Fundana
ASSET MANAGER

On Movies and Hedge Funds

Have you ever left the cinema utterly disappointed? Despite the film starring your favorite actor, it left you completely cold. You were never convinced, too conscious of the acting to immerse yourself in the story. How many actors have gone through tough patches with little creativity or mojo? Yet despite a significant difference between their best and worst performances, you continue to go to their new movies, right? So the question is, why should it be any different for your Hedge Fund allocation?

▪ First Scene: Dispersion Of Returns, A Little-Known Challenge

We often hear from investors that Hedge Funds do not work. That the returns of this "asset class" are no longer attractive and that the risks do not justify an investment. Are these investors honest with themselves? Many of them ignore a central feature of Hedge Funds: the dispersion of returns. The difference between the best and worst managers is huge and makes manager selection critical for a successful investment.

As can be seen from the chart below, the difference between the best and the worst Hedge Fund managers is on average 47% per year! This is more than twice that of traditional asset classes such as US Large Cap funds at 15%, or US Small Cap funds at 20%. In addition, this dispersion is not stable through time and increases during and after crisis periods. In other words, even if your index finishes up in a given year, your portfolio could generate a negative performance simply due to poor manager selection.

Even amongst investment professionals, the size of this challenge is poorly recognized. And so, when someone tells you that Hedge Funds do not work, I would bet you that implicitly he is talking about his poor manager selection.

Many think they can avoid that problem by just selecting the best performing funds over the last few years, just like you select the next movie you will see because your favorite actor is in it. But this ignores the fact that manager performance is also not stable through time. This approach typically generates more deception than added value!

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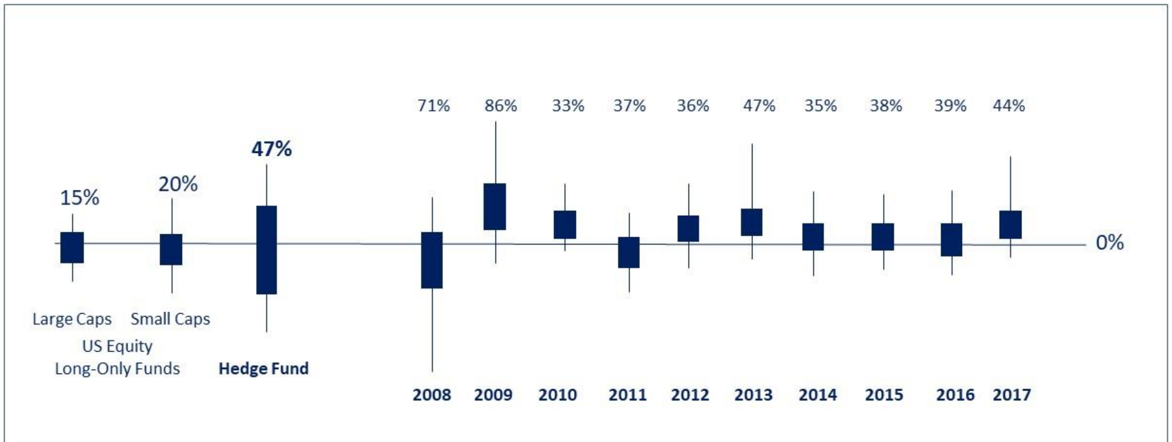
Dispersion of Hedge Fund Returns



Sources: Fundana; Morgan Stanley Hedge Fund Trends
Notes: Dispersion = 95th percentile return – 5th percentile return for a given year

▪ Suspense: Who Will Take Home An Oscar?

What to do then to find the ten award-winning managers amongst the ten thousand funds which are out there?

Our advice is for you to find an advisor, *but* (…and that this the key word), with a real track record in terms of performance. In other words, a person or a fund or an entity which can prove to you that they have real added value and that it is repeatable. Unfortunately, these advisors or managers are becoming scarce because Hedge Fund manager selection is simply very hard! If, prior to 2008, most advisors just provided access to Hedge Funds, this is no longer enough given all the databases now available to pick managers. Hedge Fund manager selection is hard because these managers' performances are not stable through time and need to be dissected constantly. How much of the return is coming from beta, how much from alpha? How much is coming from the long side and from the short side? You systematically need to convince yourself that the advisor's performance is the result of a process (i.e. skill) and not of luck to ensure a repeatable process. And this is just to name a few of the characteristics to carefully analyze. But this should not be a surprise: after all what is a Hedge Fund other than unconstrainted portfolio management?

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▪ Happy Ending: Dare Getting Help!

To end up happy with your Hedge Fund allocation, you need to clarify *ex-ante* your objectives. If most investors are looking for decorrelation, one should note that this is not easy to obtain, analyze and explain. Monitoring how alpha is generated in a convertible arbitrage or volatility arbitrage strategy, for example, is just not that easy for every investor.

So why not start with a strategy which is more accessible, that performs and where return sources are clearly identifiable? The Equity Long / Short strategy meets all of these criteria. Even better: today's market conditions are ripe for great returns in the strategy *(high equity market valuations, risk of market correction, good environment for stock picking)*.

In 2017, the HFRI Equity Hedge index was up +13.3% YTD (the hardest index to beat given some of the biases imbedded in it by the way) and the best Funds of Hedge Funds dedicated to this strategy matched that performance. Even better, so far this year managers have been able to add 1% of alpha in January as well as February. But again, make no mistake. There are about 5,000 Equity Long / Short managers in the universe and the key is in finding the best ones (remember the dispersion). So, to ensure a happy ending, just like when going to the movie, why not get some help: read the critics and look for an advisor!

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