Investing in alternatives

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Beyond the maze: Today's hedge funds should be liquid, transparent and value for money.

Alternative investments were hit hard by the global financial crisis as investors focused on events such as the collapse in 2008 of local hedge fund Basis Capital and the $US65 billion Bernie Madoff hedge fund fraud in the United States.

Investors had been sold hedge funds on the grounds that they were not correlated to other major asset classes and, therefore, were a good way to add diversity, lower a portfolio's risk profile and increase returns – but the negative returns many experienced during the GFC left investors unconvinced.

Typically local hedge funds that provide access to alternative investments focus on managed futures and long-short positions in the equities market.

Managed futures invest in futures, options, forwards and other derivative contracts. They seek to identify upward or downward trends in markets, including currencies, bonds, agriculture, energy, metals and stock indices.

Long-short funds capitalise on events that move markets throughout a day with a position normally never open longer than 24 hours. The rapid turnover in positions means transaction costs have to be minimised.

Traditionally there is a low correlation between equities and bonds and managed futures. The latter tend to perform best in volatile periods. They add diversity and risk mitigation to a portfolio and have a history of outperformance to equity indices.

Financial Risk Management is a global hedge fund that has had an office in Australia since 2001. Local chief executive Richard Keary says that although hedge funds did not perform as expected in the depths of the GFC, they still outperformed equities. He says that in 2008 the industry-wide average fall in hedge fund values was 20 per cent compared with 40 per cent for equities.

Keary says the issue for hedge funds was not strategy but the underlying assets in the fund. It was the firms offering illiquid assets such as property and infrastructure in structures that sought to give daily unit pricing to investors that "tarred the industry with one brush".

While such structures worked so long as growth remained positive and there was always someone willing to buy from an exiting seller, they failed once a lot of sellers wanted to leave and no one wanted to buy.

The other issue was leverage. Many hedge funds had suggested that investors borrow to invest and in many cases they were charging fees not just on funds raised from investors but also on the extra funds they had borrowed. When the gravy train stopped and some of these debt-laden structures failed, the ripple effect was massive. Investors wanted out and in the case where the underlying asset was illiquid, found it difficult to get their money.

Fortitude Capital founder John Corr had to watch as more than 60 per cent of funds under the hedge fund's management were redeemed in the depths of the GFC, a harrowing experience for a fund manager whose speciality is risk mitigation. But as an equities-only managed fund, the underlying assets were easily liquidated so all redemptions were met.

A wholesale fund for institutional investors, Fortitude recently merged with retail distributor Aurora Funds to gain access to its network. While Fortitude had a long track record of performance, Corr had built a business that delivered good product but in effect failed on the marketing side. In 2008-09, Fortitude should have had funds flowing in as it was just the sort of volatile market in which hedge funds are supposed to thrive – instead he faced big outflows.

Aurora Funds head of distribution Simon Lindsay spends a lot of time boosting brand awareness with financial advisers and planners. He says a lot were scared off the hedge fund industry during the GFC but are slowly returning to see what is on offer.

He says part of the problem is a misconception that hedge funds equal high risk-high returns. “I interviewed for a new position where the person was in an equities fund but said it was conservative and felt attracted to the risk profile of hedge funds,” he says. “I had to reinforce that first we manage the downside risk before looking at the potential return. We put ourselves in the risk profile of bonds and yields.”

Corr says Australia “is in love with the cult of equities and property” following decades with a macro environment that favoured those investments. “It doesn’t last and investors need to look at alternatives. The demand for our product is there, even if people don’t know it.”

In Australia, only about 1 to 3 per cent of investment funds are channelled into alternative investments, while in the US it’s about 5 per cent. Over time, Lindsay expects it will grow to 10 to 20 per cent as alternative investments can “substantially increase returns”.

Hedge funds also have to fight the reality of being high-fee products. The only way to determine if that additional fee paid is justifiable is track record. The research side of the industry has caught up with the practices and structures of hedge funds so material is available for investors to compare both performance and fee structures of the various funds.

Keary preaches that a good performing hedge fund is worth the cost. “So if an investor paid nothing to buy an equities index and lost 50 per cent of value and another investor paid a fee of 1.5 per cent through a managed futures fund and lost 7 to 8 per cent, which is better?” Keary says.

“However, as an industry, if the second generation of managers and products don’t learn from the failed product features we have witnessed and practices like gross asset fee charging – it would be pretty stupid.”

He stresses that investors have to check their profiles for sufficient diversity. For instance, a fund that combines equities with bonds is a form of diversification. But Keary says nearly all the risk is carried by the equities, so he doesn’t view it as portfolio diversity.

It’s the same with indices. “Indices were invented to explain why there was a performance difference among managers,” he says. “Now if a manager strays too far from the index they get fired. What was once a tool is now a restraint on returns and diversity.

“Alternative investments should give real diversity in a portfolio. A fund manager wants diversification in his portfolio as it lowers the funds risk profile. But for an individual that fund is just part of their overall risk profile so the manager and the individual actually have different appetites for risk.”

Keary says for those looking at alternative investments, a key requirement is to check the underlying assets to ensure there is liquidity.

The offer document is also vital and has to be read. In the US and Europe most alternative investment products have tight regulatory hurdles, which lowers returns.

Australia has a commonsense approach with the detail in the offer document. If the offer is going to the retail market, disclosure is stricter but Keary fears that globally regulators will seek to “harmonise with each other” and reduce diversity and therefore returns.

Keary says the second generation of offerings to investors has to be liquid, transparent and value for money. The “black box” operators that created wealth through unclear means have largely vanished and, as yet, there is no sign of their return.

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