DRAKE CAPITAL
ADVISORS

NOT ALL HEDGE FUNDS LOOK ALIKE

There has been a steady stream of negative articles surrounding the hedge fund industry in recent months, culminating with a piece in the July 15-21, 2013 issue of *BusinessWeek* entitled, *Hedge Funds Are for Suckers*. Our general reaction to the negative news flow has been welcoming in the sense that more negative press keeps uninformed capital away from the industry, which is a good thing. However, this article raises a number of issues, loaded with nuances and unsupported claims. It also highlights some perfectly valid observations. We thought it would be useful to review the key claims of the article and then address a number of other areas of appropriate focus. We have attached a link to the article at the bottom of this white paper.

The Claims

Fund managers as gamblers:

The opening paragraph starts dramatically with a statement that George Soros, James Simons and other hedge funds made hundreds of millions if not billions through glorified gambling. Without addressing any of the individual funds, we seek to invest with managers who stack the odds in their favor through fundamental research and risk management. If this is gambling, then the moniker should apply to all forms of investing.

Declining alpha:

The article defines alpha as a "macho term for risk-adjusted returns that surpass the overall market because of the skill of the investor." Actually, alpha refers to returns that are generated independent of the market through manager skill. As explained below, alpha has declined significantly at the industry level with the influx of capital, but top managers continue to generate very substantial alpha.

Increased competition:

The article highlights the increased resources, advanced degrees and computing firepower that are devoted to the hedge fund industry. This feature, driven by the financial incentives associated with the business model, has clearly elevated and intensified competition among hedge funds. The financial incentives have also, as we see daily in the press, motivated a small subset of managers to seek an unfair and illegal advantage. This is undeniably true. But we would argue, based on twenty-plus years of hedge fund investing and the evaluation of thousands of funds, that there are many highly successful managers who operate their businesses with the highest levels of integrity. A vitally important part of any robust due diligence process involves the critical assessment of manager character and integrity.

Hedge fund scalability:

The article refers to the alluring aspect of scalability of hedge funds. While the concept may be alluring to managers who are trying to maximize the enterprise value of their business, we have never believed in the scalability of hedge funds or been attracted to managers who do. The hedge fund graveyard is full of funds which became too big for their markets. The best managers recognize their limits and are willing to return capital when the opportunity set is inadequate for the capital base. We broadly agree with the life cycle concept of hedge funds, where the combination of a small asset base and intense focus on results generates outsized performance. Size is generally an enemy of returns, as is a lack of focus that sometimes comes with success. But there are numerous top managers who are fiercely competitive and are as intently focused on performance as they were twenty years ago.

Disappointing recent performance:

The article highlights disappointing performance of a number of funds in 2013, most notably Bridgewater and Paulson. We have no need to defend them or their records, but to make a case based on six months of disappointing results lacks credibility.

Most interesting to us is that after bashing hedge funds with selective use of data, the article concludes that hedge funds can serve a useful purpose for prudent investors looking to manage risk, and that hedge fund moguls are not magicians. We agree with this important conclusion, even if it does not seem to fit with the title of the article.

Having addressed some of the assertions made in the article, it is useful to take on the subject with a broader focus. The key question is not whether hedge funds are good or bad, for smart investors or for suckers, because there is not a right or wrong answer in absolute terms. The much more relevant questions are, "Do hedge funds add value?", "What role do they play in a portfolio?" and "How does any investor maximize the odds of success?"

Overview

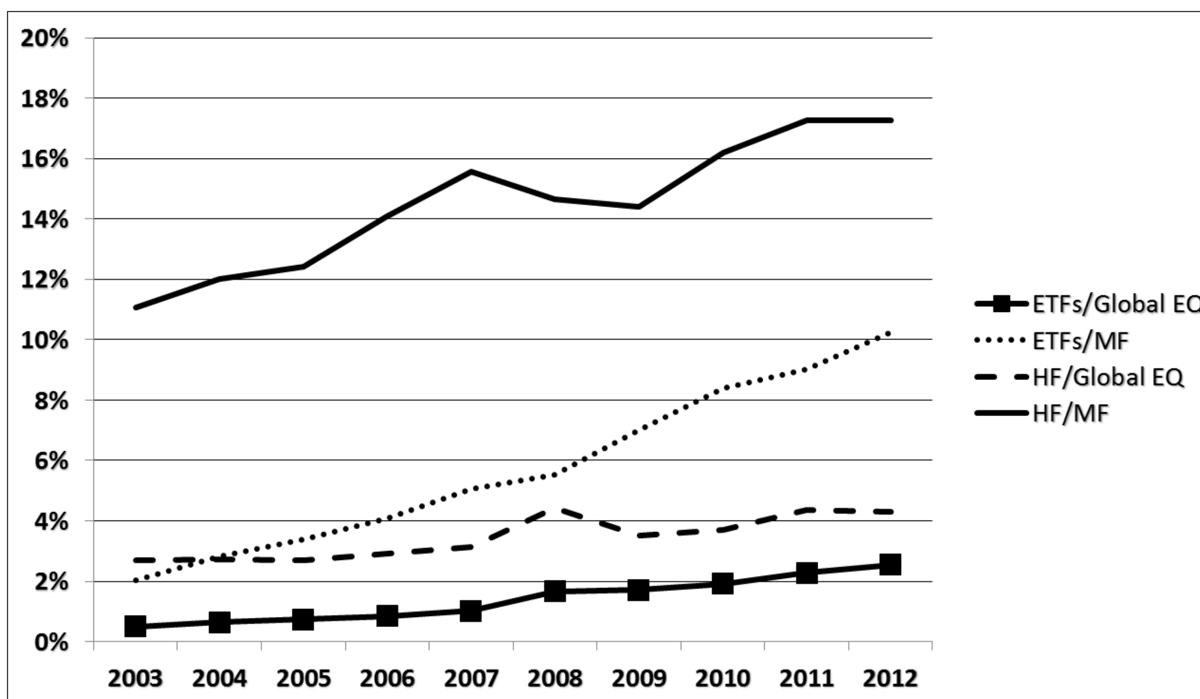
We have known for a long time that most hedge funds fall well short of providing an attractive value proposition for their clients, much the same as most mutual funds add little value. The combination of high fees, limited liquidity and variable transparency are high hurdles. But even with these hurdles, hedge funds as a group have provided meaningful alpha. One of the criticisms of hedge funds is that they have lagged in performance terms in recent years. For anyone who views hedge funds through an appropriate lens, this is not surprising. Most hedge funds actually hedge – the point is to generate attractive returns while managing risk, so it is not surprising that hedge funds as a group have underperformed a strong equity market; historically however, hedge funds have outperformed market indexes over a market cycle. So a longer-term perspective is critical. However, the bottom line is that there are many hedge funds which, in our view, do not deserve to be in business. The more critical point is that we should not be looking to merely invest in the industry – rather, our goal should be to identify a small group of exceptional managers who

are focused on performance and whose incentives are aligned with investors. There continue to be managers who consistently outperform. This is even more the case among smaller managers with a broad range of opportunities and inefficiencies to choose from. **We continue to believe that the flexible investment mandate that characterizes the top hedge funds provides the best model for long-term investment returns in marketable securities.**

How and Why Do Hedge Funds Exist?

As a broad generalization, hedge funds exist to exploit inefficiencies created by institutional rigidity and biases. They thrive by applying a high labor-to-capital ratio. Many institutions traditionally could not hold non-investment grade debt or defaulted debt, creating opportunities for active managers without these restrictions. In equities, many institutions are limited by their tracking error to diverge from benchmark indices. Spinoffs create companies in non-core industry sectors. Restructurings create equities that lack sponsorship from debt holders. The list goes on and on. Within this framework, the long-only industry has become increasingly specialized over the years, breaking down some of these institutional rigidities while creating others. The explosion of ETFs has provided investors a broader range of liquid, low-cost options which has similarly broken down certain biases and created others. Meanwhile, the hedge fund industry has grown assets tremendously. In the 1980s, the hedge fund universe was a small club populated by wealthy families and a handful of forward-thinking endowments. Today, hedge funds populate pensions, endowments and even retail portfolios through "40 Act" funds. In this sense, as hedge funds have grown relative to traditional long-only assets, not only has competition within the hedge fund space intensified, but the aggregate pool of inefficiencies is spread across a larger asset base, undermining available returns on capital at the industry level. It is also worth stating that a great deal of institutional capital in search of fixed income-like returns with low volatility has stimulated a huge supply of funds focused on this need. This is a very different focus than the hedge funds of 20 years ago.

The graph below shows the growth over the last ten years of hedge funds and ETFs as a percentage of Mutual Funds and Global Equity Market Capitalization. Clearly, this growth of hedge funds has contributed to declining industry level returns.



Sources: Hedge Fund Research, Inc.; Investment Company Institute; Bloomberg.

Hedge Fund Return History

We have looked at the trend in returns and in the alpha generation of hedge funds over 20+ years, and the trend clearly reflects a diminishing pool of available returns. We would argue that in the most recent period referenced, which includes 2008, hedge fund returns were negatively impacted by significant government intervention, most critically the banning of short sales during that period. The other important impact on hedge fund returns has been the dramatic decline in short-term interest rates which negatively impacts returns through reduced short rebates. Nevertheless, returns for the last 7.5 years to June 2013, shown below, reflect annualized alpha for the HFRI Equity Hedge Index of 117 basis points relative to the MSCI World Equity Index. Nothing to write home about, but certainly significant in the context of traditional asset management. BUT, the critical point is that the HFRI Equity Index assumes an investment in the industry average, weighted for size. Good manager selection provides an opportunity for meaningful incremental returns.

Period	HFRI Equity Hedge Index		MSCI World		Alpha	Interest Rates*
	Compound Return	Standard Deviation	Compound Return	Standard Deviation		
1990-1997	22.37%	7.46%	8.35%	13.41%	20.07%	5.38%
1998-2005	12.17%	9.82%	5.22%	15.18%	9.33%	3.64%
2006-/06/13	3.47%	9.51%	3.96%	17.77%	1.17%	1.90%

*Interest Rates are calculated using a monthly average of 1-month LIBOR over the period.

As a different measure of the value of manager selection, based on data from Cambridge Associates, the top quartile of long/short equity hedge fund managers produced a compounded return that was 290 basis points per annum in excess of the median performance for the 10-year period ended March 2013.

Active Management vs. the Wall of ETF Money

There is an ongoing debate among institutional investors as to the value of active management. Clearly, the explosion in ETF trading volumes has been fueled by their flexibility, liquidity and low cost. Over the last ten years, global assets in exchange-traded products have grown from $300 billion to over $2 trillion (Blackrock *ETP Landscape*, May 2013). During this time, there has also been a massive divergence between the flows into ETFs relative to mutual funds, with net flows into U.S. equity ETFs outpacing net flows into U.S. equity mutual funds by more than 3:1 in 2012. We do not have any hard evidence to indicate when the pendulum will swing back in favor of active management, but we believe the dramatic growth in indexed assets increases the odds of a resurgence in the value of active management. Much like venture capital, private equity and other idiosyncratic strategies, the opportunity set, return potential and value proposition for hedge funds can be somewhat cyclical and difficult to time.

Conclusion

Notwithstanding the *Businessweek* article's lack of logical progression based on hard data, there are features, as highlighted, with which we agree. The rapid changes in the industry work to the benefit of sophisticated investors, as historical perspective, judgment, evaluation of people and important historical relationships provide such investors with the tools to generate a differentiated and value-added investment framework.

http://www.businessweek.com/articles/2013-07-11/why-hedge-funds-glory-days-may-be-gone-for-good

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About Drake Capital Advisors

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Founded in 2001, we seek to deliver outstanding long-term investment performance for clients by managing portfolios of exceptional hedge funds across a range of global strategies. We focus on funds that combine superior investment skill with operational depth and robust infrastructure.

Our experience and skill in sourcing and investing in outstanding hedge fund managers while actively managing portfolio risk has produced attractive absolute and risk-adjusted results for investors focused on long-term capital appreciation.

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Past performance is not necessarily indicative of future results.