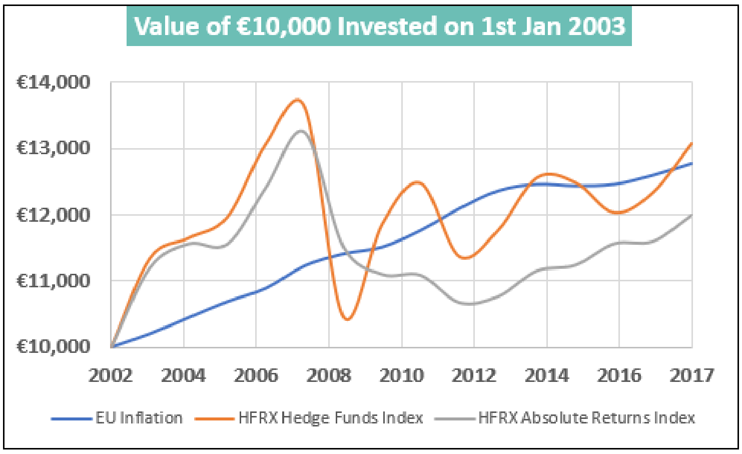
Gillen MARKETS

Hedge & Absolute Return Funds – Serving No Useful Purpose!

15th January 2019

Summary View

For reasons outlined in this note, GillenMarkets, as an impartial investment advisor, is no longer recommending hedge or absolute return funds as part of balanced or multi-asset portfolios. Investors should stick to balanced funds that own the traditional assets of equities, bonds (nominal and inflation-linked), cash and alternative assets. Our analysis also raises some broader questions; whether Irish institutions should be marketing absolute return funds to the retail public on the basis of 'bank deposit returns plus 4-5%' when they seem incapable of delivering such returns, and whether the Government's Irish Strategic Investment Fund (ISIF) ought to have 28% of its assets in such funds?



Source: Bloomberg, GillenMarkets

The Global Financial Crisis (GFC) not only created nerve-wracking volatility in the global financial markets during the 2007-09 period, but for many private investors who were inadequately diversified it also created permanent losses on a scale rarely seen before.

Traditionally, balanced or multi-asset funds, which own equities, bonds and alternative assets, were aimed at providing exposure to the higher returns on offer from growth assets (equities) while also covering investors for the major economic risks (of recession, deflation and inflation) with the caveat that returns would be lower over time than those likely to be delivered by equities. However, balanced or multi-asset funds in Ireland have tended to have *circa* 65% to 70% exposure to equities so that, in reality, they tended not to be all that balanced, and also suffered heavily in the GFC.

As a consequence, demand for investment products capable of lowering volatility, providing diversification and offering the Holy Grail of consistent positive returns above inflation increased significantly post the GFC.

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In Ireland, this manifested itself in the wide-scale promotion of Absolute Return Funds. However, these fund types are not delivering for investors, and we believe the issues involved are largely structural in nature rather than cyclical.

Over the 15-year period from 2003 to 2017 inclusive, returns from the HFRX Global Hedge and Absolute Return Funds Indexes have been 1.8% and 1.2% compound *per annum*, respectively. As the chart at the top right of page 1 highlights, returns from the hedge funds universe were only marginally ahead of inflation over this period; for the absolute return funds universe, returns were actually below inflation.

High costs, too much capital chasing finite trading returns and low to zero returns from risk-free assets are the likely reasons for these paltry returns.

While many of the absolute return funds promoted in Ireland have not been around for the 15-year period under review, none have delivered to expectations or to the marketing hype in the period that they have been available.

Table 1: Periodic Returns from a Sample of Absolute Return Funds Available in the Irish Market

	Cumulative Returns			
Fund	5-Years	3-Years	1-Year	2018 YTD
Irish Life Multi-Manager Target Return	n/a	n/a	-7.1%	-7.2%
Standard Life GARS	1.7%	-9.4%	-6.6%	-6.9%
Invesco Global Targeted Returns	5.0%	-4.7%	-6.2%	-5.2%
Aviva Multi-Strategy Target Return	5.3%	-3.8%	-1.2%	-0.7%
New Ireland BNY Mellon Real Return	8.5%	1.8%	-1.9%	-1.2%

As of 9th Nov 2018 *Source: Bloomberg*

The higher profile absolute return funds promoted in Ireland include the Aviva Multi-Strategies Target Return Fund, the Irish Life Multi-Manager Target Return Fund, the Invesco Global Targeted Returns Fund, the New Ireland BNY Mellon Real Return Fund and the Standard Life GARS Fund. The list in the table is not an exhaustive one.

Be Careful How You Promote the Product?

With the above facts now available, institutions in Ireland promoting absolute return funds should move away from suggesting that they can deliver '*bank deposit plus 4% to 5% annual returns*', even over 3-year rolling periods. Only equities have delivered a premium return of *circa* 5% over risk-free assets over the long-term.

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When you own equities (companies), you own productive assets capable of earning high returns on the capital employed in the businesses, and well ahead of the returns traditionally available from risk-free assets over most cycles.

Should Irish institutions continue to promote absolute returns funds on the same basis going forward they will be in danger of mis-selling the product, in our view.

Over the same 15-year period, returns from the Hedge & Absolute Return Funds universe have had higher correlation to equities than ought to have been the case further undermining the rationale for their inclusion in balanced or multi-asset portfolios. As the return statistics in **Table 1** highlight, this trend of high correlation to equities has continued in 2018.

It's therefore difficult to avoid the additional conclusion that the Hedge and Absolute Return Funds universe is not actually diversifying risks at all in balanced or multi-asset portfolios. In fact, they are increasing risk but without any commensurate improvement in returns.

In our view, then, the facts do not support the case for allocating savings to the cost-heavy, and more trading-oriented Hedge & Absolute Return Funds industry.

Should the Irish Strategic Investment Fund Have €1.87 Billion Invested in This Asset Category?

We note that the Irish Strategic Investment Fund (ISIF) had €1.87 billion (28.6% of its assets) invested in Absolute Return Funds at the end of December 2017[1]. The stated focus of the National Treasury Management Agency (NTMA) is to position the ISIF to have sufficient cash available for '*Irish investments over an indicative period of four to five years*.

Many of the ISIF's Absolute Return Fund positions are mirroring the industry trend and showing similar losses in 2018 year-to-date as outlined in the sample of funds highlighted in **Table 1**.

We wonder if a more sensible strategy for the ISIF might be to simply allocate such monies to either cash and/or equities. While cash returns are minimal at present, at least losses cannot be incurred. In the case of equities, while temporary declines in value occur regularly over shorter-term timelines – and we would view anything under a 5-year period as the short-term – at least equities can justify the claim that they hold out the potential for annual returns of 4-5% above cash returns over the medium-term.

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[1] No Interim Report to 30th June 2018 has been published at the time of writing this note

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Introduction

The global hedge fund industry came of age in the 1990s. Hedge and absolute return strategies (and funds that follow these strategies) exist to generate positive annual returns from equities and other assets or financial instruments that can be traded on markets, regardless of the performance of the underlying equity, bond or currency markets themselves.

The flexibility to sell stocks or financial instruments that they do not own (referred to as 'selling short') provides hedge funds with the ability to generate returns regardless of the overall direction of financial markets. For this reason, returns from hedge and absolute return strategies should be uncorrelated to returns from asset classes that are more sensitive to the economic cycle like equities and property. Hence, hedge and absolute return strategies aim to provide diversification benefits within an overall risk-asset investment portfolio and offer the possibility of inflation-plus returns.

Hedge funds, in particular, often use leverage (borrowings or derivatives) with the aim of magnifying the underlying returns they generate. They are most definitely risk assets; it's just that the risks they face (or take) are not the same risks as those faced by general equities.

Examples of Strategies

To better understand the variety of strategies adopted by hedge funds, we outline a few practical examples:

- **Long / Short strategies:** A hedge fund might be 'long' (own) certain stocks, while being 'short' other stocks. To be short a stock means that the manager has sold a stock that she doesn't own in the hope that she can buy it back at a lower price later. If a hedge fund, for example, had €100,000 invested in shares and was 'short' €100,000 of other shares then the fund's net exposure to markets is zero. The strategy still has risk in that the fund's 'long' positions might decline in value instead of rising and / or its 'short' positions might rise in value instead of declining, thus creating losses instead of gains for the fund. A real example might be a fund manager who owns Ryanair but sells 'short' EasyJet. A decline in the overall equity market or the European airline sector should affect both stocks similarly so that the fund manager has no 'net' exposure. Her risk is not the equity markets themselves but her own judgement regarding the merits of Ryanair *versus* EasyJet;

- **Trend-following or Momentum strategies**: Trend-following is a well-recognised hedge fund strategy. Like Newton's 'Law of Motion', a body moving in one direction tends to keep moving in that direction until a force acts on it that stops it or changes its direction. Research has highlighted that stocks, bonds and even currencies that are trending in a certain direction (upwards or downwards) tend to keep trending in that direction until an event of some sort causes a change. A hedge fund can adopt a strategy of going 'long' an equity, bond or currency that is trending upwards and going 'short' an equity, bond or currency that is trending downwards in an attempt to profit from a continuation of the trend. It sounds easy, but in practice it is more complicated because trends can end suddenly and without notice, often necessitating the use of stop-loss limits by the hedge fund to minimise losses in such instances. And a real risk exists that no sooner has the manager been 'stopped out' of a position than the original trend is re-established causing what is referred to as 'whip-sawing' or a series of losses;

- **Global Macro strategies**: Global Macro hedge funds take positions in shares, bonds and currencies among other financial instruments based on their macroeconomic views and forecasts. The fund manager may position herself around a certain outcome or set up a number of positions to profit from market volatility when she knows an event is going to occur though she may be unsure of the outcome. An example of this strategy was seen during the Brexit vote in 2016. Fund managers confident that Britain would vote to leave the EU took long positions in safe assets, such as gold, and took short positions against the British pound. Managers who were uncertain about the vote took long positions in assets that would pay-out if market volatility rose, while others guessed wrong and lost money taking long positions on assets that dipped following the vote, such as the British pound or UK-dependent stocks;

- **Merger Arbitrage strategies**: Event-driven hedge strategies look to take advantage of temporary mis-pricings in shares or corporate bonds that can occur before or after a corporate event takes place. The strategy finds investment opportunities in corporate events such as acquisitions, liquidations, spin-offs, restructurings and other such events. The following is a specific example: A firm is subject to a cash takeover at $50 a share. Prior to the announcement of the deal, the firm's shares were trading at $30 per share. The deal relies on a number of conditions, so it is expected to take six months to complete. Once the deal has been announced, the share price rises to $45 per share. As the deal involves some risk, the market has some doubts over whether the deal will go through successfully. Meanwhile, existing shareholders may not be willing to wait six months for deal completion, as they're already up 50% prior to the deal announcement. The event-driven investment manager does her research and takes a different view. She sees that by purchasing shares at $45 her known upside is $5 (that's $50 minus $45);

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- **Corporate Credit strategies**: Lastly, a hedge fund might 'short' investment grade corporate bonds or debt that are low yielding and go 'long' higher yielding non-investment grade corporate bonds or debt that are offering higher yields to try and take advantage of the extra returns (the risk premium) on offer in the non-investment grade corporate bonds or debt. Investment grade corporate bonds or debt usually provide a yield premium of *circa* 1% above the equivalent government bond whereas non-investment grade corporate bonds or debt have to offer a yield premium of *circa* 4% to 5% above the equivalent government bond because they contain higher risks of default.

These are but a few examples of hedge fund strategies, but they should serve to demonstrate their complexity and to highlight that such strategies carry the risk of losses for investors. The aim of these strategies, of course, is to generate positive returns above inflation with little or no dependence on the general economy and therefore with little correlation to general equities. In that regard, a successful hedge fund diversifies risk within an investment portfolio.

The real difficulty for hedge funds versus, say, traditional equity funds is that they don't tend to own assets; rather, they tend to trade assets, an activity which, by its very nature, is a more speculative pursuit. When hedge funds take a loss, it tends to be a permanent loss given that they don't actually own assets. Equity funds, on the other hand, own assets and often their losses are temporary reflecting temporary declines in markets.

Absolute Return Funds

Absolute return funds' aim in life is pretty much the same as hedge funds although they go about the job in a more conservative way. Such funds were introduced in the early 2000s when regulations first permitted the use of derivative contracts in funds sold to the retail public. This allowed funds to use derivative contracts to either take leveraged positions in stocks, bonds or currencies or to limit the downside without selling the underlying asset, market or currency.

Their Role in a Balanced Portfolio

The key question at this point is whether hedge and absolute return funds can add any value over and above the traditional balanced or multi-asset portfolio.

Table 2 (next page) highlights the annual and compound *per annum* returns from the hedge and absolute return funds industry and from global equities from 1998 to 2017 covering a 20-year timeline.

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About the HFRX Indices

The HFRX Global Hedge & Absolute Return Funds Indices were first compiled at the end of 1997 so that the first full year's performance statistics for the industry was 1998. These indices are designed to be representative of the overall composition of the hedge and absolute return funds universe. They are comprised of all eligible hedge and absolute return funds that voluntarily report their returns; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event-driven, macro, merger arbitrage, and relative value arbitrage.

Table 2: Annual Returns from the HFRX Hedge & Absolute Return Funds & FTSE World Index TR (€) Indices (1998 – 2017)

Year	HFRX Global Hedge Fund Index	HFRX Absolute Returns Index	FTSE World Index TR (€)
1998	12.9%	4.5%	16.5%
1999	26.7%	8.1%	48.1%
2000	14.3%	11.1%	-5.3%
2001	8.7%	9.2%	-11.5%
2002	4.7%	5.5%	-31.2%
2003	13.4%	12.0%	11.8%
2004	2.7%	3.2%	7.8%
2005	2.7%	0.0%	28.7%
2006	9.3%	7.4%	9.3%
2007	4.2%	6.7%	1.7%
2008	-23.3%	-13.1%	-38.7%
2009	13.4%	-3.6%	31.9%
2010	5.2%	-0.1%	21.0%
2011	-8.9%	-3.7%	-4.2%
2012	3.5%	0.9%	15.4%
2013	6.7%	3.6%	18.0%
2014	-0.6%	0.8%	19.3%
2015	-3.6%	2.9%	9.6%
2016	2.5%	0.3%	11.9%
2017	6.0%	3.4%	9.5%
Compound *p.a.*	**4.5%**	**2.8%**	**6.5%**

Source: Bloomberg

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The indices have come in for some criticism. In *The Hedge Fund Mirage* [2], author Simon Lack argues that the hedge fund industry is unregulated and that hedge funds provide returns data voluntarily. As poorly performing hedge funds are less likely to provide returns data, there is likely to be 'survivorship bias' in the HFRX Indices returns data – that is, the returns may be overstated due to the absence of returns data from poorly performing funds, which elect to stop reporting returns to the index compiler.

Can Hedge & Absolute Return Funds Add Value?

So, when investors look to invest in hedge and absolute return strategies (and funds that adopt them), these strategies have to add some value if they are to be considered as part of balanced or multi-asset portfolios. That value can either be in terms of improved returns or in diversifying the risks that a balanced fund or multi-asset portfolio is exposed to.

Table 2 (previous page) highlights that from 1998 to 2017 inclusive neither hedge nor absolute returns funds in aggregate added any value in terms of improved returns *versus* general equities. Over that period, the HFRX Hedge Funds Index delivered compound *per annum* returns of 4.5% while the HFRX Absolute Return Funds Index delivered compound *per annum* returns of just 2.8%. In contrast, global equities delivered returns of 6.5% compound *per annum* over this 20-year period.

Table 3: Periodic Returns from the HFRX Hedge & Absolute Return Funds Indices and the FTSE World Index

Period	HFRX Global Hedge Fund Index	HFRX Absolute Returns Index	FTSE World Index TR Index (€)
1998-2002	13.2%	7.6%	-0.1%
2003-2017	1.8%	1.2%	8.8%
1998-2017	**4.5%**	**2.8%**	**6.5%**

Source: Bloomberg

As **Table 3** highlights, returns from the Hedge & Absolute Return Funds Indexes over the 1998 to 2002 period were significantly higher than in the 2003 to 2017 period highlighting a significant deterioration in returns over this latter 15-year period.

And, over this 15-year period (2003 to 2017 inclusive), while the HFRX Hedge Fund universe returns just about matched inflation, returns from the Absolute Fund universe fell short of even the inflation rate.

[2] Lack, S. (2012). *The Hedge Fund Mirage*, New Jersey: John Wiley & Sons.

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Returns Increasingly Correlated to Equities

As **Table 2** also highlights, in the earlier 1998 to 2002 period, the hedge fund world succeeded in delivering not just good returns to investors, but the returns were uncorrelated to general equities during the technology-bust period. In other words, the hedge and absolute return funds industry added value in terms of both returns above inflation and at a time when investors in general equities were suffering losses. However, during the Global Financial Crisis and the 2011 Eurozone sovereign debt crisis, returns from the hedge and absolute returns industry were not only negative, but they were quite highly correlated to equities. In other words, since 2002, not only have returns from the hedge and absolute return fund industry been paltry, but they have not been diversifiers of risk. In fact, the hedge and absolute return funds industry appear to be acting like leveraged equity funds!

In **Table 4**, we take a look at the annual and compound *per annum* returns from a balanced or multi-asset portfolio that has a 15% allocation to hedge funds.

Table 4: Annual Returns from a Mixed Asset Portfolio that Includes a 15% Weighting to the Hedge Funds Universe (1998 – 2017)

Year	FTSE World Equity Index (€)	German Bank Deposits	German 10-Year Bond Index	Eurozone Inflation-Linked Bond Index	HFRX Global Hedge Fund Index (i)	Balanced Portfolio
1998	16.5%	3.5%	16.1%	20.2%*	12.9%	14.5%
1999	48.1%	3.0%	-7.1%	5.1%*	26.7%	23.4%
2000	-5.3%	4.5%	8.6%	6.0%	14.3%	2.9%
2001	-11.5%	4.3%	4.7%	5.3%	8.7%	-1.1%
2002	-31.2%	3.3%	10.8%	11.2%	4.7%	-8.0%
2003	11.8%	2.3%	4.2%	8.0%	13.4%	8.9%
2004	7.8%	2.1%	9.9%	9.7%	2.7%	6.8%
2005	28.7%	2.2%	7.5%	4.4%	2.7%	14.0%
2006	9.3%	3.0%	-2.2%	-1.1%	9.3%	5.1%
2007	1.7%	4.3%	3.3%	3.2%	4.2%	2.9%
2008	-38.7%	3.8%	15.7%	6.0%	-23.3%	-15.2%
2009	31.9%	1.3%	0.1%	7.7%	13.4%	16.1%
2010	21.0%	1.0%	6.8%	1.9%	5.2%	10.7%
2011	-4.2%	1.0%	13.6%	0.4%	-8.9%	-0.7%
2012	15.4%	0.5%	7.2%	10.7%	3.5%	9.4%
2013	18.0%	0.5%	-2.1%	-3.7%	6.7%	7.4%
2014	19.3%	0.1%	16.2%	5.1%	-0.6%	10.8%
2015	9.6%	0.1%	2.2%	1.2%	-3.6%	3.8%
2016	11.9%	0.1%	2.2%	3.4%	2.5%	6.0%
2017	9.5%	0.0%	-2.8%	1.4%	6.0%	4.5%
Compound *p.a.*	**6.5%**	**2.0%**	**5.5%**	**5.2%**	**4.5%**	**5.8%**

**UK Inflation-Linked Bond Index (i) Dollar HFRX Index as no Euro denominated HFRX Index existed for the entire period.*

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Table 4 acts as a record, and in **Table 5** we answer the question: did a 15% allocation to hedge funds in a balanced or multi-asset portfolio add any value in terms of returns or risk diversification over the 20-year period from 1998 to 2017 inclusive?

Table 5: Annual Returns from a Balanced Fund Including Hedge Funds (1998 – 2017)

Year	Balanced Portfolio*	Balanced Portfolio with Hedge Funds	Out/Under Performance
1998	14.6%	14.5%	0.0%
1999	19.4%	23.4%	3.9%
2000	1.7%	2.9%	1.2%
2001	-1.7%	-1.1%	0.6%
2002	-7.4%	-8.0%	-0.6%
2003	7.6%	8.9%	1.3%
2004	7.5%	6.8%	-0.7%
2005	14.3%	14.0%	-0.3%
2006	3.7%	5.1%	1.4%
2007	2.8%	2.9%	0.1%
2008	-10.4%	-15.2%	-4.8%
2009	14.6%	16.1%	1.6%
2010	10.4%	10.7%	0.3%
2011	1.3%	-0.7%	-2.1%
2012	9.8%	9.4%	-0.4%
2013	6.1%	7.4%	1.3%
2014	12.0%	10.8%	-1.2%
2015	4.5%	3.8%	-0.7%
2016	5.9%	6.0%	0.1%
2017	3.5%	4.5%	1.0%
Compound *p.a.*	**5.8%**	**5.8%**	**0.0%**

**represents returns on a balanced portfolio of 40% global equities, 20% German 10-Year bonds, 20% Eurozone Inflation-linked bonds and 20% cash deposits*

Source: GillenMarkets

The inclusion of a 15% weighting to hedge funds necessitates the lowering of the allocation to bank deposits, inflation-linked bonds and long-dated bonds also to 15%, thus maintaining a 60% weighting to non-risk and alternative risk-assets and equities at 40% over the period in question.

As **Table 5** highlights, over the period 1998 to 2017 inclusive, a balanced fund containing a 15% weighting to the hedge fund universe delivered a return of 5.8% compound *per annum*. This was the same return an investor obtained from a balanced or multi-asset portfolio that had no allocation to hedge funds. As hedge funds contain risk (of loss), all an investor achieved by including hedge funds was to take more risk!

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