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Investment Research

The Tide May Be Turning
The Improving Outlook for Hedge Funds

BALLENTINE PARTNERS | CHRISTOPHER C. CHANDLER, CFA, CAIA & BRUCE D. SIMON, CFA, CPWA® | FEBRUARY 2019

Hedge funds have disappointed investors for almost a decade; even before accounting for fees and taxes, results have trailed a traditional 60 equity/40 bond balanced portfolio over the 10 year period ending in December 2018. A number of large institutions announced their intentions to move away from hedge funds, fed up with subpar results and high fees. The financial press has taken note: a flurry of recent articles has highlighted the ongoing performance problems and closures of several high-profile funds. Frustrated by their inability to generate better performance, many funds have closed, and new money is gravitating toward a shrinking number of large managers with respectable track records.

After years of disappointment, we now believe that the environment for truly talented hedge fund managers is improving, allowing them to once again positively contribute to portfolio performance. These changes include:

- Waning impact of central bank actions on asset prices
- Higher interest rates
- Greater performance dispersion among asset classes and securities
- Muted return expectations for traditional assets
- Likelihood of more distressed opportunities as economic cycle ebbs
- Less competition

This article will explore the reasons for the disappointing past performance of hedge funds and articulate the reasons why we believe the outlook for hedge funds (or more precisely, some particular types of hedge funds) is likely to improve in the future.

Inconvenient Truth: High fees, complexity, and mediocre returns

Before getting into the details, it is important to define what we mean by the term *hedge fund*. Although hedge funds are referred to in the popular press as a homogenous group, they vary greatly in terms of strategy, holdings, and degree of risk. Investors do not speak about mutual fund performance as a group, yet many market observers lump the performance of all hedge funds together. We view hedge funds primarily as an investment structure that affords professional managers with additional flexibility to express their ideas. While their approaches vary greatly, common attributes among hedge funds include:

- Ability to profit when prices rise or fall
- Fee structures that include a management fee and a performance incentive
- Limited liquidity
- Investments predominantly in tradeable assets
- Available only to accredited or qualified investors

Beyond these commonalities, hedge funds vary widely in their investment approaches, strategies, asset class allocations, and risk tolerance. Even sub-classifications of hedge funds are not uniform among market observers. Using Hedge Fund Research's performance database (HFRI), here are the pre-tax returns of the major hedge fund sub-categories as of December 31, 2018, as compared to a traditional 60 stock/40 bond blend:

	Annualized Returns				Std Dev
Name	1 Year	3 Year	5 Year	10 Year	Since Inception
HFRI Event Driven Total USD	-1.73	5.34	2.65	6.56	6.46
HFRI EM Total	-11.13	4.33	1.37	5.29	13.21
HFRI Equity Hedge Total	-6.90	3.61	2.32	5.67	8.68
HFRI Fund of Funds Composite	-3.48	1.50	1.51	3.18	5.45
HFRI Relative Value Total	0.66	4.45	3.40	6.99	4.15
HFRI Macro Total	-3.21	-0.02	0.82	1.14	7.10
60% S&P500 - 40% Barclays Agg	***-1.47***	***5.06***	***5.04***	***7.49***	***7.24***

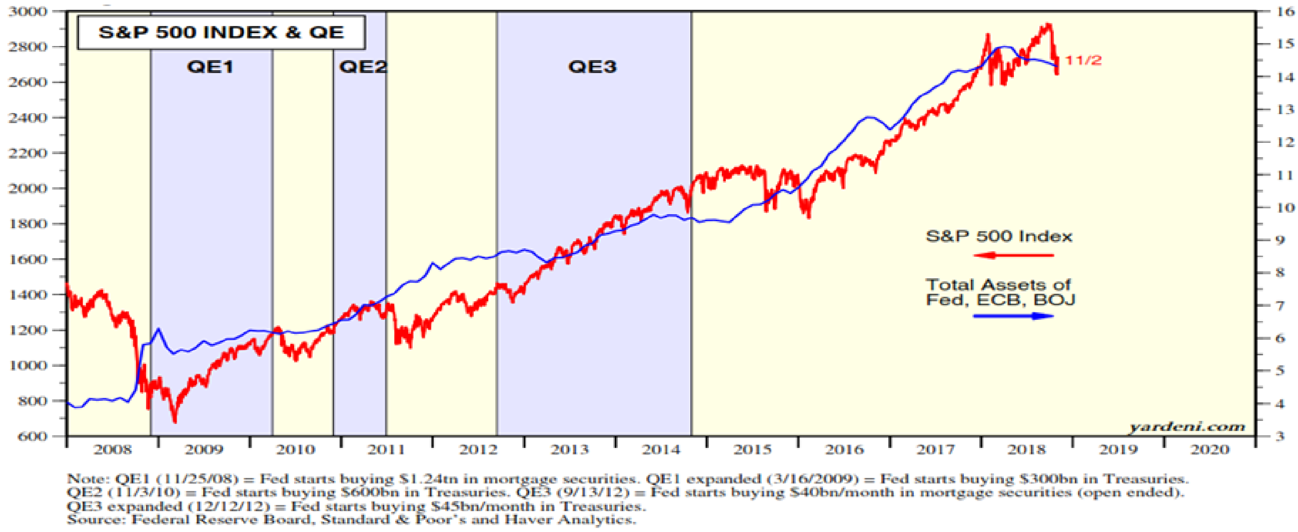
Source: Morningstar Direct, Hedge Fund Research

Given the complexity, high fees (typically 1% to 2% management fee plus a share of profits that can range from 10% to as high as 30% vs. index funds with fees of less than 0.10%), tax inefficiency, lack of transparency, and uninspiring performance, some investors are rightly asking: why bother? Let's explore a few of the changes in the economic backdrop that we will believe will create a more favorable environment for hedge funds.

1. Waning influence of global central banks

We are in the latter part of one of the longest economic cycles in recorded history. Following the great recession of 2008-'09, central banks around the world took aggressive steps to inject liquidity into their economies by lowering interest rates and acquiring government bonds, a process known as Quantitative Easing (QE). Economies, companies, and asset prices have been propped up over the last decade by artificially low and in some cases negative interest rates, bloating central bank balance sheets many years after the global financial crisis waned. This remarkable level of coordinated intervention by governments and central banks following the global financial crisis led to a period of time when a rising tide of liquidity lifted

Quantitative Easing vs. The S&P 500 Index



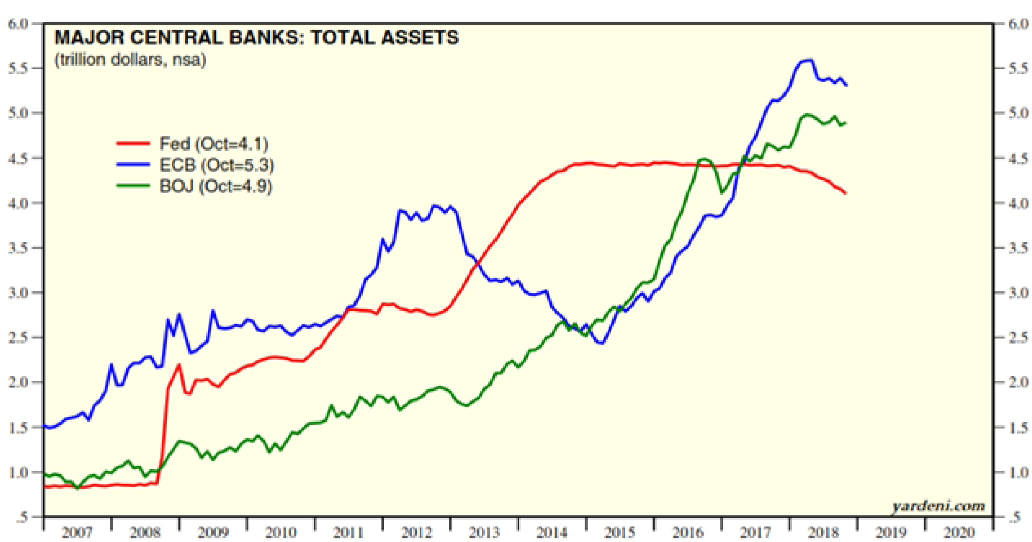
Source: Yardeni Research

all boats. Return dispersion among asset classes and securities was very low as markets moved in tandem. During periods of stress, those "boats" quickly developed similar leaks, sinking in tandem. Hence the phrase "risk on, risk off" became common vernacular when speaking about the markets.

Now that the US economy is flirting with the longest expansion on record, the Federal Reserve is unwinding the policies that supported this recovery and subsequent expansion. As the Fed raises short-term interest rates closer to historical averages (around 3%) and allows its large portfolio of bonds to mature (in effect, reducing liquidity in the financial markets), the unusual influence of the Fed on asset prices is diminishing. In theory, this should allow markets to operate more on fundamentals, creating more opportunity for informed investors. Other central banks are following suit, albeit more slowly than the US Fed.

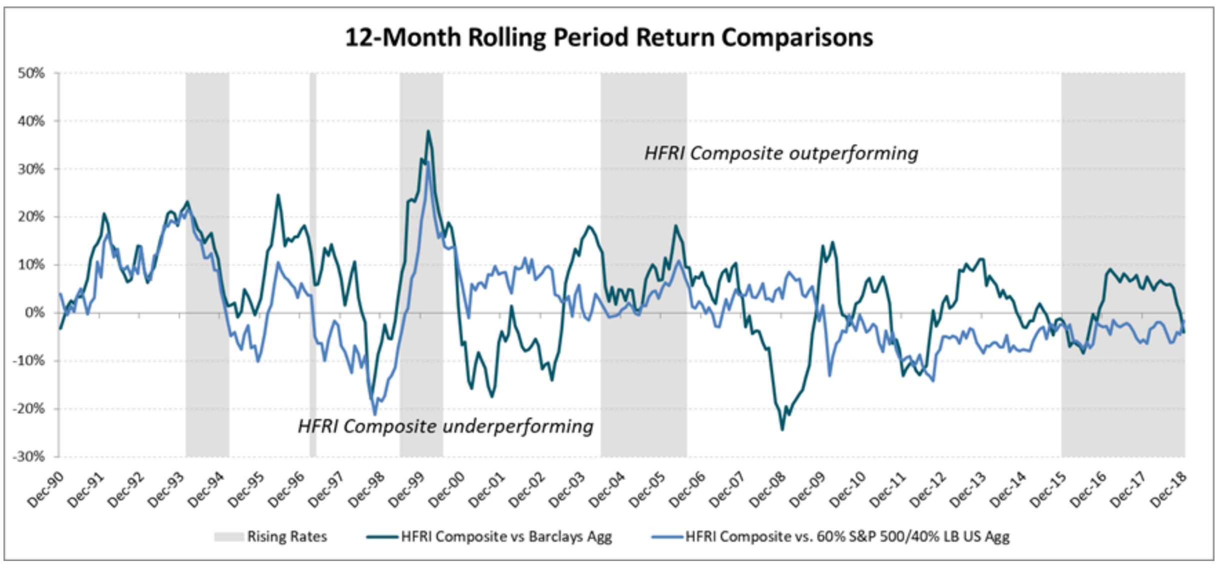
2. Late cycle and rising interest rates

While rising interest rates may represent headwinds to some traditional asset classes such as fixed income, higher rates can be beneficial to certain hedge fund strategies. Long/short managers benefit from rising interest rates in their short positions through what is known as the short interest rebate. Sale proceeds from the shorts are generally invested in interest bearing instruments and paid to the investor or holder of the short position. When the Fed pushed short-term rates to near zero, short sellers received no benefit from this rebate. Today, long short managers who are positioned roughly 50% to 60% net long are getting paid roughly 2.1% in their



Source: Yardeni Research, Haver Analytics short positions, whereas before they were earning nothing. Now that short interest rates are higher, the short interest rebate should provide a tailwind to long/short manager performance.

Rising interest rates are characteristic of the latter stages of the economic cycle. This part of the cycle is usually associated with increasing activity from mergers and acquisitions, spinoffs, and industry consolidation, which are the domain of event driven hedge fund managers. As the cycle peaks, rising interest rates make it harder for companies to refinance their debt, which creates opportunities for distressed managers. In general, hedge funds historically have performed better during periods of rising interest rates, as evidenced in the chart above.



Source: Morningstar Direct & Ballentine Partners

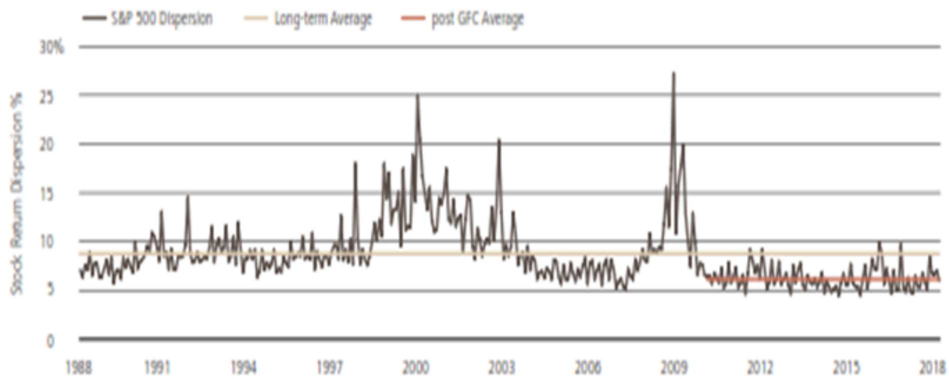
3. Increased stock dispersion

When asset prices move in tandem with little regard to their underlying fundamentals, it creates an extremely difficult environment for hedge fund managers who attempt to exploit an information and/or analytical edge. As the chart above illustrates, when money pours into the market and there is indiscriminate buying such as late 1990s tech boom and 2009 and 2010 following the financial crisis, market exposure wins over a more fundamentally based active approach. Fundamental hedge fund managers conduct extensive research to understand companies, balance sheets, growth prospects, and management team competence, among other factors. With this information, managers make investment decisions to invest in superior companies while selling short weaker companies. In a normal market environment, we would expect to see greater dispersion between the stock prices of stronger companies and weaker companies, providing the opportunity to hedge fund managers to generate excess returns.

We expect dispersion levels to revert back to normal levels as the influence of QE activity wanes and the economy slows from the impact of higher rates. Developed market economies such as Europe and Japan are behind the US in their transition to a more neutral central bank positioning, which may delay any potential increase in dispersion. However, the extended weak performance of these economies is likely to create more distressed opportunities for managers that operate in this space.

Emerging market opportunities vary based on geographic region, demographics, currency, and

S&P 500 Stock Return Dispersion
(March 1988-2018, Estimate Monthly Data)



Source: Standard and Poors

political structures, among other factors. While systematic factors such as the current trade negotiations and the strength of the US dollar have contributed to a more homogenous return pattern for emerging market equities, we expect these influences to decline over time, increasing the likelihood of greater dispersion among prices.

4. Muted returns for traditional asset classes

As an asset allocator we look at a number of quantitative and qualitative factors in the portfolio construction process including going through a process of creating return expectations over the near term and long term. While the reliability of forecasting future returns should be viewed skeptically, the relative measure between the asset classes has proven more fruitful. As we look over the next 5 years, return expectations for most traditional stock and bond asset classes are expected to be muted. Our view is based on a combination of factors including high starting valuations, high and rising sovereign debt levels, rising interest rates, sluggish productivity growth, and slow growth in the labor force, particularly in the United States. As a result, we believe traditional stock and bond asset classes will be hard pressed over the next 5 to 10 years to see returns similar to long term historical averages. For example, our expectation for US stocks over the next 5 to 7 years is 5.25% vs. a long term historical return of 10%. Our expectation for high quality taxable bonds over this same horizon is 3% vs. a historical average of roughly 5% to 6%. The lack of attractive alternatives may send more investors back to hedge funds, which can profit even when markets are directionless.

5. Likelihood of more distressed opportunities as economic cycle ebbs

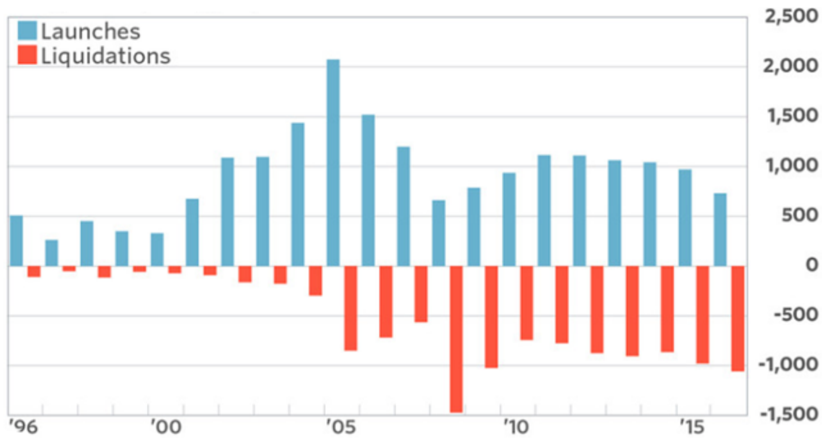
Hedge fund managers rely on a plentiful supply of opportunities that arise from economic distress. Overleveraged balance sheets, unrealistic synergies from acquisitions, and poor management decisions are often disguised during periods of strong economic growth, but become quite apparent when the economic cycle wanes. Warren Buffett famously noted that "you only find out who is swimming naked when the tide goes out". As we approach the end of the longest US expansion on record, managers are positioning for a wave of new troubled or distressed opportunities.

6. Less competition

As previously noted, we have experienced lower than average levels of stock dispersion since the financial crisis. This has proven to be a difficult and highly frustrating environment for managers who rely on fundamental analysis to drive returns. As a result, the industry experienced a cleansing process with many hedge funds closing their doors, including some well-known and previously successful managers. In our view, this cleansing process eliminated a number of funds that rode a rising tide of equity prices and whose fundamental processes were unable to adapt to this new environment.

As the chart below shows, the number of new hedge fund launches has declined dramatically over the last several years, while the number of closures has accelerated. A reduction in the number of hedge funds is likely to reduce the competition for attractive investments and increase the opportunity set for skilled managers.

Most closures since 2008: Hedge fund openings/liquidations since 1996



Source: HFR

Our Approach: Hedge funds for wealthy families

Large institutions such as pension funds, foundations, endowments, and other tax-exempt investors have more than $2 trillion invested in hedge funds, representing 58% of the total capital in the industry according to Preqin. These institutions have had a significant impact on the development of products that have shaped the hedge fund industry as we know it today. Institutional investors focus on concepts such as risk-adjusted returns, market neutral, low beta, and volatility dampening that are important metrics for managing short-term portfolio risk. Our clients are almost exclusively family entities with long time horizons that in some cases span multiple generations. Since our clients are taxable, they have the additional and very significant headwind of taxes. Taxable investors need something different than the traditional diversified portfolio of hedge funds that is looking to dampen volatility. Over the long run, volatility is not necessarily the enemy, but something to embrace if it is accompanied with higher returns.

We position our hedge fund program to provide our clients with a differentiated source of return, taking advantage of a longer time horizon to invest not only in the daily liquid markets but also opportunistically in special situations, which may require more patience to achieve the desired outcome. Liquidity comes at a very high price in today's environment. Embracing investment opportunities exhibiting higher volatility and/or a longer time horizon can provide an attractive premium. This approach lends itself to employing higher allocations to equity special situations, event driven distressed, and opportunistic credit strategies at the expense of more trading oriented market neutral, relative value strategies. Having an eye on taxes and their impact on the broader hedge fund program and the client's portfolio is important. Our focus on longer duration strategies can result in more favorable tax characteristics as compared to traditional hedge fund approaches that are designed for tax-exempt investors.

Despite the recent suboptimal results across the industry, we believe hedge funds can play an important role in our clients' investment portfolios. For the last 12 months, our recommended allocations to hedge funds have been overweight relative to long term strategic allocation targets for the very reasons cited above. For context, our clients' strategic allocations to hedge funds vary from a high single digit to a low double digit allocation within a broadly diversified portfolio depending on clients' goals and objectives. We continue to believe an overweight of a few percentage points to hedge funds is prudent given that the outlook is better than it has been for years. As in any asset class with a wide range of possible outcomes, manager and strategy selection are the keys to the success of any hedge fund program. We believe our unique approach crafted specifically for taxable clients with a focus on differentiated sources of returns and a patient, longer time horizon to invest will maximize the likelihood of success for our clients.

About Christopher C. Chandler, CFA, CAIA

Christopher is a Partner and Senior Investment Advisor at the firm. As a senior member of the investment team, Chris provides his clients with customized investment advice and recommendations, and is part of the team that is responsible for asset allocation, manager due diligence, and portfolio construction.

About Bruce D. Simon, CFA, CPWA®

Bruce is a Partner and the Director of Research at the firm. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activites for the firm.

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