Hedge Fund Benchmarking: Missing the Mark?

Manager Evaluation - June 27, 2016

Hedge funds represent a major component of non-traditional strategies and when prudently integrated into a portfolio, have historically resulted in an attractive risk–reward ratio in comparison with long-only portfolios of stocks and bonds. However, these investment strategies, specifically hedge funds and alternative mutual funds, are particularly difficult to evaluate via benchmarks and there is no standard approach. In this paper, we examine various methods noted in a major hedge fund investor survey1 and share thoughts on the limitations of each. Finally, we explain why a combination of methods is needed to better assess non-traditional investment strategies.

Benchmarking Non-Traditional Investments More Complex

There is $2.9 trillion2 invested in hedge funds, another $200 billion3 in alternative mutual funds and a McKinsey & Company report suggests these amounts are projected to grow significantly in the coming years4. That growth is understandable given our lower for longer return expectations for traditional asset classes and the potential for enhanced performance due in part to diversification benefits when including hedge fund strategies in portfolios.

The task of benchmarking traditional investment strategies is simplified because they typically fit neatly into so-called style boxes that classify investments by size (market capitalization) and by style (value, core, growth). For example, it is easy to understand the use of the S&P 500 Index as a good proxy for return when selecting a long-only, large-cap core manager. Further, the index is widely recognized and the 500 underlying companies are known. Largely, for long-only managers the investment opportunity set is readily identifiable and they are mandated to manage to the stated objective.

However, the complex nature of hedge funds and alternative mutual funds prevents a similar transparent comparison, making it difficult to evaluate hedge fund performance:

**Hedge fund strategies are not easily classifiable.** Consider a strategy that goes long the stock of a Merger and Acquisition (M&A) target and short the stock of the acquiring company. Is this manager best classified as a merger arbitrage, relative value, or event driven strategy?

**Regardless of the classification, should that manager report to some, all, or none of the hedge fund database providers?** It is highly likely, that merger arbitrage managers who report to one database provider are not the same ones that report to another provider. Furthermore, the strategy label itself does not differentiate such things as leverage, dynamic market exposures, or announced/unannounced deals that change risk profiles.

---

1 Credit Suisse eighth annual Hedge Fund Investor Survey, entitled “Staying the Course.” www.credit-suisse.com; accessed 03/03/2016
4 McKinsey & Company – The $64 trillion question: Convergence in asset management. Baghai, Pooneh; Erzan, Onur; Kwek, Ju-Hon
The hedge fund universe consists mainly of private limited partnership (LP) structures that carry no requirement to report performance to database providers. This creates biases in the databases used to create indices:

- (Self) Selection Bias: A poor performing hedge fund is not likely to report to any database, so indices are not able to capture true representative profiles of hedge fund risk/return.
- Survivorship Bias: Assuming the existence of a selection bias, the reporting of hedge fund databases only captures well performing hedge funds. Those funds that have not survived or arbitrarily stopped reporting are excluded, creating an upward bias to reported returns.
- Backfill Bias: Once a manager decides to begin reporting to the database, the provider usually backfills the entire return history.

There are a variety of studies that show the impact of these and other hurdles in hedge fund benchmark creation can skew index returns by as much as 10% per year. The chasm gets even wider when comparing hedge fund indices to alternative mutual funds due in part to the restrictions placed on them by the Investment Company Act of 1940. This topic alone could be the subject of an entire paper, but it should be noted that illiquidity risk and leverage borne by private investments can provide a significantly different risk/return experience.

**Survey Reveals Flaws in Benchmarking Methods**

Results from a recent hedge fund investor survey of 369 institutional investors, representing $1.1 trillion of hedge fund investments, show that only 41% use a publicly available hedge fund index when evaluating investment performance. Other methods of evaluation include an internal proprietary benchmark (12%), a LIBOR5-based benchmark (14%), and a publicly available equity index (15%), while 10% of investors do not use a benchmark.

Further examination of these methods reveals various shortcomings that limit their usefulness in evaluating non-traditional strategies. Of the respondents:

**41% use a publicly available hedge fund index.** This was the most popular answer and likely the easiest to understand. Hedge fund benchmarks lack precision in construction and therefore do not always serve as good proxies for individual hedge funds. They serve as one of many tools to evaluate hedge funds and alternative mutual funds. But using them in isolation and only as a measure of relative return does not provide a clear picture of a successful hedge fund investing program and we feel it should not be the only basis for comparison.

Using hedge fund benchmarks to evaluate mutual funds is even less reasonable due to the noted differences in portfolio characteristics. Some studies have estimated the “structural drag” of mutual funds versus private LP hedge fund structures to be 2% or more, but comprehensive alternative mutual fund indices simply do not exist.

**15% use a publicly available equity index.** Many alternative strategies have little to no equity exposure or are designed to provide less volatility than equity markets. Further, equity beta risk is usually what investors hope to diversify with alternative strategies. Returns versus a long-only index are not very insightful because they do not reflect how the manager delivered gains or losses.

*LIBOR reflects the short term funding costs of major banks and is the world’s most widely-used benchmark for short-term interest rates*
14% use a LIBOR-based benchmark (or similar T-bill\(^6\) based rate). Using only a risk-free benchmark is futile since each investment is taking risk in some way. Using LIBOR reflects only returns with no regard to risk. It is incumbent on our analysis to determine risk(s) and monitor investment options with them in mind.

12% use an internal proprietary benchmark. This may be acceptable, but proprietary benchmarks cannot be widely known or accepted and must overcome additional biases.

10% do not use a benchmark at all. This seems like the “set it and forget it” method, which is irreconcilable with GenSpring’s approach.

How does GenSpring Evaluate Non-Traditional Strategies?

Given the difficulties noted, our Investment Advisory Group uses a combination of some of the listed methods and additional analysis. Conclusions and outcomes center on what specifically is being measured (not just return). Evaluation goes beyond modern portfolio theory and is enhanced by the network of our team and heft of the GenSpring/SunTrust brand.

We use publicly available hedge fund benchmarks in a similar way as benchmarks are used to evaluate traditional investments. If a potential manager trails the benchmark, we need to understand the reasons. Perhaps it is structural or maybe the portfolio manager is adhering to their method of investing and the strategy is just out of favor.

We use traditional benchmarks. A simple foundation for adding alternatives is the “60/40” portfolio – 60% equity, 40% bonds. This is why we include traditional benchmarks in evaluating some alternative strategies. However, when considering the historical market environment in which this 60/40 combination was so successful, it is quite difficult to imagine the same tailwinds persisting across both equity and fixed income. Thus, alternatives can provide differentiated sources of return-added diversification in a variety of forward looking scenarios: short alpha from long/short equity, non-correlation of global macro, or systematic factor exposures. But a strategy’s potential advantages are impossible to know without thorough due diligence. Most hedge fund strategies are created within a broader portfolio context and will run hedged portfolios. These are, by design, less exposed to equity returns. Thus, anything with less than full equity exposure should not be expected to routinely beat the S&P 500 or any other equity index. When using traditional benchmarks, a keen focus on a fund’s correlation and regression statistics against a respective asset class is required to determine if the strategy adds value to the entire portfolio.

We use peer groups. For each respective alternative strategy, we have a dynamic list of best-in-class managers, many of whom we invest in already. These peer groups are proprietary and only built using thorough quantitative and qualitative metrics. Here again, a deep understanding of managers, strategies, and the universe of investment options is integral. Otherwise, comparisons are less affective. If a new potential investment does not compare well within our custom peer groups, it will not be approved for client investment.

\(^6\) A treasury bill (T-Bill) is a short-term debt obligation backed by the US government with a maturity of less than one year
We undertake additional due diligence efforts to uncover the strengths and weaknesses of each portfolio manager. Many times there is a reference strategy, such as a corresponding private fund or a sub-portfolio of another larger fund, which can serve as a good proxy. It is possible to understand where each portfolio manager excels. Our efforts seek to determine what drives portfolio risk and return, seeking target exposures which make for more efficient portfolios.

Obviously, return potential is a very large part of the investment thesis. However, it should not be the only aspect of review, especially when considered within a portfolio context. Many alternative strategies are designed to meet objectives other than beating a benchmark. For instance, some deliver lower volatility, low correlations, or consistent absolute returns through a variety of markets. The myriad of reasons to own alternative strategies ultimately also makes them complex and difficult to evaluate.

Perhaps the best illustration is a Holy Grail statistical example written by a principal of Severian Asset Management:

*Portfolio theory says that an investment is only attractive to the extent that it improves the risk-adjusted return of a portfolio. That means three things matter for each asset: expected return, expected volatility, and expected correlation with other assets in the portfolio. The first two are intuitive, but many investors neglect the correlation piece. A low return, high volatility asset can be an excellent investment if it has a low enough correlation with the rest of the portfolio.*

*Consider an asset that is expected to return 0% with stock-like volatility and a perfectly negative correlation to the stock market (meaning it moves in the opposite direction of the market without fail). Many investors, looking at the asset’s standalone returns and volatility, would be turned off. Someone fluent in portfolio theory would salivate. Assume the expected excess return of the stock market is 5%. If you own the stock market and the negatively correlated asset in equal measure, the portfolio’s expected excess return halves to 2.5% and its expected volatility drops to 0%. Apply some leverage to double the portfolio’s return and you end up with a 5% expected excess return with no volatility.*

*In practice, many investors do not assess assets from the portfolio perspective. They fixate on standalone return and volatility. Much of the time this is a harmless simplification. But it can go wrong when assessing alternatives.*

---

**Bottom Line**

In our view, the noted flaws in hedge fund benchmarks do not diminish the potential value of hedge fund strategies and should not automatically disqualify them when evaluated within the context of a total portfolio. The magnitude of benchmark biases is debatable, but their existence is certain and can be addressed through detailed understanding and direct communication around alternative strategies. It is imperative to understand the drivers of risk and return to guide expectations. Matching a strategy’s risk and return drivers with specific investor goals and objectives within a total portfolio framework is optimal when making investment decisions. Understanding each strategy is an in-depth process that we believe is worth the additional time and energy put forth by the respective parties throughout GenSpring’s due diligence efforts. We acknowledge the full-market-cycle nature of some portfolios may test client relationships, yet we remain confident in our approach and ability to add value.

Authored by GenSpring Family Offices with direct contribution by Brad Kaufman, CAIA, *Alternative Investment Specialist*, GenSpring Family Offices

**Glossary**

**Absolute Return** is the return that an asset achieves over a certain period of time, expressed as a standalone percent. This is the opposite of relative return, which is a stated percentage compared to some stated goal or benchmark.

**Correlation** is a mutual relationship or connection between two or more things.

**Equity Beta** is an indication of investments volatility relative to the entire market. A beta less than one indicates that the investment is less volatile than the market, while a beta more than one indicates that the investment is more volatile than the market.

**Event Driven** is a strategy adopted by hedge fund managers, that attempts to take advantage of events such as mergers and restructurings that can result in the short-term mispricing of a company’s stock.

**Hedged** is an investment position intended to offset potential losses/gains that may be incurred by a companion investment.

**Leverage** is the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment or hedge certain risks

**Long-Only** is a portfolio that holds only long positions on securities and no short positions.

**Market Exposure** is the dollar amount of funds or percentage of a portfolio invested in a particular type of security, market sector or industry, which is usually expressed as a percentage of total portfolio holdings. Market exposure, also known as “exposure,” represents the amount an investor can lose from the risks unique to a particular investment.
**Merger Arbitrage** is a hedge fund strategy in which the stocks of two merging companies are simultaneously bought and sold to create a riskless profit. A merger arbitrageur looks at the risk that the merger deal will not close on time, or at all. Because of this slight uncertainty, the target company’s stock will typically sell at a discount to the price that the combined company will have when the merger is closed. This discrepancy is the arbitrageur’s profit.

**Regression** is a statistical measure that attempts to determine the strength of the relationship between one dependent variable (usually denoted by Y) and a series of other changing variables (known as independent variables).

**Relative Value Arbitrage** is the simultaneous selling of one instrument that is believed to be overpriced and purchasing of another closely related instrument that is believed to be underpriced.

**Volatility** is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from the same security or market index.

**Disclaimer**

The information contained herein is intended for educational purposes only, and such views are not intended to predict or depict performance of any specific investment, and should not be construed as investment advice or a recommendation of any particular security, strategy, or investment product. These opinions may not apply to your financial status, risk and return preferences. The statements herein are based upon the opinions and information from GenSpring, its affiliate SunTrust Bank and third party sources. Information obtained from third party resources are believed to be reliable but not guaranteed. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice. GenSpring shares information and resources of the Investment Advisory Group of its affiliate SunTrust Bank.

Alternative Investments refers to a very broad category of investment choices. In general, this category encompasses investments outside of the traditional configuration of stocks, bonds and cash, and includes hedge funds and funds of funds. Alternatives will often be less liquid than traditional investments and redemptions from such investments often involve holdbacks and other restrictions on the timing of the redemption. Alternative Investments involve costs and may engage in leveraging and other speculative investment practices which may involve volatility of returns and significant risk of loss, including the potential for loss of the principal invested.

Comparisons to an index or benchmark are unreliable as performance indicators. It is not possible to invest in an index or benchmark, and therefore comparisons between an investment or portfolio and an index or benchmark are unreliable as performance indicators and should not be considered indicative of the actual performance to be achieved in a particular investment or portfolio.