Survey: weak performance fails to stop gush of new money

Research

Eric Uhlfelder and **Jonathan Kanterman** take a look behind the numbers to find five exceptional funds

"There's something happening here. What it is ain't exactly clear."

Buffalo Springfield, the 1960s rock group that penned these words, was certainly not writing about hedge funds in 2013. But they could have been.

Reports abound of money ostensibly gushing into the industry, despite mediocre performance since markets melted down five years ago. The least likely strategies are seeing strong asset growth. And 100 companies now control 61 per cent of all assets, or $1.4tn, despite government policy moves against "concentrated risk" and entities becoming "too big to fail".

BarclayHedge, the global industry data tracker and our prime data source for this study, found that since industry assets fell by nearly 30 per cent to end 2008 at $1.66tn, investors have been returning steadily. By the end of the third quarter of 2013, the figure had reached $2.33tn, almost matching the all-time asset high set at the end of 2007.

Though surrounded by negative sentiment, fixed income and emerging market fund assets have increased 13.44 per cent and 19.61 per cent, respectively, during the first three quarters of the year, reaching $318bn and $253bn.

Long-bias fund assets rose nearly 17 per cent to more than $175bn, suggesting investors think fairly naked equity exposure is OK, despite an ageing bull market. Assets in more traditional, hedged long/short equity funds have barely budged, and are now at $174bn.

Meanwhile, the industry is finishing its fifth consecutive year of underperforming stocks, cumulatively trailing EAFE, an index of non-North American developed-world stocks, in dollar terms by 26.6 per cent and the S&P 500 by more than 62 per cent over this period.

We experienced firsthand how difficult the search was for just five proven managers (see page 10 and 11) with the following parameters: fund assets of between $100m and $750m; more than five years of performance history; consistent double-digit annualised returns; moderate to low volatility; and modest historical drawdowns.

Last year, Kent Clark, Goldman Sachs Asset Management's chief investment officer of hedge fund strategies, who oversees more than $23bn, told us: "If you can find any managers with good long-term returns and moderate volatility, let me know". This still rings true.

So why do investors seem increasingly enamoured with hedge funds?

"At the [global] epicentre of this increased pace in asset growth is the continued expansion in size and number of the largest single-manager firms in the US with assets of at least $1bn," reports HedgeFund Intelligence, the industry research company.

During the first half of 2013, HedgeFund Intelligence found this group grew in number by 18, to 287 managers, whose total assets increased by $110bn to $1.57tn. That is more than two-thirds of all hedge fund assets – the highest concentration since the pre-crisis peak. Now 11 US-based firms are each managing more than $20bn.

Asset massing by large managers reflects the growing institutionalisation of the industry and relative decline in wealthy individual investors. Over the past decade, Citi Prime Finance, the global hedge fund advisory, found institutional ownership of all hedge fund assets has increased from one-quarter to more than two-thirds.

Institutions are pouring into large funds, says Martin Källström, portfolio manager of hedge funds at the $35bn First Swedish National Pension Fund. They can offer superior "investor comfort" via effective transparency, dedicated risk-management teams and continuous vetting by advisers and consultants.

"These funds can offer low-volatility performance that is uncorrelated to the market, while claiming to the have the capacity to accommodate significant capital inflows," adds Mr Källström.

Preqin, the data provider, thinks faith in these qualities is the primary reason why "institutional investors have stayed the course with hedge funds, despite performance concerns over the past few years".

Market underperformance is also tolerated because the market has twice melted down by half in little more than a decade, says Peter Rigg, who oversees $28bn and is head of alternative investments at HSBC in London. Such outsized volatility is contrary to most institutional tolerance, which seeks steady growth to meet their investment mandates.

Now 11 US-based firms are each managing more than $20bn

As an indirect result of the financial crisis, Lisa Fridman, head of European research for the $8.8bn Paamco funds of funds, sees many larger managers refocusing on so-called risk-adjusted performance rather than returns alone, to help hold on to and attract long-term institutional clients. These clients tend to have lower sensitivity to the market. This shift seems to be pushing away rich individual investors who are after more aggressive returns, she says.

The performance impact of trying to capture growing institutional demand has varied by strategy. Alexandre Col, group head of multi-management at Banque Privée Edmond de Rothschild, says: "Event-driven/activist managers are still content in taking on risk in looking for outsized performance with volatility."

But he sees long/short equity managers aiming lower and targeting less risk to achieve more stable, less volatile performance. "And this is even more evident with multi-strategy funds."

With performance expectations of large funds being ratcheted down, fund performance is accordingly being benchmarked not against markets, but cash-plus targets. HSBC's Mr Rigg says his company's benchmark is Libor plus 6 percentage points. Mr Källström of First Swedish National Pension Fund is focused on achieving uncorrelated market returns from his largely macro exposure to smooth overall portfolio performance.

Increasingly, leading institutional investors seem to be satisfied with realising steady absolute returns, even at the cost of significant market underperformance. This was made clear in a recent global investment bank report that confidently stated: "Despite new market highs, funds refuse to chase performance".

In addition to swelling institutional investor interest, there is another explanation of the paradox of rising asset flows and lacklustre industry returns.

We asked BarclayHedge to separate performance from asset growth between January 2010 and September 2013, focusing on the period after the immediate effects of the crisis were felt. We found that of the $228bn of net new money coming in to hedge funds over this time, more than half went into managed futures (that is, commodity trading advisors). Yet this sector represents less than 15 per cent of industry assets.

Furthermore, this strategy is set to register its third consecutive down year, significantly underperforming virtually all other broad hedge fund strategies and the stock market.

Net flow numbers may have been greater had broad industry returns been more vibrant. But the industry response to 2008 has altered portfolio construction systemically.

Though one could argue hedge funds did deliver impressive relative outperformance that year, the substantial absolute hit taken by investors fuelled demand for more reined-in exposure and risk. This further aligned hedge fund management with institutional demands.

Certainly, response to the crisis induced greater operational and performance transparency. But it also resulted in lower performance, as evidenced by five years of market-trailing returns and growing correlation among strategies.

Our conclusion is that, with the performance bar having been reset lower and prospects of outsized gains more limited, investors should be more circumspect about hedge fund exposure, given the risks of investing in this field.

While institutional investors claim large funds are helping them meet their asset allocation and performance models, we contend exposure alone will not improve portfolio volatility, especially taking costs and relatively modest net returns into account.

We believe there are smaller hedge funds out there, managing less than $750m, that can add unique and productive exposure to portfolios, with managers who know how to balance performance and risk, not just act as hedges against market uncertainty. Industry research widely supports this point.

Jonathan Kanterman is a fund manager and industry consultant

Methodology Separating the wheat from the chaff

By relying only on BarclayHedge for this survey – the oldest and most comprehensive hedge fund database – we ensure search parameters are precise. All 13 data fields, including strategy, assets, performance, standard deviation, worst drawdown, Sharpe ratio, firm assets and fees, are treated consistently.

BarclayHedge started the selection process by filtering 4,500 hedge funds, and then assembling a list of more than 700 that run between $100m and $750m and have at least five years of verifiable performance through June 2013. We excluded sector and commodity funds because of their limited exposure and tendency to produce outlying results.

This timeframe captures one of the most challenging investment environments and is the longest tracked by a periodical hedge fund survey.

We then screened for consistent returns and low to moderate volatility, with limited drawdown, no change in portfolio manager[s] during the study period, and avoided funds that suspended or gated. Those that made the first cut then went through a substantial due diligence review.

The difficulties we have encountered this year in finding compelling broad-strategy funds forced us to expand our search into niche and country-specific strategies, which we normally avoid because of the inherent limits it places on the manager.

Identified as statistical arbitrage, RiverNorth primarily invests in closed-end funds. While its $82m is slightly below our threshold, the firm manages nearly $2bn in this asset class.

AlphaGen Volantis targets small-cap companies in the UK. Perfin Investimentos invests only in Brazil. However, these equity country funds demonstrate the potential of what a good manager can deliver, especially in a struggling economy.

More detail on the methodology and due diligence is available online

The secret of fund success is spotting a hidden opportunity

Top funds

Eric Uhlfelder and **Jonathan Kanterman** analyse the strategy of five selected funds

Volantis's Rob Giles and Adam McConkey rely on their knowledge of under-analysed small-caps

AlphaGen Volantis
Managers: Rob Giles and Adam McConkey
Strategy: UK long/short equity small-cap

Volantis has been so accomplished that when its parent company Gartmore agreed to be purchased in 2011, the buyer, Henderson Global Advisors, agreed to sustain the fund's operational independence. Its research and investments were ringfenced to help ensure Volantis's continued outperformance.

This $526m UK small-cap fund has performed like a global industry leader, generating annualised returns of 15 per cent since it started up in April 2002. Over that time, the comparable FTSE AIM (UK micro/small-cap) index was down an average of 0.7 per cent a year.

Even more remarkably, managers Rob Giles and Adam McConkey's performance has been achieved with low to moderate volatility, despite the backdrop of the British economy's long drawn out recovery from recession.

Agnostic about gross domestic product, the managers rely on their knowledge of under-analysed small caps. They are quick to identify companies with technological and market-share advantage. After establishing a core position in a company, the managers often boost returns by also trading opportunistically in and out of the stock.

Sepura is a global leader in Tetra digital radio products and networks used by police and emergency services. A change in management in 2008 caught the fund's attention.

At the end of 2009, with the managers having sensed the return of public spending, they started buying shares of Sepura at an average cost of 41p. Early the following year, Sepura secured one of the largest post-crisis rollouts in Germany.

Company prospects have been enhanced with the US approval of Sepura to sell in the country, and private industries expressing interest in the technology. Volantis has subsequently boosted its position, which now represents 1.8 per cent of the portfolio. By mid-December, the stock was above 100p, having cumulatively contributed 2.6 per cent to the fund's value.

Believing quantitative easing would drive down mortgage rates and that expansion of loan guarantees would trigger more housing sales, Mr Giles and Mr McConkey saw a recovery play in Crest Nicholson.

The UK homebuilder emerged from a private buyout financially sound, with an initial public offering in early 2013 priced at £2.20. The managers bought at the offering, believing the company was poised to exploit pent-up housing demand that would be unleashed by expansionary policies. By mid-December, the shares were trading above £3.50, having boosted fund returns by 1.7 per cent.

Volantis's performance is largely driven by long diversified positions such as these. When managers sense market uncertainty, they tend to ratchet back gross exposure. This strategy limited losses in 2008 to just 5.4 per cent – just one-quarter the decline suffered by the average hedge fund.

Kawa
Strategy: Opportunistic debt
Manager: Daniel Ades

When this Miami Beach-based fund started up as markets began melting down in autumn 2007, manager Daniel Ades admits he felt scared "shitless".

But it never showed in his performance.

This opportunistic manager proceeded to generate double-digit returns every year, averaging gains of 16.9 per cent, with low volatility, while turning in only six negative months through June 2013.

We found a manager who jumped on deep-value opportunities when much of the market was spurning these securities, holding on for only a few months and then selling when investors realised they had panicked.

Such well-timed, shortly held purchases have limited the fund's exposure to sell-offs. As a result, its maximum drawdown has been just 2.34 per cent.

While the $238m fund has exposure to various asset classes, it is clear that the manager feels most comfortable trading debt. In fact, when asked why a so-called "opportunistic" fund failed to participate in one of the strongest bull markets ever seen, he says: "I saw greater risk-reward in fixed income".

Comparing his returns with the S&P 500 proved him right – every year.

Kawa's traditional trades include deep value (crisis-depressed bank and auction-rate preferreds), relative value trades (profiting from spread compression between mispriced assets), and growth trades (where the market has underestimated forward valuations).

Starting in June 2011, Mr Ades eventually built up a 4 per cent position in a basket of out-of-favour, long-date California school district zero-coupon bonds. These bonds were caught up in the growing fear of widespread municipal default, which hit California's struggling debt especially hard. "Effective yields" had widened from 6 per cent in October 2010 to 7.5 per cent just before Mr Ades started buying.

In selling off, investors had ignored the fact that these bonds were issued with voter approval. They were ringfenced obligations, specifically backed by the district property taxing authority. When fears eased and as "yields" fell below 6.5 per cent, Mr Ades sold out, delivering a 70 basis point boost to the fund.

Mr Ades unlocks value by restructuring bonds. In March 2012, Kawa established a 6 per cent stake in a Brazos higher education asset-backed security, which was made up of senior and subordinate government-guaranteed student loans, private loans and cash. It paid around 60 cents on the dollar. Working with Brazos, Kawa created individual securities out of these constituent parts, and resold them for a gain of around 12 per cent in less than six months.

Mr Ades has made some wrong investments, mostly involving equity. But he has reduced these losses significantly since his first year, which explains why the manager keeps his eyes trained on sound debt when it sells off.

Daniel Ades of Kawa is most comfortable trading debt

FTfm select funds for 2013 survey through June 30 2013

Name of fund	Start date	Fund assets ($m)	Strategy	One-year return	Three-year annualised return	Five-year annualised return	Annualised return since inception	Worst drawdown since inception	One-year standard deviation	Five-year annualised standard deviation	Sharpe ratio past five years	Firm	City	Firm assets ($m)
AlphaGen Volantis	May 2002	526.1	Equity Long/Short	16.65	8.86	11.14	15.00	11.34	5.56	9.74	1.13	Henderson Global Investors	London, UK	103,000
			Equity Long/Short Index	10.68	5.39	3.30	10.10	14.25	2.57	6.16	0.51			
Kawa	Sep 2007	238.0	Opportunistic Debt	11.58	12.82	18.21	16.89	2.34	1.79	4.59	3.96	Kawa Capital	Miami Beach, US	498
			Event Driven Index	9.74	5.22	5.29	9.82	19.62	3.55	7.29	0.7			
Perfin Investimentos Long Short	Oct 2007	174.5	Market Neutral / Cash Plus	11.34	12.6	15.16	15.45	5.23	2.32	3.96	3.78	Perfin Investimentos	São Paulo, Brazil	1,313
			Market Neutral Index	5.36	3.13	0.80	5.59	6.26	1.52	2.60	0.24			
RiverNorth Capital Partners	Aug 2007	82.0	Staistical Arbitrage	9.86	12.53	22.12	22.57	7.81	2.67	9.99	2.20	RiverNorth Capital	Chicago, US	2,130
			Statistical Arbitrage Average *	1.58	3.31	8.42	9.09	10.07	4.46	9.33	0.85			
Quaesta Capital Bond Gl Select	Mar 2005	672.0	Global Macro	11.17	9.26	15.83	12.12	10.67	7.13	8.69	1.80	Quaesta Capital	Frankfurt, Germany	3,125
			Global Macro Index	4.56	2.62	2.08	8.40	6.42	3.43	4.70	0.40			
Barclay Hedge Fund Index				10.09	5.67	3.26	9.43	24.09	3.31	8.44	0.37			
S&P 500 Total Return Index				20.60	18.45	7.01	11.40	50.95	6.45	18.26	0.37			
MSCI EAFE Index (USD)				15.15	6.73	-3.59	7.85	58.24	9.17	22.79	-0.17			

* There is no formal index for statistical arbitrage. It is a sub-category involving only 5 to 7 funds over the past 5 years. Accordingly, the related performance data is an average

Source: BarclayHedge, including all strategy averages

FTfm – Hedge fund analysis

Perfin Investimentos Long Short
Manager: Ralph Rosenberg
Strategy: Equity market neutral/ cash plus

Perfin derived a simple way to deal with Brazil's fickle stock market to deliver consistent double-digit returns with low volatility and drawdowns. It combines substantial exposure to the country's high overnight interest rates, which have averaged 10 per cent since the fund started in 2007, with targeted long and short equity positions, whose net exposure ranges between -10 per cent to 20 per cent.

The latter has enhanced annual performance, ranging from 1 per cent to more than 21.5 per cent.

The fund will sometimes underperform the Bovespa, explains manager Ralph Rosenberg, as it did in 2009 when the index was up 83 per cent. But when stocks plummeted as they did in 2008 (down 41 per cent), the fund gained more than 10 per cent. Bottom line: Perfin's cumulative returns have outperformed Brazilian shares 136 per cent vs -20 per cent, while the average Brazilian hedge fund has been flat.

Monthly report and performance attribution documents reveal cash's significant contribution to performance. The presentation document focuses on the equity investing strategy, which combines core and opportunistic trading, often involving the same stock.

Dufry South America, the regional airport retail concessionaire, was an early core holding. In April 2010 the subsidiary was one of many absorbed by its Swiss parent. Consolidation has created a global leader that is capturing the benefits associated with the steady rise in passenger travel. Because the Swiss parent trades in São Paulo, the fund has retained its 2.5 per cent exposure.

Over the past five years, annualised top-line growth has been running at 10 per cent and underlying earnings growth at 13 per cent. Since consolidation, this has helped push shares up from R$150 ($63) to R$402 in mid-December, adding an average of 55bp a year to the fund's performance.

Cosan, another original core holding that also represents 2.5 per cent of the fund, was Brazil's leading sugar cane and ethanol producer. Between 2009 and 2012, it decided to leverage its cash flow to transform itself through acquisitions into a transport and energy infrastructure and renewable fuels leader.

Though now burdened with R$9.8bn in debt, the market has rewarded Cosan's synergies by pushing up the stock from R$25 to R$40 over the past four years. This has boosted fund returns by 2 per cent. Mr Rosenberg believes subsequent deleveraging should drive profitability and the stock.

Foreign institutional investors would probably find the fund's equity exposure low for a long/short fund. While the performance fee is applied only to equity-related returns, some investors may balk at the management fee being applied to the fund's hefty cash position. But the net results of this hybrid strategy are compelling.

Christian von Strachwitz's Quaesta invests with a contrarian posture

Quaesta Bond Global Select
Strategy: Global macro
Manager: Christian Graf von Strachwitz

Perhaps the most critical thing one can say about this Frankfurt-based fund is that its name is a misnomer. Since it started up in 2005 under the management of Christian von Strachwitz, the fund has been macro focused, investing in equity indices, currencies and debt to achieve steady returns of more than 12 per cent a year. The fund's annualised standard deviation has averaged 8.7 per cent over the past five years, and its worst drawdown was less than 11 per cent.

Equally compelling is this $672m fund's low correlation with leading benchmarks. It has been negatively correlated to the JPMorgan EMU 1-10 year bond index along with the Macro and CTA fund indices. Its equity tilt is captured in the fund's modest correlation to the S&P 500 (0.32) and DJ Euro Stoxx 50 (0.43).

Such nonconforming numbers come as no surprise once you understand the manager's mantra. "Regardless of how attractive, we avoid crowded trades," explains Mr von Strachwitz. His contrarian posture is achieved through independent research and analysis, which he says helps him identify where the market is heading.

For instance, when the US government periodically becomes bogged down in debt-ceiling crises, Mr von Strachwitz has seen German Bunds rally.

Quaesta saw an opportunity when it sensed the supercharged yen could not hold its high value during the summer of 2012. Strong European Central Bank support for the euro combined with Japanese monetary easing suggested upside in a long euro-yen trade. After just a couple of months, Quaesta closed out this position, adding 1.6 per cent to the fund.

Around the same time, Mr von Strachwitz's team believed Spanish and Italian sovereigns were oversold on fears of collapsing domestic economies and systemic threat to the euro. Feeling the ECB would be compelled to support these markets, the fund started buying Spanish and Italian bonds. The trades received a boost when the ECB reiterated its defence of the euro and recommitted to its sovereign bond-buying programme. Steady bond appreciation ensued, enhanced by an interest-rate cut, which together added 4 per cent to the fund by mid-2013 when Mr von Strachwitz closed out these positions.

Quaesta's staff of 24 professionals maintains 15-25 investments that last from several weeks to several months. They protect the fund's downside through extensive daily stress testing and application of strict stop-losses to prevent individual trades from dragging down the fund by more than 1-3 per cent. So far, it has worked well.

RiverNorth Capital Partners
Strategy: Statistical arbitrage
Managers: Patrick Galley and Stephen O'Neill

Closed-end funds, the primary security RiverNorth trades, have been around for decades. There are around 600 such exchange traded funds, representing one out of five securities listed on the New York Stock Exchange, with no more than about 10 firms trading around the inefficiencies of this asset class.

RiverNorth's Patrick Galley and Stephen O'Neill are proving the merits of trading in a less crowded space

This is an obscure strategy, but Patrick Galley and Stephen O'Neill are proving the merits of trading in a less crowded space.

Since starting up in August 2007, the managers have racked up annualised gains of more than 22.5 per cent a year through to June 2013, with a trailing five-year annualised standard deviation that is under 10 and a worst drawdown that is less than 8 per cent.

Closed-end funds offer unique trading opportunities because their market prices deviate significantly from their net asset values. With such funds built around specific asset classes, their market prices are moved by underlying valuations and sentiment towards the asset class.

Being able to go long and short, the managers rely on statistical arbitrage to identify discounts and premiums in market prices that they anticipate will change.

With more than three-quarters of closed-end funds using leverage, which averages 30 per cent to boost yields of their dividend-paying holdings, yield-starved investors poured into these investments. This pushed the portion of funds trading at a premium to 54 per cent as of September 2012. This seemed rich to the managers.

By the spring, they saw their opportunity when Ben Bernanke, chairman of the US Federal Reserve, hinted tapering of QE was being considered. They assembled a basket of municipal, high-yield, emerging market and bank-loan funds that represented up to 52 per cent of RiverNorth's gross short exposure as of September 2012.

Between May and August of the following year the managers unwound this position. By the autumn, 90 per cent of closed-end funds were trading at discounts. The trade boosted the fund's performance by 5 per cent.

During the fourth quarter of 2012, fears about the pending fiscal cliff hit covered call option funds, capping a year of reduced dividend payments as premium-writing income fell, having created a 15 per cent discount in many such funds.

Seen as a temporary phenomenon, Mr Galley and Mr O'Neill established a 17 per cent long position in a basket of these funds by January 2013. The discount quickly closed as budgetary fears subsided. By September the managers unwound the bulk of the position, adding 3 per cent to returns.

Without a down calendar year, having gained more than 21 per cent when markets collapsed in 2008, the managers have found a niche that significantly topped more familiar, crowded strategies.

Record so far Tracking the performance of selected funds from previous years

Several years of performance is required to make a fair assessment of our thesis that investors can realise superior and operationally less risky returns through refined research and due diligence. But here is what we have found so far.

With two years under our belts, the five original funds we selected in 2011 have almost doubled the performance of the average hedge fund, rising an average of 5.1 per cent a year versus the BarclayHedge Fund Index. They have also outperformed the MSCI EAFE Index, which was up 1.58 per cent. But we underperformed the S&P 500, which had gained an average of 12.77 per cent.

Our top-performing funds were the Harvest Small-Cap [long/short equity] Strategy (+10.65 per cent per annum) and the Steelhead Pathfinder convertible arbitrage fund (+8.21 per cent). Our worst and only cumulatively negative performance from 2011 was the Forum Global Opportunities [macro] fund (-2.99 per cent), which was hurt by its high-conviction short position of emerging-market credits, which the manager still thinks will play out.

Three of the five funds we selected in 2012 have performed very well, both relative to their strategies and in absolute terms over the past 12 months through June 2013. GAM Talentum Emerging Long/Short Equity fund paced the way, rising more than 15 per cent, followed by the Parus [long/short equity] fund, which was up more than 12 per cent.

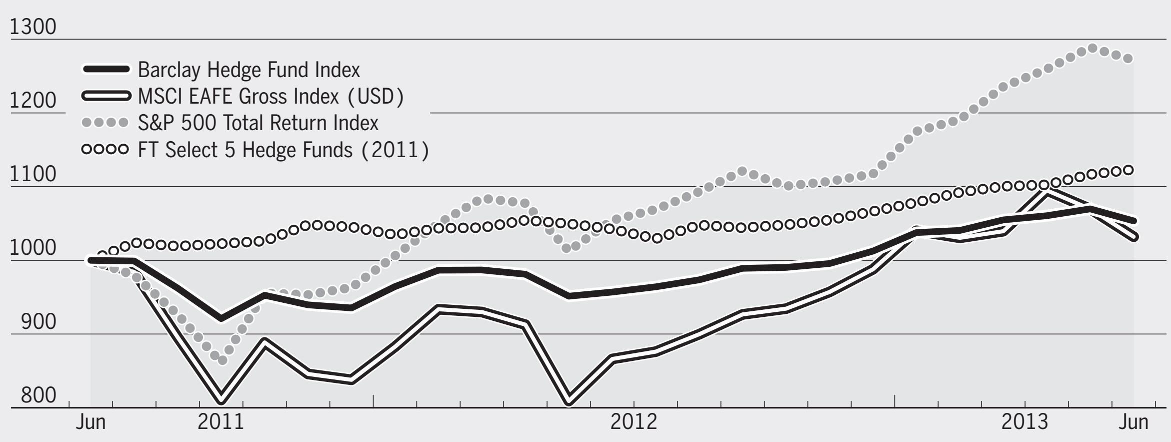
Talentum's gains were founded in the fund's predominantly long positions, spread across a variety of countries and industries. And potentially damaging currency exposure was effectively hedged. The performance of developed-market-focused Parus was driven by its bullish bottom-up approach, especially in financials, which accounted for 70 per cent of performance.

Two other funds we cited were hurt by their defensive postures. LJM Preservation and Growth, an options strategy fund that had an extremely consistent record throughout its six-year history, was down 7.7 per cent, mainly due to its performance in May 2013, when it lost an extraordinary 9 per cent.

Omni Macro fund's conviction that quantitative easing was setting up a bearish scenario for a richly priced market proved costly as stocks continued to rally, generating a loss of nearly 6 per cent over the trailing year.

More details on our performance is available online

Selected funds
Total return indices (rebased)



Source: BarclayHedge