The PODfolio Podcast Episode 21: Asset Class Mini-Series: Hedge Funds

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SARA REJAL: I would say that hedge funds maybe have this kind of high-risk label on them, but actually the way we talk about them today is they're defensive, they're diversifying, they're protecting.
SPEAKER: Welcome to the PODfolio, Willis Towers Watson's investment podcast series where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolios.
LOK MA: Hello and welcome to the PODfolio podcast, I'm your host, Lok Ma. Today's episode is the fifth one in our mini-series looking at different asset classes. So so far we've looked at equities and bonds, illiquid assets and also, alternative beta strategies for diversifying away from the mainstream market. Today is the turn of hedge funds and we welcome back our two experts from the last episode, experts in diversifying strategies, so good to have you again, Sara Rejal.
SARA REJAL: Thanks for having me again.
LOK MA: And also welcome back to you, Victoria Vodolazschi.
VICTORIA VODOLAZSCHI: Great to be here.
LOK MA: So we're still talking about ways of diversifying our investment returns. In the last episode that was about I guess, the more mechanistic approaches for investing, using thoughtful algorithms, and so on to generate returns that are different to the main equity and bond markets. Today, hedge funds, that's about the real clever clogs if you like, of the investment industry, who think up even more esoteric ways of getting a return or you might not think of them as clever clogs.
Actually, I think the people working at hedge funds do fascinate a lot of us. So we've going to touch on the people aspect as well. First of all though, maybe starting with you Sara, what are hedge funds?
SARA REJAL: Oh, there's no great definition because the universe is just so wide but the way we would think about them is unconstrained investing. So they're essentially the most flexible form of active management and they can invest in the same equities and bonds as traditional funds but they also have the ability to have a wider toolbox. They can invest in things like futures or currencies, options, structured credit, insurance, I mean the list is quite long in what they can and can't invest in. But it's not like every hedge fund can invest in everything, they have to have a mandate to which they've got to stick to and they've got to know anything really well.
I would say that hedge funds maybe have this kind of high-risk label on them but actually, the way we talk about them today is they're defensive, they're diversifying, they're protecting. And that's not just marketing spin, it's actually because we do actually consider them the safe part of portfolios but of course, they need to be managed well, they need to be well risk-managed.
And I'd say another difference is that if you went back 20 years ago when people referred to hedge funds, there were maybe five major categories. There were equity long-short funds, there were event-driven, discretionary macro, credit, and maybe systematic. But today, there's just so many different offshoots of those strategies, sub-strategies, specialisms, different styles.

And excitingly, there's even new markets that are opening up or new instruments that can be traded, things like cryptos for example. So there's just a lot of different types of hedge funds out there, which can make it really daunting to invest in hedge funds. There's definitely complexity there but I would say that shouldn't put investors off.

VICTORIA VODOLAZSCHI: So the other way to look at hedge funds is that they are absolute return. So they're expected to make money in different environments, not just when markets are going up. Some strategies are actually designed specifically to perform well when markets go down or when there is a period of high volatility.

I will also say that today we're seeing renewed interest in hedge funds given the backdrop of markets, which are at historical highs, given that the rates are pretty much near zero. So in this environment returning to expectations for traditional 60-40 portfolios are below historical averages. And hedge funds can be a good solution to the challenges that investors are grappling with, how to generate differentiated returns and how to minimize portfolio volatility because hedge funds can help with smoothing the volatility and providing downside risk protection.

LOK MA: And let's do talk a little bit about the people working at these places if you don't mind, what sorts of people work at hedge funds. I mean we tend to think of these I guess, huge egos with genius minds or amazing connections or whatever. Are they really these kind of super-beings or maybe even villains as we sometimes see them depicted in the media?

SARA REJAL: Yeah, I mean there definitely used to be some of those characteristics. I don't know if you've seen the films, you know, Wolf of Wall Street. I mean that wasn't necessarily hedge funds but that kind of personality type or there's the more recent series called Billions, I don't if you watch that, but it's based on hedge funds.

LOK MA: I haven't.

SARA REJAL: Yeah, I mean some elements of truth, but we'd like to think that things are changing, things have changed. You can't just be an aggressive trader anymore as a hedge fund manager. You need to be an entrepreneur, you need to be a good risk manager. You need to be a people person. You need to be a good salesperson as well. So I'd like to think that you get an eclectic mix, but not just the aggressive trading types. I don't know, Victoria, what do you think?

VICTORIA VODOLAZSCHI: So I agree, obviously you need to have the technical knowledge required to manage the strategy that you manage, but successful hedge fund managers also need to be good decision-makers, especially in times of uncertainty. They're obviously driven and competitive, but equally important, they need to have the emotional stability to be disciplined, to act rationally, whether it's holding your positions when they're going against you or maybe making a difficult hiring or firing decision.

I think the hardest part is sort of getting this right balance of IQ and EQ. This balance of intellectual kind of drive and determination and humility, which is really learning from your mistakes. One of the big reasons hedge funds fail is hubris because you get this sort of superstar founder who just thinks they're invincible and they never change course once they make a decision. So I guess we would ideally prefer somebody who is maybe a little bit of a less brilliant genius but who can be swayed because he or she can recognize a mistake and learn from it.

LOK MA: And Sara, I think you mentioned The Wolf of Wall Street, and I think hedge funds do still have a bit of this image problem. How does that fit with this modern world we live in now where we're much more mindful of inclusion and diversity for example?

SARA REJAL: Yeah. Look, I mean we really care about this stuff. We take it really seriously as part of our research process. And actually, there's a part of our research process that we call the culture assessment, where we go in and we spend hours and hours with the team just trying to understand them as people and seeing what motivates them and how they motivate their team because we think it's really important.

And even on the topic of I&D, we spend a lot of time with the hedge funds. They know how behind they are on this. They're trying to steer their ship in a different direction but it's just suffered from decades of not investing in enough diverse talent.

And going back to Wolf of Wall Street, you would see the environment's very male-dominated for example. They just weren't and still are today not the most inclusive of environments. So it's still really hard to convince diverse talent and women, for example, to come and work for a hedge fund.

So we're actually engaging with a lot of the hedge funds to try and help them with this process. We think we can actually help them on this journey that they're on and it's become a big part of our mission. And we're pleased by the reaction the hedge funds are showing. They do want this to change.

LOK MA: And what about this accusation that the people working at these hedge funds are maybe incentivized financially to take excessive risk almost, with other people's money. Do you think that's still true?

VICTORIA VODOLAZSCHI: Well, hedge fund managers definitely need to be comfortable taking risk because they are in a business of taking calculated risks. A good portfolio manager develops high conviction to size up their sort of best ideas which is their reward for taking that calculated risk. We also like to see managers eat their own cooking and have significant co-investments in their funds and that presumably can temper irresponsible risk-taking. But you're right, there is a belief that performance-based compensation can lead to poor risk management because managers can just decide to take a massive risk in hopes of a massive payoff.

So I think there are some mechanisms in place that can help ensure the manager does not get paid for poor performance or doesn't get paid for the same performance twice, there are things like hurdle rates, there are things like high watermarks. So for example, if a manager makes money and then sort of loses that money, so you don't just need to make up your losses but you need to return to your previous peak in the fund value. But ultimately, the best protection or risk management is doing your due diligence. We like to say that the best risk management is doing your due diligence before you invest.

LOK MA: And then you mentioned the fees paid to the hedge funds. Of course, we hear about all the money that hedge fund people make, these are very, very well-paid professionals. Is that still true given I guess kind of fee pressures, the greater transparency these days, and even the alternative vehicles that we talked about in the last episode, which you can argue are similar to hedge funds but they're the cheaper options?

SARA REJAL: Yeah, I mean if the question is, can a hedge fund manager make millions, if not billions from running a hedge fund, yeah, absolutely they still can but I would say it's much harder than it used to be. And it's not just because fees have come down. I mean fees have come down but not as much as we thought or would want them to. But it's just harder to run a hedge fund and to make it successful.

And investors have become smarter too. I mean they just don't believe everything that a hedge fund says that they've got a magic secret sauce for example. Investors want to see evidence of that alpha and skill. So that's one aspect of it.

The transparency is an interesting one. So if you go to the long-only world, for example, you will get to see the full portfolio of a long-only manager. That's still not the case for most hedge funds but I think that's improving. Victoria, what do you think?

VICTORIA VODOLAZSCHI: No, I agree. I was thinking there's an old industry joke about what is a hedge fund, it's a fee structure in search of a strategy. There's definitely some truth to that even today and there is a bit of a stigma to hedge fund fees in particular. But things are changing and we like to believe that we've been at the forefront of those changes. The way we see it, the industry is moving to a cost-plus model, meaning that the management fees are there not to enrich the founder, they really should reflect the cost of running the business and managers should make a living by generating alpha and collecting a portion of that. I also agree, Sara, that it's much more expensive to run a hedge fund business today than say 10 or 20 years ago, primarily because there is a lot of new regulatory and compliance demands.

SARA REJAL: Yeah. And I think if I'm reflecting on what the real problem with hedge funds is, it's not just the fees. I think it's just been their inflexibility over time and it was always a one-size-fits-all flagship fund, take it or leave it. And we wrote a paper called, Hedge funds-- A new way a couple of years ago. And in that paper we were really trying to encourage the hedge fund industry to think more about what do your clients actually need, what problem are you trying to solve? And so we're really pushing them to try and come up with more solutions. And we're seeing a bit of an evolution towards that way.

It's not still perfect. And the way that we're trying to achieve that is the way we approach a hedge fund now is to say, look, we don't want to see your product, just open your toolbox, let us see what you've got, and then we're going to assess what capabilities you have and try to extract and pick the things that we think will solve our client's needs. So the packaging I think has been a big part of the hedge fund industry, plus the fees and that's maybe created a bit of a bad image, but all of that is getting better.

LOK MA: So from what you're saying, I think hedge funds have also moved with the times if you like and then they obviously look to generate a return by looking for some kind of competitive edge based on the way they see the market or the way they do things. So have they still got that special edge that, for example, the alternative beta strategies can't quite replicate?

SARA REJAL: Yeah, we believe so. And we actually stopped and paused our thinking on hedge funds to actually question this and say whether they've still got it. And that paper that I referred to a minute ago was exactly that, the start of the paper is to what else can they add on top of an alt beta allocation? And we found that actually they still had skills, that because they have so many levers that they can pull on, so much flexibility, they've got breadth in their portfolio and then you put that together with all the experience and the talent that's in the hedge fund industry.

But you do need portfolio management skills. You need to be able to trade and risk manage the portfolio as well. And again, that's stuff that's really embedded in good hedge fund strategies. So I would say that it's not the whole industry that's brilliant, but we would actually try to look for specialists that we think are really good in particular areas, maybe niche areas, and we think that can be very lucrative. You're getting a return stream that's different to what you would get in alternative beta. And we're also not looking for our hedge funds to do everything anymore. Going back to alternative beta, we think it's actually bringing real honesty to the hedge fund industry because what we're trying to do there is try to extract and pull out the really high value, high skill stuff that hedge funds do and say, this is what we think differentiates you.

LOK MA: And presumably if these hedge funds have a secret formula or a special ingredient, whatever, they're not going to want to share their trade secrets with anybody, right. I mean how do you go about researching them to find the good ones to put in a client portfolio?

VICTORIA VODOLAZSCHI: Well, we don't think there are real secrets. You know, Bernie Madoff said he had a secret and we all know how that played out. So if they say they have a secret, we probably wouldn't be interested because we're really looking for evidence of a process that's robust and repeatable. And I think culture assessments also help with that because it helps us sort of see what the true motivations are and how interests are aligned between investors and the manager.

So but we assess every strategy differently and to simplify it, it's really about understanding how they make money and what risks they take to generate those returns. In general, I would say, portfolio management and risk management are crucial areas for research in addition to just understanding kind of hedge fund ability to pick stocks or credits. But ultimately, the diligence process, I think a big part of it is sort of a series of interviews with the managers and the rest of the team. It's sort of like a mosaic theory and these are not just conversations, they're conversations with a specific purpose to get information and to evaluate the manager in both content and the personalities involved.

LOK MA: Thank you. And perhaps to wrap up this discussion I want to talk about how you fit hedge fund investments into that wider portfolio. So remembering that the main point isn't that these clever clogs can necessarily beat the market, it's more that they generate returns in a different way to the other things in your portfolio. So arguably, it's much more about reducing risk and improving diversification rather than just boosting your returns. So how different are hedge fund returns from, say, just vanilla equities and bonds?

VICTORIA VODOLAZSCHI: You're correct, Lok. By definition, hedge fund returns should be uncorrelated to traditional markets because they're designed to have lower sensitivity to equity and bond markets and they're expected to generate positive returns regardless of what markets are doing. So let's just take a simple long-term equity strategy which generates returns from both long and short positions, it can hedge the portfolio, providing element of protection. So when markets decline you make gains on your shorts which dampen losses on the long positions. The more you move away from traditional equity and bond markets the more dimensions of non-correlation you can add.

So for example, global macro strategists, they trade equity and bond markets, but also currency and commodity, generating pretty different returns. And then there are also really esoteric hedge fund strategies that hedge funds can trade, like insurance-linked contracts or even more innovative strategies like trading power or electricity markets or royalties, it could be music or health care royalties, and so on and so forth. But the bottom line is that we very much believe that to have a robust multi-asset portfolio hedge funds should definitely have a place.

LOK MA: And would you say that you would invest in hedge funds alongside alternative beta strategies or are you more likely to do one or the other, depending on your viewpoint?

SARA REJAL: Yeah, we would ideally say alongside that it really depends on what you need. So it depends on your return expectations, your risk appetite, your liquidity needs, and your fee constraints. So for example, if you have high return expectations you'd probably do more in hedge funds but if you need more liquidity, you'd stick to more alternative beta.

LOK MA: And I guess to wrap up then, my final question, if you invest in just one hedge fund, then obviously the performance could depend on whether they happen to have a good year or a bad year. So how many hedge funds do you need do you think in your portfolio to smooth out the risk of a single manager doing badly?

VICTORIA VODOLAZSCHI: So I think the answer it would depend on the purpose, what purpose you are trying to achieve with your hedge fund allocation. But on average, we believe that 10 to 20 managers will give you a diversified allocation to those differentiated non-correlated sources of return that we think are worth paying hedge fund fees for. It could be a smaller number if you have a more nuanced portfolio completion objective or maybe you're just looking to hedge a specific exposure. Sara, what do you think?

SARA REJAL: Yeah, I mean, it's hard to know which strategies are going to perform well and when. So you actually need to manage that portfolio of different hedge fund strategies quite well as well. So that becomes important but that shouldn't be scary.

I would just say that investors should try and again partner with someone they trust who can help them with that journey of picking the right strategies to meet their needs and then doing the ongoing management of the exposures, but definitely, we think it's worth having a hedge fund allocation in your portfolios. And for those clients who did have it in 2020, they were very pleased because the hedge fund portfolios did protect really well when there was market stress and we were very pleased.

LOK MA: Well, thank you both for coming back onto the show to talk to us about hedge funds. So until next time, Sara, thank you very much.

SARA REJAL: Thank you.

LOK MA: And thank you very much for coming on, Victoria.

VICTORIA VODOLAZSCHI: Thank you, Lok.

LOK MA: And for our listeners, the next episode will wrap up our mini-series I will be talking about how to put all of these asset classes together within that overall portfolio. So until then, please do take care.

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