Hedge fund winners and losers

by **Christopher Joye**

While my Macquarie mates might not have been thrilled with this column highlighting their global high-yield debt-buying binge, I did stress the bank's outstanding risk-management record.

The chief executive of one listed company reckons this description of Macquarie's unique risk mitigation model – fusing a highly efficient centralised decision-making process with long-dated equity compensation –helped him get comfortable buying assets off the bank.

Another illustration of Macquarie's uncanny ability to avoid blow ups is the absence of the millionaire's factory from the interest rate rigging scandal rocking the major banks. All else being equal, one would expect our most successful investment bank to have its paw prints all over this sorry saga of greed, avarice and schadenfreude writ large.

Yet once again, Macquarie's mavens are nowhere to be seen. My stepfather, Robin Crawford (who, alongside the late David Clarke, Mark Johnson, and Tony Berg, established the bank during the 1980s and 1990s) says the leadership group identified the propensity for cultural problems in trading rooms early in the organisation's life.

"We surveyed executives across the bank's different divisions and noticed that the attitudes, ethics and values of traders narrowly focused on short-term wins were incompatible with our aspirations and clients' interests," Crawford recalls. "Numerous off-site sessions were dedicated to distilling down the essential behaviours that defined our business, which importantly have not changed since."

Embracing these core principles – which Macquarie's boss, Nicholas Moore, dubs "opportunity, accountability and integrity" – is a condition precedent for all new employees.

Positive skew

In the same way the holy dollar tribe tries to eliminate catastrophe risk, a $2 billion US portfolio manager told me on Tuesday that he spends much of his time searching for "positive skew". These are investments that perform well when markets implode, truncating the (negative) left-hand-side tail of his return distribution.

An example is the innovative local hedge fund Triple 3 Partners that we introduced back in 2013, which specialises in producing performance that is negatively correlated with markets during bad times while providing positive outcomes overall. (Triple 3 recently won a large volatility management mandate from one of our savviest super funds.)

A related maxim regularly advocated here has been buying smart "alpha" (if you can find it) and selling dumb "beta" given policymakers' unrelenting efforts to distort global risk-free rates, and hence asset prices, to unprecedented degrees.

This means avoiding passive market index benchmarks, given most are heinously overvalued, and polarising portfolios between the optionality of cash and individual equity (and debt) assets selected by experts who have confidence they are mispriced.

On Wednesday Deutsche Bank's chief international economist, Dr Torsten Sløk, warned "central bankers can lose the plot" – a phrase familiar to our readers – by "following the economic dogma of the day", which can lead to "catastrophic mistakes".

Arguing that deflation is a ruse, Sløk said that "after seven years of ever-looser monetary policy there is increasing evidence that … broad-based quantitative easing and negative interest rates risks the long-term stability of the Eurozone".

Extremist politics

Sløk subscribes to our view that "this causes mis-allocations in the real economy that become increasingly hard to reverse without even greater pain". "Savers lose, while stock and apartment owners rejoice ... the longer policy prevents the necessary catharsis, the more it contributes to the growth of populist or extremist politics."

These dislocations should in theory be enticing for absolute-return hedge funds that can ignore market indices and profit from positive and/or negative mispricings.

Equity hedge funds I've canvassed before – including the long-short VGI Partners (up 18.1 per cent), the market-neutral Perpetual Pure Equity Alpha (up 5.8 per cent) and the high conviction LHC (up 20.4 per cent) – have done exceptionally well compared to US equities (up 4.1 per cent) and Australian equities (up 3.9 per cent) over the last year. (VGI is a global equities manager while Perpetual and LHC focus on Australia.)

Other long-only products I've mentioned that can take 50 per cent plus cash weights, like Roger Montgomery's fund (up 10.1 per cent) and Rhett Kesler's Pengana Australian Equities Fund(up 5.7 per cent), have also beaten the benchmark.

Disappointingly, however, the wider industry has not fared as well.

Ultra-cheap leverage

Bloomberg's global aggregate hedge fund index is down 0.2 per cent in 2016 after miserable returns of merely 0.6 per cent in 2015 and 1.4 per cent in 2014. Clients have earned just 1.8 per cent since January 2014 compared to the MSCI World Index's 9.2 per cent. And they are understandably losing patience, withdrawing the most money from hedge funds (over $20 billion in 2016) since the global financial crisis.

This poor performance is pervasive across key sub-sectors: since 2014 "market-neutral" (-9.3 per cent), "global macro" (-1.1 per cent), "fixed-income arbitrage" (0.7 per cent) and "long-short" (3.2 per cent) funds have been smoked by generic equity and bond markets.

The message is that while there are certainly outstanding funds that have consistently won, the average highly paid "hedgie" has been a dud. The question is why.

One answer may be that many have resorted to loading up on ultra-cheap leverage to boost performance in a world where expected nominal returns are slim.

This works when prices are climbing – but the flipside is that portfolios levering badly selected assets can get smashed when markets sour. This almost certainly explains why so many equity hedge funds had horror results during the February meltdown.

It's vital that investors distinguish between a hedge fund portfolio's "net" and "gross" exposures. The gross represents the total value of trades they have in play divided by their capital. If they're running 300 per cent gross, they are leveraged 3 times. Remember this is not leveraging safe assets like senior bonds – it is using debt to leverage the riskiest part of the capital structure (shares).

Don't kid yourself

Ironically, many Australians employ much more full-recourse leverage when buying homes. (A 10 per cent deposit leverages your equity 10 times.)

To arrive at the "net" figure, the hedgie deducts the "shorts", or positions that profit from price falls, from the "longs", which are those that benefit from price increases. A market-neutral fund might have a 200 per cent gross exposure, yet report only 0 per cent net because the 100 per cent long holdings are offset by 100 per cent shorts. Equally, a long-short guy might be 100 per cent net with 150 per cent longs and 50 per cent shorts.

This all unravels when the shorts no longer behave like hedges (or reduce the risk of the longs).

Imagine a market-neutral fund with 200 per cent gross (0 per cent net), and all the long bank stocks fall in value (as prices drop) while the mining shorts lose money as iron ore surges. Despite reporting a seemingly safe zero net market exposure, this fund could suffer double the losses of a 100 per cent long-only manager that has no leverage.

"People who think they are investing in low-risk market-neutral funds that have no net exposure are kidding themselves," says Pengana's Rhett Kessler.

Bad timing

These hazards are amplified by the fact that the debt used to leverage hedge funds is "at-call" with no minimum term.

If prices are in free fall and the bank furnishing the leverage loses confidence in the fund, it can demand immediate repayment, which will force the fund to close out positions at the worst possible time. That is, sell their longs as prices slide and buy back shorts as stocks soar.

It's actually worse than this because the bank often technically owns title to the portfolio's assets through an arrangement known as "re-hypothecation". It can therefore take control of the portfolio irrespective of the manager's views and divest it instantly with no consideration for investors' welfare.

Astute asset allocators don't only focus on nets: they look at the overall gross exposures (anything more than 100 per cent is leveraged) and assess whether the extra returns are worth the risk.

While that might sound scary, the fact remains that the cost of debt is the lowest it's ever been, which makes leverage ostensibly appealing.

The rub is that many asset prices are also expensive, which implies there is acute downside risk. The trick is to find smart hedge funds that are prudently harnessing leverage to enhance returns from unquestionably cheap assets that have modest probabilities of loss.

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