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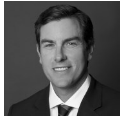

Hedge Fund Alpha's Vanishing Act

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It's certainly a popular exercise these days to bash the hedge fund industry as having evolved into a mediocre returning, high fee extraction business. The return evidence is fairly strong particularly in the past several years as the comparisons to equity markets have been tough given the strong overall returns in equities since 2009.

Exhibit #1 below lists the annual excess return to the S&P 500 of the HFRI equity hedge index which is a fair representation of the universe of long/short equity managers' aggregate performance. It's been a dismal run for hedge funds relative to equity markets as stated above, but that's not a totally fair comparison given that most managers carry short capital to achieve less correlated returns to equity markets. However, this is where the return comparisons become more problematic.

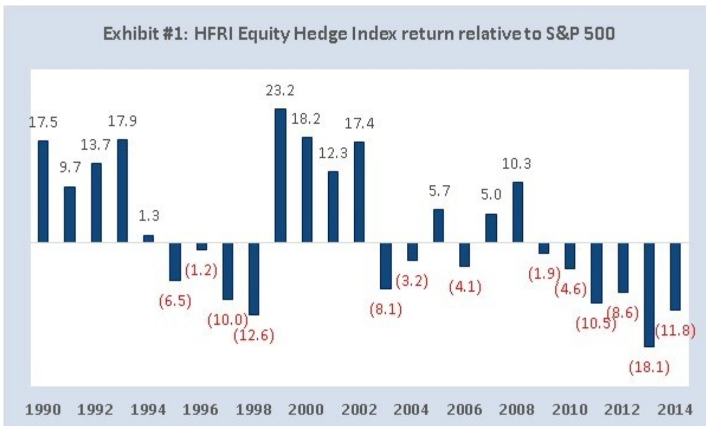
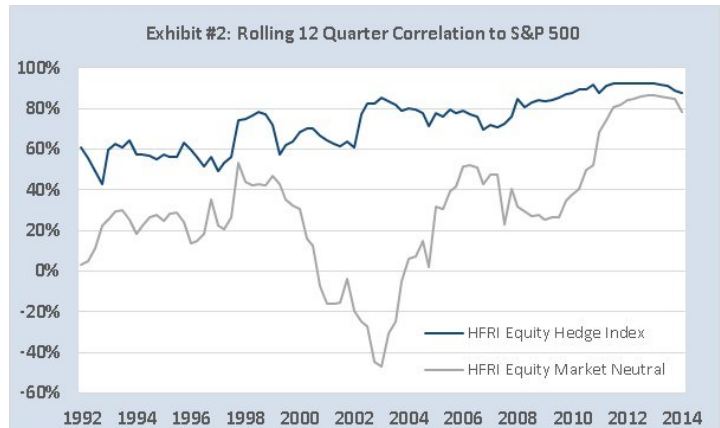


Exhibit #2 at top right details the historical correlation of HFRI's equity hedge index to the S&P 500 going back to 1997. The correlation of returns between the two reached an all-time high in 2012 and has remained at roughly 90% since. Even more surprising is the correlation of returns for equity market neutral strategies which are, by definition, supposedly constructed to be nearly uncorrelated to equity markets as they typically invest equally between long and short capital. The correlation of returns for this group has



also reached an all-time high and is currently around 80%. While hedged returns falling short in a bull market shouldn't be unexpected, it is remarkable to us that one of the primary selling points of hedge funds, specifically the uncorrelated nature of returns, has also vanished.

To get a clear understanding of why returns have been marginalized, we need to evaluate what's changed over the past decade since alternative strategies became more prevalent. The most obvious change is the amount of capital deployed in the space and the number of funds. When we started the Smith Group in 1995, there were maybe a few hundred alternative managers in the universe but today there exist by some accounts 15,000 hedge funds with nearly $3.5 Trillion in equity. This is akin to what occurred in the mutual fund industry back in the 1990's. Additionally, interest rates play a key role in hedge fund returns as most funds hold considerable cash balances as a result of short selling. For most of the 1990's and mid-2000's funds earned as much as 5% on cash balances resulting in a significant stable return component which has not only gone away since QE but actually now has become a negative contribution to return given that reference rates

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are near zero.

Given the timing of the explosion in alternative assets with the decline in alternative alpha, it seems to us that the root cause of the performance decline is most likely due to competition. Increasing levels of capital seeking to invest in a fairly fixed supply of opportunities makes alpha more difficult to achieve.

The key benefit of a hedged fund structure is the ability to be unconstrained on where you deploy capital which is a significant distinction to most long-only managers who are almost always tethered to a narrowly defined asset class. This not only allows a manager to extend the expression of return to the negative side via shorts, but also to focus on areas of the market where they can combine both skill and the opportunity to outperform. Funds need to have a clear and direct mandate of not just how they invest capital, but also where they invest it in order to generate the performance that's expected of alternative strategies.

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