World Presidents' Organization

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Combining Hedge Funds &
Traditional Managers

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What Are We Trying to Accomplish?

There are many possible reasons to add hedge funds to traditionally designed portfolios

Common reasons for adding hedge funds to a traditional portfolio:

- Engage more outperforming managers (create alpha)
- Reduce downside volatility (control variance drain)
- Diversify away from other risks in the asset base (asset allocation)
- Everyone is doing it (!)

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What Are We Trying to Accomplish?

Back in the day, investing in hedge funds was as easy as getting on an airplane

If our main interest in hedge is to engage outperforming managers:

- This used to be easy: hedge fund managers were the cream of the crop
- There was a lot of low-hanging fruit for hedge funds to harvest
- Markets were more volatile, spreads were wider, sovereign macro-economic policies were antediluvian
- The pool of potential managers was much smaller

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What Are We Trying to Accomplish?

Today, investing in hedge funds is as easy as… getting on an airplane

But today:

- Many inexperienced managers are entering the business (low barriers to entry)
- Massive amounts capital are coming into the hedge sector (CalPERS, etc.)
- Investors are far less patient (principal-protected notes, e.g.)
- Fees are going up just as returns tank

What Are We Trying to Accomplish?

As if that weren't enough…

In addition, there are other challenges:

- Traditional measures of excellence don't apply (e.g., alpha, Sharpe ratios)
- Up-front diligence is a huge challenge for individual investors
- Ongoing diligence is essentially impossible for individual investors
- Few funds of funds are worth the extra layer of fees and the tax cost

What Are We Trying to Accomplish?

If our main interest in hedge is to reduce downside volatility:

- $C = R - \sigma 2/2$
- Long-only managers are mainly engaged in a relative performance game; individual investors are absolute return investors
- Hedge funds can reduce variance drain even without alpha – because they are hedged & because many have low correlations
- For volatility-shy investors, “indexed” hedge fund exposure may be appropriate

On the volatility front, hedge funds have a lot to offer

What Are We Trying to Accomplish?

Hedge funds add an important element to the portfolio design toolkit

If our main interest in hedge is to diversify away from other risks in the asset base:

- Expected market returns too low (need alpha)
- Expected portfolio return too low (need alpha)
- Worry about a collapse in valuations (absolute return strategies, short sellers)
- Fear of a general increase in volatility (spread strategies, vol strategies)

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What Are We Trying to Accomplish?

Many investors will be disappointed and some will get killed

If our main interest in hedge is that everyone is buying hedge funds:

- Find a really good advisor
- Limit your allocation to hedge
- Consider a good fund of funds
- Avoid macro strategies

Portfolio Design Considerations

Traditional portfolio design techniques won't work

When adding hedge to a traditionally designed portfolio, keep these issues in mind:

- MVO doesn't work (hedge returns are skewed and kurtotic)
- Volatility-based risk measures are inadequate (they don't incorporate illiquidity, non-transparency, fraud, etc.)
- Sharpe ratios and alphas are problematic
- Must account for net-of-fee and net-of-tax (and phantom tax!) returns

Portfolio Design Considerations

Caution is the byword

Portfolio design advice:

- Think of hedge not as an asset class but as an alpha and/or volatility strategy
- Directional and absolute return play different roles in the portfolio
- Start with a modest allocation and work your way up
- Keep firmly in mind the three rules of hedge fund investing: Diversify, Diversify, Diversify

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Portfolio Design Considerations

There are many attractive ways to build hedge fund exposure

Strategies to consider:

- Work with a good, unconflicted advisor
- Consider funds of funds for your core exposure
- Consider a portfolio of multi-strategy funds
- Consider insurance-based products for larger accounts
- Consider derivative exposures that can convert short-term gain into long-term gain

Timing Is Everything

In case you wonder if there may be a bubble…

A final thought:

- Dennis Kozlowski's $21 million condo was just bought by a hedge fund manager…

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