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The Hedge Fund Conundrum: Are Funds Meeting Investor Expectations Or Not?

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How is it that one day the headlines are filled with cautions over unmet expectations from hedge fund investments and the very next day we hear about record inflows and proclamations of $3 trillion in AUM by year end?

Clearly, some institutions, (think private funds and CALPERS), have been disappointed by the performance, fees, and impact of hedge funds on their overall business. Still others, (think liquid alternatives, hedged mutual funds, retail investors, and 401(k)s), are euphoric about the prospects of adding hedge fund strategies to their existing portfolios. While each of these views may represent the extreme end of the investor spectrum in terms of sophistication, product access, and experience with alternatives, understanding this potential contradiction is useful for investors who lie somewhere in the middle, between the biggest of the big and smallest of the small hedge fund investors.

What accounts for such different levels of satisfaction with hedge fund programs is the way in which investor expectations have been set for this type of investment.

One reason some institutional investors been disappointed may be that those investors set their expectations for future returns based on an overreliance of historical data obtained from commercial databases. Databases are filled with statistical bias and risk. Unlike the returns from the S&P 500, it is impossible to observe or predict returns from hedge fund investing. Not all managers report to the databases and there are anomalies like survivorship and other biases that tend to inflate hedge fund performance to the upside. Although the degree of disappointment may vary, setting your course or using a model to allocate capital based on inputs that are biased will almost always result in your arrival at a destination that is different from the one that you had intended.

Another reason for disappointment is that some investors believe that hedge funds should be compared to the S&P 500. When they fail to beat this benchmark they assume something is wrong. This expectation may have developed due to the fact that, for many years, the long-term performance of hedge funds did exceed the S&P 500 and delivered lower volatility at the same time, but hedge funds are designed to provide equity-like returns with bond-like volatility over a market cycle. They should not be expected to beat the equity market consistently, or during any single period of time. An additional problem is that hedge funds are not a homogenous investment or asset class, so comparing a hedge fund composite to a single equity index is like comparing apples to oranges.

A third factor leading to unmet expectations is the pursuit of funds that are charging the lowest fees. Some hedge fund investors want their equity-like return and bond-like volatility, but at the lowest possible price. That is not how things work. Premium returns, risk adjusted returns, or returns that meet or exceed expectations often come at a premium price. Seeking out managers who charge the least will likely lead to the poorest performance. Incentives matter. Since performance is measured net of manager fees, the price paid to managers should not really be a factor. Obtaining a net return of 7% should meet most pension plan targets. So why complain that the managers who generated the return were overpaid at, say, 1.5% and 15% in management and performance fees? This seems to be more political than economical. Is it better to reallocate to other investments at a lower net return, or with more risk, or greater volatility because they charge lower fees? Remember, the best hedge funds, those that charge the highest fees, have often been associated with outperformance on a net of fee basis!

Why do so many other investors appear to be less disappointed with hedge fund returns, at least based on capital inflows to the category? Why are they piling into the asset class just when some of the biggest names are retreating, or taking a pause? Well, perhaps these investors are more interested in absolute returns and still look favorably on hedge funds and their promise of generating a T-bill plus 500 return or 5%-7% per annum, with 6% volatility or less. After all, this return and risk profile is very attractive relative to the expectation of a zero return on cash, negative return on bonds, and the fear of a 10%-20% equity market correction. Many high-net-worth individuals and even retail investors and their advisors are more focused on downside risk protection than Sharpe ratios or beating the S&P 500. Hedge funds traditionally lose less in falling markets. The worst-case drawdown and other downside measures of risk make hedge funds look very attractive relative to equities in almost all time frames and certainly relative to the forward outlook for bonds in a rising rate environment.

If you step away from the hype on both sides of the market, you will see that hedge funds are growing at a very healthy pace. Transparency is improving and performance is meeting expectations more often than not. Many, if not most investors are satisfied with the products they have purchased and the choices they are making. Even Bill Gross has changed from managing money to a traditional benchmark to a hedge fund-like unconstrained style of investing. Certainly things can get better and old expectations and beliefs need to be challenged, and certainly there is room for improvement, but it is not all doom and gloom.

Many investors believe that hedge funds are integral pieces of the portfolio construction process. They are neither disappointed, nor euphoric. Perhaps, they are just practical, thoughtfully examining individual managers and making choices on how any one manager or group of managers can help them to meet their objectives. They are fee-conscious, but focused more on value than headline manager compensation. They use funds of funds to gain diversified exposure where it makes sense, or hedged mutual funds to get some additional transparency, liquidity, and regulatory oversight. They enjoy it when hedge funds outperform the S&P 500, but they don't expect it.

For me, the outlook and process related to hedge fund investing is changing and they way in which investors form expectations needs to evolve. The world of finance rarely stands still, and the expectations and the tools used to formulate them need to evolve as well. I have no doubt that they will, but only time will tell. Are hedge funds meeting investor expectations – I guess it depends on whom you ask!

Author Bio

Kevin Mirabile is currently a Clinical Assistant Professor of Finance at Fordham University where he teaches courses on the principles of finance, alternative investing and hedge funds. Mr. Mirabile has over 30 years of business development, regulatory, financing, accounting, trading and sales experience in financial services dating back to 1983. He is an author of a book on hedge fund investing entitled, "Hedge Fund Investing: A practical guide to investor motivation, manager profits and fund performance" published by Wiley Press, January 2013 and is an active industry consultant on the topics of hedge fund investing, operational and business model risk assessment. Mr. Mirabile is a C.P.A., a member of the A.I.C.P.A., and a member of the Greenwich Roundtable's Founders Council as well as a contributor to its "Best Practices" series. Mr. Mirabile received his B.S. in Accounting from S.U.N.Y Albany in 1983, his M.S. in Banking and Finance from Boston University in 2008 and completed his doctoral studies with a D.P.S. degree in Finance and Economics from PACE University in May 2013.