What do Winston Churchill, Niki Lauda, the Internet and Hedge Funds have in common?

Winston Churchill, 1874 - 1965

At first, it would seem not much! However, after thinking about it, you quickly realize that Winston Churchill, Niki Lauda and the Internet have changed the world. What's more, while they are now regarded as visionaries or starting a new era, each of them had to fail before becoming truly recognized. Indeed before becoming the second world-war historical figure that we know, Winston Churchill suffered a major setback in 1915 when he sent more than 20'000 soldiers to their demise in the Dardanelles. Niki Lauda endured a near fatal race accident at the 1976 German Grand Prix at the Nürburgring before winning his next two world championships and improving car safety forever. The internet bubble first collapsed in 2002, before the web changed the way we live permanently.

A second chance for Hedge Funds

Hedge Funds are going through a similar phase. Indeed 6 years after the 2008 crisis, worldwide Hedge Fund Assets-Under-Management are at an all-time high with $2.6Trn (source Hedge Fund Research) and alternatives may change forever the way we invest! Why? Because pension funds must find alternatives to traditional portfolios and above all, reduce their bond allocation. And while the stock market comes as a first replacement solution, the dramatic volatility of this market has frightened more than one investment committee. Indeed stocks have *halved* not just once but twice over the last decade! As a result, investors are looking for alternatives and Hedge Funds version 2.0 are becoming a must in institutional portfolios. Whether because they improve the return-risk profile of bonds or equities, or because they provide an uncorrelated return stream. After a major setback in 2008, the Hedge Funds industry has learned from its mistakes and is coming out from the crisis stronger!

What is foreign does not necessarily have to be strange!

However for many investment committees who decide to venture in the alternative space, it is not easy for them to determine which strategies to choose from. How to decide between Private Equity, Infrastructure, Insurance Linked Securities, Hedge Funds, and Commodities? Not to mention more esoteric strategies such as Timber, Microfinance, Crowdfunding, and Movie Financing! For more than one investor, these strategies appear complex and akin to black boxes. In short, because they do not understand them, these strategies appear strange to investors. A safe and common sense approach is to start with strategies that investors can understand "easily" and that are in liquid in case they want to change their allocation. The Equity Long / Short strategy in Hedge Funds can be a good start. Indeed, typically most committees understand fundamental stock investing given their allocation to long-only equity strategies. The extension on the short side is intuitive: trying to benefit from a stock correction which could be the result of a company, for example, missing its earnings consensus forecast, being too aggressive in its strategy or worst, a fraud. Hence, it does not take much for a committee to grasp the essence of this strategy. And what's more, most professionals invested in Equity Long / Short think of their investments, not as investments in Hedge Funds but as a complement to their overall equity allocation (even if for legal purposes, a hedge fund investment must be classified as alternative). Equity Long / Short is thought of as a management technique providing asymmetric returns: capture as much as the market upside as possible while limiting losses during market corrections. Over the long-run, this provides equity returns *but* with half of the equity markets volatility and drawdowns! In addition, since equity markets are one of the most liquid markets in the world, this strategy is by nature very liquid. And as we know, liquidity is important since it gives us the option to be wrong!

Building Trust

Finally, it is probably not a bad idea to start small when going into new investments. By small, we mean literally just a couple of percent. Yes this will not make a big difference to the portfolio bottom line performance. However, this will enable the investment committee to learn how a strategy and a product react during different market cycles. This common sense approach is used in many other fields. For example, it is well known in medicine under the term *hormesis* and is in fact the basis for vaccine. A small toxin dose enables the body to build its immune response while a bigger dose could be fatal. Many wise investors recommend investing only in what you understand and in small amounts to begin with. Thus, by *gradually* increasing an allocation to an alternative strategy enables two crucial things that each pension fund is looking for: understanding its investment while avoiding the risk of ruin and building trust!

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