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INVESTMENT MANAGEMENT

Hedge Fund "FOMO"—Looking Beyond the Benchmarks

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With relatively high equity valuations and rate pressure on bonds, the value proposition for hedge funds has become increasingly positive. While we envision a reasonably benign economic and market environment, we believe that global equity and bond markets will be hard-pressed to continue delivering the strong returns they have in the recent past.

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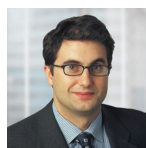

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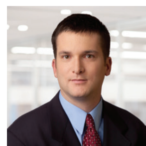

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Equity markets are broadly expensive and susceptible to weaker-than-expected earnings growth going forward, and extremely low government bond yields and tight credit spreads pose significant headwinds for fixed income. Meanwhile, strong shifts in consumer behavior and business models, coupled with powerful fiscal and monetary influences, are likely to lead to meaningful performance dispersion among companies. In this environment, we believe that skill-based absolute return strategies are well-positioned to continue prospering.

Not only is the outlook for hedge funds favorable, but recent industry performance has been historically strong. The global pandemic is creating numerous dislocations and opportunities for fund managers. Hedge funds, as represented by hedge fund index data, have generated more alpha in the last year than in any 12-month period in the last decade. The HFRI Fund Weighted Composite Index is up an eye-popping 30% in the 12-month period through May 2021. The HFRI Fund of Fund Composite Index, which is more conservative than the Fund Weighted Composite Index, is up 20% over the same period.

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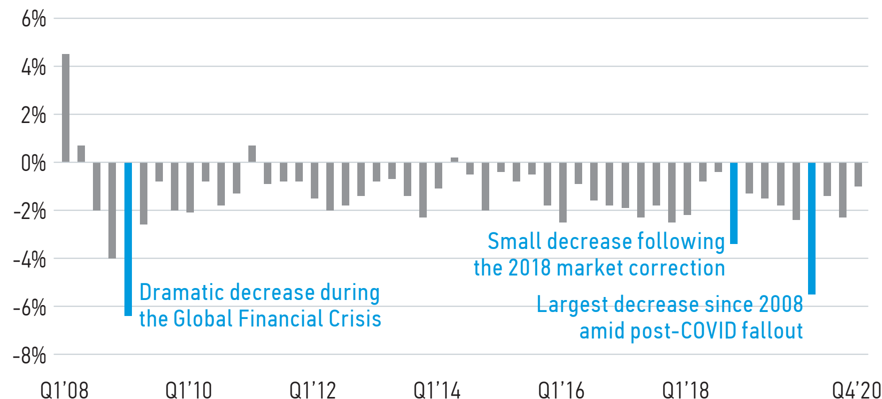
DISPLAY 1

Historical Constituent Fund Count in the HFRI Fund of Funds Composite Index

FoF Count % Change (Quarterly)



Source: Hedge Fund Research Inc. as of June 30, 2021

So why aren't all hedge fund portfolios up over 20%? If you are holding a diversified portfolio of hedge funds, it has likely performed well recently, but not to the level we have seen for the indexes. Relying solely on industry benchmarks to contextualize individual portfolio performance and extrapolate future trends can be frustrating and misleading. Here's why:

1. Hedge fund indexes are not representative of the full universe of hedge funds. Many indexes are self-reporting, which means they are vulnerable to survivorship bias. In other words, only the strong survive and report their performance.

2. The majority of hedge fund indexes, unlike their traditional market peers, tends to be non-investable. They do not necessarily reflect an experience an investor can obtain.

3. Hedge fund indexes do not share a consistent methodology. They can be asset-weighted, equal-weighted or strategy-weighted. Depending on an index's composition and concentration, comparing performance of the same portfolio of hedge funds to each index type could yield dramatically different results.

4. Hedge fund indexes are not necessarily market neutral. In fact, many of the broad hedge fund indexes are highly correlated to equity markets and benefit significantly in bull markets.

For the purposes of this article, we will examine Hedge Fund Research (HFR)[1] indexes. HFR is one of the leaders in hedge fund index reporting and analysis, and in our experience, it is the one most often used by hedge fund investors to benchmark their portfolios. However, the biases in the indexes we are describing apply to many other industry index providers as well.

1. Survivorship/Selection Bias

The key motivation for a hedge fund to report its performance to an index is to market itself. Subscribers to the HFR database are looking into the database to find candidates for investment. Therefore, there is little reason for a hedge fund to continue to report poor performance to the database provider, and there is certainly no incentive to report catastrophic results.[2] Hedge funds that get off to a bad start will not choose to report their performance, while those that have fantastic starts will be eager to provide it.

These biases can be strongest around market inflection points. A market dislocation can damage many funds, while the subsequent recovery can boost many newly launched funds into a rally. We can see evidence of this in the fund count of the HFRI Fund of Funds Composite Index. Fund of fund indexes are less subject to selection/survivorship bias given they are more diversified and less prone to large swings in performance. Additionally, the underlying funds held by the fund of funds are compelled to report to the fund of funds because it is an investor. Nonetheless, even with fund of funds, we see that periods with the greatest number of drops occur during large market sell-offs. *Display 1* shows fund count by quarter, as reported by HFR.

[1] www.hfr.com

[2] It should be noted that there is little motivation for a hedge fund that is doing exceptionally well and is therefore closed to new investors to report to a database provider. We find, however, the overall effect is toward overstating performance.

2. Dispersion Between the FOF Index and Hedge Fund Investable Indexes

HFR does produce an investable index family called HFRX that is not impacted by self-reporting-related biases. Underlying constituents are obligated to report their performance. Given this, they can help approximate the impact of bias in non-investable indexes.[3] The HFRX Global Hedge Fund Index returned 6.8% in 2020, trailing the HFRI FOF Composite Index by more than 4%. At Q1 2021, the 12-month return dispersion was even wider, with the HFRX Global Index trailing the HFRI FOF Index by 7.8%. *(Display 2)*

3. Dispersion Between Asset-Weighted and Fund-Weighted Indexes

The indexes most often used to evaluate funds of hedge funds are equal-weighted. In such indexes, small, niche funds have the same weight as large funds, which is not indicative of what "the average" hedge fund investor would likely experience. While HFR does not provide an asset-weighted FOF index, the impact of fund weighting can be seen in its hedge fund indexes. For example, for 2020, the HFRI Asset-Weighted Index returned 2.2% versus 11.8% for the HFRI Fund-Weighted Index. This variance of 9.6% between the two indexes was the largest on record through 2020 and has continued to widen in 2021. *(Display 3)*

DISPLAY 2

Historical Performance Spread Between HFRX Global Hedge Fund Index and HFRI FOF Composite Index

12m Return Spread

Source: Hedge Fund Research Inc. as of June 30, 2021

DISPLAY 3

Historical Spread Between HFRI Asset-Weighted Index and HFRI Fund-Weighted Index

12m Return Spread

Source: Hedge Fund Research Inc. as of June 30, 2021

[3] Though we must also acknowledge that willingness of fund to participate as a constituent of an HFRX index is itself another form of selection bias.

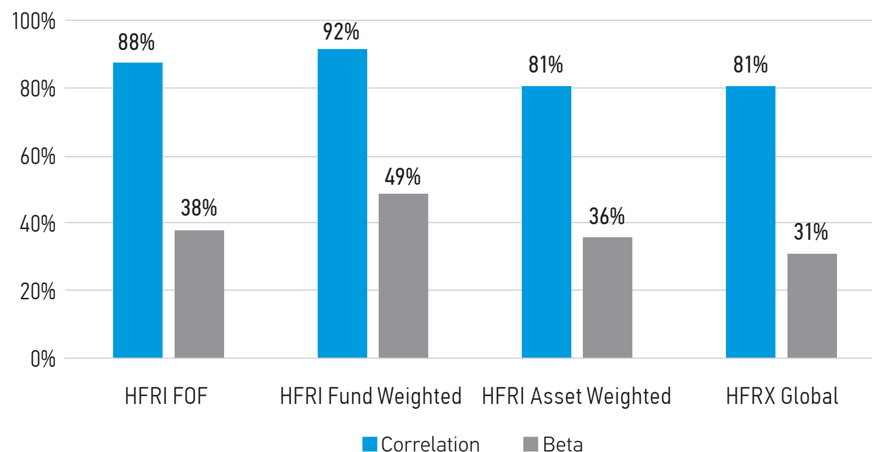
4. Correlation to Equity Indexes

Hedge fund indexes can be highly correlated to equity markets and thus exposed to higher-than-expected levels of market risk. The investable hedge fund universe, however, is very heterogenous, with many defensive and market-neutral strategies. Understanding this may be particularly relevant for investors seeking risk mitigation or meaningful returns that are uncorrelated to the broader equity markets. The HFRI FOF Index has often been highly correlated to the MSCI AC World Index, running at a correlation of 0.88 over the last three years *(Display 4)*. Going back to the beginning of 2008, the MSCI AC World Index had its largest 12-month return at 52% through 3/31/2021. Unsurprisingly, we saw strong returns from the HFRI FOF Index over that same time frame from beta alone. While this correlation can be beneficial in bull markets, it can also lead to periods of underperformance, such as in Q1 2020 when the MSCI AC World was down 20%. In addition to correlation, it is important to consider the beta of the hedge fund index relative to equity markets. For example, recently, the HFRI FOF Index has run at a beta just shy 0.4 to the MSCI AC World Index. For an investor seeking a market-neutral portfolio, this may be a higher-than-desired beta profile.

DISPLAY 4

36-Month Correlations and Betas of Hedge Fund Indexes to MSCI AC World Index

36 Month Correlation & Beta to MSCI AC World



Source: Hedge Fund Research Inc. as of June 30, 2021

Beyond Benchmarks

Despite the shortcomings we have described, we do believe hedge fund indexes can provide useful relative information. For instance, if your portfolio of hedge funds normally exhibits correlation to a given hedge fund index, and if over a given month or quarter your portfolio zigs while the index zags, this suggests that your portfolio has done something materially different from the index. This could be a good thing. But it could also indicate unintended concentrations and/or exposures, which an investor would be wise to investigate.

We therefore recommend some complementary monitoring approaches investors can use to evaluate the performance of their portfolios:

1. **PEER ANALYSIS**—A simple consideration should be done to compare the portfolio with investable hedge fund indexes and/or peers. This will provide a direct representation of performance.

2. **BETA TARGET LEVEL**—An investor should consider the portfolio's target beta. If its beta is significantly different from that of the FOF index being used as a proxy, then it would be difficult to make a like-for-like comparison. For example, if a provider's beta is intentionally targeted lower than the index against which it is being compared, then it shouldn't be unduly penalized for "underperformance" in a rallying equity market.

   If a provider is targeting 0.2 beta to the equity market, and the market is up 10%, one would expect a 2% return to be realized. If the index is running at a 0.4 beta to equities, then the expected return would be 4% in that 10% equity market. Keeping with this example, if the provider's actual return was 2.5% and the index returned 4%, then the provider realized 0.5% of alpha to outproduce its beta-expected return of 2%. Meanwhile, the index would have realized no alpha, as the actual return was in line with its beta-expected return. In this scenario, the FOF index outperformed on an absolute basis, but on a beta-adjusted basis, the provider actually outperformed the index. As beta can be more cheaply sourced outside of hedge funds, it is important for investors to remember the inherent beta in FOF indexes when evaluating their own returns.

Conversely, if the hedge fund provider is taking less beta to the equity market than the index, one would expect it to outperform the index when the equity market is negative. Since hedge funds are often put into portfolios to mitigate against market dislocations, it is particularly important to evaluate returns versus index returns during down markets.

3. **ACTUAL RETURN PROFILE**—Investors should also consider historical return profiles for their investments. Hedge fund performance typically does not reflect a standard distribution curve. If the objective is hedging, then evaluating down capture in a market sell-off would be a valuable measurement. Straightforward measures of market correlation can also help determine how independent and valuable a hedge fund portfolio has been to portfolio diversification.

In conclusion, we believe investors should think of hedge fund indexes as just one tool—and a rather blunt one—for evaluating hedge fund portfolio performance. For a more holistic evaluation and robust analysis, investors may wish to consider complementing index data with peer group analysis, alpha-beta decomposition and down-market capture statistics for the funds in their portfolios.

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HFRI Fund Weighted Composite Index ("HFRI Fund Weighted"): The HFRI Fund Weighted Index is a global, equal-weighted index of single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in USD and have a minimum of $50 million under management or $10 Million under management and a twelve-month track record.

HFRI Asset Weighted Composite Index ("HFRI Asset Weighted"): The HFRI Asset Weighted Index is a global, asset-weighted index comprised of single-manager funds that report to HFR Database. Constituent funds report monthly net of all performance in USD and have a minimum of $50 million under management or $10 million under management and a twelve-month track record.

HFRX Global Hedge Fund Index ("HFRX Global"): The HFRX Global Index is an investable index designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; this includes, but is not limited to, convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.

MSCI All Country World Index is a stock index that tracks about 3,000 stocks in 49 developed and emerging market countries, representing a total market capitalization of tens of trillions of dollars.

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