Democratisation of hedge funds

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UOB Asset Management

Key takeaways

- Hedge funds are no longer an exclusive asset class with growing retail investor acceptance through the participation of "liquid alternatives".
- Investing into "liquid alternatives" provides the advantage of liquidity, easier access with small investment sizes and lower fees against traditional alternatives, in addition to regulation and reporting transparency comparable to widely accepted European UCITS.
- Allocating into hedge funds or alternative investments can typically provide diversification and downside risk management in a diversified global portfolio. This is attributed to a lower correlation to the general market and positive enhanced risk-adjusted returns calculated by the Sharpe ratio, which measures annualised returns and annualised volatility.
- Asian hedge fund returns have outperformed their global counterparts over a 1-year and 3-year period.

Introduction

Hedge funds have evolved over the years, and are now gradually accepted by retail investors and advisors from Europe to the Americas. From 2009 till 2014, reported total assets of hedge funds, also termed liquid alternative mutual funds, quadrupled to US$422 billion according to Lipper. In comparison, a report from Mercer on *'The Role of Liquid Alternatives in Wealth Management'* showed that assets in mutual funds grew by 50 per cent over the same period. Capital continues to pour into hedge funds as the asset class widens access to retail investors.

Posh beginnings

Hedge funds were once considered an exclusive asset class available to sophisticated institutional and high net worth investors via private banking relationships. Entry into these assets was characterised by low liquidity (ranging from monthly to annually) and usually accompanied by high minimum investment sizes. Often, these hedge funds operated with details of investment strategies and client holdings shrouded in opacity from regulators. Consequently, general understanding of hedge funds remained esoteric and was often viewed with some fear from those unfamiliar with the asset class. Rightly or wrongly, hedge funds were also labelled as the culprits which triggered a series of currency devaluations which led to the Asian financial crisis of 1997.

A brave new world

Hedge funds have evolved since the global financial crisis (GFC) of 2008 where retail accessibility to hedge funds increased through the growth of "liquid alternatives". Conceptually, liquid alternatives are alternative investments such as hedge funds and private equity funds available to any investor. While traditional alternative investments can only be purchased by accredited investors (i.e. individuals with net personal assets exceeding S$2 million, or whose income in the preceding 12 months is not less than S$300,000), liquid alternatives are open to a wider range of investors. For instance in Singapore, the minimum size to invest in a diversified portfolio of alternative investments is only S$1,000, as stipulated by prospectuses lodged with the Monetary Authority of Singapore. Hence liquid alternative investments are intended to provide the benefits of alternative investments in a daily liquidity structure together with increased transparency and greater regulations.

Hedge fund investing 101

Hedge funds are part of a class of investments called "alternatives" to distinguish them from traditional investments which usually refer to bonds and equities. Morningstar defines "alternatives" as an investment falling into one or more of the following three buckets:

- Non-traditional asset classes (i.e. commodities and currencies)
- Non-traditional strategies (i.e. shorting or hedging)
- Illiquid assets (i.e. private equity, private debt)

Within an investment portfolio, hedge funds are meant to produce positive risk-adjusted returns (over a reasonable time frame) and exhibit a lower correlation to traditional investments.

History of hedge funds

Alternatives are hardly strangers to the investment world. The modern private equity fund emerged in 1946 through the founding of the first two venture capital firms - American Research and Development Corporation (ARDC) and J.H. Whitney & Company. The first hedge fund was generally regarded as incepted in 1949 by Alfred Winslow Jones. Alternatives started flourishing in 1966 when Fortune Magazine ran an article on hedge funds titled, '*The Jones Nobody Keeps Up With*' The article's opening line summarises the results at A.W. Jones & Co. - "There are reasons to believe that the best professional money manager of investors' money these days is a quiet-spoken seldom photographed man named Alfred Winslow Jones. Coining the term 'hedge fund' to describe Jones' fund, it pointed out that his hedge fund had outperformed the best mutual fund over the previous five years by 44 per cent, despite its management-incentive fee. Another Fortune article reported that on a 10-year basis, Mr. Jones's hedge fund had beaten the top performer Dreyfus Fund by 87 per cent."

Enter the 1980s, and hedge funds were hitting the news headlines through the exploits of global macro hedge funds managed by legends such as Julian Robertson and George Soros. In the 1990's, alternatives become an integral part of any long-term investment portfolio through the popularisation of the Yale Endowment Model, which advocated a high allocation to alternatives. Later, steep declines in global equity returns during the GFC — from late 2007 through early 2009 — provided the initial catalyst for investor and manager interests in liquid alternative funds. More recently, concerns of underperforming bond returns have fueled that interest. For example, in 2014, Vanguard's research noted that as an alternative strategy, long/short credit funds generally outperformed the global bond benchmark when interest rates rose in 2013.

Investment rationale

The investment rationale of investing in alternatives is based on the modern portfolio theory which advocates that the risk-adjusted returns of an investment portfolio can be improved through the addition of asset classes with low correlation and positive Sharpe Ratios, which calculates risk-adjusted returns or the average return earned in excess of the risk-free rate per unit of volatility or total risk. The theory of compounding returns also supports the use of hedge funds by arguing that the avoidance or reduction of drawdowns can improve long-term wealth.

Currently, alternatives have become an integral part of any investor's portfolio due to its proven diversification and downside risk management properties. Even the Government of Singapore Investment Company (GIC) continues to be active in allocation into alternative assets including hedge funds.

Liquid alternatives: Advantages compared to traditional alternatives

- **Smaller investment sizes** – Liquid alternatives in a diversified portfolio are open to anyone at a minimum investment size of S$1,000. This contrasts against the staggering amounts for traditional alternative investments that can only be purchased by accredited investors.
- **Enhanced liquidity** – In most cases, investors have access to their monies pretty much on demand. In contrast, traditional hedge funds and private equity funds often have restricted time frames investors can sell their holdings.
- **Greater transparency** – Liquid alternatives are required to produce periodic reports of their underlyings and disclosures in same way required of a mutual fund. For example, Collective Investment of Transferable Securities (UCITS) funds are required to publish a prospectus, annual and semi-annual reports and a Key Investor Information Document (KIID), and its annual report must provide a breakdown of transferrable securities by asset class and by exchange (listed or regulated). In contrast, traditional alternatives vary tremendously in how they disclose information on investments since hedge funds generally remain free from the regulatory requirements of reporting.
- **Reduced fees** – Generally, performance fees are not charged with liquid alternatives. In contrast, traditional alternative investments often entails a two per cent management fee and 20 per cent of the profits once a particular pre-determined level of performance is achieved.
- **Improved regulation** – Liquid alternatives are generally regulated under the same regime as traditional mutual funds such as the widely accepted European UCITS.

In order to deliver the benefits of diversification, downside protection and ultimately long-term outperformance, hedge funds employ strategies and instruments that are different from traditional long-only unit trusts. Examples of these strategies include: Equity long/short, global macro and relative value entailing financial instruments which may not be liquid, derivatives, concentration of investments, leverage or short selling, and aim for low correlation to conventional asset classes such as stocks, bonds and cash.

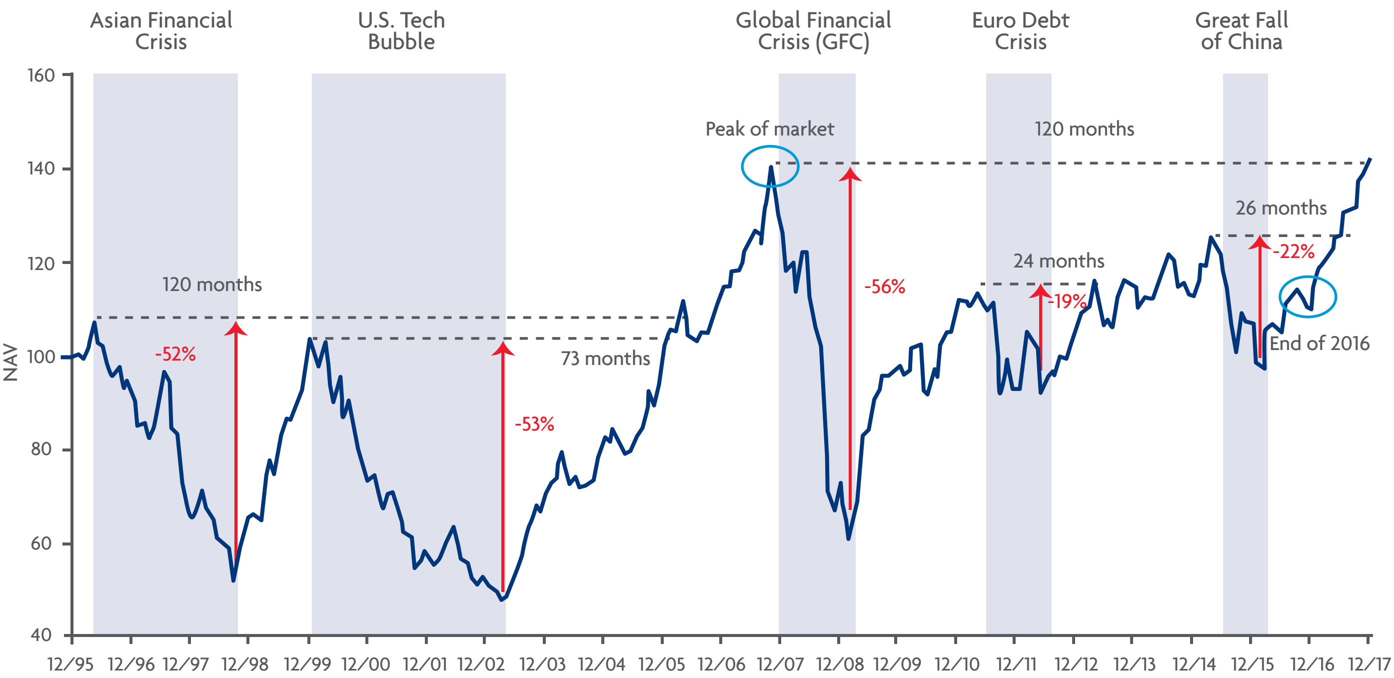
Equity long/short are strategies that separate market risk from individual stock risk and allow hedge fund managers to use superior information by shorting stocks, while global macro strategies are large directional bets made, often on the direction of currency exchange rates or interest rates. Meanwhile, relative value strategies are a broad category of market neutral hedge fund strategies that take advantage of anomalies among related financial instruments.

While different, many of these strategies and instruments are not all new. In fact, Alfred Winslow Jones had been using two of these strategies - short selling techniques and leverage since the 1960s. These instruments are also currently traded on well-regulated exchanges involving large counterparties.

The case for actively managed funds in Asia

An actively managed portfolio is critical to managing volatility, the key risk to loss of capital. Consider the performance of the MSCI AC Asia Pacific Index between December 1995 and December 2016 (see chart below). If an investor invested at the peak of the market before the onset of the GFC in December 2007, he would still not have recouped his capital by the end of 2016. Since the volatility detracts from long-term returns, a buy-and-hold strategy may not be effective in generating long-term returns in Asia (in USD terms).

Figure 1: MSCI AC Asia Pacific Index
(December 1995 – December 2017)



Adding Asian hedge funds to a diversified global portfolio can provide the following key benefits (all in USD terms):

a) Diversification and improved Sharpe ratio

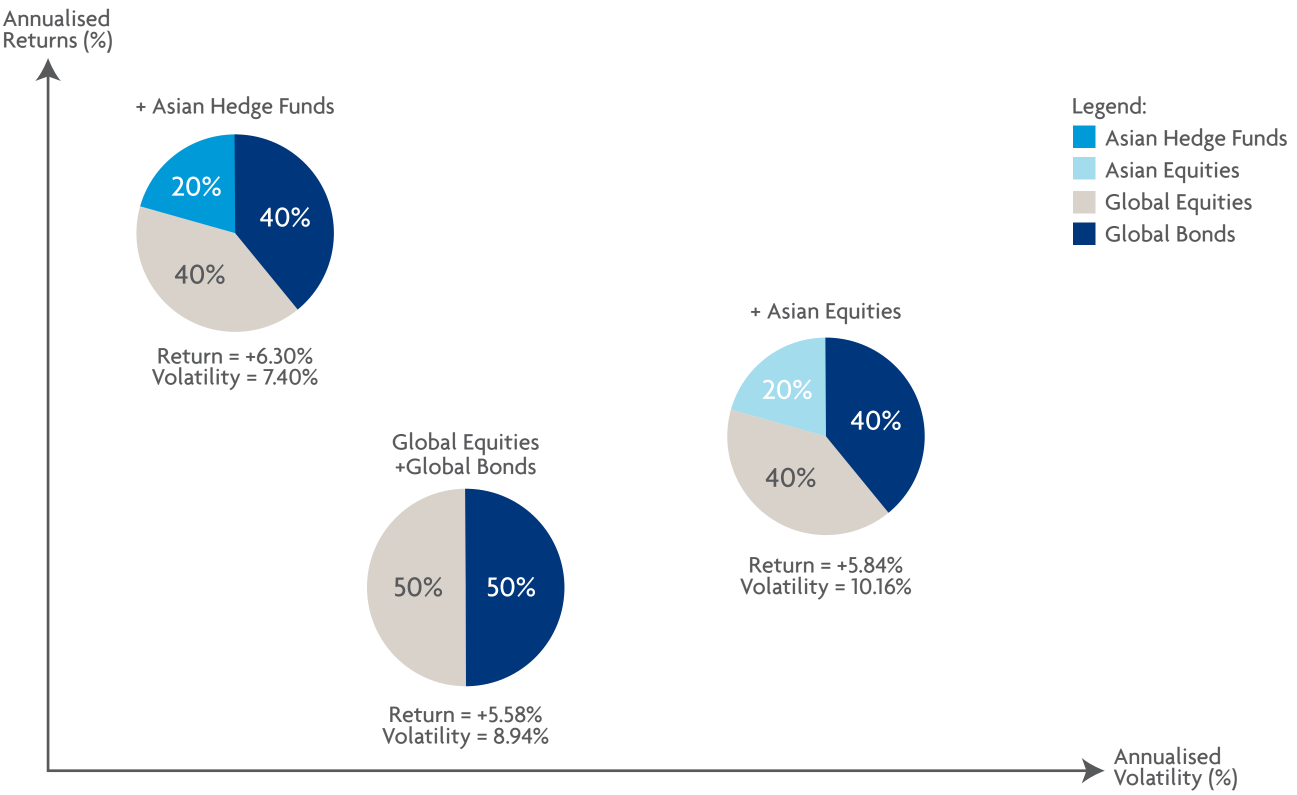
Asset Classes	January 2001 - November 2017	
	Correlation against Asian hedge funds	Sharpe ratio
Global Equities	0.78	0.37
Asian Equities	0.89	0.39
Global Bonds	0.21	1.18
Asian Hedge Funds	-	1.21

b) Downside mitigation

Global financial crisis 2007-2008	Max drawdown	Recovery period (from trough to last peak)
Global Equities	-54.9%	55 months
Asian Equities	-54.9%	64 months
Asian Hedge Funds	-24.9%	17 months
Asian Market Neutral Hedge Funds Composite (Equal weight of Asian Macro, Asian Relative Value and Asian event driven)	-14.63%	8 months

c) Better portfolio returns at lower risk

Portfolio returns
(January 2001 – January 2018)



d) Investment outperformance against global hedge funds

Benchmark	1-year annualised returns (Feb 2017 – Jan 2018)	3-year annualised returns (Feb 2015 – Jan 2018)
Eurekahedge Asia Pacific Hedge Fund Index	18.38%	8.67%
Eurekehedge Asia Pacific Fund of Funds Index	17.33%	7.39%
Eurekahedge Hedge Fund Index	10.02%	5.58%
Hedge Fund Research HFRI Fund Weighted Composite Index	9.97%	5.10%
Hedge Fund Research HFRI Fund of Funds Composite Index	9.16%	3.35%

Source: Bloomberg. Returns are measured in USD. All calculations are updated as of 31 January 2018

Global Equities: Morgan Stanley Capital International ("MSCI") All Countries ("AC") World Net Total Return Index (NDUEACWF Index), Asian Equities: MSCI AC Daily Total Return Net Asia Pacific Index (NDUEACAP Index), Global Bonds: Bloomberg Barclays Global-Aggregate Total Return Index Value Unhedged USD (LEGATRUU Index), Asian Hedge Funds: Eurekahedge Asia Hedge Fund Index (EHFI38 Index), Eurekehedge Asia Pacific Fund of Funds Index (EHFI244 Index), Eurekahedge Hedge Fund Index (EHFI251 Index), Hedge Fund Research HFRI Fund Weighted Composite Index (HFRIFWI Index), Hedge Fund Research HFRI Fund of Funds Composite Index (HFRIFOF Index)

In summary, investors should seek the help of professional advisors if they do not have the required resources in-house for investing in liquid alternatives as it requires a higher level of diligence, monitoring and communication with their managers. It is important to emphasise that increased transparency and daily liquidity associated with liquid alternatives does not eliminate the complexities synonymous with hedge fund strategies.

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