The revolution is coming

Is a Vanguard-like revolution coming to hedge funds? **ANDREW BEER**, founder and managing member of Dynamic Beta investments, argues his case

IN A YEAR where the world has stood still, 2020 was a turning point for hedge funds. After a difficult 2010s, alpha has roared back: in the first 13 months of this decade, equity long/short alpha was 5.8%. Hedge funds outperformed longs by a record margin. Discretionary macro gunslingers, left for dead, posted astonishing numbers through the pandemic. Given current equity and bond valuations, hedge funds may be poised for a Second Golden Age over the coming decade.

Yet two decades after hedge funds began to institutionalise, many aspects of the allocation process seem archaic. Hedge funds with daily liquid portfolios require investors to lock up money for years. Fee structures that were rational and aligned interests in a $20m fund now look obscene at $20bn. Allocators chase performance and scramble for access to recent stars, which leaves all negotiating leverage with managers, not investors.

Some wealth managers use buying power to extract fee concessions and pocket the difference – as though Walmart charged as much as the corner store. More bizarrely, allocators pay annual incentive fees with no clawbacks.

GameStop is illustrative: consider that one manager appears to have been paid up to $1bn on $4bn of gains, only to lose up to $8bn the next month and not return a penny. Even in a great year, most alpha ends up with managers, not investors. For all hedge funds' sophistication, the process of investing these vehicles simply needs to be reformed.

We believe things are about to change; the hedge fund world is on the cusp of a John Bogle-like revolution.

Allocators are aware of the need for more client-friendly options. The problem is, virtually every effort to build more client-friendly hedge fund strategies has failed. Investable index products were launched in the early 2000s – the equivalent of super-diversified funds of managed accounts with daily liquidity – only to underperform by breathtaking margins; hedge funds worth their salt refused to play along, with only the most desperate signing up. 2012-13 saw the launch of US mutual funds with portfolios managed by credible hedge funds; five years later most had been shuttered, as allocators realised trying to jam hedge fund strategies into a mutual fund structure was like asking a mixed martial artist to fight using only his feet – known as structural performance drag.

In 2014-16, virtually every investment bank and quant launched alternative risk premia products that promised to deliver hedge fund alpha with low fees by mimicking trading strategies that worked a decade earlier; with negative Sharpe ratios and losses in the billions, the space is now considered a failed experiment.

More recently, wealth managers have built portfolios of UCITS versions of hedge funds, which has merit due to lower fees and liquidity. However, constraints within UCITS vehicles often cause performance drag to exceed fee savings.

For more than a decade, I have been singularly focused on how to outperform leading hedge funds with less downside risk, equitable fees and daily liquidity. I simply believe hedge fund investors deserve more alpha.

> "Most alpha still ends up with managers… For all hedge funds' sophistication, the process of investing these vehicles simply needs to be reformed"

We need to take a step back and think through what allocators are trying to achieve with their hedge allocations. They spread their bets across strategies – and larger investors will diversify among not only sub-strategies, but among single managers within those strategies.

A well-diversified portfolio is, by definition, "index-like" in that hedge funds indices themselves are collections of individual funds. Allocators recognise the difficulty of overcoming high fees, and place bets that a collection of the right managers will deliver enough value to ▸

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▸ compensate. By analogy, the goal is to build a portfolio that is "index-plus" – lower risk via diversification, but with some outperformance relative to published hedge fund indices.

Twenty years of evidence from the funds of hedge fund industry demonstrates that, at best, manager selection covers their fees but fails to compensate for those charged by hedge funds: manager selection is, unfortunately, efficient.

Now imagine that Vanguard approached those same allocators with a revolutionary product: a daily liquid UCITS fund sub-advised by one hundred prominent hedge funds. Those hedge funds have offered Vanguard an extraordinary deal: they will copy 90% of their high fees portfolios but charge one fifth the fees.

Consequently, this new "super fund of funds" could be offered to investors with an expense ratio of 100 bps or less. In almost all scenarios, 90% at 1% is much higher than 100% at full fees. Hence, this product would be index-plus, and every allocator would find a place for it in their portfolios. With a liquid, low-cost benchmark product, passive investing could finally invade this bastion of active management.

> **“Allocators are evolving. This new generation of allocators is less entrenched, less wed to myths about hedge funds perpetuated in the early 2000s”**

What we are talking about is effectively factor-based hedge fund replication. Instead of hiring hedge funds, factor models can determine with great accuracy how portfolios of hedge funds are invested today – in recent years, on the order of 90-100% of the drivers of performance. Like the theoretical "super fund of funds", fee reduction drives alpha generation.

A solution has been there all along. Ours were among the first products launched in 2007; virtually every product from this period has materially outperformed funds of hedge funds and UCITS hedge funds. One of our innovations was to seek to replicate pre-fee returns, which passes more alpha back to investors.

The remarkable part is how vigorously the industry has fought adoption. Consulting firms have published research arguing the products "would not work", yet a decade of contrary evidence has produced zero retractions. The industry is replete with allocators whose job is defined by selecting the next hedge fund winner.

Replication challenges many industry canons – are factor rotations more important than stock selection, does short side alpha exist, the persistence of alpha among managers, etc. Its indisputable success leads to uncomfortable questions for an industry built on an ethos of access, mystique and stories.

Why, then, do we expect the gale-force headwinds to abate? Simply, allocators evolve. A new generation of allocators is less entrenched, and less wed to myths about hedge funds perpetuated in the early 2000s. A new generation of asset allocators are concerned more about outcomes than stories – alpha generation from fee disintermediation is just as valuable as picking a winner.

Forward-looking allocators are looking for solutions to improve portfolio efficiency, reduce expenses, improve performance, and minimise fat tail risks. For them, replication is a powerful building block, not a threat. **H**

For more information, dynamicbeta.com

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