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The Allocator's Dilemma:

Challenge Convention or Yield to It?

Sidebar: Lessons for Investors from *Moneyball*

Eric Uhlfelder & Ben Crawford

WHILE PAST PERFORMANCE doesn't assure anything, long-term consistency can be a pretty good indicator of an effective and repeatable investment process. And when that process has delivered attractive gains regardless of what the market is doing — especially these days — then maybe that's something worth looking for.

Global Investment Report's annual global hedge fund survey, published by Backstop BarclayHedge, doesn't target the highest flyers whose historical performances tend to look like Sine curves. Instead, it erects a bunch of barriers that helps narrow the field to a short list of broad strategy managers that have delivered consistent gains. Identifying such managers is especially useful when markets are manic.

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Sophisticated investors certainly screen hedge fund databases for ideas. But short lists are often guided by a more "usual suspects" approach. Allocators are attracted to funds they know. Often, celebrity is an important consideration. Consultants and prime brokers are frequently brought in to point the way toward familiar names and those in which they have vested interests. At the end of the day, many investors are most keen on established, well-known players.

And herein lies the allocator's dilemma: While this approach may provide shelter from headline risk (i.e., getting tagged for being in a lesser-known quantity that fizzles), it's not necessarily going to produce the most desirable long-term results.

This is clearly demonstrated in the hedge funds of funds space. BarclayHedge found 300 such managers generated average annual returns of less than 4% over the past decade through 2021.

Active investing isn't easy. Markets are mercurial, subjected to unexpected forces, and year-over-year consistency is a rare quality. This was especially evident in 2021 at the tail end of the bull market when some venerable names, including Tiger Global, Element Capital, and Alphadyne, lost their way. And such rudderless performance continued into 2022 as markets went into freefall.

Because sources of hedge fund performance are often opaque, it's difficult to know what went wrong when funds lose lots of money.

LESSONS FOR INVESTORS FROM *MONEYBALL*

A DIFFERENT WAY OF LOOKING AT INVESTING

Allocators are often attracted to big-name managers across various strategies in seeking performance and diversification. However, there are only a few exceptionally consistent superstar managers, many of which are closed to new investors or now come with hefty fees. GIR's survey, like Billy Beane, places consistency over brand recognition and outsized performance in ranking the most desirable funds that can meet allocators' high due-diligence standards.

AFTER LOSING THREE of the team's top players in 2001 to free agency, the budget-constrained general manager of the Oakland Athletics, Billy Beane, realized he had to figure out a different way to win.

In *Moneyball: The Art of Winning an Unfair Game*, Michael Lewis explains how Beane built a roster of unconventional players who excelled at getting on base. Certainly not as crowd-pleasing as inking a lineup of power hitting demigods. Instead, Beane focused on the most capital efficient way of generating runs and wins — enabling one of the League's poorest teams to compete with the wealthiest.

While Beane never won a World Series with the A's, he accomplished the unimaginable.

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Identified by their consistent historical performance through 2021, the Top 50 hedge funds went on to outpace the market by more than 23 percentage points in 2022.

But here are two basic truths: Managers delivering outsized returns often get hit the worst when markets turn; and when fund losses persist for an extended period, the process of selecting and managing investments may have changed, style drift may have set in, and risk management has failed.

In every presentation document, managers claim they can control downside. That is until they don't.

Put simply, if funds don't follow a proven investment approach, regularly refine their thinking, acknowledge material change when it happens, reassess their positions, harvest profits, and redeploy assets into new ideas, and if they don't employ true hedges and stop-losses, then declines can cascade.

THIS BRINGS US BACK to the value of looking at short-, medium-, and long-term past performance.

Before 2022 (save for the market collapse in March 2020 due to Covid-19), the last time managers were hit with an unexpected sell-off was in the fourth quarter of 2018 when a decent year suddenly turned negative in very short order.

At that time, when the Global Investment Survey was published by *The Wall Street Journal*, it established a hurdle for inclusion of +5% in 2018. Funds that straddled this number — while delivering solid trailing 5-year annualized returns — suggest an investment process that's materially independent of the market. This achievement is what Warren Buffett likens to managers who swim with trunks when the tide rolls out. And that hurdle has been maintained for 2018 and for all subsequent reporting years.

The 2022 survey's Top 50 performing funds, based on the leading 5-year trailing returns through 2021, nearly kept pace with the market and did so with far less risk. Their collective market correlation was just 0.32. Lower volatility and drawdowns helped when things get dicey. Their first quarter 2022 returns outperformed the market by more than 7 percentage points. And by the end of the year, that outperformance blew out to more than 23 percentage points.

Over the course of 23 seasons, spanning from 2000 to 2022, his *Oakland Athletics* won an incredible 1,911 games, generating 15 winning seasons and 11 playoff appearances. Over this interval, the average team spent $1.38 million on payroll for each win they notched. The A's spent $762,000 per win. The five franchises that outperformed the *Athletics* during this time had payrolls well more than double that of Oakland. In having delivered such success, Beane changed professional baseball forever.

EVERY PROFESSIONAL COMMUNITY holds fast to its conventional wisdom: Attitudes, assumptions, and deeply held truths deemed essential to succeed. Moneyball drives home the point that a system dominated by increasingly questionable beliefs crowds out alternative thinking. But in doing so, it offers opportunities for those willing to look at things differently.

Lewis showed that in the absence of objective statistical criteria by which to build a winning team, decision-makers consistently fell back to traditional reasoning: buy brand name players, power hitters, and recruit prospects with the right "baseball bodies and faces."

This approach hamstrung clubs from objectively assessing a player's actual contribution to their success. This led teams to overpay, sometimes grievously, for star-power and to ignore seemingly more subtle talent, which could more efficiently increase a team's offensive output.

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Another compelling characteristic of the Top 50: The funds' average age is more than 14 years. Their annualized returns and risk since inception were pretty close to what they've delivered over the past five years. *(Note: the average life span of hedge funds is just a couple of years.)*

Jérôme Berset, head of alternatives at the $181 billion Swiss-based EFG International, believes in certain large proven managers. The 2022 survey's average fund size was $3.4 billion, a number that got a boost from scalable multi-strategy funds that add managers to expand capacity — so far without compromising performance. Ten such funds made the cut with returns that tripled the performance of the average multi-strategy gain over the trailing 5 years.

But unlike many major allocators, Berset also considers smaller managers with proven track records because they can benefit from accessing a much greater part of the equity and debt universe — from mega-cap to micro-cap. Their trades are less likely to affect pricing, and, he notes, their returns are are often less linked to what the market is doing.

Nearly half the funds in the survey were running less than $900 million, 8 of which were managing less than $500 million. They're on average 11 years old. That paints an odd picture. Such unrecognized success may suggest reticent investor sentiment (perhaps driven by funds lacking institutional-level redundancies) or fund management that's simply more focused on performance rather than asset gathering.

For larger allocators, it takes more time and effort to source enough managers to deploy big chunks of capital across smaller funds. But maybe it's worth it. And if you're a smaller investor, the same thinking certainly applies.

Thinking differently about how to win opens up disruptive opportunities for any GM courageous enough to pursue them. And management has found it can often mitigate risks that come with signing overlooked talent by surrounding such players with sound coaching.

In having exploited market inefficiencies, Beane built productive rosters relying on significantly discounted players and locking in talent that didn't show up on his competitors' radars. By deploying his limited capital more thoughtfully and efficiently, Beane was able to effectively compete and at times outperform many of the League's wealthiest clubs for more than 20 years.

— Ben Crawford

SAMPLE OF SOME OF THE MOST CONSISTENT SMALLER FUNDS

Global Investment Report has seen their asset size steadily rise with increasing recognition of their success

Fund Name	Fund Strategy	Fund Inception	Fund Assets (Millions)	YTD Returns through 2022	5-Year Annualized Net Returns (through 2022)	Annualized Net Returns (Inception through 2022)	Worst Drawdown (Last 5 Years through 2022)	Worst Drawdown (Inception through 2022)	5-Year Annualized Standard Deviation (through 2022)	Annualized Standard Deviation (Inception through 2022)	Correlation to S&P500 TR (Last 5 Years through 2022)
HGC LP	Event Driven	Jun-13	975	1.40%	12.19%	12.73%	-5.45%	-5.45%	9.26%	7.32%	0.254
Millstreet Credit	Credit Long/ Short	Jun-10	1683	4.84%	15.50%	11.82%	-4.39%	-33.26%	5.27%	8.26%	0.427
Aristeia Partners	Multistrategy	Aug-97	1918	0.91%	8.58%	10.68%	-4.28%	-29.22%	5.13%	7.61%	0.310
Arena Special Opps.*	Special Opportunities	Oct-15	2756	1.34%	6.63%	7.04%	-5.73%	-5.73%	3.84%	3.70%	0.182

*Arena's data was available through Nov 22

MILLSTREET CREDIT

Millstreet has been one of the most consistent credit funds around, highly ranked in Global Investment Report's annual global hedge fund survey over each of the past four years. Based on trailing five-year annualized returns, the fund was the 8th best performing broad strategy fund in the 2022 survey.

Since the high-yield credit fund's launch in 2010, managers Craig Kelleher and Brian Connolly have been generating annualized returns of 12.4% through 2021. The fund sustained this standing by weathering difficult times exceedingly well.

> **As interest rates soared and debt again sold off in 2022, the fund maintained a relatively low net exposure of 58% through June... by the end of year, the fund was up nearly 4.8% as net exposure remained cautious at 55%.**

During the COVID selloff, the managers saw increased opportunity in the under-researched space of small- to-mid-cap firms, which contributes to debt mispricing. The firm's net long exposure moved from 52% to 63%. At that time, Kelleher conceded there would be a, "couple of ugly quarters as companies burn through cash, credit metrics deteriorate, and defaults rise." But he saw the broad selloff creating long and short opportunities. The fund ended 2020 up more than 21%.

As interest rates soared and debt again sold off in 2022, the fund maintained a relatively low net exposure of 58% through June. Its sustained focus on first-lien debt supported by hard assets, receivables, short duration, and avoidance of covenant-lite paper helped Millstreet end the first half up nearly 3%. And by the end of year, the fund was up 4.8% as net exposure remained cautious at 55%.

Keys to the firm's credit selection include identification of liquidation value, a corresponding stock price that trades at an exceedingly low earnings multiple, a long runway that will allow the company to stay in business over a targeted period, access to credit, relatively low Debt/EBITDA, and stronger cash positions compared to the rest of the high-yield industry.

The managers have preserved capital by largely investing in senior-secured credits, avoiding firms running substantial leverage, materially hedging long individual or sector positions, focusing on fundamental issues that may reveal risk before financials do, and not making emotionally-driven decisions, especially when there may be an innate urge to act.

***Note from the Authors:** The 2023 Global Investment Report Annual Hedge Fund survey will be published by BarclayHedge in June 2023.*

ARENA SPECIAL OPPORTUNITIES

Arena Special Opportunities doesn't try to hit home runs or even doubles. The fund, which ranked 41st in the 2022 global hedge fund survey, specializes in hitting singles.

"We're not looking for large gains, but we will bore you to death with consistent, repeatable steady returns," quips Portfolio Manager Dan Zwirn. The fund has been averaging net gains of around 8% over the last 5 years through 2021. During this time, its volatility was a low 2.82. This translated into a Sharpe Ratio of 2.67, while the fund's correlation to the S&P was less than 0.20 over this period.

> **While interest rates shot up in 2022, the manager doesn't believe the risks related to this shift have been fully factored into economic forecasts. Zwirn believes, "debt loss recognition" is largely being masked by refinancing.**

In 2022, while fixed-income investors took it on the chin, Arena eked out a gain of 1.3% through November.

Arena targets under-researched opportunities, making more idiosyncratic loans that are high in the capital structure to help reduce impairment risks. Its diversified sub-investment grade loan book is backed by real estate, corporate credit, and commercial and industrial assets. Arena invests predominantly in developed markets worldwide where there are well-established regulations and litigation processes in place.

Loans range in size from $5 to $50 million and the number of outstanding loans ranges between 100 and 120. Loan-to-value ratios are typically 60% with short-term maturities running from one to three years. Heavy reliance on floating rates has helped mitigate hits to loan valuations.

Another key to the fund's steady returns and low volatility is that it hedges many risks. For instance, when lending to oil and gas concerns, it will require borrowers to enter into swaps to lock in the underlying value of the loan. With 20% of the Arena's NAV involving foreign exposure of some kind, the fund hedges FX risk.

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But he predicts, "a maturity wall will soon be hit when leveraged loans and distressed bonds come due, but refinancing isn't available for increasingly troubled companies."

Arena is addressing this growing risk several ways. A rising number of counterparties with which Arena can transact is putting the firm in a strong negotiating position. Zwirn is requiring "tremendous margins of safety, as senior as possible, with as little duration as we can get, with as much compensation and control we can bargain for."

Arena initially protected itself against rising rates by having rotated into Put options. Arena also has been investing into private convertibles and positions, "that are intrinsically disconnected from the overall economy," explains Zwirn, "such as litigation finance, pharmaceutical or musical royalties, and insurance-related investments." ■

AUTHOR BIOS

Eric Uhlfelder is presently working on his 20th annual global hedge fund survey. The Financial Times, The Wall Street Journal, Barron's, and SALT published past editions. He has interviewed dozens of hedge fund managers, from New York and London, Denmark to Switzerland, to Hong Kong and Sydney. For more than three decades, he has reported on capital markets for leading financial publications. He wrote the first book on the advent of the euro, *Investing in the New Europe,* for Bloomberg Press. And he has earned a National Press Club Award. His website: globalinvestmentreport.net

Ben Crawford is the VP, Head of Research at Backstop-BarclayHedge. A finance and technology geek at heart, Ben has been building products at the intersection of these disciplines for more than 16 years. His latest foray has him shaping the lifecycle of BarclayHedge's database and analytical products while building new products and innovative services on the foundation of the company's well-established expertise and reputation for excellence. Ben completed an MBA from the University of California, Davis in 2011 with a focus in Finance and Technology Management. He received PMP Certification© in 2014 and a CFA Charter© in 2018. Ben lives with his wife and two little ones in suburban Chicago.

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