

# REALITY CHECK

A pension fund perspective on long/short equity hedge funds.



BY DAVE FINSTAD

Hedge funds have evolved into a \$2 trillion industry, moving into the mainstream among institutional investors.

With new financial instruments and esoteric strategies popping up on a regular basis, it appears to this observer that many long/short equity managers have a long way to go in order to convince institutional investors, and many plan sponsors, of their value.

To start, there are low barriers to entry—and the strategy is relatively simple. Just about any long-only stock picker who has a prime broker, an administrator, some willing (and preferably wealthy) clients and some negative views on a few overpriced stocks can start a long/short equity hedge fund. It might not be quite that simple, but compared to many other strategies, a long/short equity fund is relatively easy to start up. Prospective managers don't need to negotiate complicated deals and they don't need to know what a CDS, an ABX or a CDO is. One of the problems with low barrier to entry industries like long/short equity is that these industries have a relatively low proportion of true success stories.

## A MATTER OF FEES

At the same time, long/short equity fees are one of the most difficult to justify. I always find it hard to watch a manager charge 50 basis points (give or take) for a long-only product, then start selling short a few stocks and bump up their fees to 1% and 20% or 2% and 20%. These fees are appropriate for those few managers who can consistently deliver significant and real alpha. However, a big issue is created with the 20% incentive fee that goes toward beta that institutional investors can get very inexpensively elsewhere.

For example, the average manager in the HFRI Equity

Hedge (long/short equity) index had a return of 12.8% with an S&P 500 equity beta of just over 0.5 for the four years ending June 2007. With an S&P 500 return of 13.5%, short-term interest rates of 3.4% over this period and assuming an average fee schedule of 1.5% and 20%; the gross beta-adjusted alpha generated by the average manager was about 9.0% and the net alpha delivered to the investors was 4.3%.

This implies that the manager kept 52% of the gross alpha. These results aren't too bad until you consider that the HFRI index includes a number of managers that are closed and likely has significant survivor bias, which has been estimated at up to 4% per year (e.g. an imploding manager that is about to close down is not likely to send their results to a hedge fund index provider—thus creating survivor bias). Therefore, an investible index like the HFRX index may give a truer picture of performance. The HFRX Equity Hedge index was up just 6.7% over this period, with a similar beta around 0.5. This translates into a gross alpha of 1.5%, a net alpha of -1.7% and the manager keeping 213% of the gross alpha.

## OVER THE HURDLE

A solution to this problem would be to introduce an appropriate hurdle before incentive fees are collected. The vast majority of long/short equity funds charge an incentive fund without a hurdle—that is, everything above a 0% return is subject to the typical 20% manager's cut. However, if the manager averaged or expected to average having an equity beta of, say, 0.4 over the long term, then the performance hurdle should be based on 40% of the return of the S&P 500 (or the Russell 3000, the S&P/TSX Composite, the MSCI World or whichever pond the manager is fishing from) plus 60% of the cash (e.g. T-bills or LIBOR) return.

This type of hurdle is warranted because an investor

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can replicate this benchmark easily and inexpensively by investing 40% in the equity index and 60% in cash. In the HFRX example above, an investor could have outperformed the index by 1.7% just by putting 50% of their portfolio in cash and 50% in the S&P 500 index. (Note: most market neutral equity funds—a cousin of long/short equity—do have a hurdle such as LIBOR or T-bills).

### THE ETF OPTION

When it comes to replicating long/short equity returns, investors could take the process one step further by replacing an investment in the index with exchange traded funds (ETFs). Many ETFs available today are rules-based approaches that represent quasi-active management or exotic (alternative) betas. For example, there are ETFs that invest in value stocks or in stocks with a history of growing dividends. Therefore, an investor has a choice between paying 1.5% and 20% for a long/short equity hedge fund or putting a portion of their investments in cash and a portion in an exotic beta ETF (which typically charge in the range of 50-75 basis points and can be purchased or sold short). An investor needs to be very confident in their manager's alpha-generating potential before dismissing the replicating option.

Another threat to long/short equity managers is the recent introduction of 130/30 or 120/20 type mandates (sometimes referred to as net long or extended alpha). A 130/30 manager has \$130 of long equity exposure and \$30 of short equity exposure for every \$100 of capital; for a total of \$160 or 160% active management. This compares to a long/short equity hedge fund that typically has about 70-150% long exposure and 30-70% short exposure. In other words, the 130/30 manager has a similar level of gross active management, but charges much lower fees—normally a flat fee of 75-100 bps or a management fee of 20-30 bps plus a 20% performance fee above the equity index hurdle.

Investors can create their own synthetic market neutral fund by using derivatives to remove the equity beta, or they can create a synthetic long/short equity hedge fund by removing a portion (e.g. 50%) of the equity beta.

### THE RIGHT TIME

It should be noted, however, that one major weapon the long/short equity manager possesses versus the replicators and the 130/30 managers is the possibility to successfully time the market. By increasing market exposure during bull markets and decreasing market exposure or even going net short in bear markets, a long/short manager could add significant value. The problem is that market timing is inherently difficult and determining if someone has market-timing skill is perhaps equally difficult. This is because big top-down events are few and far between as compared to stock selection, which provides a wide breadth of opportunities.

Finally, long/short equity is just not as compelling as a number of other more interesting hedge fund strategies. Without going into detail, a few of these strategies include event-driven, activism, asset-based lending, reinsurance and energy trading. In general, what these strategies have in common is that: they invest in less efficient markets, they rely on more creative deal making, and they offer unique, uncorrelated return streams.

Ultimately, long/short equity hedge funds face a number of issues in the eyes of institutional investors. These are the low average quality tag that comes from being in an industry segment with low barriers to entry, their fees may be difficult to justify, they face competition from replicating hedge funds and from 130/30 managers, and other hedge fund strategies appear to be a lot more interesting. That said, however, like any investment strategy, there are a few exceptional long/short equity hedge fund managers out there—it just takes a little work to find them. ■