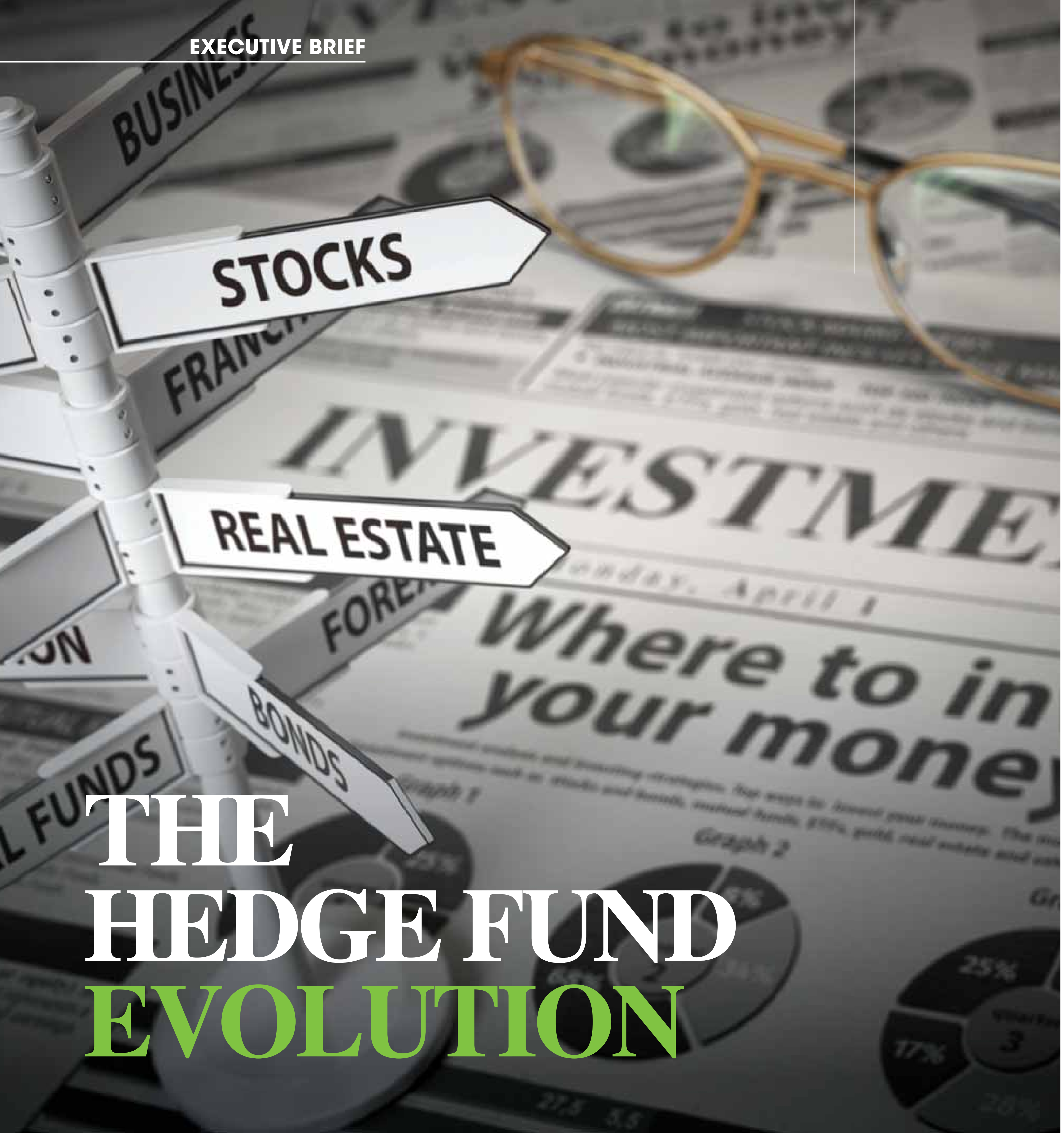

THE HEDGE FUND EVOLUTION

From periphery to mainstream.

By Suhaimi Zainul-Abidin

In 1966, an article published in *Fortune* drew attention to Alfred W. Jones' hedged fund, describing it as "the best professional money manager" of the era, and reporting that it had beaten the top performing Dreyfus Fund by 87 percent over a 10-year period.[1] The hedge fund industry has grown by leaps and bounds since then, and it is estimated that there are over 20,000 hedge funds worldwide today.[2] It has drawn the interest of the investment world, prompting talented traders and money managers to launch new hedge funds, and attracting wealthy investors to these nouveau investment firms.

While Jones' hedge fund, launched in 1949, was truly a *hedged* fund, this is not necessarily true of many contemporary hedge funds today. It is often said that the term 'hedge fund' is clearer for what it is not, rather than what it is. Hedge funds are not mutual funds, which are highly regulated investment vehicles made available to the public, and typically restricted from the use of leverage and derivatives. Instead, hedge funds span a broad spectrum of asset classes and investment strategies, and have a wide range of tools at their disposal including trading of derivatives, taking of short positions, and investment in illiquid markets. This has resulted in a hedge fund world comprising a variety of risk/return profiles, catering to different mandates and investment goals.

The hedge fund industry initially grew under the radar and without much regulation until LTCM blew up in 1998. LTCM was a hedge fund with US$126 billion in assets, and it boasted spectacular annual returns, including a return of 40 percent in 1995 and 1996. Because of its size, it was deemed too big to fail and the U.S. Federal Reserve had to step in to bail it out. This led to regulatory authorities seeking to make more sense of the hedge fund industry. Over time, as hedge funds negotiated further financial crises, more questions were asked about their role and impact on the financial system.

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Despite these challenges and, at times, criticisms, the hedge fund industry continues to draw more talent and capital. As at end-2019, the industry's assets under management (AUM) globally had doubled from its 2011 levels to reach roughly US$3.1 trillion over the eight-year period.[3]

The global financial crisis and effects of the Madoff scandal

The 2008 global financial crisis (GFC) was a trying time for hedge funds in general. Hedge funds were labelled the true villains of the GFC for adding too much risk to the banking system or, at the very least, exacerbating the crisis. Regardless of the role that hedge funds may have played in the crisis, they were nonetheless severely impacted by it. Many hedge funds suffered their biggest losses ever during that period, even though the average industry losses of 15 to 20 percent paled in comparison to the 40 to 50-percent contractions registered in the equity markets during the same period.

Following the GFC, hedge funds were subjected to a slew of new regulations, aimed at improving investor protection, ensuring market integrity and reducing systemic risks. The Dodd-Frank Act in the U.S. and the European Union's Alternative Investment Fund Managers Directive, for instance, imposed very prescriptive regulations on hedge funds.

2008 was also the year that the Madoff investment scandal made the news. The elaborate multi-billion-dollar Ponzi scheme shook the investment world. In his guilty plea, Bernard L. Madoff admitted that he had not actually done any trading since the early 1990s, and all of his returns since then had been fabricated. He was sentenced to 150 years in prison and was ordered to make restitution of US$170 billion in total.[4] However, the price of Madoff's indiscretion was also paid by the fund management industry. Investors were spooked and demanded higher governance standards that zeroed in on the need for independent validation of positions and valuations. Despite this, the industry quickly regained its footing as investors began to recognise the diversifying value of hedge funds—some hedge funds delivered admirable positive returns in 2008 and many others recovered to new highs faster than the equity markets.

Every strategy will have its day in the sun, but ultimately, it is how a strategy performs through the storm that matters.

Institutionalising the hedge fund industry

In its earlier years, the hedge fund industry attracted mainly high net worth individuals (HNWIs) and family offices as its investors. Then came investors with tax-exempt status like endowments and foundations, and later, insurance companies. The outperformance of hedge funds following the dotcom bust and the GFC led to increasing inflows from corporate and public pension funds, as well as sovereign wealth funds, which led to an increasingly institutionalised investor base. By 2009, the hedge fund industry was managing more assets for institutional investors than for its traditional clients, the HNWIs and family offices.

Although the industry's AUM had quickly recovered and expanded following the GFC, the barriers to entry were also raised, while the inclination to invest only with big brand names began to take hold. This led to a concentration of assets among the biggest firms. The 1,600 or so hedge funds in the 'Billion Dollar Club' today manage over 25 percent of the assets in the hedge fund universe.[5]

Investors now expect hedge funds to have robust operational set-ups, strong governance and risk management procedures, independent board directors, independent valuations of the fund's assets, and reputable independent service providers such as auditors and fund administrators. Not all these standards can be met by start-ups and small managers. So while the tighter regulations and heightened investor expectations have helped institutionalise and professionalise the industry, the number of hedge fund start-ups has fallen over the years.

The rise of systematic hedge fund strategies

Hedge funds were traditionally managed in a discretionary manner, with trades and positions taken based on an individual manager's stock-picking or market-reading skills. In recent times, however, systematic funds that use quantitative computer models to guide trading decisions have become more popular. This is not to say that any one way of investing is necessarily better than others. Each strategy has its own strengths and weaknesses, and different strategies may outperform others at different points in time depending on the prevailing market environment and market cycles.

Systematic investing, as the name implies, relies on a set of rules to make investment decisions systematically, requiring little or no human discretion or intervention. It attempts to remove human weaknesses (such as human emotions and cognitive limitations) from the trading equation and operation. A systematic investment strategy seeks to automate investment decision-making and trading processes, starting from data collection and analysis through to signal generation and trade execution. This allows the fund to trade globally and around the clock, as well as across multiple exchanges around the world, while continually monitoring a portfolio that can comprise thousands of positions, all done consistently according to certain pre-defined rules.

The systematic investment manager would typically create a model comprising algorithms that define the rules that will produce trading signals for the firm to act on. The more complex the rule set and the larger the investment universe, the more complex the model will be. The basis of the rule set can differ depending on the investment philosophy and the approach to portfolio construction. It can be based on macro, fundamental, or technical data, or a combination of them.

Systematic managers typically use statistical techniques to forecast short-term volatility of the markets within their investment universe and correlations among different assets or markets, in order to construct an optimal risk-adjusted portfolio. This approach also allows for a more disciplined approach to risk management, which can be built into the investment models rather than applied as an afterthought. The model can include rules that set hard limits on exposures and risks, including limits for volatility, as well as leverage at the instrument, asset class and portfolio levels. There are also systematic strategies designed to target a pre-defined level of portfolio risk. This gives investors a better idea of the overall risk of the investment strategy.

Singapore as a hub for hedge fund activity

The most successful hedge fund managers have traditionally been based in New York and London. Over time, as financial centres developed in other jurisdictions, successful funds were established in cities like Hong Kong, Sydney, Shanghai, and Singapore, with many of the bigger fund managers establishing offices in multiple jurisdictions.

Hedge funds tend to thrive in ecosystems that are conducive for fund management activity and Singapore is one such location. The country boasts an impressive collection of global financial institutions and intermediaries, a deep talent pool, strong rule of law and a favourable tax environment. The development of the local ecosystem has in turn stimulated the establishment of home-grown fund management companies such as Quantedge Capital and Dymon Asia, two of the largest home-grown hedge funds in Singapore. Local hedge funds Quantedge, Prulev, and Vanda were in the spotlight when they were named as some of the top performing funds globally in 2019, with all three funds adopting a systematic approach to investing and targeting a relatively high level of portfolio risk.[6]

The future of Asia bodes well for Asian hedge funds. While in the past, it may have been necessary for a hedge fund's success to market itself well in the U.S. and Europe (particularly Switzerland), where the largest pools of institutional and private capital were traditionally managed, the outlook is changing. There are increasingly impressive pools of capital in Asia and these investors are largely non-institutional investors looking for high-performing professional money managers. At the World Economic Forum in 2019, it was predicted that the gross domestic product of Asian economies would surpass that of the rest of the world (in purchasing power parity terms) by 2020.[7] Asians have become wealthier, more financially savvy, and more integrated with the rest of the world. According to an article published by *Forbes*, the rate of growth of ultra-HNWIs between 2012 and 2017 in countries like China, India, Bangladesh, and Vietnam had surpassed that of the United States.[8]

High risk, high returns

The occasional headline-grabbing drawdowns of hedge funds create the impression that hedge funds are inherently risky. While it is true that the ability to take leverage exposes hedge funds to higher risks relative to mutual funds and investments in other traditional assets, the reality is that the level of riskiness of any fund depends on its investment strategy.

At one end of the spectrum, there are hedge fund strategies that target low volatility and aim to ensure principal protection. On the other end of the spectrum, there are hedge fund strategies that make large concentrated bets on market moves. In between, there is a wide range of strategies with varying investment philosophies and approaches to risk management.

There can also be varying degrees of transparency for a hedge fund's investment portfolio. For example, quantitative funds are often described as operating within a 'black box', denoting a strategy whose inner workings are opaque to outsiders. 'Black box' strategies are necessary because they are typically rules-based strategies, and a degree of secrecy is required to protect the intellectual property of the fund manager. That being said, it is up to each manager to demystify the investment process and help investors understand the risk-return profile associated with the proposed strategy. A good investment manager should be able to explain how the strategy fundamentally works, and how the investment model will react under different market environments, while still protecting the intellectual property underlying the strategy.

On the other hand, a discretionary fund manager making trading decisions based on macroeconomic assessments can afford to be transparent about the fund's holdings. But since it is a discretionary strategy, there may be less consistency to the fund's trades and performance, and it may be more difficult to explain to investors how the strategy really works.

Choosing a hedge fund

All else being equal, investors would naturally want to choose the fund with the highest returns. This is the single most important criterion applied by investors for choosing hedge funds and it relates to not only the fund's average historical returns, but also the variability and duration (or track record) of its returns. In general, investors would much prefer investing in a fund that has proven itself over a long period of time, compared to a fund with a short track record of phenomenal returns. Every strategy will have its day in the sun, but ultimately, it is how a strategy performs through the storm that matters.

Apart from performance, the size of the fund and the robustness of its team are also important. A firm with more AUM will have a healthier capital base that allows it to invest in talent and systems.

Hedge funds require all parts of the business to be firing. Along with the front-office investment and trading teams, there are back-office operations teams, investor relations and capital-raising functions, and also legal and compliance teams. If not performed well, any of these functions can trip the firm up. Investors also prefer that the investment strategy is not resting on the shoulders of just one or two individuals–something the industry terms as 'key man risk'.

While more AUM is generally considered a good thing, a fund that has raised too much capital may struggle to replicate its historical returns. All investment strategies have a strategy capacity limit, and the more profitable strategies tend to reach those limits faster. Beyond a certain point, the strategy will suffer from diminishing returns. Renaissance Technologies' famed Medallion Fund, for instance, closed itself off from external investors in 1993 when it reached its strategy capacity. It returned external capital and made the fund exclusive to its employees, and therefore prioritised sustainability of the strategy's returns.[9]

There is no one-size-fits-all approach to choosing a hedge fund. Investors individually have different preferences regarding asset class limitations, risk tolerances, liquidity requirements, and so on. There are some managers who are willing to cater to investor demand and design strategies that meet different investor goals. Some of the big brand-name asset management firms like Man Group and Blackrock do a great job of creating something for every investor type and are constantly launching new products. Given that at least two-thirds of the capital in the hedge fund industry comes from institutional investors such as pension funds, university endowments, and sovereign wealth funds, it makes perfect sense for investment managers to try to meet their requirements.

Institutional investors generally prefer hedge fund strategies that have low volatility, deliver returns that are uncorrelated to equity markets (since these institutional investors tend to invest the bulk of their capital in equities), and which can be easily liquidated. This is one of the reasons liquid alternative strategies like the equity long/short is such a popular hedge fund strategy. It involves buying stocks that are expected to outperform and the short-selling of stocks expected to underperform, resulting in a strategy that should be market-neutral and relatively liquid.

However, there are also boutique hedge funds that focus on a single investment strategy, which is typically their core strength. In such cases, the focus tends towards maximising the performance of that single strategy, rather than trying to satisfy investor preferences.

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Industry challenges and trends

The alternative investments industry, which includes the hedge fund industry, offers a wide variety of strategies with very different return profiles. Being alternative to traditional asset classes means that hedge funds will always be compared to traditional assets such as equities, bonds, and real estate. Investors often expect hedge funds to not only provide non-correlated returns, but also outperform traditional asset classes. This has been challenging in recent times, given the stellar performance in recent years of developed market equities that are easily accessible through Exchange Traded Funds (ETFs).

The world's largest ETF is the SPDR S&P 500, which tracks the S&P 500 index, an index that has delivered an average annual return of roughly 13.6 percent in the last 10 years. Investing in an ETF is generally considered a passive strategy as ETFs mainly seek to replicate the performance of a broader equity market, or a specific sector or trend. The main benefit of ETFs is its tradability (investors can buy and sell ETFs throughout the trading day), its diversity of holdings (since it seeks to reflect broader market performance), its low expense ratios, and its transparency.

While markets are doing well and so long as alternative strategies struggle to outperform the markets, it makes sense for investors to prefer passive investment strategies like ETFs, rather than pay the higher fees associated with actively managed strategies. This has certainly been the case in recent years as many actively managed funds, including hedge funds, have struggled to match the returns of the S&P 500.

The success and growth of passive investing have led to tremendous downward fee pressure on the hedge fund industry and other active investment strategies. The average management fee charged by hedge funds has dropped from 2 percent per annum in the past to 1.5 percent per annum, on average, today. There are even firms that have done away with management fees completely, offering to levy only a performance fee when the fund delivers gains, in order to attract more capital.

Investment managers are also increasingly experimenting with machine learning to improve performance. In theory, machine learning could potentially improve the model's ability to detect and adapt to changes in market conditions, thus boosting operational efficiency and returns. However, the 'noise' in the financial markets makes the application of machine learning challenging and it will take some time before such strategies are validated.

In the meantime, hedge funds are dealing with the more urgent investor demand to apply environmental, social, and corporate governance (ESG) principles to their strategies. Apart from merely demanding that their portfolios avoid the so-called 'sin' industries, like those dealing with liquor, there is an overarching call for hedge funds to use their capital to generate positive social and environmental outcomes, while still delivering financial returns. Some hedge fund managers have responded by integrating ESG principles into their strategies, but the majority of managers are still grappling with the concept and have been forced to climb a steep learning curve.

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Investing in uncertain times

2020 has been a challenging year for most investors and fund managers. Not only was the market decline in March one of the steepest ever seen, investors were largely still licking their wounds and were unprepared for the market's swift rebound immediately thereafter.

With the effects of the pandemic on the global economy still unfolding, and the almost inevitable march towards a trade and technological war between the U.S. and China, no one seems to be predicting a good year ahead for the financial markets and the fund management industry. But there are a great number of possible outcomes and there is just no way the future can be predicted consistently. As if to illustrate this point, the S&P 500 fell by roughly 10 percent in September, thanks to a confluence of negative events.

Over the decades, since the advent of the first hedge fund and the birth of the hedge fund industry, hedge funds have traversed from the periphery towards the mainstream of the financial world. During this period and through many crises, the industry has evolved and matured into a global and institutionalised industry, recognised for the important role it plays within the global financial system.

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