Seeking asymmetry

What the Hedge & Diversifying asset class brings to a portfolio

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The hedge & diversifying asset class can serve an important purpose in a portfolio. In this paper, we examine the benefits of this asset class and how it fits into a diversified strategy.

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Introduction

Why hedge? What is the purpose of the hedge & diversifying asset class, and what objective does it serve as part of a diversified portfolio? In this paper, we'll look at some of the defining features of hedge funds, and what role hedge & diversifying investments can play in a portfolio. What are the advantages of hedge and diversifying strategies, and why should investors incorporate them into their asset allocation strategy?

Investor sentiment around hedge funds varies based on the market environment; it can be challenging to recognize the value of hedge funds during strong bull equity markets. But we believe the Hedge & Diversifying asset class adds stability and downside protection, and we'll share our reasoning in this paper.

Note: Throughout this paper, we use the HFR Fund Weighted Composite, which is composed of a large basket of hedge funds, as a proxy index for the Hedge and Diversifying asset class, and all performance is reported net of fees. However, there is a broad range of strategies and types of hedge funds, and manager selection is of critical importance. It's also important to note that the HFR Fund Weighted Composite Index does not include funds of hedge funds.

"A HEDGE FUND CONSTITUTES AN INVESTMENT PROGRAM WHEREBY THE MANAGERS OR PARTNERS SEEK ABSOLUTE RETURNS BY EXPLOITING INVESTMENT OPPORTUNITIES WHILE PROTECTING PRINCIPAL FROM POTENTIAL FINANCIAL LOSS."

- Ineichen, *AIMA's Roadmap to Hedge Funds*, 2012

What are hedge funds?

Like mutual funds, hedge funds are pooled investment vehicles that provide investors with a group of securities in a single fund. However, hedge funds are not required to register under the Securities and Exchange Commission (SEC), and as such, are not bound by the same reporting requirements as mutual funds. Hedge funds may be structured as limited partnerships or limited liability companies, with the investment manager acting as the general partners and investors as limited partners.

Whereas mutual funds aim to either track an index (passive funds) or outperform an index (active funds), most hedge funds are focused on absolute return. "Hedge funds force you to think outside the benchmark," notes Mark Anson, CEO of Commonfund (*Ineichen, 2012*) With capital preservation as a key outcome, they seek to earn a positive annual return with limited volatility. Hedge fund managers seek return through taking risk, but also actively manage for contingencies on the downside.

"The first recorded hedge fund-style investment was a 'call option' trade and appears to have occurred about 2,500 years ago. Aristotle told the story of a poor philosopher, Thales, who proved to doubters that he had developed a 'financial device, which involves a principle of universal application,' by making a profit from negotiating with owners of olive presses for the exclusive rights to use their equipment in the upcoming harvest. Olive press owners were happy to pass on the risks of future olive prices and to accept payment now as a hedge against a bad harvest later. As it turns out, Thales correctly predicted a bountiful harvest, and the demand for olive presses rose. He sold his rights to use the presses and made a profit. Thales's 'call option' risked only his down payment. Although he did not invest in fields, workers, or olive presses, he participated actively in olive production by taking on a kind of risk olive growers and press owners were unable or unwilling to take - in the process enabling them to concentrate on growing and processing olives. They made a profit from their work, and he made a profit from his."

- Demystifying Hedge Funds, 2006

Mutual funds versus hedge funds

	Traditional Mutual Funds	Hedge Funds
Regulation	Highly regulated with many restrictions and reporting requirements	Set up as a limited partnership with relatively little regulation in terms of investment restrictions, reporting, and fees
Investment universe	Limited by regulations	Unlimited
Investment objective	Performance is measured relative to a benchmark index	Performance success is often based on an absolute return objective
Risk/return	Goal to generate added value compared to the index	Can generate positive returns in both up and down markets; risk/return characteristics vary widely by fund and strategy
Liquidity	Daily liquidity	Varying liquidity provisions, which may include lock-up periods
Fees	Limited by regulation, based on a percent of assets under management	Unlimited by regulation; typically include a fixed fee and performance-related incentive fees
Disclosure requirements	Prospectus outlines the fund details	A private placement memorandum, or PPM, outlines the strategy, fees, and other rules of the fund

Asset class correlations: Q2 1997 - Q4 2023

	Cash & Low Duration	U.S. Bonds	Global Stocks	Private Equity	Real Estate
U.S. Bonds	0.8				
Global Stocks	-0.3	-0.1			
Private Equity	-0.2	0.0	0.9		
Real Estate	-0.1	-0.2	0.0	0.0	
Hedge Funds	-0.3	-0.1	0.9	0.9	0.0

Correlation statistics are based on the returns of the following indexes: Bloomberg US Aggregate, Bloomberg US Govt 1-3 Yr, MSCI ACWI, Red Rocks Global Listed Private Equity, NCREIF Fund ODCE, HFRI Fund Weighted Composite

Many look for opportunities for "asymmetric returns," in which the potential return is higher than the potential for loss.

Hedge funds cannot be marketed to the general public but are limited only to accredited investors, who have significant investable assets and are presumably able to take on and manage the risks involved in alternative investments. Hedge funds often require a significant minimum investment, and may be limited to a certain number of investors.

Hedge fund managers have a wider latitude in terms of strategies, markets, and investment vehicles than do mutual funds. They may include tools such as leverage, swaps, options, futures, and other derivatives. They may hold both long and short exposures. Hedge funds can hold illiquid securities that do not fit well in the daily liquid mutual fund business model, but which can often be bought cheaply and earn a return premium over daily liquid investments.

Why hedge?

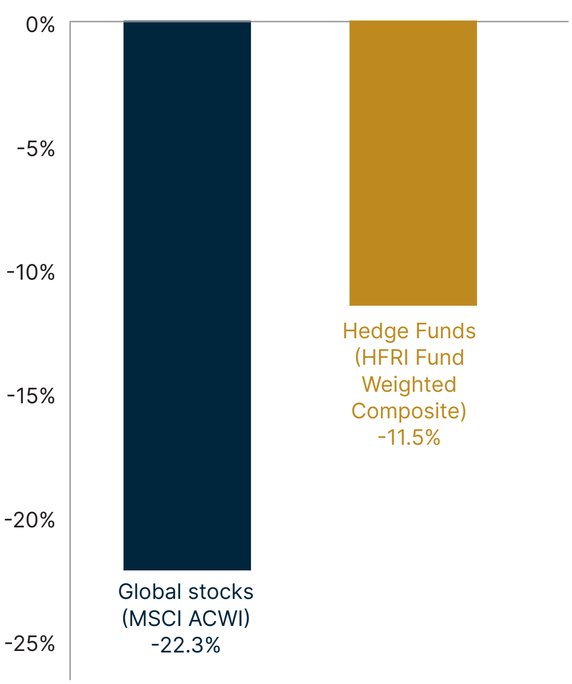
DIVERSIFICATION BENEFITS

Because the objective and strategy of hedge funds differs from that of other asset classes, hedge funds offer diversification benefits to a portfolio. You can see in the correlation table on page 4 that hedge funds are fairly highly correlated to equities; however, they generally have had much lower volatility than stock funds. Hedge funds have low correlation to bonds, on the other hand, but have tended to have a higher return profile than bonds.

The focus on capital preservation has historically resulted in a generally smoother ride for hedge funds over equities, while providing returns that have been highly competitive relative to bonds. The ability to hold both long and short positions means that hedge funds are often protected from large single-period drawdowns. The Worst Quarter chart below reflects the worst quarter for equities and the worst quarter for hedge funds between Q2 1997 and Q4 2023. Global equities dropped -22.3% in Q4 2008, but in the worst quarter for hedge funds, Q1 2020, they only dropped -11.5%. You can see the same effect in calendar year 2022, when both stocks and bonds experienced severe negative returns, whereas hedge funds did a good job of preserving capital during this difficult period.

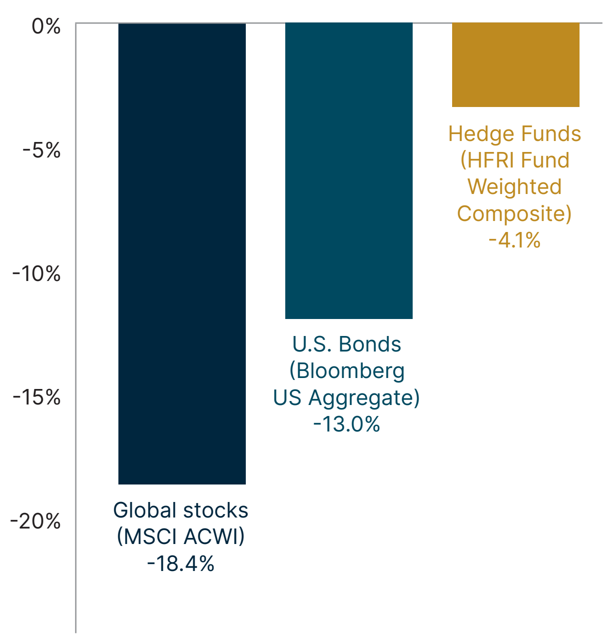
Hedge funds are generally expected to provide greater protection to investors' capital.

Worst quarter: Q2 1997 - Q4 2023



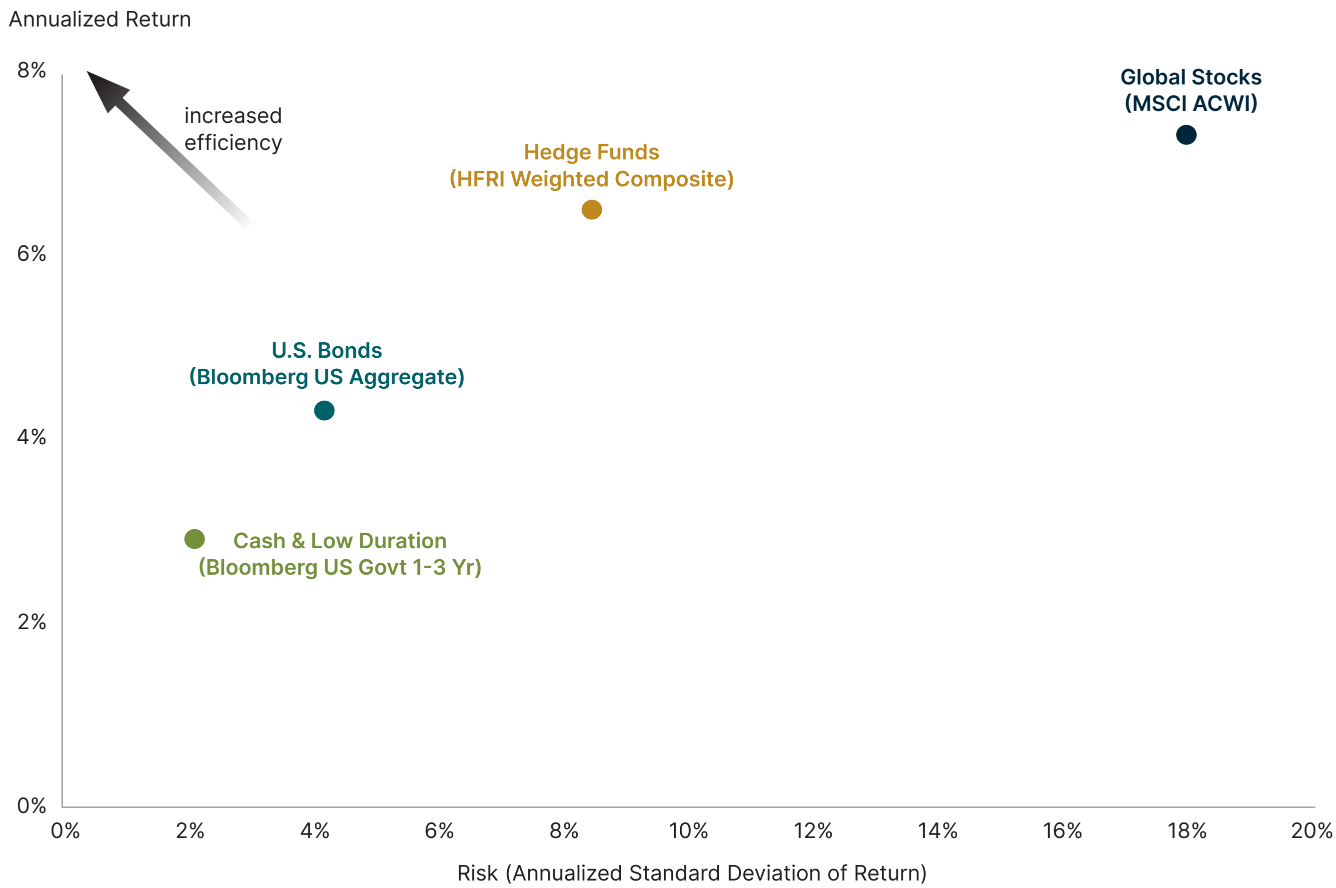
Source: Morningstar Direct

2022 Calendar year returns



Source: Morningstar Direct

Historical return and risk of asset classes: Q2 1997 - Q4 2023



Return and risk data is based on the maximum common period (April 1, 1997 to December 1, 2023) for the representative indexes. It is not possible to invest directly in an index. Past performance does not guarantee future results.

EFFICIENT RISK/RETURN PROFILE

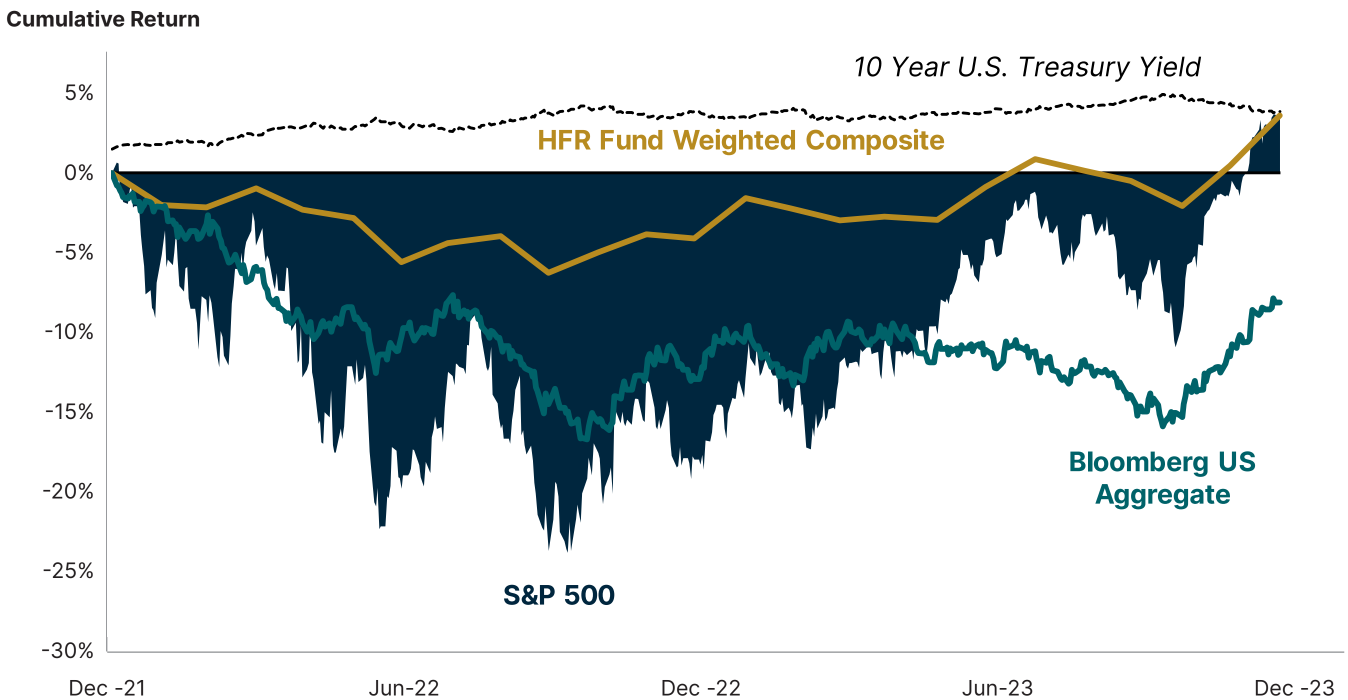
When we compare asset classes, long-term return is certainly a critical factor to evaluate, but so is risk. An asset class can have a very high return profile, but if it has high volatility, an investor needs to either have a very high tolerance for risk or balance it out with lower-risk options. High volatility means an investor may need to stay invested longer to reach their desired return goals, and they may see significant downturns along the way. It is a general rule of thumb that the greater risk you are willing to take, the higher potential return you are likely to earn.

We can plot that phenomenon on a chart, as you can see above. The historical return and risk chart notes each asset class's long-term annualized return relative to its long-term annualized risk (standard deviation).

> "One of the marketing one-liners in hedge fund space is that 'hedge funds produce equity-like returns on the upside and bond-like returns on the downside.' While this one-liner is somewhat tongue-in-cheek, it is not entirely untrue."
>
> \- Ineichen, *AIMA's Roadmap to Hedge Funds*, 2012

The further up and to the left on the chart, the greater an asset class's efficiency, referring to the level of return per unit of risk. Cash and low duration has very

Two-Year Perspective



Sources: FactSet. Cumulative return includes reinvestment of dividends and interest.

low risk, of course, but also has had a relatively low return over time — it lies to the left but low on the y-axis. Global stocks, on the other hand, have had a very high long-term return but comes with commensurate higher volatility, sitting up high on the y-axis and to the right on the x-axis of the chart.

Hedge funds have been highly efficient, with a risk profile significantly lower than that of global equities and only slightly higher than that of U.S. bonds, but with a return profile much higher than that of U.S. bonds, and not much lower than that of U.S. equities.

Nowhere is this asymmetric pattern and high efficiency more evident than over the course of the past two years. If you look at the two-year perspective chart above, you can see that U.S. equities and hedge & diversifying ended the two-year period essentially even — and much higher than bonds — but hedge & diversifying had a much smoother ride along the way.

The annualized return chart on the following page illustrates the long-term annualized returns of all three asset classes, providing a comparison of their respective return profiles. And the hypothetical growth of a dollar chart on page 9 illustrates the pathway over time; you can clearly see the smoother ride hedge & diversifying has offered across the full time period.

> **"IN SIMPLE TERMS, THE ASYMMETRIC RISK IS THE NOTION OF TAKING A RISK THAT WILL GENERATE A PROFIT THAT IS BIGGER THAN THE RISK TAKEN... IN OTHER WORDS, AN ASYMMETRIC RISK REWARD PROFILE HAPPENS WHEN WE HAVE A DISPARITY BETWEEN THE RISK TAKEN AND THE POTENTIAL REWARD."**
>
> \- *Trading Strategy Guides*, March 2020

Hedge fund considerations

Hedge funds differ from mutual funds and ETFs in two additional important dimensions: liquidity and cost.

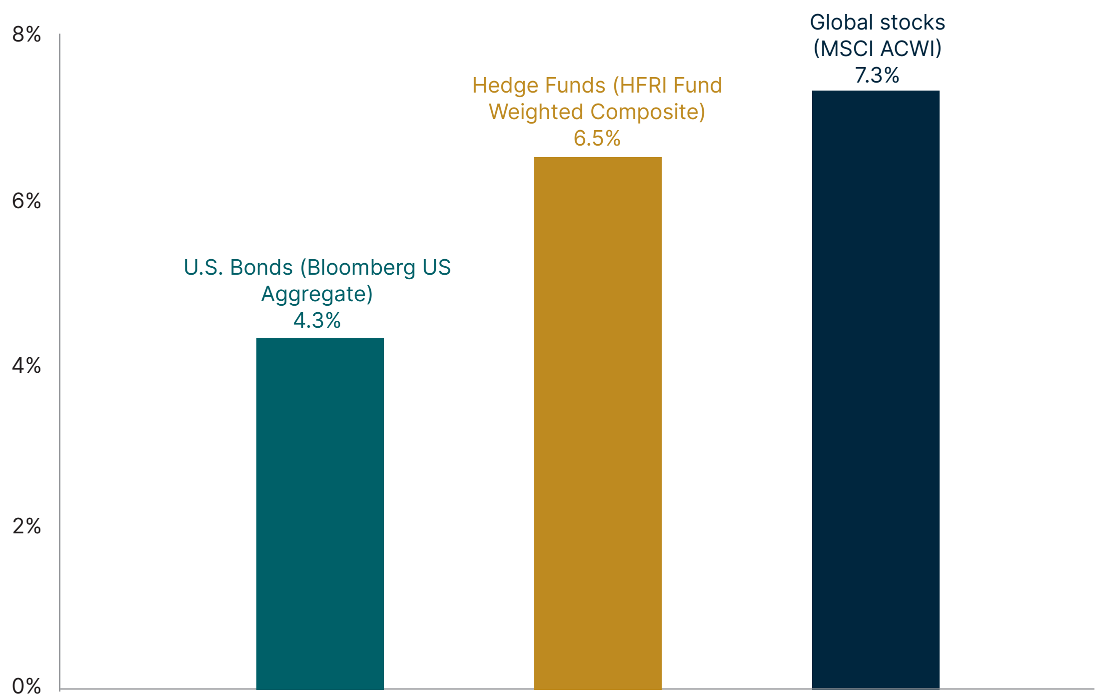
LIQUIDITY

Hedge fund investors may give up some liquidity when investing in these assets. Liquidity provisions differ from fund to fund, and many hedge funds place restrictions or impose lock-up periods when investors are unable to liquidate shares. Investors should pay attention to and understand the liquidity profile of a hedge fund or fund of fund before investing.

FEES

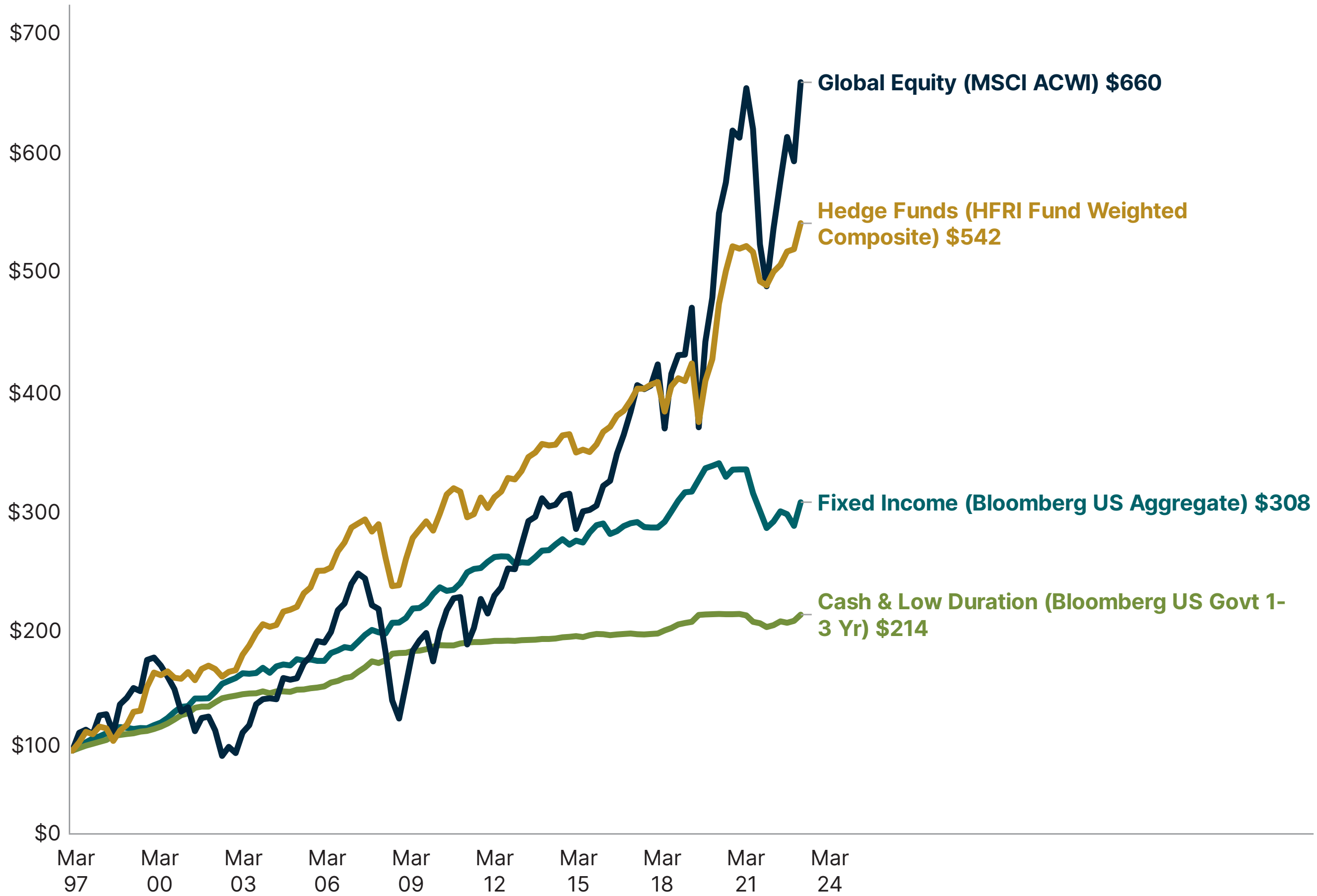
Hedge funds use a different fee structure than mutual funds. Whereas a mutual fund or ETF charges a percentage of assets under management (expense ratio), hedge funds often use an incentive pay structure in which managers are compensated based on the performance of the fund. A typical hedge fund fee structure would include an annual fee based on assets under management — similar to an expense ratio — *and* a share of the investment gains in excess of a stated benchmark. Many hedge funds include high water mark provisions to ensure that the incentive fee is based on the actual value provided to investors. Hedge fund fees are almost always higher than mutual fund fees. However, because the upside potential

Annualized Return: Q2 1997 - Q4 2023



Source: Morningstar Direct

Hypothetical Growth of $100: Q2 1997 - Q4 2023



Based on data from April 1, 1997 to December 1, 2023). It is not possible to invest directly in an index. Past performance does not guarantee future results.

income for managers is virtually unlimited, hedge funds tend to attract skilled, talented, and knowledgeable managers. The incentive structure maintains a strong alignment, ensuring that the management team is highly motivated to produce results.

Hedge & diversifying strategies

Alfred Jones, often called the "father of hedge funds," created the original hedge fund, which used short selling to reduce the risk of long-term stock investing. He was hedging his long-term bets, so to speak — hence the eventual term of the hedge fund (originally, the "hedged fund"). Nowadays, hedge funds use a wide variety of tactics and strategies to minimize risk and generate return, both by looking for value but also working to exploit inefficiencies in the market. Here, we discuss a few of the most common hedge strategies, but investors should understand that many managers utilize multiple strategies or a combination of strategies.

ARBITRAGE AND RELATIVE VALUE

A pure arbitrage strategy involves the simultaneous purchase and sale of an asset that is priced differently in different markets. True price inefficiencies are rare and quickly eliminated, however, so many managers use a relative value strategy. Relative value looks for assets that are mispriced relative to their normal or historical value, planning purchases and sales so that profits occur when prices return to normal. Arbitrage and relative value strategies often make use of leverage to increase the potential for return.

OPTIONS

The purchase of put options gives an investor the right to sell an asset at a specific price within a predetermined time frame, essentially locking in a price regardless of the market price at the time. Options can be used to hedge a position and limit downside risk.

LEVERAGE

Leverage involves using borrowed capital to amplify the investor's financial exposure in an effort to increase potential return. Leverage can be an important tool but having that increased exposure also increases an investment's risk. When using leverage, depending on the level of exposure, the downside risk can exceed the value of the investment.

SHORT SELLING

Hedge managers sometimes take short positions that profit from price declines. Often, short positions are used to hedge long positions so that funds can profit from both rising and declining stock prices.

EVENT-DRIVEN

Event-driven strategies focus on opportunities created by singular events, such as mergers or companies in distress through liquidations, restructuring, bankruptcies, or other situations.

Managers strive to take advantage of price discrepancies leading to the ultimate valuation of the company following the event, as well as the fluctuations caused by ongoing news of the event.

MACRO

Macro hedge funds focus on macroeconomic movements and invest based on major economic events and shifts, such as currency movements or interest rate adjustments.

How we invest in hedge & diversifying

Arnerich Massena has a long history of experience in alternative asset research; the firm has been implementing alternative investments since its inception in 1991. When we recommend a hedge & diversifying allocation in a strategy, it is with the goal of crafting a better, more efficient portfolio. The hedge & diversifying asset class accomplishes two specific goals in a portfolio:

- To provide additional stability and downside protection to assets without sacrificing significant performance
- To capitalize on specific opportunistic investment strategies

As discussed earlier, hedge & diversifying investments can add valuable diversification benefits and optimize the efficiency of a portfolio. They can act as a hedge to equity investments, reducing the potential for large drawdowns. Hedge & diversifying as an asset class adds unique value to an investment strategy, but it's important to recognize that not all hedge funds are equal. Because the asset class covers such a broad spectrum of strategies and success relies heavily on the skill and talent of the manager or managers, research, due diligence, and selection are critical.

> "Manager identification and evaluation is probably the key to success. Investing in hedge funds is essentially a people and relationship business. By allocating capital to a manager or a group of managers, the investor expects to participate in the skill of the manager or managers and not necessarily in a particular investment strategy or a mechanical process."
>
> - Ineichen, *AIMA's Roadmap to Hedge Funds*, 2012

HEDGE FUNDS VERSUS FUNDS OF FUNDS

Arnerich Massena invests primarily in hedge funds of funds rather than directly in hedge funds, though we do incorporate individual strategies on occasion when appropriate, usually as supplemental exposure. A fund-of-funds approach provides greater diversification benefits, and often offers access to a broader network of top-tier managers. Larger pools of assets gain entry into the best and brightest. We are careful to seek out bespoke solutions with low negotiated fees to avoid the high fees sometimes associated with hedge funds of funds.

SIZE

Size can be the enemy of performance in the hedge & diversifying fund space. Opportunities to leverage market inefficiencies are limited and close quickly. Large hedge funds have a tendency to become over-leveraged to make the most of a limited opportunity set. Smaller managers are more agile in the marketplace and typically use less leverage.

Additionally, as a fund grows, management fees increase while incentive fees become a smaller proportion of the manager's total compensation, meaning managers of large funds may have less financial incentive to drive performance. We favor funds that have strict capacity constraints.

> **“RESEARCH SHOWS THAT SMALL HEDGE FUNDS CRUSH LARGE HEDGE FUNDS IN TERMS OF RETURNS. WE’RE NOT TALKING SMALL OUTPERFORMANCE IN MOST CASES, WE’RE TALKING ABOUT HUGE DIFFERENCES IN PERFORMANCE, AGILITY AND RISK PROFILES.”**
>
> - Kane, *Seeking Alpha*, January 2019

ALIGNMENT OF INTEREST

In our opinion, the talent, skill, knowledge, and motivation of the manager determines a fund’s performance as much as does the particular strategies employed. We seek out managers who have a significant personal stake in the fund and are free from any pressures that would create conflicts of interest.

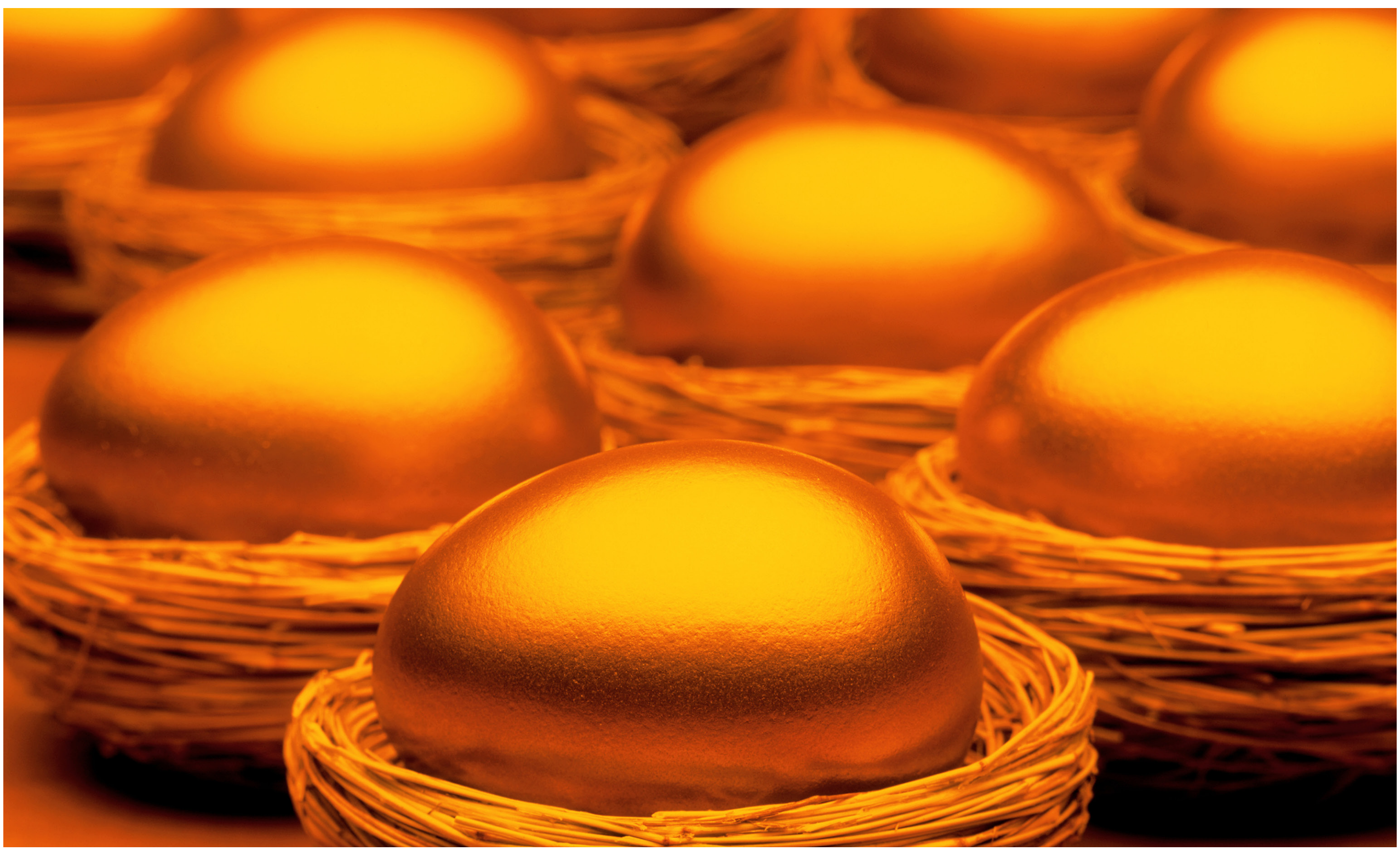
We also believe that transparency is very important, and favor managers whose processes, systems, and people are observable in the due diligence process.

OPPORTUNISTIC AND DIFFICULT TO REPLICATE

We seek managers who are niche-oriented and hunt down strategic investments with uncommon value and high asymmetric return potential. We are looking for managers who can provide a differentiated alpha source — one which is uncorrelated and delivers a unique return stream so that it can act as a true hedge & diversifying allocation in client portfolios.

LIQUIDITY & LEVERAGE

Given Arnerich Massena’s long-term approach, some liquidity restrictions are generally acceptable to us, but we carefully review liquidity provisions relative to clients’ needs and the portfolio. We usually view annual liquidity as sufficient.



Most of our managers use modest leverage and are generally conservative in their use of leverage. We focus on managers who can provide alpha without the need to apply excessive leverage, which are often smaller funds.

Conclusion

The perception of the hedge & diversifying asset class has a tendency to waver depending on the market environment. When equity markets are strong and growing, it can be difficult for investors to recognize the value of apportioning a slice of their portfolio to hedge strategies. But when markets slow, the value of this asset class becomes more evident. Hedge & diversifying can add tremendous value over time to a portfolio, providing stability and downside protection and taking advantage of special opportunities in the market.

We encourage investors to be active partners in creating the right investment strategy and understanding how Hedge & Diversifying can fit into it. Our hope is that by providing some information about the unique features and advantages of this asset class, investors can become more familiar with hedge funds and better equipped to understand and evaluate their own allocation to Hedge & Diversifying investments.

To learn more or discuss how Arnerich Massena can help you build a diversified investment strategy, please contact us.

ENDNOTES

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ABOUT ARNERICH MASSENA

Arnerich Massena builds lasting legacies in service of a greater good by investing with vision, passion, and purpose. Founded in 1991, Arnerich Massena is an independent, 100% employee-owned investment advisory firm servicing wealth management clients and endowments & foundations from across the United States, providing portfolio management, investment advisory services, and family office services. Arnerich Massena is a Certified B Corporation®.

Focused on client service and investing in change, Arnerich Massena creates portfolios that reflect top-tier research and collaborative expertise cultivated over nearly 30 years. The firm is different by design, bringing innovation and a forward-looking approach to investment research and portfolio construction. Known for successfully investing in high-impact areas like water resources, sustainable agriculture, fisheries, healthcare, and clean energy technology, Arnerich Massena has been a pioneer in the investment industry with alternative investment strategies, global portfolios, and private markets expertise.

Arnerich Massena is dedicated to constantly seeking new opportunities that resonate with clients' values, objectives, and the outcomes they are looking for. The firm strives to be a business that exemplifies both corporate citizenship and professional service, and has received awards for its innovations in corporate philanthropy.

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