Hedge Fund Investing: A Conversation with Kevin Mirabile

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Introduction

Kevin Mirabile is a clinical assistant professor of finance at the Gabelli School of Business, Fordham University, where he teaches courses on the principles of finance, alternative investing and hedge funds. Professor Mirabile has enjoyed a long career spanning the investment industry and academia, with a focus on hedge funds and alternatives. He is also on author of a book on hedge fund investing. His book, Hedge Fund Investing: A Practical Guide to Investor Motivation, Manager Profits and Fund Performance, was originally published by Wiley Press in 2013 and is now in its second edition (2016). CAIA had a chance to speak with Professor Mirabile this summer about his perspective on hedge funds, where the jobs are for young people, and how the CAIA program fits in to the picture at Fordham.

How did you get started in alternative investments and what was your career path leading up to your teaching position at Fordham?

I started my career as a graduate from SUNY –Albany with a degree in accounting and economics. I went into public accounting with Arthur Andersen and quickly began to work on assignments in financial services clients. This was in 1983 and much of the work focused on small limited partnerships. At the time, they were not necessarily calling themselves hedge funds or private equity funds; they were simply part of the investment management practice.

After spending a few years at Arthur Andersen, I moved to Morgan Stanley and started a career in capital markets that lasted for almost for 25 years, with several prominent firms and job responsibilities ranging from sales and trading to financial control and risk management. Ultimately I developed products and services for the hedge fund sector. After Morgan Stanley, I went to Daiwa Securities and then sold that business to Barclays Capital and spent seven years there, running many of their balance sheet businesses and some of their listed derivatives, as well as their global prime brokerage business. Throughout this time, I continued to focus on servicing the hedge fund sector and was very fortunate to see the hedge fund industry go from nascent stages in the mid to late 1980s to its peak of over $3 trillion of assets under management in 2015.

After this long stint as a practitioner, I returned to school and obtained a Masters in international banking and finance and a Doctorate in finance and economics and began my teaching career. I became a full time member of the faculty at Fordham University in 2011, after spending several years running a hedge fund and fund of funds business while I was in school. I have been at Fordham ever since then.

For the students that you are teaching at Fordham now, what are some of the challenges they face in the financial world these days?

For students who want to understand hedge fund investing, it is important to develop a very strong baseline in securities investments and analysis, as well as market microstructure. Not every undergraduate program or even every graduate program offers the kind of deep analysis required to understand the dynamics of short selling, or capital structure arbitrage, or fixed income, or relative value. The students in my program are highly motivated self-starters who are excited by capital markets and securities analysis. I believe that you need to have a love for stocks and bonds first and then a passion for hedge funds can evolve from there.

At a practical level, students need access to data – Bloomberg, Preqin, and other financial and economic databases. They also need to read journals like CAIA's Journal of Alternative Investments. And they have to take advantage of professional networking opportunities. Since we are in New York, we have a wonderful alumni network and, in terms of our student base, there is a lot of sponsorship and interest for supporting education in alts.

However, it's still challenging for students coming in directly from undergraduate programs to get into hedge funds. Many of our students will work on the sell side first for a number of years in sales and trading, covering hedge funds, or in investment banking providing leverage to private equity firms – LBOs or MBOs. Over the course of their careers, they will navigate to positions in private equity and hedge funds. Many of these firms are boutiques and the young professionals need the underlying training that can be done by the sell side institutions before they join the alternative firms. This has been changing to a certain extent, as some of the large sell side firms have been cutting back and don't provide the level of education and training that they once did. So I am starting to see some firms hiring directly out of undergrad, but we often tell students these are a destination and it's a goal to end up in a hedge fund or other alternative investment environment; it may not happen right away.

Since you have had a long career and participated in many aspects of the investment business, what do you see as some of the major challenges in the industry now?

I just came back from a training course that I offered to institutional clients in US that covered this topic and it is a timely question. The hedge fund industry, like some of the other investment categories, but perhaps more so, is suffering from a number of challenges.

First, let's look at performance and performance expectations. Since the financial crisis, hedge funds have been underperforming, on an absolute basis, the almost 200% return that we have seen from the S&P 500 since 2008. All too often investors hold hedge funds accountable to nearly matching those types of returns, even though that is misguided, because hedge funds typically have a lot less risk than the S&P 500 – they have much lower annualized volatility, and you would expect them to have a lower return. Having said that, there have been a number of high profile exits – Calpers and NY State Pension fund, for example, have elected to close their hedge fund programs, largely due to the high fees and perceived underperformance.

This generation of hedge fund managers will have to explain, manage, and anticipate investor expectations and be sure that they are delivering what their investors want. In many cases, investors want absolute return, not relative return and then the level of absolute return becomes the issue. We used to say that hedge funds were expected to deliver 80% of equity return with 50% of the volatility – people used the phrase "stock-like return with bond-like volatility." While that is still generally the case, when you have large bull markets like 2013 and a 30% return from the stock market, you should not expect that hedge funds would perform at that level while keeping volatility muted.

Hedge funds have also experienced a number of unusual interventions over the past decade, like the Federal Reserve and central banks being involved in QE1, 2, and 3. A lot of the ability to identify the trends and leverage those trends that we used to see in global macro and CTA funds is diminished when you have government and central bank intervention, and that can change on a dime. For example, this spring we were looking at a June rate rise and now that has been pushed out to September or December, or maybe not at all. You have a lot of unanticipatable regulatory and central bank action that makes it that much more difficult for trend following funds to make a profit.

Even firms that are oriented towards credit or fixed income relative value have ben affected. When credit spreads are low, narrow, and stable, it is very hard to make money on volatility. And even up until to Brexit, the equity market volatilities were relatively low compared to history. So there have been a lot of headwinds against the hedge fund community as firms are trying to capture profits. Going forward, some of those headwinds may become tailwinds, but this has been the biggest issue in recent years.

The second major challenge is related to scalability and infrastructure issues. Hedge funds have gotten bigger faster and now 80% of the assets under managements are managed by funds with greater than $5 billion. Using rough numbers, the top 300-500 firms out of 10,000 control 60-70% of the AUM. So if you are not one of these very large firms, you will still be dealing with higher regulatory costs, higher compliance costs, better due diligence, and a need for improved infrastructure – all of that is expensive. This means there are economies of scale that the

Bridgewaters and Brevan Howards of the world have that the small managers with $100 million doesn't have, even though they will be held to the same standard in terms of creating institutional quality infrastructure. So scalable infrastructure is a big issue.

Finally, the third issue that has had a significant impact is the severe contraction of the Fund of Funds industry. At one point FOFs were providing 50% of assets that flowed from individuals and institutions to hedge funds. That is down to about 25% now and this has forced hedge funds to add larger distribution capabilities and figure out the best channels to market their funds. Retail and liquid alts are a big growth channel, but many hedge funds are not set up to offer '40 Act products. Identifying the appropriate channels and investing in product and business development elements in order to grow their AUM is another important area. This that will offset some of the contraction from the pension funds who have withdrawn, but they have to be successful at accessing new and emerging distribution channels and funding the business development efforts.

What do you think this means for young professionals and how does something like the CAIA designation fit into the picture?

Students of finance are often interested in alternatives, but they need to pursue the education and training proactively. Fordham offers a three-course concentration encompassing private equity, hedge funds, and real estate. This culminates in a capstone course on pan-alternative investments that follows the CAIA Level I curriculum. Students who are enrolled in our program are eligible to receive a scholarship to take the CAIA exam, since we are part of the Academic Partner program, and many students do sit for the exam. This has worked out very well.

In terms of career growth and where the jobs are – areas like collateral management, compliance, risk management have taken on a new level of significance and have to be added in size in many hedge funds. So when we see people obtaining jobs directly out of college, we see that the front office positions –equity research, portfolio management, and trading – are still jobs that require experience, but many of the middle and back office functions, including treasury, collateral management, risk management, securities lending, and technology, are all areas where students and young industry professionals have a lot of opportunities. They may also consider investor relations and client services, where there is a need to explain what funds do and maintain that "high touch" with investors who want to understand what is going on.

Let's turn to your book, since you have covered a vast amount of material on hedge funds there.

Yes, a number of the educational firms have been very interested in the book, including the CFA CAIA FRM and I have been happy with the uptake on this edition. The book was intended to provide a holistic understanding of the hedge fund investment process, so it covers why people invest in hedge funds, what the basic strategies are, and how to perform due diligence on individual fund managers. It is not intended to be a treatise on any one trading strategy, but rather it offers the entry level or recent grad working in the business a big picture view on the hedge fund investing world. Whether you might be a hedge fund allocator, service provider, or analyst, it is useful to articulate what the structure of the industry is. Readers have said that the book is very useful as a complement to organizations that are in the early stages of allocation of resources to hedge funds. It is a quick way to get up to speed on what is happening in the industry. A lot of financial advisors have also been interested in the book because they are now being held to the suitability standard, so some of the intermediaries that sell hedge funds have to have a deeper understanding to meet their fiduciary responsibilities. I also provide consulting and training to firms who want to learn about the industry and interest has been strong there as well.

Alternatives and hedge funds in particular are something that I love and I was fortunate to have seen some of the early movers and shakers in the industry – David Shaw, Donald Sussman, and Paul Tudor Jones, for example, when they were all just starting out; they were clients of mine and the companies that I worked for, like Morgan Stanley in the late 1980s. So I have had pleasure of seeing business grow from a kind of hobby for high net worth individuals to large-scale institutional firms. Now we even have integrated alternative investment shops too - they may offer private equity, hedge funds, and real estate all under one roof. In this evolution to the mega firm, with companies like KKR and Carlyle, there is a great convergence. It's an exciting time because firms that are single product, single distribution channel are still a boutique offering, but firms that offer multiple products and multiple investor channels are the wave of the future. However, moving from A to B is complex and you need a good strategy to get there. It reminds me of the time when traditional fund managers went down the path of going global and began incorporating derivatives in to their portfolios. Today you see big organization integrating alternatives into their portfolios – so there are lots of opportunities and challenges for all of us during this new period of change.

Bio

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Professor Kevin Mirabile, CPA, teaches finance at the Gabelli School of Business, Fordham University. He has more than 30 years of business development, regulatory, financing, trading and sales experience in financial services. He has developed a specialty in hedge fund business model risk assessment, including counterparty credit, liquidity and operational risk management.

From 2008 to 2011, he was COO and a member of the investment committee at Larch Lane Advisors. Prior to joining Larch Lane, he was COO of Orca Asset Management, a startup hedge fund and registered investment adviser. Professor Mirabile has held senior executive positions with Morgan Stanley, Daiwa Securities and Barclays Capital related to sales, trading, clearing and financing products, while based in New York, London and Tokyo. He is an author of Hedge Fund Investing: A Practical Guide to Investor Motivation, Manager Profits and Fund Performance (Wiley 2013, 2016). He belongs to the Greenwich Roundtable's Founders Council and is a contributor to its "Best Practices" series. He received his BS in accounting from the SUNY Albany, his MS in banking and finance from Boston University and his DPS in finance and economics from Pace University.