Why hedge funds still manage to seduce investors

Hedge fund investor Hugh Culverhouse Jr. says the $2.25 trillion industry was an easier place for wealthy individuals to make money a decade ago.

Funds were smaller, returns were higher and managers did more to cultivate the support of those well-heeled individuals and families because large institutions like pension funds had yet to embrace the industry.

"It was so simple (for managers) to leverage up and make a fortune," said Culverhouse Jr., 64, a Miami-based trial attorney whose father owned the National Football League team, the Tampa Bay Buccaneers, from 1976 until the early 1990s. Shortly after his father's death in 1994, Culverhouse Jr. sold the team.

Though he has money with Daniel Loeb's $13 billion Third Point LLC, Culverhouse said he favors smaller, more nimble hedge funds that have more flexibility to trade and capitalize on different markets.

Even hedge fund managers admit it's become harder to generate big returns as the industry, which in 1990 consisted of about 600 hedge funds, has ballooned to almost 10,000.

"Most investors are not going to create alpha. It's a zero sum," said billionaire Ray Dalio, the founder of $120 billion Bridgewater Associates, one of the world's largest and best-known hedge funds, at a conference in Manhattan in November.

Investors, money managers and consultants who spoke with Reuters said very few hedge funds still produce the type of returns that justify their hefty management and performance fees, typically 2 per cent and 20 per cent, respectively.

Between 1990 and 2000, annual average hedge fund returns regularly surpassed the 20 per cent range and never recorded negative performance, according to industry tracker HFR.

Since 2000, the industry has registered three negative years and average returns have declined. But money has continued to flood the industry because investors view them as a necessary, albeit expensive, part of their portfolio in good times, and even more so in the bad times, the investors, money managers and consultants said.

Hedge funds "offer really good diversification with low volatility," letting investors get access to a market niche or use a strategy they cannot do on their own, said Adam Taback, president of alternative strategies for Wells Fargo Private Bank, which manages $170 billion.

That may be why record inflows persist despite average returns of about 7.7 per cent through October, trailing the Standard & Poor's 500's 19 per cent rise at that point. It's the third year in a row that the industry has failed to keep pace with the US stock market.

Yet the industry experienced its highest inflows in more than two years in the third quarter, with investors sending over $23 billion of net new capital to managers during that period, according to HFR, a research firm.

"It's easy to look at hedge funds in a straight-up environment and say, "Who in their right mind would pay 2 and 20 and taxes?' But it was not that long ago, we had two big, economic events," said Stephen Martiros, an independent consultant to family office and private investors, referring to the 2008 financial crisis and the early 2000s recession.

"People still believe there's a lot of systemic risk globally," he said, adding that they think hedge funds perform better in choppy or down markets.

One high-net-worth investor in several brand-name hedge funds, including Third Point and Greenlight Capital, said he is content to see slightly lower average gains to avoid the "magnitude of downside of what an unlevered S&P index could do."

"Hedge funds may lag the market this year, but they are still profitable," he said, noting that they are generally avoiding drawdowns to keep compounding his returns.

Wells Fargo's Taback said there has been some "disappointment in the amount of upside capture" hedge funds have achieved this year, but investors don't think of them as straight equity substitutes and won't flee en masse simply because the S&P 500 is putting up "spectacular returns." The S&P 500 has climbed 26.6 per cent for the year so far.

HIGH FEES FOR ACCESS

Taback also said investors are happy to pay a premium for hedge fund managers focused on more obscure corners of the financial market, such as loan origination or structured credit, or that use a strategy like activism.

"Our view is that you use a hedge fund with all it's baggage - inferior liquidity, generally higher fees, frequently less tax efficient - only if there is a compelling investment thesis that cannot be properly executed otherwise," said Todd Petzel, chief investment officer of Offit Capital Management. "There are some of those certainly but the vast majority of funds out there fail our test."

Culverhouse Jr., the Miami-based investor, likes a small fund based in New York that invests in healthcare companies.

The high-net-worth investor with Third Point and Greenlight has money with mortgage specialist Metacapital Management. His managers "justify their fees because they're doing something extra and special that an individual cannot do on their own," he said.

Several money managers and investors said this week that they are wary of new alternative mutual fund products, which offer investors exposure to hedge fund strategies with lower fees and daily liquidity. A number of asset management firms, including

Blackstone, have launched these products, which are advised by a number of underlying hedge funds.

No hedge fund manager can form "a new fund with favorable fees, liquidity or other terms without disadvantaging its existing investors or cannibalizing its existing fund," said Michael Weinberg, a family office chief investment officer and a professor at Columbia University's business school. "They must, therefore, create a second-quality fund with no alpha short book and beta shorts or hedges."

He said these lower-cost hedge fund-like strategies are a "brilliant concept, but sadly a second-rate product."

But Josh Brown, CEO of Ritholtz Wealth Management, said even though these vehicles "may not always measure up to the best and brightest, let's be honest: How many people can really allocate to Ray Dalio?"

CHANGING PLACES

Martiros, the family office adviser, said that the question "is being asked more and more: Is the net return worth it?"

He said that for now, there is still a place for hedge funds in his clients' portfolios.

"Will there be a rush out of hedge funds? I doubt it. Will there be some trimming? Maybe. It might be more like swapping seats on the deck versus getting off the boat altogether."

Several money managers at the Reuters Global Investment Summit this week said investors will continue to invest, but will push for lower fees along the way, and they can use lower returns as leverage in those negotiations.

Wells Fargo's Taback said some strategies are under particular fee pressure, such as managed futures funds, which have been punished already by investor outflows.

"The fee pressure there is tremendous," he said.

Institutions like pension funds, which write checks for hundreds of millions of dollars, are increasingly negotiating a better deal for themselves, even with the industry's best-known managers.

"I think hedge funds' fees are still in a bubble," said short-seller Jim Chanos of Kynikos Associates. "The days of 2 and 20 are well behind us; investors have gotten a lot more sophisticated."

(Economic Times)