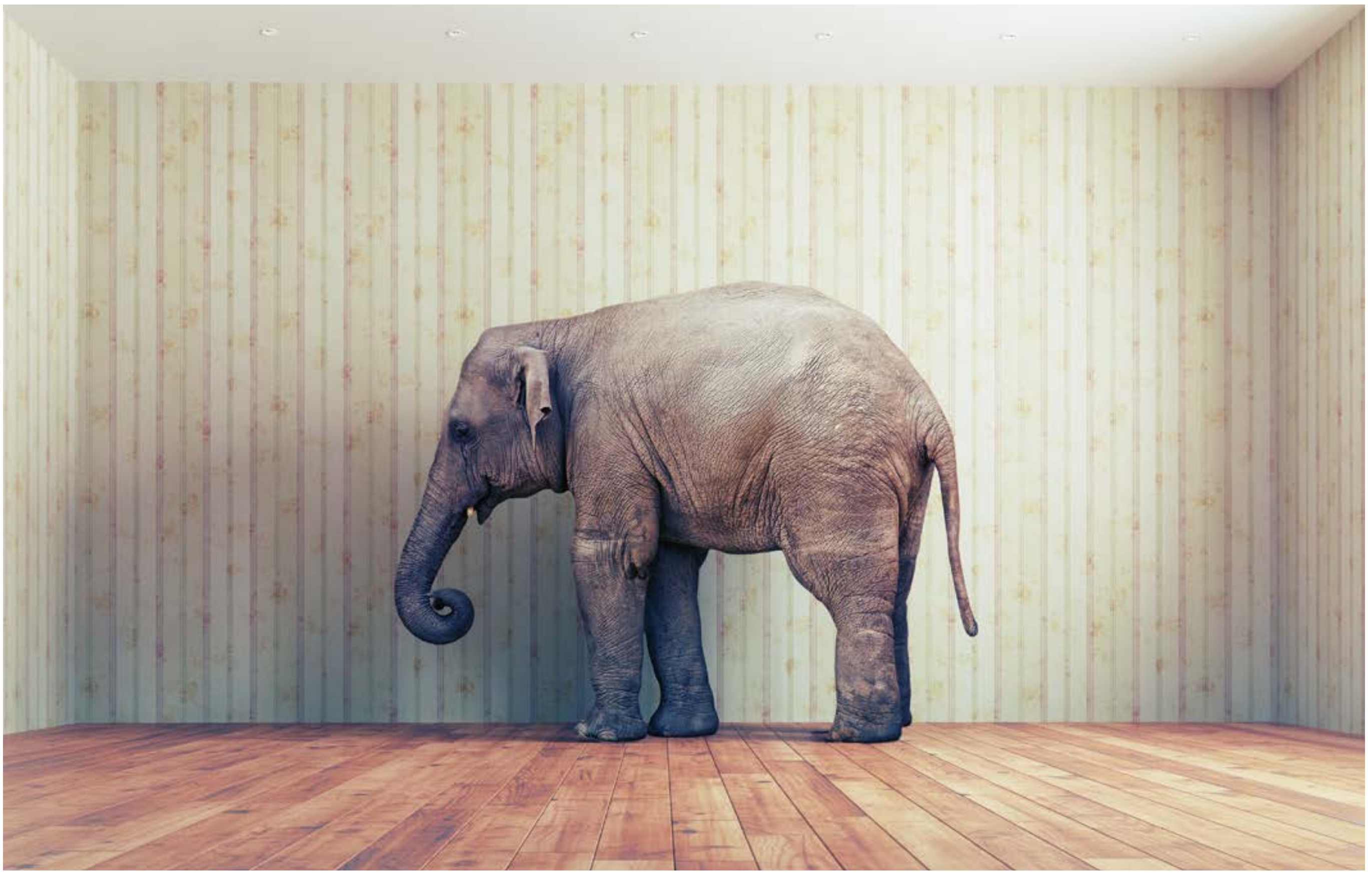

Hedge fund performance – The elephant in the room

By James Williams

As the title of this article suggests, evaluating hedge fund performance over the last decade can be a little awkward, and give rise to a variety of opposing viewpoints. In that sense, it should make for a fascinating panel discussion at ABN AMRO Clearing's Amsterdam Investor Forum (AIF) 2020, which takes place at the bank's headquarters in Amsterdam on 5 February.

Speaking to Hedgeweek ahead of the event, one of the panellists, Wilrik Sinia, Founding Partner and Director of Mint Tower Capital Management, points out that since 2010, "the tide has been receding for hedge funds as investors have sought to ride the wave of low-cost, passive investment returns".

It's hard to argue against this logic, when one looks at the supercharged returns from traditional equity and bond markets. As eVestment points out in its latest data, in 2019 hedge funds had their best aggregate return since 2013, generating +9.74 per cent, but by comparison the S&P 500 Index returned +31.49 per cent.

It's been a similar tale throughout much of the previous decade; some good years (+8.91 per cent in 2017) punctuated by periods of poor performance (-5.08 per cent in 2018).

There are various factors at play, when discussing hedge fund performance, and of course, blithely comparing them to long-only equity markets is a complete fallacy, given that any savvy investor understands hedge funds are not designed to outperform bull markets. They are a diversifier, a low risk option to protect one's portfolio from dramatic downturns.

Sinia, who runs volatility based arbitrage strategies at Mint Tower, will be joined on the panel at AIF 2020 by Theodoros Tsagaris, CIO of Bayforest Technologies and Iuliia Shpak, Systematic Strategies Specialist, Sarasin Quant Solutions. The moderator is Mike Marcey, Managing Director, Efficient Capital Management.

Commenting on the low risk point made above, Sinia remarks: "When I look at my own fund, investors are paying for low volatility as opposed to high risk returns, which can be expensive to generate. We have a maximum drawdown of 2 per cent in the fund. If you look at the hedge fund sector as a whole, very often the volatility of the asset class is lower than broader equity markets: so if you have a market that has been rising for the last decade, the average risk-return profile of hedge funds has tended to be lower. The big question is: Why am I taking less risk? And am I happy doing so?

"Buying ETFs has been the easiest, cheapest way of making the highest returns. Anyone doing something smart has had to defend themselves against this bull market."

How one defines 'performance' is open to interpretation. Within any specific hedge fund sub-category, there will always be dispersion of returns. Long/short equity funds generated +14.26 per cent in 2019 but if one were to drill down, returns would likely produce a bell curve distribution. Some investors might be more than happy with the performance of their equity long/short managers, others not so.

One consideration for how we might think about performance is consistency. Does the manager have a good Sharpe ratio for the strategy, and has he been able to demonstrate that over an extended period of time?

"At the end of the 90s, hedge funds were making 10 to 15 per cent on average," says Sinia."This, though, was generally seen as insufficient as investors were making 20 per cent-plus in equity markets. After the bubble, hedge funds clearly outperformed with their market neutral and uncorrelated risk taking. The bubble has been a great boon for hedge funds.

"But one also has to consider consistency of risk/return, on a statistical basis. A lot of hedge funds tend to experience style drift, where they might initially be pure arbitrage but then, as they get bigger, they find themselves taking outright directional bets, and it kills the quality of their original performance.

"It's quite scarce to find hedge funds that have track records of 10 years or more that have delivered consistent, quality returns."

Part of the discussion around hedge fund performance, which has invariably been negatively impacted by central bankers' commitment to expansionist monetary policy since 2010, is to view it over multi-year cycles, as opposed to year-on-year. Investors need to appreciate the value that hedge funds offer across an economic cycle, not in isolation.

"A lot of our clients look to us as being additive to their traditional portfolios," explains Sinia. "Our average returns, over the years, have been 7 per cent; that doesn't compete with equities, it competes with bonds and that's where our clients are looking to bring diversification...investing in our strategy to protect against a downturn in bond markets.

"That's where hedge funds can bring something to the table. We might not make as high a return, compared to traditional markets, but our investors end up with a better mix of strategies (including other hedge funds) and lower risk."

In his view, rising inflation, higher bond yields and a more depressed equity market could be on the horizon for 2020 and beyond. Moreover, a return to classic fundamental market economics could well play to the strengths of active fund managers and usher in a period of better, uncorrelated returns.

"One consideration for why hedge funds could end up having a strong decade is where you have an end to this ETF, Delta One product universe, where investors are trading the market for short periods. Market valuations are high but if things shift to a more fundamental value play, where stock picking really matters, then paying for managers to generate returns might become more valuable again. I think value investing as a methodology has been almost impossible the last five years," opines Sinia.

Asked how Mint Tower have had to adjust to the low volatility regime in recent years, Sinia is sanguine in his response: "We saw the volatility in some indexes dropping to 1, which is almost ridiculous. We've slowly come out of that over the past 18 months but the price of volatility remains very cheap.

"Even when something does break in terms of market stability, and volatility elevates, it very quickly falls back down. You can't just plug in your 25-year data sets and say 'This is the cheapest volatility has ever been, let's load up and wait for the money to roll in'. Periods of low volatility tend to be followed by periods of high volatility – but we are still some way from that happening."

Last year's performance was welcome for hedge funds. Perhaps moving forward into this new decade, there will be a more substantial break in market stability and lead to currency market stress, equity market stress, bond market stress: and go some way towards reversing the trends that have led to periods of subdued performance.

"Any return to classical normality will, I think, prove positive for the macro players, volatility players and market neutral players, who can handle stress and volatility much better," concludes Sinia. ■

Registration for the AIF 2020 event is now open. For more details please visit: www.amsterdaminvestorforum.com