RETURN OF THE HEDGE FUND

With the financial crisis behind them, are investors ready to re-risk? We brought together money managers and consultants in a virtual roundtable to discuss whether Canada's institutional investors are, once again, exploring this space.

By Yaldaz Sadakova

ROUNDTABLE PARTICIPANTS (FROM LEFT TO RIGHT)

- Ian Struthers, partner and investment practice director, Aon Hewitt
- François Bourdon, associate chief investment officer and vice-president, asset allocation and fixed income, Fiera Capital
- Jean Baram, managing director, investor relations, Innocap Investment Management
- Martin Gerber, president and chief investment officer, Connor, Clark & Lunn Investment Management Ltd.
- Ryan Bisch, Canadian alternatives boutique leader, Mercer

Q. Are hedge funds making a comeback among institutional investors?

Ian Struthers: It is fair to say that there is interest and discussion on hedge funds and their role in a portfolio, but we have yet to see a lot of demand from clients to implement these strategies—certainly not to the extent we are seeing outside Canada. There is more of a priority among Canadian institutional investors on building out their illiquid alternatives exposure using real estate and infrastructure.

François Bourdon: Non-traditional strategies in general are appealing to more and more institutional investors that are looking to dampen their downside risk. Hedge funds with the most appeal among institutional investors are those that are transparent, contain simple strategies and boast consistent returns for their clients.

Jean Baram: Simply based on assets under management, it is true that the assets in the industry are at an all-time high, and that can be seen as a comeback following the losses posted during the 2008 financial crisis. However, when taking a more granular view, we observe that the industry has experienced significant changes after the crisis. While investors were mainly funds of funds, family offices, high-net-worth investors and private banks, the demand in the industry is now predominantly driven by pension plans and other institutional investors. These investors are allocating more to hedge funds than in the past, as the 2008 crisis awakened their need for diversification and downside protection.

From our perspective, the crisis has generally led to an increase in demand from institutional investors for hedge funds (and not a decrease—thus, not a comeback per se). These investors have changed the way they invest, switching from the traditional funds of funds model to direct investment and, more specifically, via managed accounts. However, the other groups of investors that reduced exposure to hedge funds after the crisis have been reluctant to increase their allocation to the space.

Q. How has institutional money changed the hedge fund space, for better or worse?

Baram: The changes to the industry are notable. Institutional investors have changed the way they invest. They have also increased their requirements in the areas of fund governance, risk management process, enhanced transparency and legal terms. For example, they require a clear separation of tasks between portfolio management and risk management. Some also require the hedge fund manager to amend its general offering documentation to reflect these enhancements and have other clients benefit from it.

In terms of fees, they are certainly pressuring managers to move away from the traditional 2-20. We are seeing a lot of variations on fee structure that we didn't see before. Overall, the increasing needs of institutional investors have pushed hedge fund managers to make their processes more robust and scalable in order to attract these large allocators.

Gerber: Institutional investors have brought higher scrutiny to the hedge fund industry and a more disciplined approach to manager evaluation and oversight. To accomplish this, institutional investors have demanded greater transparency from hedge funds. I believe these are positive developments for the industry.

Q. From a pension fund's perspective, what are the risks involved with investing in hedge funds?

Bisch: Hedge funds are risky investments, not unlike traditional stocks and bonds. Hedge fund risks, however, can be more difficult to identify and manage, given the general opacity of the investment vehicles and the complexity of the strategies traded. The key to successful hedge fund investing is to identify and diversify or avoid those hedge fund risks that are non-compensating and accept those risks that are expected to reward with attractive risk-adjusted returns.

Non-compensating hedge fund risks include business risk. A pension fund would not invest in a single stock to gain exposure to large cap equities, for instance—yet we have seen some plan sponsors make this very mistake with their hedge fund allocation. The result is that the business risk of the individual hedge fund becomes the dominant risk, swamping the potential benefits. This situation is easily solved, however, through diversification across multiple hedge funds—exactly the approach investors take with traditional stocks and bonds.

Baram: When investing in hedge funds, pension funds face similar risks as those they face in traditional funds, such as market risk, geopolitical risk, operational risk, fraud risk, blow-up risk, liquidity risk, etc. Due to the nature of hedge fund investing, they face additional risks such as diversification risk, credit and counterparty risk, and leverage risk, as well as reduced regulatory supervision. This has given rise to the popularity of managed account structures, as they mitigate some of these risks.

Gerber: A key challenge that sponsors face is the difficulty of finding managers with the necessary skill to produce consistent active returns. In assessing past performance to select active managers, it is quite difficult to discern true skill from luck.

Q. What are the possible benefits?

Bisch: When properly implemented, hedge funds can provide exposure to non-traditional risks that diversify and complement traditional stocks and bonds. By diversifying the drivers of return beyond equity market risk and interest rate risk, the portfolio enjoys multiple drivers for potential success, achieving superior diversification. This diversification may be particularly timely today, given where we are in the interest rate cycle.

Historically, investors have sought to mitigate equity volatility with high-grade fixed income. High-grade fixed income securities, however, are priced for disappointing prospective returns, enhancing the allure of an alternative to traditional investments.

Gerber: The main benefit hedge funds bring to pension plans is the potential for uncorrelated returns. Much of this diversity arises from active investment strategies used by hedge fund managers. This additional diversity can be used to reduce volatility or to increase returns.

Baram: Pension funds gain important benefits through hedge fund investing, such as access to broader strategies, better usage of each dollar deployed (via leverage and notional funding), improving the risk/return profile of their investment, diversifying their portfolio or reducing the drawdowns.

Q. Are funds of hedge funds over, or do they still offer opportunities for pension investors?

Gerber: I believe that the original funds of hedge funds model is challenged in a couple of ways. For investors, many of the fees-on-fees structures were too costly. For hedge fund managers, the pressure funds of hedge funds face to add value by managing managers resulted in them being unreliable sources of capital. That said, if these issues can be addressed, there is still a need for good advice in this segment of institutional investing.

Bisch: From a Canadian investor's perspective—given the size and internal resources of the typical Canadian pension

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plan—I expect funds of hedge funds to remain relevant. That said, the funds of hedge funds model can be one of the key implementation hurdles to overcome when considering an allocation to hedge funds.

Struthers: Contrary to many industry observers, we do not believe that hedge funds of funds are on the way out. We believe that, in the right situation, they can play an important diversification role in a Canadian portfolio. Some of the advantages of using these products include immediate strategy and manager diversification, a more streamlined governance and monitoring model for investors, an ability to customize mandates for larger allocations, access to otherwise closed products, an ability to negotiate terms and fee structures with underlying managers, and attractive risk adjusted returns. Manager selection for the fund of funds provider is critical. For certain institutional investors making their first foray into a hedge fund allocation, there is a preference for hedge funds of funds for all of the reasons listed above.

Bourdon: Funds of hedge funds can still offer value to investors that are not in a position to make individual selections and that are looking for further ways of managing risk. In addition, for funds where governance is a key consideration, funds of funds are still attractive to gain access to the asset class. The additional layer of fees is, however, an important consideration, so multi-strategy funds—which typically have only a single layer of fees—become of greater interest.

Q. How can institutional investors that have been let down by hedge funds before prevent it from happening again?

Baram: Generally, the performance of the hedge fund industry in the last few years did not meet investors' expectations. However, many hedge fund strategies performed well. Like many investments, past performance is not indicative of the future, so a thorough due diligence process aimed at understanding the strategy, its drivers, favourable and unfavourable environments, and the manager's investment process is key for investors.

Bisch: There is no inexpensive, passive means for implementation (at least, not one that has proven its mettle over market cycles), and implementation risk is high in selecting managers and constructing portfolios. We observe that some investors seek to minimize costs through a do-it-yourself approach. Ironically, we have observed far more capital destroyed through inexperienced allocating than through the cost of seeking professional advice.

Q. What trends are emerging in the hedge fund space?

Bisch: We continually see new trends emerge that are intended to solve the problems associated with hedge fund investing, such as highly liquid offerings, mutual fund hedge funds and low-cost approaches. While there is certainly a healthy dose of demand for such solutions, it is interesting to note that such breakthroughs are not new but are recycled versions that have previously disappointed in past incarnations. It strikes us that many investors are trying to solve for the wrong problem, looking for a more liquid or cheaper product, when the problem they should actually attempt to solve for is manager selection. We believe the future will demonstrate that well-structured hedge fund allocations offer an attractive alternative to traditional stocks and bonds.

Struthers: The global growth of institutional money into hedge funds has led to a trend of improved transparency, lower fees and increased operational rigour. These are strong positives. Institutions have a much stronger view of how they fit into a portfolio as a risk diversifier, as well as what is required to construct an effective portfolio of hedge funds. There are variants of hedge funds, such as hedge fund replication, which have yet to be proven.

Baram: We have seen many trends slowing down, such as the interest in structured credit and credit managers. On the other hand, we are seeing the continuation of some trends, such as more variations of managed account structures, a big wave of hedge funds being offered to retail and more concentration in client portfolios (i.e., fewer hedge fund managers). Generally, investors should expect more changes and regulations, and these changes will lead to opportunities. For example, due to increased regulatory scrutiny, banks are exiting some business lines that they traditionally dominated, allowing asset managers such as hedge fund managers to step in and fill the gap.

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