Wespath
Investment Management

Wespath's Hedge Fund Strategy—The Path Not Followed

by Dave Zellner

Wespath Investment Management division of the General Board of Pension and Health Benefits of The United Methodist Church continually evaluates new and innovative investment strategies to help its clients attain superior risk-adjusted returns. After conducting thorough due diligence, we are willing to be early adopters of an investment strategy—if justified by our analysis. In 1991, Wespath was an early investor in positive social purpose loans and in 1998 we invested in U.S. Treasury Inflation Protected Securities—approximately one year after the U.S. Treasury began offering them. Each has produced compelling returns for investors in Wespath Funds.

Wespath has also been at the forefront in alternative investment strategies such as private real estate, private equity, emerging market equities and debt, commodities, senior secured bank loans, and several other unique approaches. Yet an investment strategy that Wespath has avoided—and intentionally so—is hedge funds. While a wide variety of institutional investors embrace hedge fund investing as an integral and "sophisticated" element of their overall program, Wespath has concluded that the potential risk-adjusted return opportunities do not justify the requisite resources and costs required for prudently engaging in this popular form of investing. In the following White Paper, we explain our rationale for declining to establish a significant investment of the assets entrusted to us by our stakeholders in hedge funds.

Riding a Roller Coaster

Hedge funds have had what can best be described as a roller-coaster existence since Alfred Jones established the first hedge fund in the early 1950s. Periods of great success were inevitably followed by heavy losses.

Rampant growth in the number of hedge funds followed a 1966 *Fortune* magazine article on Jones' still little-known venture. By the early 1970s, heavy losses and numerous fund closures were the result of fund managers altering Jones' original concept by attempting riskier strategies based on the extensive use of long-term financial leverage.

The ensuing quiet in the hedge fund market was interrupted when a 1986 article in *Institutional Investor* profiled the hugely successful Tiger Fund. Over the next decade, thousands of hedge funds with seemingly thousands of competing strategies took center stage. The results, although relatively strong, failed to live up to many investors' loftier expectations.

In recent years, introduction of the "fund of funds"—in reality a structure similar to a mutual fund that invests in multiple hedge funds—provided even more diversification for investors and made hedge funds available to a broader group of investors. The roller-coaster ride continues today as hedge funds are yet again gaining popularity.

There are a number of valid reasons why hedge funds make sense. The concern—on Wespath's part as well as others—is that there are just as many valid reasons why hedge funds can be more trouble than they are worth.

Dave Zellner, Chief Investment Officer

Dave has been with the General Board since 1997 and is responsible for the Wespath Investment Management Division, comprised of Investment Management, Institutional Investment Services and Corporate Relations. Formerly, he managed equity portfolios for Shell Oil Company's retirement plans and was a portfolio manager and responsible for managing investment operations for Investment Research Company (an investment management firm). Dave is responsible for executing and administering the General Board's investment program as directed by its Investment Strategy Statement and Statement of Administrative Investment Policy. Dave earned a B.S. degree in Finance from Louisiana State University and an MBA from the University of Houston.

Alfred W. Jones—The Father of Hedge Fund Industry

Definition of Hedge Fund

According to the website Investopedia, a hedge fund is *"an aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark). Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least one year."*

Investopedia further explains that "They are similar to mutual funds in that investments are pooled and professionally managed, but differ in that the fund has far more flexibility in its investment strategies.

"It is important to note that hedging is actually the practice of attempting to reduce risk, but the goal of most hedge funds is to maximize return on investment. The name is mostly historical, as the first hedge funds tried to hedge against the downside risk of a bear market by shorting the market (mutual funds generally can't enter into short positions as one of their primary goals). Nowadays, hedge funds use dozens of different strategies, so it isn't accurate to say that hedge funds just 'hedge risk.' In fact, because hedge fund managers make speculative investments, these funds can carry more risk than the overall market."

Wespath's Brief History of Hedge Fund Investing

Wespath first explored hedge fund investing a decade ago. The endeavor was brief and unrewarding.

In 2003 a now disbanded alternative investments division of a major money center bank was hired to operate as a "fund of funds" manager, selecting individual hedge funds on behalf of Wespath. Approximately $100 million was allocated to the strategy. Overall, performance was weak, as were many hedge fund investments during that period, and the fund of funds management firm resigned from its account in May 2005, ultimately exiting the business altogether due to its inability to achieve a sufficient scale. Wespath decided not to replace the manager with a different fund of funds manager and it has avoided hedge fund investing ever since.

Two Sides of the Debate

Hedge Fund Benefits

The most significant benefit to investing in hedge funds is access to unique sources of investment return. Many hedge fund investors possess specialized knowledge—of markets and investment strategies. They tactically exploit perceived market inefficiencies by applying their technical knowledge aided by sophisticated analytical and trading tools. Some funds stay true to their hedge fund roots—by holding "long" positions in securities they think are undervalued and then "short" (selling borrowed securities) positions with similar characteristics they think are overvalued. Other funds don't fully hedge, but are able to take long positions in difficult-to-access markets or apply very complex trading strategies.

Accessing unique sources of return can provide institutions investing in hedge funds with diversification benefits resulting in reduced risk for the overall fund. Wespath frequently assesses alternative asset classes and the extent to which they provide diversification benefits to its funds. A common statistical measurement used to evaluate diversification is "R square," which evaluates the correlation of a return series for an asset with the return series for another asset. When compared with the return of Wespath's Multiple Asset Fund, a common index of hedge fund returns has an R square of about 0.6, which would be considered diversifying. Of course, this measure applies to a composite of all hedge fund returns, and specific results will differ depending on the strategy.

Hedge Fund Challenges

There are several compelling reasons why investing in hedge funds is problematic. First and foremost is the skill and resources required to conduct initial and ongoing due diligence of the hedge fund investments. Many hedge fund strategies are extremely complicated and those conducting the analysis must have extensive experience in understanding complex strategies. Not only must they understand the underlying investment strategy, they also must understand how the hedge fund manager will execute that strategy. Investors need a deep and established network of professional industry contacts to verify manager skills and have access to sophisticated analytical tools to assist them in dissecting and understanding the source of investment returns.

Assessing investment skill is only half of the due diligence formula. Hedge funds frequently fail not because of an unsound investment strategy, but because they neglect to establish a robust operational platform with sufficient internal controls and compliance procedures. Accordingly, investors also must perform extensive due diligence on operational capabilities and compliance. This includes not only carefully examining the hedge fund manager's back office procedures, but also examining the work of the fund's prime broker, which is responsible for safekeeping the fund's assets (i.e., the prime broker performs a role similar to a master custodian yet also provides additional services such as borrowing securities for executing short sale strategies).

All this due diligence and analysis requires a considerable expenditure of resources. Yet even with these resources, the investor's assessment depends on the hedge fund providing a significant level of transparency, which will facilitate an adequate assessment of the hedge fund's operational practices and strategies.

Unfortunately, this need for transparency is hampered by the very nature of hedge funds. Hedge funds are generally very secretive about their strategies in order to protect their investment ideas. Most institutions that invest in hedge funds do not have custody/control of the assets supporting their strategies and, hence, do not have a window into their own holdings.

Another challenge is governance and shareholder rights. Hedge fund investors have much less control in fund management than they do with other investment vehicles. Investors may not be able to exercise such rights as attending an annual meeting or learning the identity of other shareholders, let alone replacing the fund manager.

Finally, a hedge fund manager could presumably change course from the initial strategy portrayed, and investors may not learn about this change due to the prevalent lack of disclosure by these funds. Even if the change of course was communicated and an investor was uncomfortable with the new direction, they would be limited in how quickly they could access their funds.

The combination of all these factors is best summed up in Warren Buffet's sage advice, *"Never invest in a business you cannot understand."*

An Identity Crisis

A December 22, 2012 The Economist article entitled *"Hedge Funds: Going Nowhere Fast," stated: "leverage, which once helped to juice up hedge fund profits, is now at an all-time low."* This has caused hedge funds to portray themselves differently than in the past. The article goes on to say, *"the message to investors has changed dramatically. Whereas hedge funds used to sell themselves as the spicy, market-beating wedge of an investment portfolio, they now stress the long-term stability of their returns. Comparing their returns with a bubbling stock market misses the very point of 'hedged' funds…"*

> "Hedge funds frequently fail not because of an unsound investment strategy, but because they neglect to establish a robust operational platform with sufficient internal controls and compliance procedures."

Performance: Perception vs. Reality

While many hedge fund investors believe that superior performance is a benefit of hedge fund investing, such claims depend on the skill of investors in selecting the right hedge funds. Reliable hedge fund data first became available in 1990 and, indeed, reported results for the first 10 years averaged an annual compounded rate of return of 12.6%. Further, hedge funds have produced a compounded rate of return for the entire 23-year period of 7.3%, with an annual standard deviation of about 10%. This compares favorably to returns of the S&P 500 Index, which was 8.5% for the same period, but with an 18% standard deviation of return. Hedge fund advocates often refer to this data when promoting hedge fund investing with the claim that "hedge fund returns are comparable to the returns of stocks, but have only half the risk."

However, some experts have challenged whether hedge funds have actually produced the returns claimed.

In a seminal study published in 2009 on hedge fund returns entitled "*Higher Risk, Lower Returns: What Hedge Fund Investors Really Earn*," academicians Ilia Dichev and Gwen Yu analyzed investor dollar-weighted internal rates of return achieved by hedge fund investors versus a "buy and hold" return. Unlike stock indices, hedge fund indices are not cap-weighted (i.e., weighted based on the amount of money investors have invested with each hedge fund). According to the authors, *"… buy-and-hold returns measure the return on the fund, or equivalently, the return for a passive investor who joined the fund at inception and held the same position throughout."* The conclusion that Dichev and Yu reached after performing their analysis was: *"Our main finding is that annualized dollar-weighted returns are on the magnitude of 3 to 7 percent lower than corresponding buy-and-hold fund returns."*

Simon Lack, who sourced hedge fund investments as a former J.P. Morgan employee and later authored the book *The Hedge Fund Mirage*, offers a more sobering yet controversial analysis of hedge fund returns. Nearly all hedge fund investors recognized the potential for modest losses, but very few (if any) anticipated that the average hedge fund would lose more than 20% of its value in any given year—until it occurred in 2008. Lack points out more starkly what that meant to hedge fund investors when he states: "…*in 2008 the hedge fund industry lost more money than all the profits it had generated during the prior 10 years."* Lack goes on to talk about hedge funds fees and the extent to which hedge fund investment returns are consumed by fees: "*Since 1998 hedge fund managers have kept 84 percent of the profits, leaving 16 percent for investors."*

The typical hedge fund fee structure commands an annual management fee of 2% of the value of a client's assets and 20% of any earnings. To put these numbers in perspective, if Wespath invested only 10% of its assets in hedge funds that earned a very modest 5% return, the fees paid for hedge fund investments would exceed the total of all fees paid to managers of the other 90% of Wespath's investments.

Analyzing the Impact

Supporting its commitment to due diligence, Wespath analyzed the impact on return and risk of not having hedge fund investments for the last 10 years in its broadly diversified Multiple Asset Fund (MAF). The study model assumed that Wespath hypothetically allocated 10% of its assets to hedge funds and that it proportionately reduced its holdings in all of the other asset classes held by MAF.

10-Year Net Return Ending December 31, 2012

	Return	Risk[2]
100% MAF	8.40%	10.96%
90% MAF/10% HF1[1]	7.96%	10.29%

[1] *Based on the returns for the HFRI Fund of Funds Composite Index*
[2] *Annual standard deviation of return*

Under this scenario with hedge funds, MAF would have exhibited marginally less risk, yet would have also had a lower return.

In addition, if Wespath had invested 10% of its assets in hedge funds, it would have had to devote considerable resources to sourcing and monitoring its hedge fund investments. MAF's fund administration expenses would have been higher, which would have certainly affected returns.

Never Say Never

Wespath has no immediate plans to make a strategic allocation to hedge funds. This decision reflects our lack of confidence that the returns available from hedge fund investing justify the diversification benefit attained from a meaningful allocation to hedge funds (e.g., 10% of assets). Investing 10% of Wespath's assets in hedge funds would require either building a qualified team of at least three professionals or engaging the services of an outside fund of funds manager.

However, the Investment Management team continues to identify unique sources of market returns. As such, Wespath may consider hedge fund managers in the future if they are the most qualified firms for accessing unconventional markets. In addition, periodic market dislocations will create tactical opportunities for exploiting market inefficiencies, and the Investment Management team will certainly consider specific hedge fund strategies as a way to exploit these inefficiencies as they arise.

Our Path

Wespath is firmly committed to a long-term investment strategy and regularly reviews its investment funds to align with market conditions and projections. It seeks investment opportunities using a thoughtful, judicious approach, utilizing well-researched analytical data and state-of-the-art investment tools executed by qualified individuals. We believe that when it comes to investment management—knowledge, experience and due diligence—are the essence of sophistication.

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Wespath provides UMC-affiliated institutional investors with access to well-managed investment programs that historically have delivered competitive performance while honoring United Methodist Social Principles. Wespath is the investments division of the General Board of Pension and Health Benefits of The United Methodist Church, a century-old institution with a well-regarded reputation for delivering returns aligned with values.

Wespath is an established investment manager with approximately $18.5 billion in assets under management.

Our name honors John Wesley, the founder of Methodism and a leader in establishing social principles that outline the tenets of socially responsible business practices. Wespath reflects this heritage, along with the idea of putting clients on the right path to financial growth with a commitment to values-driven investing.

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