

INVESTMENT

To hedge, or not to hedge?

Lynn Strongin Dodds explores European pension schemes' relationships
with hedge fund investment

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Notwithstanding the patchy returns and high management fees, hedge funds have come back into the fold as European pension schemes continue to battle against low interest rates, according to the latest *Mercer European Asset Allocation Survey*. However, as with many investments, institutions need to be more selective and not follow the crowd to the point of no return.

Investment increases

The survey, which canvassed 1,241 institutional investors across 13 countries, with total assets of around €1.1 trillion, found that overall allocations to hedge funds rose by 4.6% year-on-year, the biggest growth of any alternative investment. Drilling down, this translates into over a third (37%) slotted into hedge funds with the average weighting at around 6%. Fund of funds were the most popular route to gain access, followed by multi-strategy vehicles.

"Despite the headlines on redemptions, we have seen year-on-year incremental increases," says Mercer Investments principal Robert Howie. "This is part of the long-term trend of investors looking for diversification, and hedge funds are one of the natural strategies that fit into that. We are also seeing a similar interest in private markets for the same reasons."

Specialist active equity



management house Martin Currie's global head of hedge fund sales Alastair Barrie also believes that the sector has been on a reasonable progression upwards. "However, people have been disappointed by strategies in the past such as long/short, which accounted for around one third of all capital allocated," he adds. "There was too much correlation on the downside for long/short strategies and in recent years performance has been poor in terms of upside capture."

Hedge funds though are back on the investment radar screen, partly because the bumper crop of returns produced by equities and fixed

income over the past few years will not be nearly as bountiful going forward. As consultancy firm bfinance's managing director, head of risk and diversifying strategies, Toby Goodworth notes: "We are seeing a move slightly upwards in hedge funds due to the demand for diversification across return-seeking strategies. The increase, which may be from 8% to 10%, is not dramatic but still meaningful."

He adds that "equity valuations are looking topy and the typical rotation from equities to bonds is less desirable than it had been in the past. The result is that the released capital from equities is going into investments such as hedge funds".

The stronger performance of hedge funds over the 15 months has also been encouraging. Separate figures from Preqin show its All-Strategies Hedge Fund Index ratcheted up a 7.40% increase last year, which was the best annual return since 2013 and more than triple the 2.03% generated in 2015.

Take up

The momentum has continued in 2017, with the index recording a 0.76% rise in April, its sixth consecutive month of gains, taking 2017 year to date and 12-month performance to 3.99% and 10.67% respectively. All leading hedge fund strategies were comfortably in the black in the first three months of the year, except commodity trading

Hedge Funds

advisers (CTAs), which dropped 0.30%, compounding the losses of 0.40% and 1.86% in the third and fourth quarter of 2016 respectively.

Prequin's first quarter report though shows that the enthusiasm has not been infectious across the region. The UK continues to be at the forefront, accounting for around 48% of the \$663 billion assets under management of European-based hedge funds. Switzerland came in second at 29%, while other countries have much smaller slices. For example, France, Luxembourg and the Netherlands only have a 2% sliver each.

There have also been some high profile withdrawals, such as the Dutch pension fund, Pensioenfonds Zorg en Welzijn (PFZW), Europe's second-largest public pension; pulling its entire €4.2bn investment, but US behemoths such as Calpers, as well as pension funds in New Jersey, Massachusetts and Rhode Island have also withdrawn or trimmed their allocations. This has in general given investors pause for thought and explains the recent research from Chicago-based Hedge Fund Research, which revealed that pension funds and other big institutions now account for only 43.1% of hedge funds' assets, down from 47% three years ago.

Barriers

One reason is the high fees charged at a time when the sector has not, until recently, delivered the promised alpha. Institutions have increasingly balked at the 2% management and 20% while Prequin data shows that the global average has slipped to 1.63% and 17.21%, they are still considered too expensive and are much less than the 1% charged by

mainstream passive fund managers.

Another factor for the reluctance in Europe is regulation. For example, earlier in the year, the Germany's Federal Financial Services Authority supervisor, the Bafin, issued

a consultation on investment guidelines and limits for Pensionskassen and Pensionsfonds, which are two of the major types of pension funds in the country. It has proposed that open-ended funds that



engage in loan origination should be classified as alternative investments and fall under the 7.5% quota applicable, which could have an impact on hedge funds.

Equally as important are the

politics. Market participants point to a country like France where politicians have regularly vilified the industry, although it is too early to tell whether the tone will be muted under the new President Emmanuel Macron.

Route to entry

When Europeans do venture into the asset class, the most popular route is the so-called gold standard Ucits funds due to their transparency and liquidity. “Many European investors are obsessed with the Ucits wrapper because they want the daily or fortnightly liquidity even though many do not need it,” says Willis Tower Watson global head of liquid diversifying strategies Sara Rejal. “However, we encourage clients to invest in hedge funds under the AIFMD (Alternative Investment Fund Managers Directive) which allows a wider choice of strategies and more flexibility. They should not take the light-touch approach but conduct more stringent due diligence.”

The AIFMD though has narrowed the choice in terms of managers, according to Barrie. “We have seen non-EU managers not wanting to set up compliant AIFMD funds because of the cost. However, we invest in both Ucits and offshore and think the AIFMD is doing a good job at raising the bar in terms of standards, transparency and best practices. The days of two people setting up shop with a PC are over.”

Future

Looking ahead, hedge funds still have their work cut out for them, particularly with the rise of the smart beta funds sweeping across the industry. A recent survey of global institutional investors revealed three-quarters were either using or evaluating the approach while a separate report from research firm

ETFGI showed that at the end of January, roughly \$534 billion was invested in smart-beta exchange-traded funds. Compound annual growth in assets under management in the sector has been 30% over the past five years.

“We are seeing a lot of money flowing in what we call alternative risk premia, which are technically not hedge funds but are perceived as such and also offer diversification,” says Goodworth. “They are attractive because they offer a high degree of transparency and a low cost, flat fee solution.”

Howie adds: “I think smart beta or alternative risk premia is snapping at the heels of hedge funds. However, there is a minority of hedge funds that can add value and investors need to work hard to find them. Past performance is not a good indicator of future performance and our approach is to conduct fundamental research, meet the managers and then sensibly blend strategies together to create a robust portfolio.”

Howie also would like to see greater use of hurdle rates in performance fees. “We need structures that reward for long-term performance and fund managers should not be earning fees until they deliver the returns.”

Rejal agrees, adding that over the past year, the investment community, which had different views, have come together to exert pressure on hedge funds to lower their fees. She says: “On average, they have not been generating alpha in certain strategies and the fees need to reflect this. We also need to address the structures to generate better outcomes.” ■