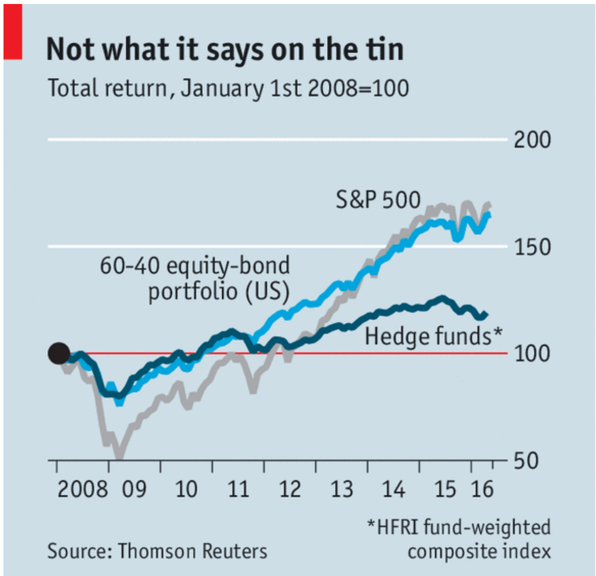
Our View on Hedge Fund strategies

We believe that a mix of diversified hedge funds will likely produce poor risk-adjusted returns to clients, net of fees. The steep fee structure of 2 plus 20 is eating into the already low returns in today's world of extensive QE, negative rates and low liquidity in risky asset markets. In this month's Thinking Man, we highlight different dynamics and characteristics of the hedge fund industry that lead us to have a negative views, including: low performance; the size of the industry; fee structures; lack of permanent capital and redemptions; fund closures and the "herd" mentality of hedge funds.

Low Performance



Economist.com

In the 1990s, hedge funds were able to deliver high returns or uncorrelated returns –fundamental reasons for investors to hold them in their portfolios. Since the 2008 financial crisis, hedge funds have not been delivering, and returns have been mediocre. Since the market hit its post-crisis bottom in March 2009, hedge fund returns have underperformed the S&P 500 by 51% (cumulative returns), as illustrated by the chart below. Hedge funds continue to face challenges in 2016. Through the first four months of the year, the HFRI Fund Weighted Composite Index was up 0.33%, trailing the S&P 500 index's gain of 1.73%. But the HFRI Asset Weighted Composite Index—which is more reflective of what investors experience, since the largest funds are given a heavier weighting and the smallest barely count—fell about 2%. Even more disconcerting, the performance woes are widespread. Hedge Fund Research (HFR) divides the hedge fund universe into four buckets—equity hedge, event-driven, macro, and relative value—and all were down in the first quarter on an asset-weighted basis. The 6% YTD decline of the most popular long positions in hedge funds has contributed to the -4% average return of equity long/short funds. Goldman Sachs hedge fund VIP list has lagged the S&P 500 by 13% since August 2015, matching its 2008 record underperformance.

The Thinking Man's Approach

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The hedge fund industry has long been considered an attractive asset class, but many recent trends are causing it to lose its appeal. With so many players in the hedge fund arena there is little room for differentiation. Managers are making the same passes and shooting the same shots. Hedge funds used to be paid to think differently. Today, our sentiment is that the majority of managers are using the same playbooks and strategies which have led to underperformance and overcharging. Low returns, crowded markets, herd mentalities and a lack of permanent capital make up the new landscape of the current hedge fund environment.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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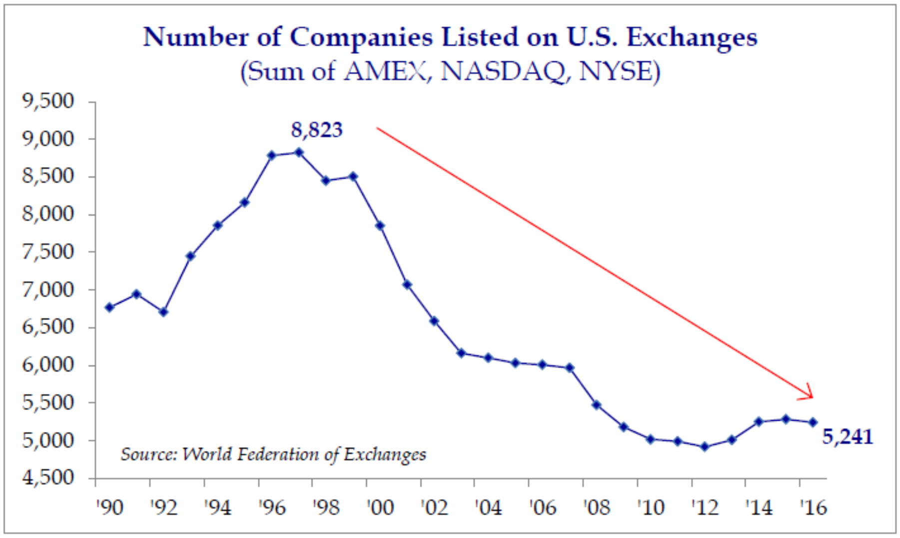
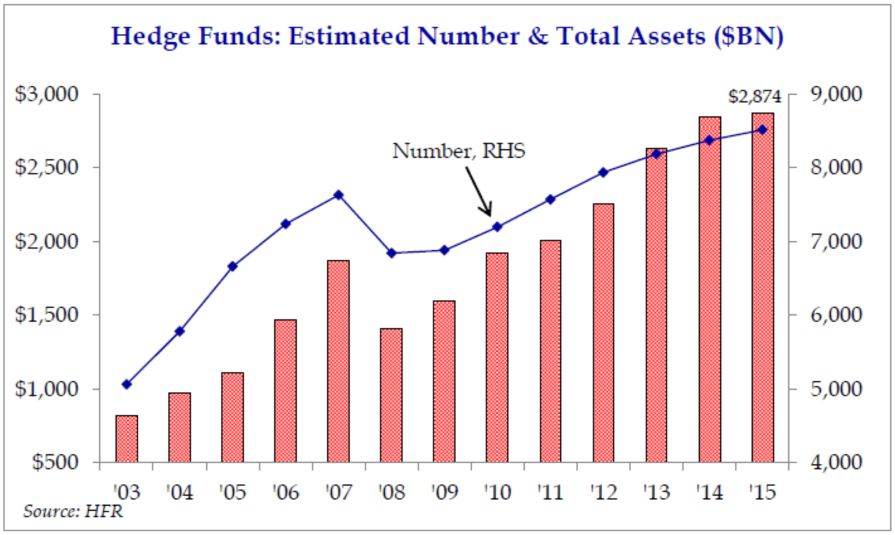
Size of Industry

More capital is chasing the same investment ideas. There is now nearly $3 trillion sloshing around the funds, versus a little more than $1 billion in 1970. Even in 1990, hedge funds were still rare birds; 500-odd funds managed around $40 billion, mostly for high net worth individuals. Few people understood what they did or bothered to find out. By the end of 2015, the sector had mushroomed to include nearly 9,000 funds. Along with private equity, the industry was categorized as an "alternative asset", attractive to pension funds and endowments. But a recent wave of fund closures, and the expectation that more will follow, suggests that the industry's era of stratospheric growth may be a thing of the past. Part of the problem is the hedge fund industry size. Managing over $3 trillion, some argue that it is too difficult to generate meaningful and differentiated returns with this size.



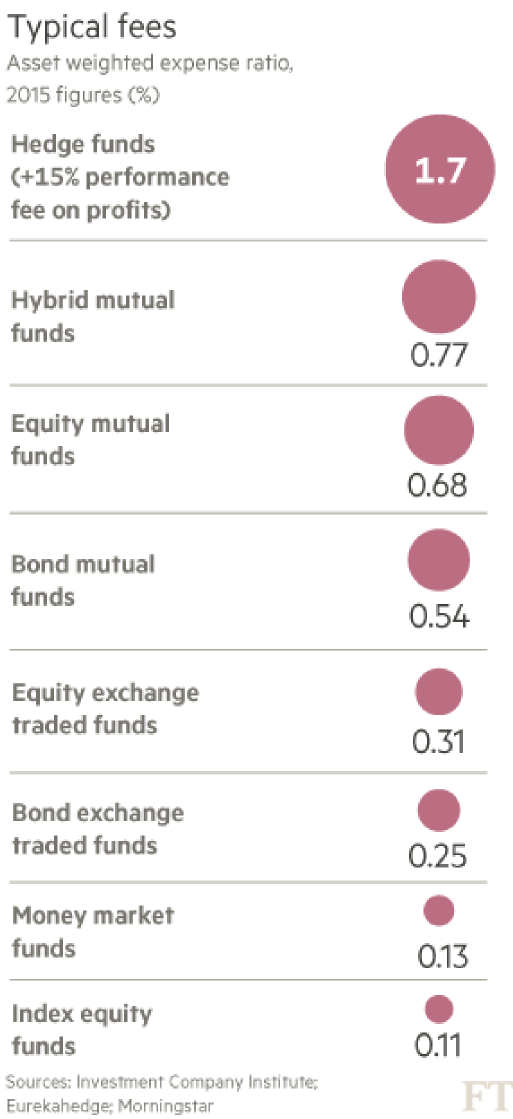
For example, if we compare the US stock market with the hedge fund market, we see that paradoxically, while the number of shares listed on AMEX, NASDAQ and NYSE dropped to 5,241 in 2016, the number of hedge funds increased to close to 9,000. FT Columnist Miles Johnson says, "to create even 5% of outperformance as an industry would require finding opportunities on a scale that usually do not exist." Supporting these points are the two charts to the right from Strategas, which show that the industry has grown too big for the opportunity set.



Rich Managers, Poor Clients

The typical fee structure is a "2 and 20", a 2% management fee on assets plus 20% of fund profits—or even higher. The logic of hedge funds charging 2% / 20% is beyond rational comprehension.

Performance numbers on an absolute basis are coming down, so fees on a percentage have actually gone up. With returns coming down, these fees are hard to justify, especially considering how high they are relative to asset classes with better performance and lower fees. There are many investors paying a steep and painful price for plunging into this volatile and aggressive investment structure. BigSur did not follow that herd of investors, and will not. This is captured in the table below from the Financial Times.



Hedge Funds Have a Lack of Permanent Capital

Some in the hedge fund industry are complaining about institutional investors' tendency to redeem after short periods of underperformance, saying that "investors may be giving up on hedge funds just as they prove their worth as a portfolio diversification tool in a down market." When funds have non-permanent or "flight" capital, and this capital leaves, the managers become forced sellers in the market, often selling their winning positions or most liquid positions. This can add another drag on performance which then can lead to further redemptions.

Managers with permanent capital, then, will be at an advantage. Permanent capital most typically is in the form of partners of the firm owning a large chunk of the assets. It can also be from other sources—take Pershing Square, run by industry leader Bill Ackman. The fund has a permanent vehicle listed on the stock market in Amsterdam which accounts for one-third of the fund's assets.

The "Herd Mentality", "Crowded" Trades and Risk on / Risk off Market Dynamics

Diversification is another key fundamental reason investors look to invest in hedge funds. Hedge fund managers are paid to "think differently" about the markets and identify unique trades. However, over the last few years we are seeing many hedge funds think and act the same way as each other—there is a herd mentality which is destroying the benefit of diversification.

Where does this herd mentality come from? Many of the portfolio managers studied the same subjects in the same universities, come from similar backgrounds as analysts at investment banks or investment houses, and live in the same areas of New York or London. They read the same books, socialize in similar circles and even eat in the same restaurants. This "intellectual monotony" has translated into non-differentiated strategies and crowded trades. Take Valeant for example: several hedge funds suffered tremendously when its accounting had to be revised. Pershing Square dropped 9% year to date just because of this position. Another example was in October 2015 when the cancellation of AbbVie's £32bn deal to acquire Shire left many big merger arbitrage hedge funds nursing heavy equity losses, and may have contributed to the rapid repositioning that would eventually engulf markets.

Markets are less transparent, thanks to the retreat of banks from market-making and the rise of index funds and algorithmic traders. Prices can move rapidly (fat tails), perhaps in response to a trading mistake. This too increases risks. Due to lower market-makers inventory, for example, it now takes seven times as long to liquidate a bond portfolio as in 2008 (source: Bank of England). Thus, the exits for trades are crowded. If investors suddenly sell "en masse", prices will surely gap down.

The risk on / risk off dynamic in the markets amplifies the effects of the crowded trades, of lack of liquidity and of a herd mentality. For example, when the Bank of Japan announced it was adopting a negative interest rate policy earlier this year, many macro hedge funds that specialize in trading on economic events opted to short the Yen. The Yen has been very strong vs. the dollar (up 8.3% YTD). As these hedge funds were forced to close their short positions, they led the rally for the yen to move even further up. The "Risk-on / Risk-Off" market dynamics are here to stay with frequent spikes in volatility and spikes in correlations between DXY (index showing the US dollar value against major world currencies), SPX (index for S&P 500) and CRB (index for commodities) in the risk-off moments.

Fund Closures

A number of large high-profile funds, such as BlueCrest, Nevsky Capital and more recently, Standard Pacific and Orange Capital, have chosen to return outside capital to investors. Disappointing founders wrote to investors that "sometimes there is a logical conclusion to even a good thing. BlueCrest's Michael Platt, who in December told investors he would return their money, claimed the industry's fee model was "no longer a particularly profitable business." Compared with private equity, hedge funds have short lockup periods, which means investors can redeem their cash relatively easily whenever they feel queasy about China, the oil price, or whatever market headline is causing them anxiety. Some managers have responded to this fickleness by converting their funds to private family offices, much like Steve Cohen, George Soros or Stan Druckenmiller.

Redemptions: Increasing and From Large Pension Funds

In September 2014, California Public Employees' Retirement System (Calpers), the world's largest public pension plan (with over $300 billion under management), was the first big institutional investor to openly split with hedge funds, announcing that it would liquidate its $4 billion dollar hedge fund portfolio. It was thought that this would immediately trigger a wave of redemptions, but given the nature and structure of public boards, which tend to be bureaucratic and deliberative, it is only now that "the wave seems ready to break," and we are seeing a large uptick in redemptions. In April 2016, the New York City Employees' Retirement System, a $51 billion public pension plan, announced plans to liquidate its $1.5 billion hedge fund portfolio, representing the latest public pension plan to follow this trend. Others have followed suit, and today large pension funds only account for about 25% of money managed by hedge funds. These institutions are looking to cut costs and complexity, and have been disappointed with hedge fund performance.

This year's redemptions are going along at a much faster pace: in the first quarter of 2016, investors withdrew $15 billion from hedge funds—the largest amount since 2009. This is ten times the amount withdrawn in the previous quarter ($1.5 billion in the fourth quarter of 2015). Many fear that worse is still to come: Dan Loeb of Third Point, one of the most influential and powerful hedge fund managers, says that we are only in "the first innings of a washout in hedge funds."

Conclusions: A limited opportunity set across hedge fund land

- The hedge fund industry has grown to a massive $3 trillion which makes it difficult to generate alpha as a whole, and hence a diversified portfolio of funds is unlikely to outperform as well.
- As the SkyBridge Alternatives (SALT) Conference in Las Vegas this month showed: roughly half of all hedge funds lost money in 2015. A majority of investors surveyed by Preqin, a hedge fund data company, said for the first time in the survey's history that they expect to reduce their allocation to the high-priced investment vehicles. Few hedge fund managers had high conviction, so their positioning is defensive. Risk appetite has declined substantially during the last 12 months. Goldman Sachs estimates hedge funds in aggregate operate 44% net long, down from a record high of 57% in early 2015 and the lowest levels since mid-2012.
- In the aftermath of the financial crisis, many lockup and gating arrangements were eased. To satisfy institutional investors, hedge funds shot themselves in the foot as looser lockups force funds to keep more cash on hand and to invest over shorter periods than they did before.
- But with a defensive portfolio positioning and liquidity issues to exit from many positions: who wants to pay 2 / 20 to a HF for a defensive portfolio positioning?
- The Hedge fund market is far more crowded than when industry pioneers such as George Soros, Julian Robertson and Paul Tudor Jones made their names. With so many assets and so many funds, beating the market becomes far more difficult. The skill and quality of people involved in hedge funds has also become diluted. Hedge funds that lack the skill to add value are being slowly forced out of the business. As Daniel Loeb commented at the SALT Conference: the industry is in "first innings of a washout". Expect more liquidations to come.
- There will continue to be increasing hedge fund closures. In the first nine months of last year, 785 new funds were launched and 674 were closed, according to Hedge Fund Research (HFR), compared with figures of 814 and 661 over the same period in 2014. In 2016, for the first time since the worst of the financial crisis, there may be more closures than launches, as per Preqin.

In the longer term, the shrinking of assets and of fees will allow the unconventional thinkers the chance to shine again. But for now: we recommend or suggest selling diversified portfolios (or funds) of Hedge Funds (by asset class and investment strategy). There is no doubt that many hedge-fund managers are extremely clever and work diligently at ferreting out profitable opportunities. But are there enough opportunities to sustain an industry with 9,000 individual funds and $3 trillion of assets? Nowhere near.

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