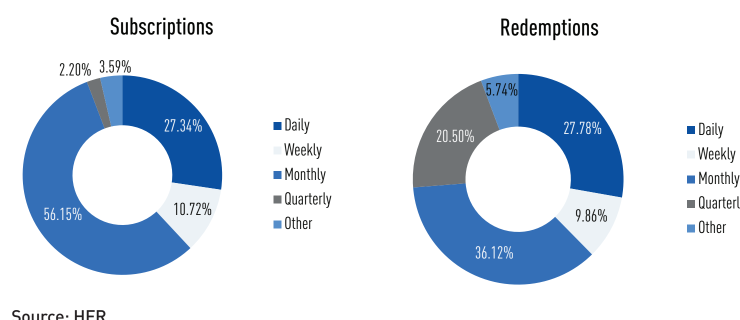
However, while investors may be granted added transparency on portfolios, that does automatically make hedge funds more investable than long-only strategies. A list of securities and the explanation of how a strategy works, plus a track record may be all investors can ask for. But the way returns are generated will depend on the market environment, thus only seeing the money at work will prove the robustness of the strategy.

Cédric Kohler, head of advisory at Fundana, a Swiss-based fund of hedge funds focused on equity long/short strategies, says: "Transparency in itself should never be the end goal. The end goal is to understand how performance is generated; that is, where returns are coming from. Even if you do get full look-through from a fund, you might get position-level data that is almost impossible to make sense of. Investors really need to spend time and resources on taking the information and making sure it matches with the returns that are being generated."

Assuming investors can identify hedge fund strategies that suit them in theory and in practice, there will be liquidity issues to consider. Certain strategies naturally require longer holding periods. But on this front too, hedge funds are said to have become much more transparent and accessible to the average investor.

Hedge fund subscription and redemption terms

Estimated investment subscriptions and redemptions by number of funds, at end of 2016



Source: HFR

On the one hand, managers are striving to offer more liquid structures, by taking advantage of regulatory frameworks such as UCITS.

On the other hand, managers are also making sure they do not over-commit, which is a key aspect.

Investors can encounter great divergence in this area. Some managers take more steps to avoid a potential liquidity mismatch than others. It often has to do with the asset class they invest in. Alison Trusty, a hedge fund analyst at Aon Hewitt, says: "We often come up against hurdles around liquidity in the credit space. Sometimes managers offer certain liquidity terms, then a look-through on the portfolio shows there is a higher weighting to what we would describe as level-three assets [assets of which fair value cannot be calculated accurately using observable measures] or other private assets. A higher weighting to these assets may not match the liquidity terms offered. This is an issue which could lead us to interrupt the due diligence process."

Generally speaking, however, investors who want access to hedge fund strategies will not need to lock away their capital for a long time. Brooks Ritchey, head of portfolio construction at K2 Advisors, Franklin Templeton's alternatives business, says: "Products and portfolios within our opportunity set are becoming more liquid. That said, one is constantly on guard for a liquidity mismatch, and full look-through of portfolios helps us achieve that, whether funds offer daily or quarterly liquidity. There may be opportunistic transactions or themes from which investors can extract an illiquidity premium, but those are few and far between in our opinion. There is enough capacity in the liquid space to invest long and short."

"Investors really need to spend time and resources on taking the information and making sure it matches with the returns that are being generated"

Cédric Kohler

The issue of cost has also put off investors for a long time, and in many cases managers have had to meet their demands to reduce fees. There are exceptions, however, says Ben Watford, partner at asset management consultancy MJ Hudson. "There has been downward pressure on management and performance fees," he says, "but if the fund is performing well, then managers do not need to drop their fees."

There are various options to achieve better alignment of interest between investors and managers, explains Watford, but getting the balance right is notoriously hard. "Certain managers are happy to trade lower management fee for a higher performance fee or keep their performance fee the same but raise the high watermarks or hurdle rates. But if a manager is driven by a high performance fees, they might be encouraged to take more risk," he points out. The fact is, discussions between managers and their clients about fees are much more open than pre-crisis, which should give added comfort to investors.

More debate not just on fees, but on every aspect of what hedge funds can offer to institutional investors, is to be welcomed. The industry takes the issues seriously, judging by Kohler's words. Kohler is also on the research committee of the Alternative Investment Management Association (AIMA).

Speaking on a personal level, he says: "What the industry needs to do better is let investors come back to the basics of hedge fund investing. We are often seen as an asset class, and an asset class needs a benchmark. But hedge funds are no more than pure, unconstrained portfolio management, and in this sense benchmarks are not relevant. At the same time, we need to talk about the prejudices around aspects such as liquidity and regulation. The majority of hedge funds are not illiquid and unregulated – the opposite is the case."

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