FINDING THE RIGHT HEDGE FUND

There are straightforward ways to identify hedge funds that offer unique exposure and generate consistent returns.

BY ERIC UHLFELDER

AT THE BEGINNING OF SUMMER, *The Financial Times* ran a story: "Top advisers pull their clients' investments out of hedge funds."

That sounded pretty extreme.

In late July, Erik Morgan, senior partner at the $4 billion Seattle-based asset manager Freestone Capital, told *Private Wealth* his firm has reduced its hedge fund exposure from $500 million in 2011 to $150 million. "We were seeing managers caught in a challenging place," Morgan explains, "cautious about how much further the market can rally and the likely blowback from rising interest rates, and this gave us pause."

Protracted underperformance of the industry has certainly borne out Morgan's concerns.

But if you look at total hedge fund assets, they closed the first half of 2017 at a record high of $3.1 trillion, according to leading industry data tracker HFR.

Hedge funds are not essential to anyone's portfolio—individual or institutional. Many have been poor investments, especially compared with the S&P 500. And while improving, their fees still weigh on net returns.

A key argument for hedge funds, however, is their ability to preserve capital during down markets.

In the middle of the Tech Wreck in 2001 and 2002, the average fund outperformed the S&P 500 by more than 42 percentage points; in 2008, industry outperformance exceeded the market by more than 15 percentage points, according to another leading data source, BarclayHedge. But from the beginning of 2009, the market has generated an additional 67 percentage points over the average hedge fund through June 2017.

Many observers would agree the S&P 500's recent annualized growth rate—in excess of 14% over the eight and a half years since stocks cratered—is unsustainable. And unless one is a closet indexer, virtually all managers—hedge fund or otherwise—would invariably have lagged the market.

Since portfolios need to be diversified beyond the market, there are a number of unique hedge fund managers and strategies that are worth a look.

In our list below, you'll find a fund that provides first-lien, low loan-to-value bridge loans focused primarily on quality New York City properties to qualified owners with immediate, short-term funding needs. Manhattan-based W Financial, run by Gregg Winter and David Heiden, has been filling a space neglected by traditional lenders with a precise, transparent, easy-to-understand strategy. Over its 14 years, the fund has never suffered a negative year or even a drawdown—because the value of the loans has never fallen below the value of the attached property. The $275 million fund has virtually no volatility and has racked up consistent net annual gains between 6% and 11%. The managers follow a disciplined investing approach and will only accept new money when they can put it to use.

A hedge fund based in Spain that has been around since 2010 has generated even higher annualized returns, nearly 21%, by doing something most other investors don't—actively helping underperforming small-cap European companies realize their potential. The EQMC Europe Development Capital Fund, which runs $580 million, enjoys the benefits of being a small, nimble fund while being part of a large parent firm. Alantra Group is a $4 billion European asset manager that provides the fund with more robust administrative structure, financial and legal support, research and business links across the continent.

Managers Jacobo Llanza and Francisco de Juan operate the fund like a hybrid private-equity shop, concentrating on a limited number of companies, working with company managements that want help, and leaving firms better off than when they found them. This longer-term strategy comes with greater volatility, but so far the fund has justified the risks.

WHAT TO LOOK FOR

"We must get to know a manager well enough to trust and admire him [or her] before investing," explains Alexandre Col, former partner of the venerable private bank Edmond de Rothschild and now co-manager of Geneva- and Luxembourg-based alternative asset manager Iteram, which manages 1 billion euros, 300 million of which is invested in hedge funds. His firm also wants to see a dedicated compliance officer to ensure funds follow their mandates and the ever-changing regulatory landscape.

Hilmi Unver, former CIO and now head of ultra-high-net-worth individuals and family offices at Swiss-headquartered

Compelling Funds

Ranked By 5-Year Annualized Returns

FUND	INCEPTION	STRATEGY	FUND ASSETS (M)	1-YR RETURNS	3 YR ANNUAL RETURNS	5 YR ANNUAL RETURNS	ANNUAL RETURNS*	WORST DRAW DOWN*	ANNUAL STANDARD DEVIATION*	SHARPE RATIO*
EQMC Development Capital	01/10	Euro Sm-Cap Activist	580	42.94	26.98	27.23	20.82	25.32	14.67	1.41
Napier Park Euro Credit Opportunity	09/10	Euro Credit Long/Short	653	13.73	9.49	20.63	17.70	15.31	8.25	2.13
Asgard Fixed Income I Ltd EUR	07/03	Fixed-Income Arbitrage	665	18.80	13.05	15.25	14.33	10.40	6.51	2.01
Hildene Opp Master II Ltd	08/11	Asset-Backed Securities	602	16.96	8.89	13.85	15.81	5.55	5.03	3.11
Cheyne High Income Regulatory Capital	10/11	Credit Long Only	185	15.92	8.98	12.98	11.96	8.50	5.30	2.23
PH&N Absolute Return	10/02	Multi-Strategy	1,192	22.16	11.61	12.29	14.06	15.69	7.09	1.81
Harvest Small Capital Partners	01/06	Equity Market Neutral	425	2.22	7.45	11.77	13.66	9.77	9.28	1.36
Moab Partners LP	04/06	Event Driven	529	12.21	8.62	10.04	8.91	16.86	7.02	1.13
W Financial LP (B)	07/03	Asset-Backed Loans	268	8.82	9.00	8.88	9.60	0.00	1.10	7.61
Orsay Merger Arbitrage	05/11	Merger Arbitrage	347	7.70	10.27	8.64	9.58	5.77	5.66	1.67
BarclayHedge Hedge Fund Index	07/03			9.58	3.54*	6.07	6.04	24.09	6.29	0.77
S&P 500 Total Returns	07/03			17.46	10.13	15.41	8.95	50.95	13.45	0.57

*Since inception. As of May 2017. Source: BarclayHedge

Notz Stucki, an $8.5 billion asset manager with more than $2 billion in hedge funds, wants managers to be able to articulate a "strong, well-argued large-picture view of things to understand how individual investments fit into that thinking."

The tax efficiency of a hedge fund must also be of concern to individual investors, explains Jeffrey Willardson, partner and head of portfolio solutions at PAAMCO Prisma, which has $30 billion invested in hedge funds.

Since the Tech Wreck, institutional investors—who don't pay taxes on profits—have represented a growing percentage of the hedge fund investor base. They now represent more than three-quarters of all invested dollars. "That transformation has altered the way many funds are run," Willardson says.

High-turnover strategies such as quant funds generate a lot of short-term profits, which are taxed at high personal income tax rates. Longer maturing strategies, such as distressed funds, expose individuals to lower long-term tax rates. Advisors should select funds according to their clients' post-tax targets.

After a decade of tracking the industry, I've found nine additional features advisors should look for.

1. Look at smaller funds running between $100 million and $1 billion with at least five years of audited performance and top-tier service providers (prime brokers, administrators, accountants and lawyers); while there are a handful of multibillion-dollar funds that have solid long-term track records, it's easier to find more opportunities and to exit them more profitably when dealing with managers running a much smaller amount of money. Responsible, smaller fund managers also tend to be extremely diligent and hungry to prove their worth.

2. Make sure managers are extremely well-versed with their investment processes, operations and risks; if they can't describe what they're doing succinctly and compellingly, move on.

3. Managers should have a substantial amount of their own wealth in the fund.

4. Make sure a fund's strategy and assets are compatible with its liquidity terms. Many funds were forced to gate and suspend redemptions (which are death knells) during the financial crisis because of such mismatches. Features that can help address this risk include lockup periods and the prevalence of long-term investors, such as pension funds.

5. Management and performance fess should not exceed 1.5% and 20%, respectively, and look for hard hurdles that set an annual return threshold that a manager must exceed before earning a performance fee, which prevents payment for subpar returns.

6. Smaller fund managers tend to have a deeper appreciation for their investors and the need to maintain clear communication about what they are doing; if they begin to flail and their messaging becomes muddied, that's a bad sign.

7. One of the most convincing indicators of a good hedge fund is its willingness to temporarily close to new investors when the manager doesn't see enough quality opportunities to effectively put new capital to work; funds that are pure asset gatherers will have a harder time maintaining performance.

8. After taking extensive profits, a good manager who subsequently sees insufficient opportunities to reinvest may occasionally return capital to investors.

9. A manager's willingness to cap the size of a fund is also a positive sign—showing his or her recognition that performance can suffer when the fund is trying to run too much money.

STRATEGIES

Confusion about—even avoidance of—hedge funds is in large part due to the industry's perception as an impenetrable monolith. To help unravel the mystery, we've published stories over the past several years that explain the industry's distinct strategies, which can give investors unique, understandable and flexible exposure they can't find elsewhere.

- Distressed investing targets opportunities when companies are in trouble but are likely to recover, and managers arbitrage bad news that's priced into securities.
- Event-driven strategies are among the most consistent in performance because they respond to short-term triggers that tend to have more predictable outcomes.

• Fixed-income arbitrage is one of the most challenging strategies, targeting comparable securities whose values have diverged but are expected to realign.

• Equity long/short is the most popular stock strategy; it's designed to outperform during down markets, but is likely to underperform during bull markets.

• Global macro targets broad economic and market metrics, from interest rates and foreign exchange to commodities to stock and bond indices. Managers profit from riding protracted moves and struggle when markets are trendless.

FUNDS

Since its launch in April 2006, MOAB Partners has been a steadily performing event-driven fund with annualized returns of nearly 9% and volatility of just 7%. A key to its consistent performance is its ability to excel during down markets: It's outperformed the market 44 of the 45 months when the S&P lost money.

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Whether it involves senior unsecured debt, distressed credit or equities, this contrarian performance has been achieved because the fund avoids crowded trades, explains manager Michael Rothenberg. MOAB seeks exposure to quality, underfollowed small companies that are flying below most radar screens and selling at attractive values. The portfolio's blend of arbitrage and credit positions generates consistent yield, which helps dampen volatility. And Rothenberg is efficient in regularly redirecting capital to the most attractive opportunities.

Just as important, the fund, with $529 million in assets, limits drawdowns (the worst being 17% during the financial crisis, which it made up in four months). It does this by sizing positions inversely to their potential downside. This means the manager can miss the mark on a number of bets but still end up netting attractive gains.

The Napier Park European Credit Opportunities Fund was a "Volcker baby," a forced spinoff out of Citibank when the ex-Federal Reserve chairman Paul Volcker required banks to get out of hedge funds.

Since its launch in September 2010, the London-based fund has generated annualized returns close to 18% with relatively low volatility of just 8.25% and a worst drawdown of 15.31%.

The $653 million fund, part of the $8.4 billion alternative asset manager Napier Park Global Capital, has delivered these returns by investing in European corporate credit, specifically high-yield bonds, leveraged loans and structured credit. While this sounds risky, Michael Micko, the managing director and head of European credit strategies, explains that his team is able to exploit misperceptions and confusion about the European credit market, which is far more inefficient and fragmented than the U.S. debt market.

"Our extensive bottom-up research gives us an edge in better assessing risk than the broad market and many rating agencies," explains Micko. "This not only enables us to move aggressively into dislocations, but reduces potential downside of non-investment-grade exposure."

The fund also mitigates risk by hedging overall macro conditions. If managers have misjudged negative sentiment, these shorts can limit the fallout. Collecting substantial yields on its credit exposure on core investments can do the same.

The Hildene Opportunities Fund II, co-managed by Brett Jefferson and Dushyant Mehra, also shops the high-yield market. But the Stamford, Conn.-based fund is far more domestically focused on credits of regional and community banks and financials, corporate debt, real estate and consumer and mortgage debt. Like Napier's, its book has extensive exposure to structured credits because that's where it's able to identify value. "Their complexity can give an edge to investors who can drill down and truly distinguish risk and opportunity," explains Mehra. This is especially true for smaller segments of structured credits, which larger firms, the ones that do the most research in the space, avoid because there's insufficient liquidity to meet their needs.

Though Hildene's history dates back a decade, this fund is one of the youngest on our list, having launched in August 2011. Still, during its first six years, the fund has racked up annualized gains of nearly 16%. Its standard deviation was a very low 5.03%, and its worst drawdown was just 5.55%. The fund's management has achieved these remarkable numbers by staying small, being quick to adjust duration when struc-tured credit markets change, by applying hedges and by seek-ing high current yield as ballast.

It's also compelling that the $602 million fund has periodically closed to new investors and has returned over $150 million in capital to investors when there haven't been sufficient opportunities.

Another unique feature: Half the fund's performance fees are not paid to the manager until investors redeem. This rare structure prevents investors from paying for a substantial part of performance that could be lost if the fund was to subsequently struggle. *Pw*

NOTE: We are not recommending any fund. Past performance guides but does not predict. You need to do your own homework. For help, please see our article "No Short Cuts" on hedge fund due diligence in the November 2013 issue of Financial Advisor *magazine.*