Seeking Alpha

Portfolio Strategy

Be Thankful You Don't Have Access To Hedge Funds

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Summary

- The exclusive nature of hedge funds, available only to institutional and wealthy (accredited) investors, makes many small individual investors wish they had access to this exotic asset.
- Over the last 10, 15, and 20 years, an exposure to global stocks (bonds) of 31.0% (69%), 24.5 (75.5.%), and 23.7% (76.3%), would have matched the volatility of hedge funds while producing higher returns.
- Gold has provided more downside protection than have hedge funds.
- Hedge fund performance has deteriorated over the past 20 years as markets became more efficient and their trades become more crowded.
- Individual investors do not seem to have much of a reason to cry for lacking access to hedge funds.

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Be Thankful You Don’t Have Access to Hedge Funds

> *Hedge funds are investment pools that are relatively unconstrained in what they do. They are relatively unregulated (for now), charge very high fees, will not necessarily give you your money back when you want it, and will generally not tell you what they do. They are supposed to make money all the time, and when they fail at this, their investors redeem and go to someone else who has recently been making money. Every three or four years they deliver a one-in-a-hundred year flood. They are generally run for rich people in Geneva, Switzerland, by rich people in Greenwich, Connecticut.*

— Cliff Asness

The exclusive nature of hedge funds, available only to institutional and wealthy (accredited) investors, probably makes many small individual investors wish they had access to this exotic asset. As you review the evidence you will see that they don’t know how lucky they are that they don’t have access.

William Bernstein, author of the minibook " Skating Where the Puck Was: The Correlation Game in a Flat World," examined the returns of hedge funds, applying a three-factor analysis to the Hedge Fund Research Global Returns series for the period 1998 through 2012. Bernstein found that while hedge funds did produce large alpha in the first third of the period, as investor assets chased those returns, alpha shrank and then turned negative. From 1998 through 2002, hedge funds produced an incredible alpha of 9.0%. However, from 2003 through 2007, their alpha went to -0.7%. And from 2008 through 2012, the alpha became -4.5%. The performance of hedge funds deteriorated as competition increased and their trades became crowded. Keep this in mind as your review the results over the last 10, 15, and 20 years.

Javier Estrada, in his paper " No Hedge Funds, No Cry," examined the performance of hedge funds over the 10-, 15- and 20-year periods ending in 2020. His sample consisted of the HFRI Composite Index of hedge funds, (a different index than the aforementioned HFRX Index), the S&P 500 Index of U.S. stocks, the Bloomberg Barclays U.S. Aggregate Index of U.S. investment-grade bonds, the MSCI ACWI Index of global stocks, the Bloomberg Barclays Global Aggregate Index of global investment-grade bonds, and gold prices. Following is a summary of his findings using U.S. equities for the comparison with stocks and U.S. bonds in a 60-40 portfolio:

- Over the last 10-year period, the annualized return of hedge funds (4.2%) was far lower than that of stocks (13.9%) and a 60-40 strategy (10.0%), albeit with lower annualized volatility (6.1% for hedge funds versus 13.5% for stocks and 8.0% for the 60-40 strategy). They also produced lower risk-adjusted return than both stocks and the 60-40 strategy (0.20 compared to 0.30 and 0.36, respectively).

- Over the last 15 years, hedge funds underperformed stocks and the 60-40 strategy in terms of return (4.7% versus 9.9% and 8.1%), though they exposed investors to lower volatility (6.6% versus 15.1% and 9.0%). In terms of risk-adjusted return, hedge funds underperformed the 60-40 strategy and slightly outperformed stocks (0.21 compared to 0.27 and 0.20).

- Over the last 20 years, hedge funds again underperformed both stocks and the 60-40 strategy in terms of return (5.5% versus 7.5% and 6.9%) but again exposed investors to lower volatility (6.3% versus 15.1% and 8.8%). Over this period, on a risk-adjusted basis, hedge funds outperformed both stocks and the 60-40 portfolio (0.26 versus 0.16 and 0.23). Keep in mind that the performance deteriorated as their assets under management increased. Over the last 10, 15, and 20 years, portfolios with an allocation of 44.8%, 42.9%, and 42.3% to stocks matched the volatility of hedge funds and produced a higher return.

Estrada also examined the downside protection provided by hedge funds. Following is a summary of his findings:

- Over the worst 12 months during the 20-year period, the average loss was -9.9% for stocks, -5.6% for the 60-40 portfolio, and -3.2% for hedge funds. Gold averaged a gain of 1.5%, providing superior downside protection to that of hedge funds.

- Over the worst six quarters during the 20-year period, the average loss was -16.8% for stocks, -8.2% for the 60-40 portfolio, and -6.9% for hedge funds. Gold averaged a gain of 5.4%, providing superior downside protection.

- Over the worst four calendar years during the 20-year period, the average loss was -18.9% for stocks, -8.9% for the 60-40 portfolio, and -5.2% for hedge funds. Gold averaged a gain of 7.9%, providing superior downside protection.

Estrada noted that the superior downside protection of gold relative to hedge funds should not have been surprising because, although hedge fund managers typically stress their goal of delivering uncorrelated returns, the correlation between hedge funds and stocks was a very high 0.89, 0.85, and 0.83 over the last 10, 15 and 20 years. On the other hand, the correlation of gold to stocks was 0.08, 0.06, and 0.04.

International Evidence

Estrada also examined the performance using global equities for stocks and for the 60-40 portfolio. Given the very poor performance of international equities over the last 20 years (over the period 2001-2020, while the S&P 500 Index returned 7.5% per annum, the MSCI EAFE Index returned just 5.0%), it is not surprising to see that hedge funds performance looks somewhat better when a global equity portfolio is the benchmark:

- For the 10-year period, hedge funds underperformed, producing a risk-adjusted return of 0.20 versus 0.21 for global equities and 0.23 for the global 60-40 portfolio.
- For the 15-year period, hedge funds outperformed, providing a risk-adjusted return of 0.21 versus 0.16 for global equities and 0.19 for the global 60-40 portfolio.
- For the 20-year period, hedge funds outperformed, producing a risk-adjusted return of 0.26 versus 0.14 for global equities and 0.19 for the global 60-40 portfolio.
- Over the last 10, 15, and 20 years, an exposure to global stocks of 31.0%, 24.5%, and 23.7%, with the rest in global bonds, would have matched the volatility of hedge funds and produced higher returns.

His findings led Estrada to conclude: *“Individual investors do not seem to have much of a reason to cry for lacking access to hedge funds.”* He added that his conclusions were unchanged using the asset-weighted returns of hedge funds. It’s important to add that the underperformance of hedge funds is even before accounting for their lack of liquidity (for which investors should require a risk premium) or considering their lack of transparency.

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