

HEDGE FUND HEADLINES MISLEAD: PROVIDING PERSPECTIVE ON HEDGE FUNDS

WHITE PAPER

Arnerich Massena, Inc.

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HEDGE FUND HEADLINES MISLEAD: WHY YOU SHOULD BE CONSIDERING HEDGE FUNDS

Recent headlines have announced that several large insurance companies and pension funds are exiting hedge funds, a striking move. These headlines are generating worries about hedge funds that may be misleading investors. Should investors be concerned about their hedge fund investments? In this paper, Arnerich Massena brings some perspective to the headlines and examines the value hedge funds bring to a portfolio. We discuss the important role hedge funds can play in a long-term investment strategy and how Arnerich Massena uses hedge funds.



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HEDGE FUND HEADLINES MISLEAD: WHY YOU SHOULD BE CONSIDERING HEDGE FUNDS

Some of the biggest headlines covering hedge funds in the last few years have announced a withdrawal from hedge funds by significant institutional investors:

“AIG Seeks to Redeem \$4.1 Billion From Hedge Funds After Loss” ~ *Bloomberg News*, May 3, 2016

“MetLife Joins AIG in Scaling Way Back on Hedge Funds” ~ *The Wall Street Journal*, May 5, 2016

“New York City Public Pension Pulls Hedge Fund Investments: NYCERS joins a growing list of public pension funds opting to drop hedge funds” ~ *The Wall Street Journal*, April 14, 2016

“America’s largest pension ditches hedge funds” ~ *CNN Money*, September 16, 2014

“Why America’s largest pension fund dumped hedge funds” ~ *Fortune*, September 16, 2014

“CalPERS is largest investor to exit hedge funds, but decision isn’t a surprise to some” ~ *Pensions & Investments*, September 16, 2014

The media reports that these large insurance companies and pension funds are abandoning hedge funds because “the investments had become too complex, too expensive” (Laughlin, 2014) and that they had “experienced inconsistent hedge-fund returns over time.” (Scism, 2016) Institutional investors may have a variety of reasons for exiting hedge funds; recent lackluster performance, combined with high fees and complex oversight issues reduce the attractiveness of hedge funds, particularly if they are a smaller portion of the portfolio, as they are for many of the above institutions. We’ll discuss further why they may be making this highly visible decision to eliminate hedge funds, and whether these decisions are sparking a broader trend.

Most importantly, how should investors be responding to this news? The biggest question is: are hedge funds worth the effort and expense? As is often the case, the perspective you see in the news may be only one angle of a multi-faceted situation. In this paper, we’ll shed some light on hedge funds and the hedge fund industry, discussing how hedge funds can add value, how to use hedge funds in a portfolio, how to establish appropriate expectations, and what strategies and criteria Arnerich Massena uses to select hedge funds.

WHAT IS A HEDGE FUND?

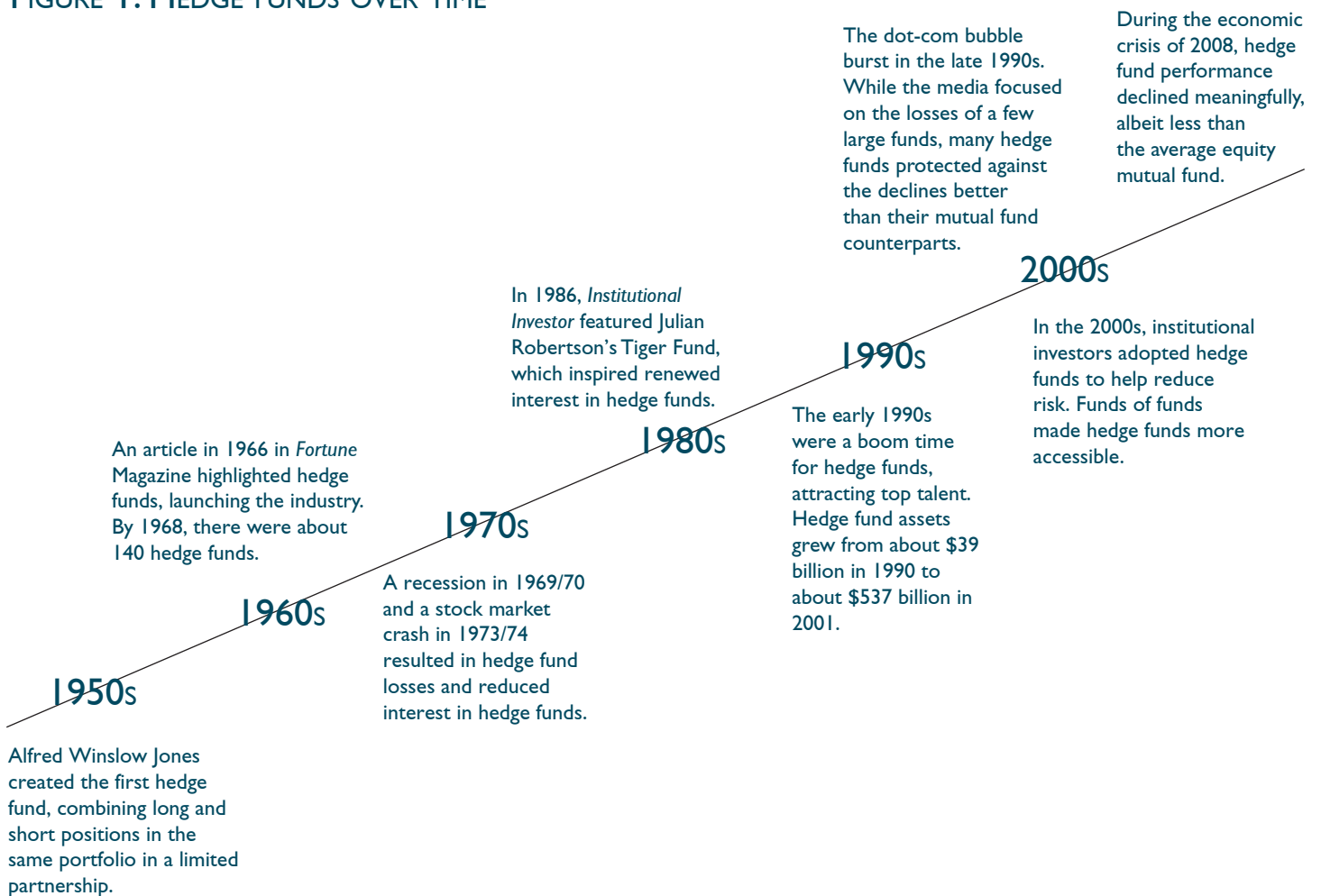
Hedge funds are investment vehicles that typically employ alternative strategies within a private investment partnership. Hedge funds have a broader latitude than most traditional mutual funds and can employ a wider range of investment strategies and techniques. Hedge funds are only open to investors who meet certain thresholds of investable assets and/or income size, with the assumption that they are more sophisticated investors who can better understand their complexities and risks. Hedge funds typically have higher fees than mutual funds, and are often less liquid.

Hedge funds may invest in a broad range of asset types and implement a wide variety of strategies. Their structure makes it possible to seek out investments that don’t easily fit into mutual funds and to take both long and short positions. Hedge funds may seek to achieve a variety of objectives, but generally focus on generating a return in both up and down markets rather than trying to match or outperform a particular benchmark.

HEDGE FUND CYCLES OF PERFORMANCE

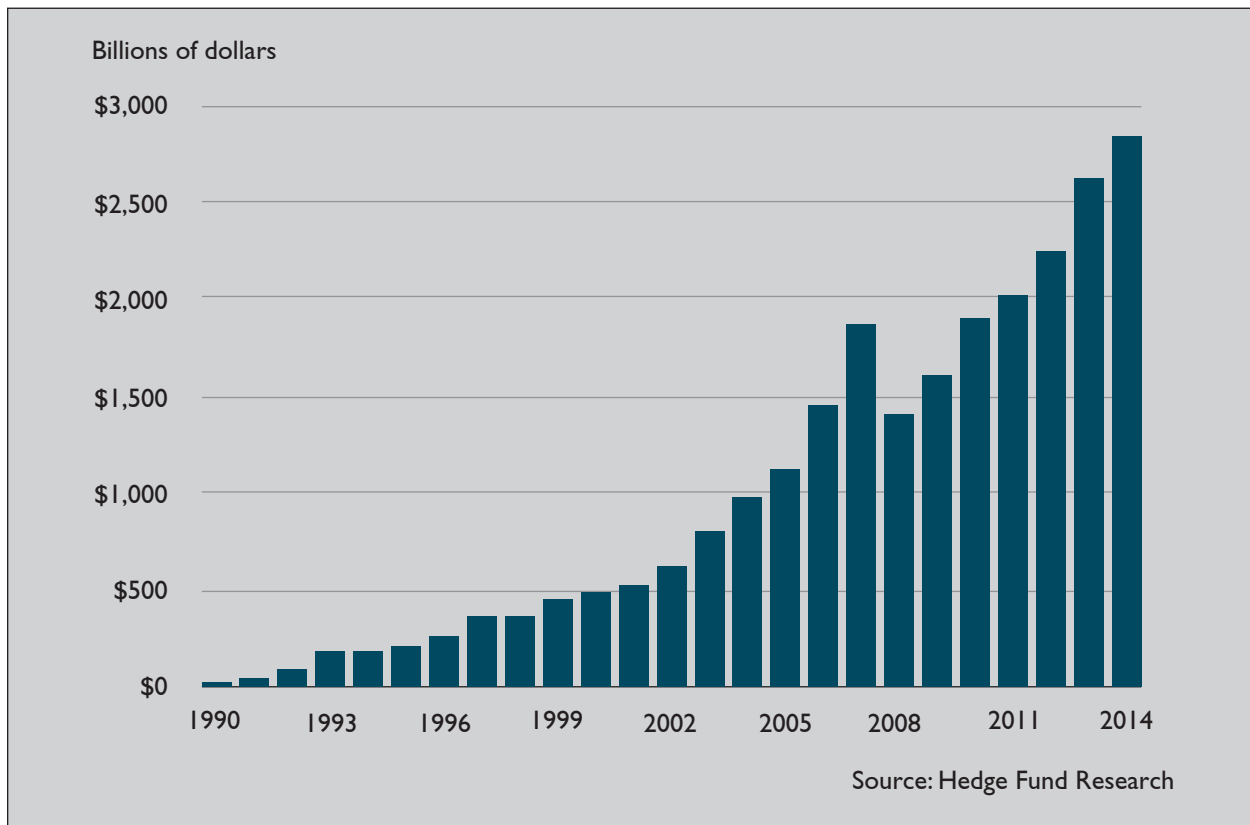
Hedge funds, like most investments, experience cycles, of both performance and popularity. The timeline below shows some of the highlights and turning points in the history of hedge funds.

FIGURE 1: HEDGE FUNDS OVER TIME



Despite negative news, hedge fund assets continue to grow, as show in Figure 2. As of the end of 2014, there are about \$2.8 trillion in hedge fund assets and more than 10,000 hedge funds. This continued growth and expansion in the industry is due to hedge funds' unique value proposition. Hedge funds generally provide greater flexibility than mutual funds to invest in a wider array of strategies and opportunities, offering investors long-term potential.

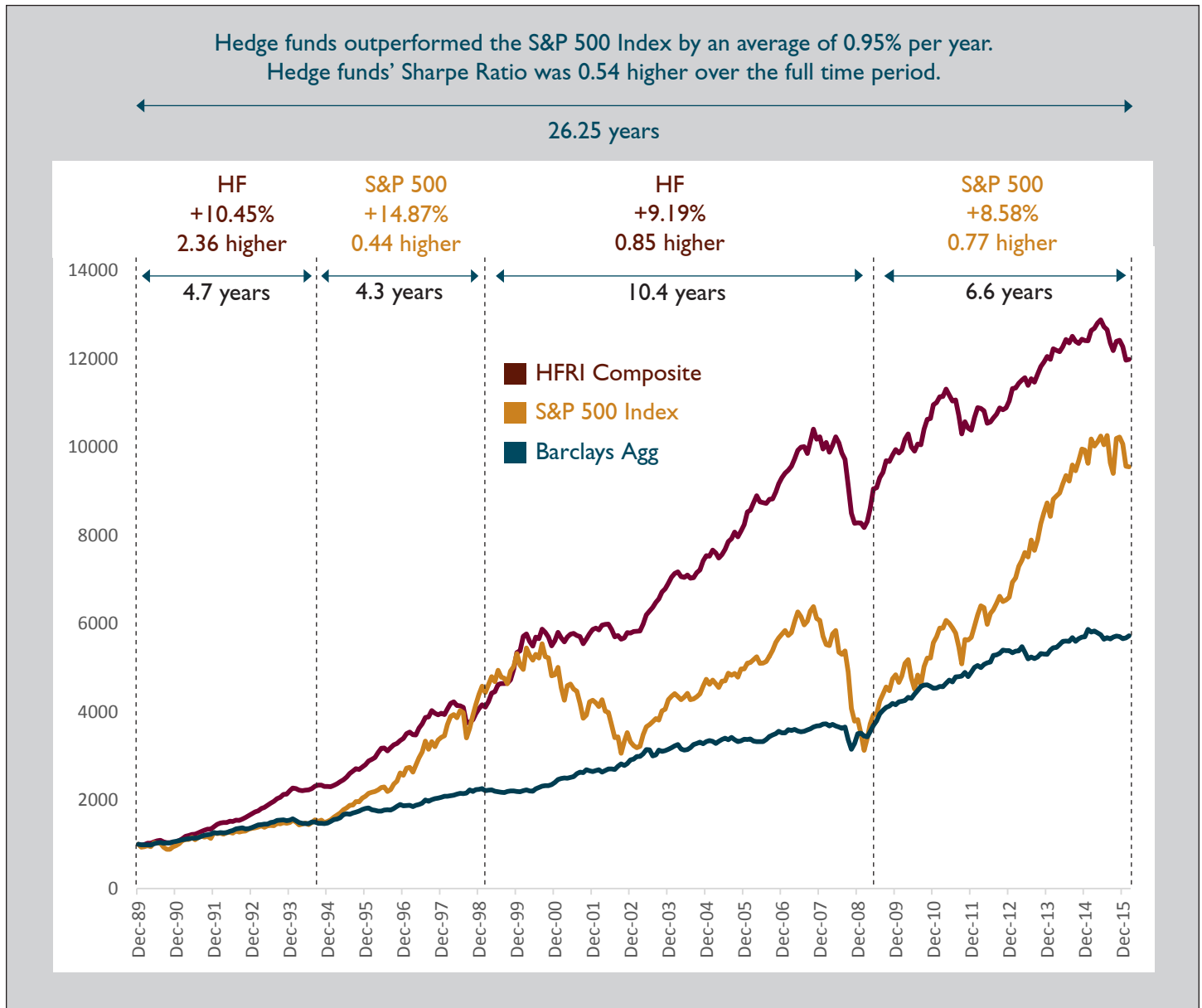
FIGURE 2: ESTIMATED HEDGE FUND ASSETS CONTINUE TO GROW



Over the last 25 years, hedge funds have outperformed the S&P 500 Index by an average 0.95% annually, materially outperforming on a risk-adjusted basis. You can see in Figure 3 on the following page that hedge fund outperformance has been cyclical, moving through several significant up and down cycles relative to the S&P 500 Index. The chart compares performance over several time periods that saw the greatest discrepancies between hedge funds and U.S. equities.

It's important to remember, however, that not all hedge funds are created equal. With such variety across this asset class, overall comparisons may be helpful but may not tell the whole story. Different hedge funds seek different objectives and experience a wide range of performance outcomes. For this reason, we caution investors against blanket judgments on hedge funds. Having criteria by which to select and evaluate hedge funds is critical to successful hedge fund investing.

FIGURE 3: HEDGE FUNDS' CYCLES OF OUTPERFORMANCE



Hedge Funds/HF/HFRI Composite: HFRI Fund Weighted Composite Index. S&P/S&P 500: S&P 500 Total Return Index. Barclays Agg: Barclays Aggregate Total Return Index. All data and calculations are for the period 12/31/1989 - 2/29/2016.

WHY ARE SOME INSTITUTIONAL INVESTORS ABANDONING HEDGE FUNDS?

Hedge funds have undoubtedly faced headwinds over the last few years, and many have lagged the broader stock market. The table below outlines some of the recent factors that may have negatively affected hedge funds.

Factors affecting hedge funds

Adverse Factors	
Low market volatility with brief spikes	Hedge funds tend to do well during periods of higher volatility, excluding periods in which volatility is spiking upward.
Computerized trading models	Some opportunities which fundamental strategies were taking advantage of may be extracted out of the market more quickly through computer trading.
Unprecedented levels of central bank intervention	It's difficult to quantify the effects central banks have caused to financial markets, but they have shifted prices away from fundamentals, which has impacted many hedge fund strategies.
Markets driven by liquidity rather than fundamentals	Since the financial crisis, the environment has been one in which investors often sell what's liquid rather than what they believe to be the least fundamentally sound part of their portfolio
Dramatic decline in bond yields	Falling interest rates have provided a huge tail wind for fixed income assets, from which most hedge fund strategies do not benefit.
Hedge fund institutionalization	The structure of the average hedge fund portfolio looks different today, and may be designed more to minimize risk than to outperform equity markets
Burdens of new regulations	Many hedge funds have had to increase their non-investment resources to meet the increasing demands of regulators.
Increased competition	With over 10,000 hedge funds finding and repeatedly exploiting opportunities in financial markets and many funds following similar strategies, trades can become "crowded," reducing their potential risk-adjusted return.
Indexing trend	The flow of capital to passive investment management has negatively affected growth in the hedge fund industry.

Institutional investors face additional considerations. On average, hedge funds not only have higher fees but also incur additional costs because they generally require more research and due diligence due to their complexity. For large portfolios, it may be difficult for them to put a material amount of their capital to work in the types of hedge funds that offer the greatest potential benefit. The larger asset sizes may require hedge funds that invest in larger, more efficient markets, which usually offer less return potential than smaller, less efficient markets. Additionally, hedge funds may make up such a small percentage of the overall portfolio for large

institutional investors — while consuming a disproportionate amount of resources — that any advantage has a minimal impact. Combined with the need to hire specialized staff to conduct research and due diligence, the benefit of a small allocation may not outweigh the challenges, which, as a business decision, could be the primary hesitation for a large institution. A larger allocation to hedge funds, on the other hand, may be more proportionate with the resources required.

Headline risk is another consideration that is likely affecting organizations' decisions to include or not include hedge funds in their portfolio. Organizations may be benchmarked against peers, and are most certainly compared to peers, resulting in a tendency toward conformity. Being outside the norm may be the source of unwanted attention, particularly in the media, otherwise known as headline risk. Headline risk is at the root of many trends, a major factor in why organizations sometimes follow trends rather than fully exercising independent decision-making in their investment decisions.

WHY INCLUDE HEDGE FUNDS IN YOUR PORTFOLIO?

For long-term investors, the key is not to follow the crowd as it shifts direction to favor different asset classes. Decisions to buy and sell assets, we believe, should not be based on short-term trends. A carefully crafted asset allocation can instead make strategic use of cycles; often, the best risk-adjusted opportunities can be found in areas that have recently gone through periods of underperformance.

BENEFITS

Diversification

Risk mitigation

Return potential

Broader opportunity set

CONSIDERATIONS

Illiquid

Higher fees

Complexity

Difficult to benchmark

How can hedge funds contribute to a carefully crafted asset allocation? Hedge funds, like every asset class, should be utilized to fill a particular role in a portfolio. A benefit of asset allocation is to employ the tendency for different investments to behave differently to the investor's advantage. Because there is such a variety of hedge funds available, with widely differing objectives, it is important to seek funds that meet specific criteria to achieve the portfolio's objectives.

It's possible to gain significant diversification benefits through the use of hedge funds. While traditional equity funds, whether large or small, U.S. or international, all tend to move in relative tandem due to macroeconomic market influences, hedge funds, with their broader investment toolkit, may be less affected by these forces. This diversification can serve to provide a significant risk reduction tool for portfolio construction.

Certain hedge funds can also increase a portfolio's return potential. Because of the nature of the funds, they have a much wider latitude of available investments and strategies. Some hedge fund strategies intentionally bear greater risks through strategies such as concentration and leverage, which have the commensurate potential for a greater reward. They also have the ability to focus on long-term opportunities, having a meaningful advantage in a format that doesn't offer daily liquidity. Hedge funds' ability to lock up capital allows for a long-term perspective, which can open doors to opportunities that would not be feasible with a shorter time frame.

The current investment environment is one of historically low yields, creating a challenge for fixed income investors. Fixed income has traditionally played a crucial role in an investment strategy as a stable companion to an equity portfolio, providing predictable income and capital preservation. But in this environment, fixed income investments may not even keep up with inflation. Hedge funds are particularly important in this type of market, as they can provide an alternative to traditional fixed income that can offer some of the same advantages — stability, capital preservation, capital appreciation — often with even less risk. For investors seeking liquidity, however, hedge funds may not be a suitable replacement for fixed income.

The benefits of hedge funds come with costs, however, of which investors should be aware. They may be well worth their fees, but they also require a deeper level of dedication, commitment, and research. Hedge funds are often less liquid than mutual funds; how illiquid depends on the fund. Some funds have lock-up periods to allow them to generate returns over a specific period of time or to better match the liquidity constraints of their underlying holdings. Hedge funds can be complex investments, as well, making research and due diligence challenging. Investors will likely need to have specialized resources dedicated to the selection and monitoring of hedge funds. Selection and timing are critical in the hedge fund space.

Evaluating the results of a hedge fund is another challenge for investors. Hedge fund investors should be prepared to evaluate performance based on metrics other than benchmark outperformance. Traditional mutual funds are typically designed to either match or outperform a specific benchmark as a representative of the market in which they invest. Hedge funds, however, seek returns not necessarily tied to any particular part of the market or benchmark. Most hedge fund indexes, such as the HFRI Index, are simply a composite of a number of hedge funds — i.e. a peer group rather than an actual benchmark. While peer comparatives are valuable, strategies within the same hedge fund category can be significantly different; the evaluation of a fund's performance will require more analysis than this simple relative comparison.

The hedge fund industry is continuing to grow despite the negative headlines. We believe that opportunities outside of traditional investments will continue to exist and investors will recognize the benefits that can be found within hedge fund strategies. As demonstrated, hedge funds, like many investments, have cycles. Their relative underperformance over the past few years has posed challenges to the industry, but hedge funds will continue to offer opportunities for long-term investors.

That said, we highly recommend that investors seek out specialized expertise when investing in hedge funds. With such a variety of strategies available, and a wide range of qualitative differences, hedge fund investing requires dedicated, knowledgeable, experienced professionals to have the greatest success.

HOW DOES ARNERICH MASSENA USE HEDGE FUNDS?

Hedge funds serve an important function in our clients' portfolios. We believe there are attractive investment opportunities outside of traditional assets, especially as a cash and/or fixed income alternative, and that skilled hedge fund managers are best positioned to access them. Hedge funds often have a greater opportunity set and more tools to utilize as they invest in the global financial markets.

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Hedge funds can also serve an important role as diversifiers and volatility dampeners. Because hedge funds may experience less volatility and fewer large swings, either up or down, they can help to smooth out the return pattern of the overall portfolio.

Hedge funds require dedicated research, and we commit experienced talent to the research and due diligence of hedge funds to find truly outstanding, unique opportunities. There are both sector-specific hedge funds and generalist hedge funds, and we work with both, but have a number of criteria that we seek, including:

- Managers whose interests are strongly aligned with those of their investors: Our hedge fund managers need to have skin in the game, so to speak, with personal assets invested in their fund. Many of our managers have a significant proportion — if not most or all — of their investable net worth invested in their funds.
- Capacity-constrained strategies: One of the major criticisms of hedge funds is that they have grown too large and thus have a diminished opportunity set, but at Arnerich Massena, we look for funds that have an appropriate amount of assets for their strategy, and in which the manager is focused more on portfolio management than on business development.
- Managers finding sources of return that are not linked to traditional investments: We identify managers who deploy strategies that seek unique opportunities, which results in funds that have low correlation to other asset classes.
- Managers with a long-term outlook to their performance: We seek out managers who think about their performance over longer time periods, not those who allow their investment decision-making to be influenced merely by short-term returns to aid in asset-gathering efforts.
- Managers who are experts in their strategies: Successful managers have specialized knowledge that makes them uniquely qualified to manage their strategy.
- Managers who are passionate about what they do: We look for managers who love what they do, because it affects portfolio management. It's also important that as a fund grows, the manager continues to focus on the portfolio rather than getting drawn away by day-to-day business management needs.

In terms of hedge fund strategies, there is not a particular type of strategy that we prefer. We feel it's worthwhile to examine any type of strategy if the fund meets the criteria listed above, provided the manager has a sound philosophy and is consistent within that strategy.

Hedge fund investing requires patience and a long-term outlook. Understanding a hedge fund's strategy can help to provide perspective when performance struggles. When we have conviction in a strategy, we will often take advantage of lagging performance periods to add assets, which seems counterintuitive but is exactly what is meant by the adage "buy low, sell high," and reflects a long-term view.

HEDGE FUND HEADLINES MISLEAD: PROVIDING PERSPECTIVE ON HEDGE FUNDS

In today's global low interest rate environment, fixed income strategies cannot provide the same return expectations as they have in the past. We believe that hedge strategies, properly implemented, can be a valuable portfolio tool, providing a viable fixed income alternative. We think investors would be well served by giving up daily liquidity in the bond market for a carefully crafted approach using hedge funds instead. Hedged strategies have the potential to achieve a similar expected return (as fixed income used to provide) with an even lower risk profile.

For our clients who are concerned about hedge funds, we suggest taking a step back to look at the bigger picture. Reevaluate the purpose hedge funds serve in your portfolio: are they continuing to serve that purpose even during times of lagging performance? The industry will continue to grow and evolve, and may experience some ups and downs but, like the market itself, is on a long-term growth trajectory.

Feel free to contact your Arnerich Massena advisor to continue to discuss this topic and how it applies to your investment strategy.

ENDNOTES

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