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NO HEDGE FUND FAD

Most thought hedge funds were a passing trend, but they have proven to be valuable trading vehicles.

Few pension plans, particularly in Canada, had dipped their investment toes into the hedge fund pool 10 years ago. Academics had mixed pronouncements and the limited media coverage generally portrayed hedge funds as speculative, volatile and usually secretive trading vehicles. In 2005, while speaking to the Tuck School of Business, Warren Buffett proclaimed that hedge funds are a fad and the majority are run by imitators and incompetents.

In recent years, however, growth in the $1 trillion plus hedge fund industry has been largely fuelled by interest from institutional investors. Many pension plans are now looking to this asset class. The strategies pursued by hedge funds are generally not highly correlated to traditional long-only equity and fixed income markets and provide the potential for consistent absolute returns within a lower band of volatility. In the new environment where the actuarial return assumptions of 10 years ago no longer hold, alternative assets which include hedge funds have been increasingly seen as interesting tools to assist plan sponsors in meeting their asset/liability objectives.

Research has shown that adding hedge funds, as well as other non-traditional assets, significantly enhances the portfolio optimization equation. Efficient portfolios including hedge funds can be shown to lower volatility and increase potential returns compared to traditional "optimized" stock and bond-only portfolios.

The quantitative and empirical evidence is compelling, however, a pension plan needs to understand that this sector is not without risks. While hedge funds do typically seek to hedge away directional market risk, they are never fully "hedged" and are very much in the risk-taking business. Many hedge funds extract risk premia by making well-informed liquidity, credit or volatility bets, to name but a few. It is often how well they articulate and execute these bets that separates the best funds from those "imitators and incompetents" cited by Buffett.

Plan sponsors need to identify and understand precisely what risks a fund is focused on taking and how the fund manager proposes to consistently extract these risk premia from the market. As these funds are not as regulated as their long-only counterparts in the equity/fixed income world, investors need to have a very solid comfort level with the key trading individuals involved, the strength of their business models, as well as how well they have integrated a disciplined risk management and compliance philosophy into their day-to-day thinking. Back-office capabilities and infrastructure are of course critical components in the mix.

Unfortunately, assessing and monitoring these considerations are not typically areas of core competence for many small- to medium-sized plans. Cost containment in managing these plans is a continuing reality and many plan sponsors are running on a lean staffing and internal resource mixture. But today's plan fiduciary is not without options. Actuaries and consultants are now much better versed in the alternative asset space and better able to provide guidance in these areas. Such professional allocators as funds of funds have also become a popular first step into the alternatives space. They offer pensions access to an instantly diversified portfolio of hedge funds that have already been thoroughly scrubbed by their due diligence teams. Finally, the portable alpha concept has gained significant traction in the pension community. Many plans that have implemented portable alpha programs have generated consistent positive returns, immunized somewhat from the dramatic swings in equity markets over the past 10 years.

In today's pension paradigm, as more plans wade into this pool, hedge funds can no longer be considered the black sheep of the investment community. Plan administrators in the current age cannot confine themselves to the old ways of thinking and need to evaluate all options available in order to prudently fulfill their fiduciary responsibilities to members. ■