

Time to look at hedge funds again

By **Stirling Larkin**

DURING a month when global financial headlines were dominated by the well-publicised divestment of hedge fund investments by the California Pension Fund (CalPERS), in striking contrast a select group of very private Australian individuals made several key investments into this alternative investment category.

This was likely because they believed that this wholesale investment vehicle could best capture the uncorrelated market opportunities they saw ahead.

Amid relatively flat markets — like those seen throughout the majority of this year — it was difficult to see the benefit of actively managed funds versus passive alternatives, such as ETF-trackers. However, with volatility returning and correlations between different asset classes and investment strategies diverging, these benefits started to become clearer.

Hedge funds have once more become an attractive investment for Australian Ultra High Net Worth (UHNW) investors and family offices looking to capture the active market moments which were not married to monetary policies, mining booms or real estate bubbles.

Hedge funds are a distinct wholesale investment class that differentiate themselves through their unique use of leverage and their ability to “hedge” risks within portfolios via the use of derivatives and short positions.

They separate themselves from other styles of managed funds by their specific aims of delivering outperformance, referred to as Alpha, in excess of the broader markets’ performance, known as Beta.

First named by the Australian sociologist Alfred Jones in 1949, they have given asset managers the unique ability to generate higher returns by arbitraging market inefficiencies, capturing event-driven opportunities and monetising macroeconomic directional trends.

Adriana Kostov, Australian Regional Director of the Hedge Fund Association, believes increased market volatility generally presents a positive opportunity for hedge funds because, “their primary investment goal is to preserve capital, reduce risks and provide investors with stable returns uncorrelated to market movements”.

In markets categorised by higher volatility, Kostov says, “the benefits of specialised trading strategies and risk mitigation programs offer investors an opportunity to reduce overall portfolio risk”.

This appeals to many Australian family offices who inherently carry concentration risks embedded throughout their portfolios in sectors such as real estate, textile clothing and footwear and mining services.

Equally and at the same time in the US, “hedge funds remain a very popular allocation for Family Offices and UHNW individuals and these investors continue to serve as the historic foundation for the industry, even in the face of increased institutional allocations,” according to Tim Spangler, lawyer, academic and renowned author on the subject.

Regarding the concerns surrounding the CalPERS divestment, Spangler points out that although this has been big news in the US, the true moral of this story is not quite as clear as the critics would like.

“CalPERS (hedge fund) allocation amounted to less than 1.5 per cent, which is hardly enough to move the needle from a performance perspective.”

As several other US public pension plans continue to increase their hedge fund allocations, CalPERS “needed to go big or go home — they went home”.

These institutional level allocations can be important sources of information for Australian retail investment communities, who cannot directly invest in hedge funds.

According to a recent Goldman Sachs report which analysed 775 hedge funds with \$US1.9 trillion of gross equity positions, in August those funds made notable investments into health care and emerging markets equities while selling down rate-sensitive real estate investment trusts (REITs) holdings worldwide.

They remained overweight in consumer discretionary investments and most particularly underweight in consumer staples, information technology and - financials.

But most interestingly the report highlighted that the typical hedge fund in 2014 allocated 33 per cent of its assets to small-cap stocks positions.

An example of a highly successful Australian asset manager in this space has been Ophir Asset Management, which has returned 171.8 per cent since inception in August 2012.

According to portfolio manager Andrew Mitchell, who manages a portfolio of listed Australian stocks focused outside the ASX150, “as a firm we use enterprise value to cashflow multiples as our principal method of valuing industrial companies”.

Mitchell added: “We prefer this methodology as it specifically rewards companies with good balance sheets and the optionality that comes with having available cash to make smart acquisitions and investments.”

Steven Hall from Brookvine, a boutique team which helps private wealth investors select fund managers, believes that “a continued decline in correlations between different asset classes and investment strategies, shifts in global monetary policy and an expected uptick in volatility may help create trade opportunities for hedge funds”.

He points out that “tactical and trading-oriented managers, with a flexible mindset and a preparedness to alter their market exposures dramatically, are well positioned to benefit from these trends”.

Brookvine believes that this may include certain “global-macro” managers, who may have underperformed in 2012, 2013 and through 2014 to date but are typically those who are able to generate strong returns through trading when volatility ticks up, unlike buy-and-hold strategies.

Like in any investment class, there are roses and thorns, and as Howard Marks, co-founder and chairman of Oaktree Capital Management recently pointed out that in the industry’s early days, “there might have been 20 hedge funds run by 20 geniuses”, however today, “you have 11,000 hedge funds and I’m pretty confident they’re not run by 11,000 geniuses. So the quality is uneven. The larger quantity of players tends to drive out bargains. It’s tougher to outperform.”

However, some of those 11,000 asset managers may very likely be talented proprietary traders who were pushed out of investment banks in 2010 solely because of the “Volcker Rule”, which was introduced by President Obama’s Dodd Frank Reform Act.

For Australian investors selecting which managers to support, the traditional three guiding principles have been “smarts, pedigree and performance”.

For Australian family offices, this must also then complement their existing portfolios and concentrations and ensure that allocations are hedged to preserve capital, mitigate risks and deliver outperformance, uncorrelated to broader market movements.

With market volatility returning a re-look at hedge funds is now most definitely sagacious.

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