The Pros and Cons of Hedge Funds

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International Foundation of Employee Benefit Plans
Education | Research | Leadership
Hedge Funds–Three Perspectives

- Reintroduction to hedge funds and fund of funds strategies—Why do investors use hedge funds—An investment consultant’s perspective
- Hedge fund risks, returns and expectations—An investment manager’s perspective
- Ways to protect your plan—A plan counsel’s perspective
- After recent performance struggles, what does the future hold for hedge fund strategies and investors’ sentiment?
What Are Hedge Funds?

- Privately-offered investment vehicles not constrained by a specific benchmark
- Use traditional and alternative asset classes
- Use specialized trading strategies—More tools available
- Attempt to take advantage of market inefficiencies
- Use an expanded set of financial instruments and securities
- Can use leverage
- Generally have less exposure to market risk
Hedge Fund Strategies

RELATIVE VALUE
- Convertible Arbitrage
- Fixed Income Arbitrage
- Equity Market Neutral

EVENT DRIVEN
- Merger Arbitrage
- Special Situations
- Distressed Securities

DIRECTIONAL
- Global Macro
- Long Biased
- Short Sellers

TARGET RETURN %

EXPECTED RISK %

LOWER [Convertible Arbitrage, Fixed Income Arbitrage, Equity Market Neutral]}

HIGHER [Global Macro, Long Biased, Short Sellers]
Why Plans Initially Got Involved

Diversification / Low Correlation
- HFOFs and hedge funds generally offer differentiated risk/return profiles relative to traditional bond and equity investments
- HFOFs and hedge fund strategies offer a variety of correlation benefits

Preservation of Capital / Downside Protection
- HFOFs and hedge funds have consistently preserved capital during more stressed market environments

Reduced Equity Volatility
- HFOFs and hedge funds use a variety of investment tools to mitigate equity risk in order to deliver steady returns with lower volatility
- Long-term, HFOFs and hedge funds have outperformed unhedged investments on a risk-adjusted basis

Diversification / Investment Flexibility
- HFOFs and hedge funds offer flexible investment mandates, enabling them to adapt to changing market environments and to capitalize on the prevailing opportunity set
### Correlation Analysis: January 1994 - April 2016

<table>
<thead>
<tr>
<th></th>
<th>HFRI FOF Composite</th>
<th>S&amp;P 500</th>
<th>S&amp;P 400 Index (Mid Cap)</th>
<th>S&amp;P 600 Index (Small Cap)</th>
<th>MSCI ACWI</th>
<th>Barclays U.S Aggregate Bond</th>
<th>Barclays HY Credit</th>
<th>Bloomberg Commodity Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>0.607</td>
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<td></td>
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<tr>
<td>S&amp;P 400 Index (Mid Cap)</td>
<td>0.656</td>
<td>0.900</td>
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<tr>
<td>S&amp;P 600 Index (Small Cap)</td>
<td>0.621</td>
<td>0.792</td>
<td>0.914</td>
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<tr>
<td>MSCI ACWI</td>
<td>0.684</td>
<td>0.944</td>
<td>0.881</td>
<td>0.789</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Barclays U.S Aggregate Bond</td>
<td>0.038</td>
<td>0.035</td>
<td>0.007</td>
<td>-0.072</td>
<td>0.019</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Barclays HY Credit</td>
<td>0.546</td>
<td>0.625</td>
<td>0.649</td>
<td>0.613</td>
<td>0.678</td>
<td>0.217</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bloomberg Commodity Index</td>
<td>0.445</td>
<td>0.317</td>
<td>0.374</td>
<td>0.328</td>
<td>0.428</td>
<td>0.045</td>
<td>0.359</td>
<td></td>
</tr>
<tr>
<td>CS Leveraged Loan Index</td>
<td>0.474</td>
<td>0.428</td>
<td>0.481</td>
<td>0.444</td>
<td>0.488</td>
<td>-0.022</td>
<td>0.756</td>
<td>0.368</td>
</tr>
</tbody>
</table>
Why Plans Initially Got Involved

Downside Protection

Up/Down Market Analysis

Average monthly net returns
January 1990 – August 2016

<table>
<thead>
<tr>
<th></th>
<th>HFRI FW Composite</th>
<th>S&amp;P 500 Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Down Market</td>
<td>-0.79%</td>
<td>-3.51%</td>
</tr>
<tr>
<td>Up Market</td>
<td>1.70%</td>
<td>3.24%</td>
</tr>
<tr>
<td>All Markets</td>
<td>0.82%</td>
<td>0.84%</td>
</tr>
</tbody>
</table>

Down Market
114 months

Up Market
206 months

All Markets
320 months

Data sources: Hedge Fund Research (HFR); S&P. S&P and its third-party information providers do not accept liability for the information and the context from which it is drawn.
Past performance is not necessarily indicative of future results.
Why Plans Initially Got Involved

Positive Slope to Hedge Fund Returns

Count of monthly returns by range
January 1990 – August 2016

Data sources: Hedge Fund Research (HFR); S&P. S&P and its third-party information providers do not accept liability for the information and the context from which it is drawn. Past performance is not necessarily indicative of future results.
Why Plans Initially Got Involved

Downside Protection

Hedge Funds During Challenging Environments

Ten worst monthly S&P 500 drawdowns
January 1990 – August 2016

Data sources: Hedge Fund Research (HFR); S&P. S&P and its third-party information providers do not accept liability for the information and the context from which it is drawn. Past performance is not necessarily indicative of future results.
Why Plans Initially Got Involved

Higher Cumulative Return, Lower Volatility

**Growth of $1,000 vs. market indices**

January 1990 – August 2016

<table>
<thead>
<tr>
<th></th>
<th>Annualized</th>
<th>Return</th>
<th>Volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>HFRI FW Composite</td>
<td>10.0%</td>
<td>6.7%</td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>9.4%</td>
<td>14.5%</td>
<td></td>
</tr>
<tr>
<td>Barclays U.S. Agg.</td>
<td>6.3%</td>
<td>3.6%</td>
<td></td>
</tr>
</tbody>
</table>

Data sources: Hedge Fund Research (HFR); Barclays Bank PLC, 2016; S&P. S&P and its third-party information providers do not accept liability for the information and the context from which it is drawn. Past performance is not necessarily indicative of future results.
Why Plans Initially Got Involved

*Improve Risk Adjusted Performance*

Asset Allocation: Time Period 01/1990 to 01/2016

<table>
<thead>
<tr>
<th></th>
<th>60/40 Portfolio</th>
<th>5% to Hedge Funds</th>
<th>10% to Hedge Funds</th>
<th>15% to Hedge Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annualized Return</strong></td>
<td>8.22%</td>
<td>8.16%</td>
<td>8.10%</td>
<td>8.04%</td>
</tr>
<tr>
<td><strong>Annualized Standard Deviation</strong></td>
<td>9.04%</td>
<td>8.75%</td>
<td>8.45%</td>
<td>8.17%</td>
</tr>
<tr>
<td><strong>Sharpe Ratio</strong></td>
<td>0.88</td>
<td>0.90</td>
<td>0.93</td>
<td>0.95</td>
</tr>
</tbody>
</table>

Improve plan level risk adjusted performance
Why Plans Initially Got Involved

*Summary Check List*

- Diversification / Correlation Benefits
- Preservation of Capital / Downside Protection
- Reduced Equity Volatility
- Investment Flexibility
Considerations When ERISA Plans Invest In Hedge Funds

- Plan Document Considerations
- Who is the Fiduciary For Investment—Manager or Trustees?
- Due Diligence
- Potential Contracting Pitfalls And Solutions For Benefit Plan Investors
Plan Document Considerations

- Do Your Plan Governing Documents Allow for this Hedge Fund Investment?
  - Trust Agreement
  - Investment Policy
- Avoid unnecessary ERISA fiduciary breach issue (ERISA Section 404(a) failure to follow plan documents)
Who is Fiduciary For Investment?

- **Who is ERISA fiduciary for investment—Trustees or Manager?**
- Does Investment Hold Any ERISA Plan Assets?
- If NO, Trustees remain fiduciary for investment.
- If YES, Not Treated As ERISA Plan Assets if Participation By ERISA Benefit Plan Investors Less Than 25% of Investors.
  - 25% Excludes Governmental, Certain Church and Foreign Plans.
- If ERISA Plan Assets over 25%, Manager is fiduciary (unless exception applies).
Exceptions To Who is Fiduciary For Investment

- Not Plan Assets Subject to ERISA if investment in Venture Capital Operating Company (VCOC Rules)—Usually private equity strategy.
- VCOC is entity with at least 50% of its assets invested in “venture capital investments” in which it has “management rights”.
- Management rights = Rights to substantially influence management of the operating company.
  - Must be “direct” rights that VCOC can exercise.
- Asset/management tests done annually.
Exceptions To Who is Fiduciary For Investment

- Not Plan Assets Subject to ERISA if investment in Real Estate Operating Company (REOC Rules).
- REOC is entity with 50% or more of its assets invested in qualifying real estate and directly engaged in real estate management or development activities.
- Tested with first investment and annually thereafter.
Hedge Fund of Fund
Special Delegation Issues

- Named Fiduciary = Only fiduciary with ability to delegate its ERISA fiduciary duty to another entity
- Must be identified in Plan Document (Trust Agreement)
- Board of Trustees/Retirement Committee usually named fiduciary
- “Master manager” of hedge fund of funds
  - Is master manager also a named fiduciary to delegate ERISA fiduciary duty to sub-managers/underlying investment funds?
  - Does Trust Agreement allow designation of master manager as named fiduciary?
  - If not, does master manager acknowledge that it is liable for sub-manager’s actions?
Due Diligence Before Investing In Hedge Fund

Investment Consultant Role

• Selection And Ongoing Monitoring
• Asset Allocation Decision
• Modeling And Stress Testing
  – Look-Through Analysis Of True Risk Exposures
  – Return expectation and timing/ “J curve”
  – Lock-ups and cash flows
• Independent Valuation
• DOCUMENT PROCESS!
Issues Under Investment Contract

• Side Letter To Hedge Fund Investment - Documents
  – Governs if investment fund documents inconsistent
  – Right to see side letters of other investors

• Standard of Care
  – ERISA fiduciary standard
  – ERISA-like contractual standard
  – ERISA-light contractual standard (prudence standard only)

• Indemnification
  – By manager of Plan and Trustees?
  – By investment fund of manager?
  – By Trustees personally?
Issues Under Investment Contract

Fees

• Most Favored Nations ("MFN") Treatment on Fees, Rights and Features
• Fees on Un-called Capital
• Incentive Fees
  – Warrant under DOL guidance?
  – Valuation of Portfolio and Potential Conflicts
• Claw back
  – How is high-water mark for payment of incentive fees set and reset?
Issues Under Investment Contract

More Fees

- Unrelated Business Taxable Income
  - Effort to avoid?
  - Protections if taxable income is earned?
  - Impact of tax on net return/incentive fee?

- Imposition of Organizational and Operating Expenses
  - Charged to investor or manager absorbs?
  - Capped?
  - If early investor, spread to later investors?
Issues Under Investment Contract

• Confidentiality
  – Of Plan’s information?
  – Of Plan’s identity?

• Reporting
  – Sufficient for ongoing monitoring by investment consultant?
  – Financial statements of underlying investments?
  – Section 101(k) for multiemployer plans?
Issues Under Investment Contract

• **Conflicts of Interest**
  – Avoided, either by ERISA or by contract?
  – Limits on hiring its affiliates for middle & back-office services?
  – Fees from underlying investments/investment managers?
  – Valuation by independent entity

• **Scope of other agent’s liability (administrator, custodian, board of directors)**
Issues Under Investment Contract

- **Voting**
  - Pro-rata?
  - Control over changes in future?

- **Investor Advisory Councils**
  - Right to position (if desired)

- **Involuntary Redemptions**
  - Allowed?
  - At any time?
  - For limited reasons or manager’s complete discretion?
Issues Under Investment Contract

• **How To Get Out?**
  - No Fault Divorce/Liquidity—*When and with What Notice?*
  - Lock Up?
  - Liquidation impractical or inadvisable?
  - Extended beyond initial term? If so, who decides?
  - Unilateral by manager as GP or vote of investors?
  - What is Fund getting—in kind or cash?
  - If in kind, who manages until liquidated and for what fee?
Hedge Funds as Return Enhancers or Help Reduce Volatility? 
*Limited Recent Outperformance (Alpha) Compared to Public Markets*

### Annualized net returns by calendar year

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>HFRI FW Composite</td>
<td>10.3%</td>
<td>-5.3%</td>
<td>6.4%</td>
<td>9.1%</td>
<td>3.0%</td>
<td>-1.1%</td>
<td>3.5%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>15.1%</td>
<td>2.1%</td>
<td>16.0%</td>
<td>32.4%</td>
<td>13.7%</td>
<td>1.4%</td>
<td>7.8%</td>
</tr>
<tr>
<td>Barclays U.S. Agg.</td>
<td>6.6%</td>
<td>7.8%</td>
<td>4.2%</td>
<td>-2.0%</td>
<td>6.0%</td>
<td>0.6%</td>
<td>5.9%</td>
</tr>
</tbody>
</table>

### Rolling period returns and volatility

<table>
<thead>
<tr>
<th></th>
<th>Trailing 1-year</th>
<th></th>
<th>Trailing 3-years</th>
<th></th>
<th>Trailing 5-years</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>HFRI FW Composite</td>
<td>2.8%</td>
<td>4.6%</td>
<td>3.6%</td>
<td>4.0%</td>
<td>3.5%</td>
<td>4.6%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>12.6%</td>
<td>12.4%</td>
<td>12.3%</td>
<td>10.7%</td>
<td>14.7%</td>
<td>11.6%</td>
</tr>
<tr>
<td>Barclays U.S. Agg.</td>
<td>6.0%</td>
<td>2.2%</td>
<td>4.4%</td>
<td>2.6%</td>
<td>3.2%</td>
<td>2.6%</td>
</tr>
</tbody>
</table>

Data sources: Hedge Fund Research (HFR); Barclays Bank PLC, 2016; S&P. S&P and its third-party information providers do not accept liability for the information and the context from which it is drawn. Past performance is not necessarily indicative of future results.
Significant up and down fluctuations in equity markets

S&P 500 Index Level

-12.2%  +13.0%  -13.3%  +15.9%  -6.4%

Data sources: S&P. S&P and its third-party information providers do not accept liability for the information and the context from which it is drawn.
Hedge Funds Performance
Saturation - Impact on Market Efficiency

Growth of Hedge Fund & ETFs Over Time

Select Reasons for ETF Proliferation
- Simplicity
- Enhanced Liquidity
- Speed of Execution
- Diversification
- Attractive fees

Select Risks of ETF Proliferation
- Market instability
- Market efficiency
- Herd mentality

Hedge Funds Performance

Over-Diversification? Similar Fund Characteristics?

- 1
- 25 - 50
- 3 - 6
- 8,000+

Traditional Multi-Strategy HFOF Vehicle

Month Liquidity Provisions (On Average)

Underlying Hedge Fund Investments

Underlying Security Investments (Long & Short)

Source: Lighthouse Partners, K2 Advisors
Commitment to Hedge Funds Today

How Investors View Hedge Funds

Investors’ intentions for their hedge fund allocations in next 12 months

- Increase allocation
- Maintain allocation
- Decrease allocation

Source: Preqin Hedge Fund Investor Interviews

Commitment to Hedge Funds Today
How the Investment Consultant Community Views Hedge Funds

Despite recent performance struggles, institutions and consultants alike remain steadfast in their pursuit of hedge fund-like exposures as critical components of broader portfolios.

Source: 2016 Preqin Global Hedge Fund Report
Despite Recent Performance, Hedge Fund Industry Is Stable

As of June 30, 2016:
- AUM: $2,898 billion
- Count: 8,406 hedge funds

Evolving Hedge Fund Investment Landscape

Improved partnership between managers and investors

- Customization
- Transparency
- Fees

Portfolio concentration

- New strategies blur the lines of PE vs. HF vs. traditional investing

Regulatory changes

- Increase in talent leaving banks to join hedge funds
- Hedge funds replacing banks as longer-term liquidity providers

Hedge Fund Alternatives
Potential Headwinds for Traditional Assets?

**Equity markets**

High equity market valuations

- Price-to-earnings ratios remain high

- S&P 500 Index Trailing Quarter P/E Ratio

- Trailing 5-year average: 16.6

Declining earnings growth

- Year-over-year earnings per share growth has turned negative

- S&P 500 Index Trailing 12-Month Weighted EPS Growth

- Trailing 5-year average: 6.8%

**Fixed income markets**

Potential for rising bond yields and falling bond prices

- Government bond yields continue to compress

- U.S. 10-year Treasury Note

- Average since 2000: 3.7%

Potential for widening credit spreads and increasing defaults

- High yield spreads near pre-crisis levels

- Credit Suisse High Yield Spread to Worst

- Average since 2000: 638 bp

Data sources:

- Federal Reserve Bank of St. Louis; Credit Suisse; Bloomberg Finance L.P.; S&P

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Setting the Stage for the Future

*Capital Market Assumptions*

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<tbody>
<tr>
<td>Equity</td>
<td></td>
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<tr>
<td>U.S. Large Cap</td>
<td>6.6%</td>
<td>9.3%</td>
<td>-2.7%</td>
<td>16.9%</td>
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<tr>
<td>Emerging Markets</td>
<td>8.5%</td>
<td>12.5%</td>
<td>-3.0%</td>
<td>26.4%</td>
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<tr>
<td>Fixed Income</td>
<td></td>
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<tr>
<td>Core</td>
<td>3.4%</td>
<td>4.2%</td>
<td>-0.8%</td>
<td>6.0%</td>
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<tr>
<td>Alternatives</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Hedge Fund of Funds</td>
<td>5.4%</td>
<td>7.4%</td>
<td>-2.0%</td>
<td>8.4%</td>
</tr>
</tbody>
</table>

Source: Horizon Actuarial Services, LLC – 2016 Survey of Capital Market Assumptions
Greater Macroeconomic Uncertainty

Why we might see increased global equity/credit market dispersion:

- Slower economic growth globally
- Diverging global monetary policies
- Unprecedented central bank actions
- Binary macro events like Brexit
- Geopolitical risks globally
- Potential for U.S. interest rate hikes
- Detrimental effects of negative interest rates in Europe and Japan
- Decline in inflationary expectations globally
- Rising risk of credit-driven crises due to high leverage levels (China)
- Technical factors increasingly driving stock valuations

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Incorporating Hedged Investment Solutions Today

Hedge Fund-Like Investments Across the Liquidity Spectrum

...Hedge fund-like exposures come in various shapes, sizes, and liquidity profiles today. Traditional multi-strategy HFOF vehicles remain viable, but other solutions exist across the spectrum.

Liquid Alternatives
- Risk Parity
- GTAA
- Style Premia
- Equity Options
- 40 Act Alternative Mutual Funds
- Other

HFOFs / Direct HFs
- Multi-Strategy
- Strategy-Specific
- Sector-Specific
- Region-Specific

Illiquid Alternatives
- Opportunistic
Session #I09

The Pros and Cons of Hedge Funds

• Be Sure Your Plan Document Allows The Hedge Fund Investment
• Know Who is Fiduciary For Investment—Manager or Trustees?
• Complete and Document Due Diligence
• Negotiate Over Contracting
• New Investors—Understand What is the Role of the Hedge Fund Allocation
• Existing Investors—Review Why were Hedge Funds Added
• Review Whether or Not Hedge Funds have Met Goals—Have Goals or Expectations Changed?
• Consider Recent Hedge Fund Performance in Light of Current and Potential Market Conditions
• Understand the Evolution of Hedge Fund Products and Alternatives—including a Consideration of Liquidity Needs
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Investments

63rd Annual Employee Benefits Conference
October 22-25, 2017
Las Vegas, Nevada
www.ifebp.org/usannual

Portfolio Concepts and Management
May 1-4, 2017
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