HEDGE FUNDS AND POSITION CROWDING

As of mid-month October, the S&P 500 was down over 5% and the MSCI World was down 6%. In this context, drawdowns among hedge funds have been unexpectedly large. Before fees, the HFRX Global Investable index was down over 4%, while the Equity Long/Short and Event-Driven sectors were down 5% and over 7%, respectively (note that the reported losses are lessened by the reversal of accrued performance fees). The average alternative multi-manager mutual fund (generally with 0.2 to 0.3 equity beta targets) was down 3% net of fees.

What explains the underperformance? A significant portion likely is due to position crowding, which occurs when many hedge funds hold similar positions. In good times, additional buying can support stock prices and contribute to excess returns. For instance, the GS VIP index, which tracks positions in which hedge fund managers have a significant stake, outperformed the S&P 500 index by around 400 bps (per annum) from 2009 to September 2014. Performance like this is used to support the thesis that hedge fund managers add value over time through stock selection.

In periods of market stress, however, those same positions can underperform significantly as hedge funds cut positions simultaneously. The table below shows the GS VIP performance during the market drawdowns of 2008, 2011 and the current year:

	Sept – Oct 2008	Aug – Sept 2011	Sept – Mid Oct 2014
S&P 500	-24.21%	-12.08%	-6.80%
GS VIP	-32.58%	-18.48%	-8.65%
Underperformance	-8.37%	-6.40%	-1.85%

In each of these drawdowns, widely-held positions declined by 30-50% more than the market as a whole. While gross underperformance in September through mid-October has not been nearly as pronounced as earlier periods, the data suggests that these positions will further underperform if the markets decline further.

Another form of position crowding occurs when hedge funds invest in a common theme. This year, many event-driven managers have owned stocks that are takeover candidates due to tax inversion arbitrage; a recent shift in the regulatory environment led to price declines in numerous such positions (most recently Shire, which purportedly caused over $1 billion in losses for hedge funds last week alone). Anecdotally, many hedge funds also have outsized exposure to oil and gas producers, an implicit bet on high oil prices; it remains to be seen if the recent decline in oil prices has caused outsized losses here as well. Likewise, the sudden drop in 10 year Treasury yields last week has also been blamed on hedge funds scrambling to cover short positions.

It is quite possible that the concentration of capital among the largest hedge funds will exacerbate this going forward. Further, numerous investment products now clone long positions of prominent hedge funds (from recent 13F filings) and investors regularly piggyback on positions held by their hedge funds. This additional capital may amplify both upside and downside performance in the quarters and years ahead.

Position crowding is analogous to (or maybe a form of) illiquidity risk. Alpha can quickly turn negative in periods of market stress, as we saw with illiquid hedge funds during 2008. Looked at another way, low beta funds became high beta when markets declined. The same is true for position crowding. Hedge fund investors who are seeking to protect against downside moves may need to factor this into overall portfolio construction.