The Role of Hedge Funds in an Institutional Portfolio

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Why Hedge Funds?
In our opinion, hedge funds have a specific and important role in institutional portfolios today. We consider hedge funds, along with traditional fixed income securities, to be a “risk reduction” asset. While hedge fund managers actively take risk, we focus on managers that provide exposure to risks that are differentiated from traditional market risks. These “alternative” risks include deal, spread, litigation, liquidity, volatility, and security selection risks. These risks are frequently amplified through leverage and/or concentration and isolated through hedges. With the exception of extreme market events, these risks generally generate returns that display low correlation to the traditional markets.

Equities are included in institutional portfolios to participate in global economic growth and provide relatively strong long-term returns. At this time, however, we believe that public equities are priced to produce returns below their historical averages. Traditionally, fixed income securities were included in portfolios to dampen the volatility of equities and provide a safe haven during substantial market declines. However, given current yield levels, fixed income securities also appear to be priced for future returns below past levels.

Given the current market environment, we believe a wellcrafted hedge fund program can add significant value to the risk/return profile of an institutional portfolio. With a focus on differentiated returns and high quality managers, hedge funds offer volatility and equity downside characteristics that are similar to traditional fixed income securities under most scenarios, with prospective returns not unlike that expected from public equities.

Portfolio Construction and Manager Selection

Describing hedge funds as risk reducers is incomplete. The primary commonality across hedge fund managers and strategies is simply the structure of the investment vehicle. The variation in managers and strategies across the spectrum of risks and expected return is extreme. Risk reduction is only the product of a conscious effort in portfolio construction and manager selection.

Our focus is to create a diversified basket of alternative risks through a prudently concentrated roster of managers (10 to 20). We endeavor to gain exposure to these risks through investments with managers best-positioned to capture them. For example, we prefer to gain exposure to traditional hedge fund “betas” (for example, the expected return for bearing the risk of a proposed merger failure) and providing liquidity primary through multi-strategy managers. Inclusion of these managers provides an attractive tactical overlay to the hedge fund portfolio, as these managers opportunistically pursue the most attractive risk-adjusted trades across strategies.

Security selection and spread risks are primarily captured through long/short investors in the global equity and credit markets. These managers generally display higher volatility and market sensitivity than multi-strategy managers, which must be factored into the allocation between the two categories and the position sizing of each individual manager.

Alternative risks generally display low correlation to the equity markets except during periods of extreme market stress. As such, where appropriate, we recommend the inclusion of hedging strategies, which are expected to offset a degree of the systematic risk embedded in the hedge fund portfolio. As we believe credit risk is among the most mis-priced risk in today's capital markets, we are currently recommending a short credit manager to provide protection versus market events and hedge the credit risk inherent in many hedge fund strategies.

While portfolio construction is an important driver of the risk/return expectations of a hedge fund program, success or failure will largely be driven by the managers selected. We seek managers with impeccable integrity, great pedigree, sound risk management systems, solid infrastructure, an understandable investment strategy, appropriate respect for market forces, and an identifiable competitive advantage expected to drive future success. Through sound judgment in the selection and sizing of manager and risk allocations, as well as complementary and diversifying exposures, we believe a hedge fund portfolio represents an attractive risk reducer.