Crossbow Partners
Experience & Discipline

Miami Trip Report

Conference week by MFA, Morgan Stanley and Context

Jan 28th to Feb 1st, 2019

Executive Summary

After a difficult 4Q 2018 managers were humbled by the markets and surprised about the losses that they accumulated in just a few months

Fundamentally not that much has changed and the volatility was mainly driven by fears of slowing global growth and large money flows

Nevertheless, a recession will arrive one day and investors are nervous about it which will ultimately lead to a selloff of risky assets similarly to 2008

Hedge fund conferences see a record attendance as investors are getting more cautious and are looking for diversification

Florida is hosting a number of hedge fund events with the Context Summit at Miami Beach being the largest by presenting close to 1'000 funds over 3 days

Conferences are useful opportunities to screen across a number of new funds for the first time that could be followed-up with meetings later

Hedge Fund Trends in 2019 and beyond

Investing in hedge funds has evolved from a close circle of wealthy private investors to an industry that is dominated by large institutional investors today. This has led to changes for the industry driven by agency investors with fiduciary duties.

Analyzing hedge fund returns and getting value for money

Traditional hedge fund exposures are being disaggregated, packaged and sold. Banks, hedge funds and others are offering access to traditional hedge fund exposures at a much lower price point than was previously the case. Systematized 'carry' trades somewhat replicate factor exposures found in a sub-set of hedge fund strategies. These factor exposures have been packaged and sold to investors under the label 'alternative beta'. These products are rules-based, long/short strategies; for example, buying 10 high-yielding currencies and selling 10 low-yielding currencies in order to collect the carry. Other return components include traditional market beta and alpha, or unexplained returns.

This disaggregation has led to a better understanding of the drivers of hedge fund factor exposures. As a result, investors are able to access hedge fund-like returns much more cheaply. The commoditisation of these strategies has also allowed for scale investment by large institutions. Providers who can execute these strategies efficiently will provide the purest exposure for investors. However, the cost of trading remains an issue in some cases, and strategies are not yet standardised. As ever, investors need to take a look under the hood to gain a better understanding of each investment opportunity.

Can hedge funds still provide alpha and what should it cost?

Differentiated, uncorrelated returns remain hard to produce. However, the evidence suggests it is possible although the managers who can do it are rare. Where returns can be explained by traditional or alternative beta factors, appropriate fees should be charged. The remaining alpha, or unexplained return component, should command a higher fee. Where alpha is available, it warrants a premium. However, the proportion of alpha that investors should give up in fees must be appropriate − the majority of the alpha should go to the investor.

Structural changes within the long/short equity sector

The shift to risk-off mode will cause assets to flow out of the long/short equity sector, which has typically represented about a third of the industry. Funds with long net exposures will likely to see outflows. Among those, funds that will be particularly hard hit will be those that focus primarily on large cap stocks in developed markets. Many investors believe that the large cap equity market has become so efficiently priced that it is difficult to gain an information advantage. Areas within long/short equity that should see an increase in demand are those managers that focus on small and mid-cap stocks that are less followed by Wall Street, companies based in Asia, and sector specialists such as those that focus on technology or healthcare.

Partnering with investors

Managers increasingly understand the benefits of partnering with their investors. As an example, many provide bespoke investment portfolios on a managed account basis that align with an investor's broader portfolio. Similarly, hedge fund managers and investors are entering into co-investment opportunities, where they are able to add specific exposures to an overall portfolio on a selective basis.

Well-resourced and adaptable intermediaries, who are able to offer a multi-manager model in various formats, are well placed to facilitate tailored partnerships between investors and hedge funds. This model allows the intermediary to understand what the entire hedge fund community has to offer, and translate that into a solution for the end investor.

Investing responsibly

Investors are increasingly demanding both responsible investment (RI) and environmental, social and governance (ESG) investment options. Hedge funds are beginning to respond to this trend. As recently as three years ago, very little attention was paid to these issues, and many practitioners did not see them as relevant to them. Fundamental equity investors have long engaged with company management and boards in order to improve governance, although this is typically done with a focus on unlocking shareholder value in the short to medium term. Recently, however, hedge fund manager thinking has evolved considerably regarding RI and ESG.

Applying hurdles for performance fees

There has been significant fee pressure within the hedge fund industry over the past few years. A majority of this fee pressure has been focused on the management fee, as most investors do not mind paying for performance. Investors are increasingly seeking to differentiate between performances driven by alpha versus beta. As a result, there is growing use of hurdles for performance, which vary from the risk free rate to performance above an index for long biased managers.

Greater focus on hedge fund expenses

Historically, investors have focused very little on the overall expense ratio or which expenses the hedge fund has charged to the fund. There is no clear market standard as to which expenses are allocated to hedge funds and which are borne by the management company. Some managers have been more aggressive than others in allocating expenses to the fund. Recent changes to the US tax code, limiting the deductibility of fund expenses for taxable investors, will create significantly more focus on this issue. As investors and their advisors begin to address 2018 taxes, they will realize the extent to which these expenses are impacting net returns. This will either reduce the expense allocation over time or increase the number of hedge fund managers applying a cap on fund expenses.

What does the fourth industrial revolution mean for the hedge fund industry?

As cheap processing power and increasing amounts of data become available, more and more managers are using Artificial Intelligence, Machine Learning and Big Data to analyse and invest in markets. Although these techniques are still under development, and the amount of available data continues to grow, they need to be understood and harnessed, albeit to varying degrees.

In order to assess the incremental value of each dollar spent, investors should focus on understanding where, and how much, budget is being allocated to harnessing these techniques, and what the impact of that investment is.

Are hedge funds still able to attract the best talent?

Previously, hedge funds typically hired talent from banks, who in turn tended to hire MBA graduates. While people with these skills continue to have a place, hedge funds increasingly focus on hiring computer scientists and physicists, competing for this talent with the large technology firms. This new talent works to analyse large amounts of data and build systems to exploit it.

Investors should look to hedge fund firms that are adopting similar structures to the large technology companies when they are competing to attract talented employees. These firms tend to have flat structures where ideas can be quickly and easily shared among teams in an open environment.

The future growth lies in Asia

2018 saw broad based decline in Asian markets and a reduction in the demand for Asia focused managers. We remain sensitive to the political landscape and the potential near term impact of trade policies by the US, China and other prominent global trading partners. Nonetheless, this declining trend will reverse, and the reversal will be a strong trend over the next decade.

We expect growth from both the investor side and the hedge fund side. Last year, the International Monetary Fund reported that two thirds of world economic growth over the next 5 years will come from Asia. At the same time, valuations of equities in a number of Asian markets trade significantly below valuation levels of European and US markets. Many of the Asian markets are dominated by retail investors creating pricing inefficiencies that are ripe to be captured by hedge fund managers. With the growing Asian markets, there will be an enormous expansion of wealth that will be looking for investment ideas to deploy their capital. For many US hedge fund managers, their global marketing strategy has been primarily focused on Canada, Switzerland and the UK. Over the next decade this will expand to include Singapore, Hong Kong, Japan, Australia, and Korea among other countries.

Sources: AIMA, Aberdeen Standard Investments (ASI), Agecroft Partners, Crossbow