



Do Institutional Investors Affect Hedge Fund Performance?

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Has the growing presence of large institutional investors in the hedge fund market had negative performance implications for hedge funds?

That was the question when Jim McGovern, AIMA Canada's founding chairman and managing director & CEO of Arrow Hedge Partners Inc., squared off in a debate with Chris Guthrie, CEO and founding partner of Hillsdale Investment Management Inc.

McGovern argued that the presence of large institutional investors in the hedge fund market has had negative performance implications for hedge funds. Guthrie argued that the opposite was true, their presence has not had negative performance implications.

What follows is an abridged version of the comments made.



Jim McGovern

Founding Chairman
 AIMA Canada's
 Managing Director & CEO
 Arrow Hedge Partners Inc.

Let's begin by defining institutional investors as those good folks who run our pension funds, endowments, and, of course, funds of hedge funds. This group of investors directly or indirectly represents more than 60 per cent of the capital in hedge funds today and has been the single biggest driver of demand for hedge funds over the past five years.

It is no secret as to why institutions are interested in hedge funds with inflation and real yields where they are today. They simply cannot meet their future obligations and that must be a terrifying proposition. Portable alpha, or virtual free return, certainly sounds like a wonderful solution, so, not surprisingly, institutions are moving en masse to the siren call.

But what is the upshot of all this activity?

The elephants are leaving very large footprints on the industry and creating a rather messy situation that will eventually need to be cleaned up. In particular, they are stomping out the very thing they are looking for — alpha.

Let's look at some examples of these investors at work.

Convertible bond arbitrage was a very popular strategy in the '90s. In the early days, there was truly free money to be made as the arbitrage was as wide as a 747.

But, as expected, the big money poured in. The big brokers were very happy to issue lots of new paper to meet the demand of hedgies flush with cash. Companies also found this form of financing cheaper than issuing stock or debt outright. The new convertible bond



Chris Guthrie

CEO and Founding Partner
 Hillsdale Investment
 Management Inc.

In arguing that the presence of large institutional investors in the hedge fund market has had negative performance implication for hedge funds, first, Jim (McGovern) must prove that hedge fund performance has, in fact, declined.

Secondly, and most importantly, he must prove beyond doubt that this decline can be directly and causally attributed to a growing institutional presence in the hedge fund market.

For my first point, I would like to take you back to June of 2002. Celine Dion was busting up the charts with 'A New Day Has Come;' Nortel had just paused at \$3.23 down from \$123; and Cisco had just hit \$14, down from \$74. Many, many hedge fund managers, including some very good ones, were on the wrong side of these trades.

For example, in June 2002, Soros Management, the hedge fund titan, was toppled by bad technology bets. It lost four top level managers, announced plans to lay people off, and said it would revamp its structure.

"We have come to realize that a large hedge fund like Quantum Fund (which saw its assets drop significantly) is no longer the best way to manage money,"

Soros wrote in a letter to shareholders in April of 2002. "Markets have become extremely unstable and historical measures of value at risk no longer apply." He also said he was revamping the company to take a more conservative posture.





McGovern continued

issue would open up five points, the stock hedge went on, add in a dollop of leverage, and, together with falling interest rates – VOILA! – instant alpha.

However, when volatility started hitting new lows and issuance dried up along with performance in early 2005, this caused a stampede out and overnight those very pretty return profiles looked pretty awful.

So where are the elephants hiding today? They are in event driven strategies where the CDS issuance has ballooned in size. Notional versus the cash market is at some lofty multiple that we cannot even measure. The vast majority of these strategies are short volatility and sensitive to credit spreads at a time when both are at historic lows.

Ed Altman, of NYU's Stern School, points out that Delphi's bonds rallied 20 points following its bankruptcy announcement as CDS holders scrambled to buy the busted paper to deliver for payment. This is a new twist on the short squeeze – and an undisclosed one at that!

In terms of classic merger arbitrage, the capital flows have compressed spreads so much that the cost of deal break risk is too high.

We can also look at the impact of institutions via the huge bifurcation going on in the hedge fund market today.

The big institutions need big hedge funds so that they do not become too large a part of a manager's capital base. Guess what, the big keep getting bigger and the performance keeps falling. This is not a case of lack of expertise or skill gone missing, but simply the law of gravity at work. It does not take much of a leap of faith to understand that these behemoth funds are lacking a key hedge fund return driver – flexible or managed beta. Size is an impediment to trading credit, volatility, commodity, and other risks.

Institutional investors have also impacted the psyche of managers. Their demands for monthly consistency, no down periods, and full transparency have definitely come at the expense of excess return.

As these giant FOFs have stumbled, those other bastions of the institutional world – the indexers – have decided that the fees have gone high enough and it is now time to index our alpha. Literally billions and billions have flowed to S&P, HFR, MSCI, and the others as decision-making in the hedge fund allocation world hits a new low – let's make passive decisions on these active managers. Let's not kid ourselves, many in the institutional world fear the reputational risk of hedge funds and are more than happy to leave it to the pros at S&P and MSCI to do their jobs. And, yes, mediocrity is the result.

This institutionalization of the market continues to have a tremendous impact on the type and nature of managers coming into the business. Because institutional investors are so focused on low volatility and low correlation strategies, managers are encouraged to aim for lower, steady returns in line with those demands. To quote Michael Steinhardt, who has been in the hedge fund business for close to 40 years: "When I became a manager, the industry attracted people who perceived themselves as exceptional. They were paid large amounts to produce exceptional returns. Now it is much more a money game ... Managers avoid possible superior performance for fear of cracking the golden egg." Steinhardt's hedge fund world is one where "wisdom, judgment, and understanding" are the keys to success – not standard deviation, skew, or kurtosis. ■

Guthrie continued

The question is: 'Did Soros take on a more conservative posture because of his growing institutional asset base?'

I offer a different explanation – that human frailty, business and personal preservation, past performance, and competition will always drive risk budgets, and that because of these factors, in 2002 risk budgets for hedge funds were driven down to levels from which we are only now recovering.

For my second point, I would like to refer to the experts.

I do this because I have never met a manager who could not explain his poor performance through some combination of unpredictable events – currency movements, too much volatility, not enough volatility, bad volatility, intermittent stochastic volatility of random frequency, and variable amplitude. Increased institutional participation is just another of those 'lazy' answers.

According to most experts and analysts, a rigorous 10 to 15 year analysis of the determinants of hedge fund performance yields the following principal components (principal components is a statistical technique used to reduce dimensionality, and isolate the true determinants and weed out the noise) of hedge fund returns:

- ◆ performance of the S&P 500
- ◆ small cap return net of large
- ◆ change in the yield curve
- ◆ change in credit spreads
- ◆ straddles on bond, currencies, and commodities

According to the experts, these seven principal components explain 88 per cent of the returns of the HFR Index.

Wouldn't these smart people have mentioned 'the growing presence of institutional investors,' if it had been relevant?

My third and final point simply reinforces my first two.

The 2005 *Goldman Sachs Fund Investor Survey* shows that last year, equity hedge and event-driven strategies experienced their largest year-on-year increase in allocation. They now account for 33 per cent and 13 per cent of total investment in hedge funds respectively, up from 26 per cent and eight per cent respectively. Equity long/short and global macro strategies are expected to see the greatest increase in capital allocation in 2006 on an asset-weighted basis.

The AIMA primer contains data on correlations of hedge fund indices with U.S. equity and world indices. Among eight major indices, the highest correlations to equity markets are reserved for equity hedge and event driven strategies both being greater than 65 per cent.

More than one-half of respondents are investing or looking to invest in alternative products other than hedge funds. Almost one-half are favouring private equity while 42 per cent favour absolute return long only products.

The *Investor Survey* goes on to say that "Market neutral strategies now account for two per cent of respondents' hedge fund investments, down from 12 per cent in 2003 while exposure to convertible bond arbitrage is only four per cent on average, down from 13 per cent in 2003 peak levels. Short selling remains below one per cent.

After almost four years of continuous up markets, the risk budget of choice for a hedge fund investor is finally rising. This is the largest determinant of hedge fund performance and far outweighs the growing presence of large institutional investors. ■