NEXT GENERATION INSTITUTIONAL HEDGE FUND INVESTING

Institutional hedge fund investing is entering a new era. Generation one entailed investing through funds of hedge funds, which offered manager selection, access, diversification and better liquidity in an era when hedge funds were more opaque and less well understood. The crisis, however, revealed that many funds of funds were running a dangerous asset-liability mismatch as over 80% of redemptions in early 2009 came from funds of funds. Madoff and other frauds highlighted the risk of failures to adequately diligence certain strategies, which further heightened risk aversion in the coming years.

Generation two has been a disintermediation of funds of hedge funds through direct allocations to a diversified portfolio of single managers. Driven by institutionalization and dissemination of knowledge about manager selection and due diligence, three quarters of investors today allocate directly. This has helped to reduce the all in cost of investing by 100 bps or more.

Generation three involves a shift to a core satellite model, where the core allocation to a given strategy or sub-strategy is implemented through low cost, liquid alternatives, including dynamic or alternative beta programs. A good analogy is long equity investing, where two decades ago an institution might have selected two dozen active managers – each at relatively high fees – but now utilize low cost index funds/ETFs to obtain core exposures and concentrate resources on identifying higher value added, more idiosyncratic "alpha" satellite funds. Generation three promises to materially drive down all in fees by 200 bps or more, improve liquidity and risk management, and enable investors to concentrate resources on higher alpha opportunities.

Why is this happening today? There are four principal drivers:

- Numerous liquid alternative products have established track records of delivering comparable returns to higher cost, illiquid hedge fund portfolios. This contrasts with investable hedge fund indices, which have materially underperformed due to adverse selection and investment constraints.
- With lower returns, institutions face increasing pressure to reduce all in fees. The flow of capital to only the largest firms has prevented a material reduction in fees, even among larger investors. Whereas the focus of the past five years was on disintermediating fund of funds level fees, attention has shifted to the 2/20 structure.
- A better understanding of the underlying drivers of performance, such as more sophisticated factor/risk premia models, has demystified the drivers of returns and demonstrated that many funds are overpaid for providing beta-like performance.
- Capacity issues for larger investors (e.g. CalPERS).

There is little question that the hedge fund industry will continue to grow. Citibank estimates that traditional hedge fund assets will rise to almost $5 trillion by the end of 2018, or roughly five times the total just a decade ago, as institutions diversify away from low yielding fixed income investment and seek to meet high long term return targets. The rise of liquid alternatives could bring another $1 trillion into the industry as retail investors make meaningful allocations for the first time.

With growth comes the need to evolve. The traditional investment business has shifted to a model of "pay less for beta, pay up for alpha." With more innovative tools at their disposal, institutional investors can better manage their portfolios to enhance net of fee returns, lower costs, improve liquidity and reduce risks.