Hedge Funds

This is our 4th Worth Sharing on Alternative Investments. The previous 3 are available on our Website: "Alternative Funds - 1/28/18", "Managed Futures - Uncorrelated Volatility - 2/17/18", and "Private Equity - The Crown Jewel of Alternatives - 2/25/18".

The Incredible Shrinking Hedge Fund

By Katherine Burton, Melissa Karsh and Sam Dodge

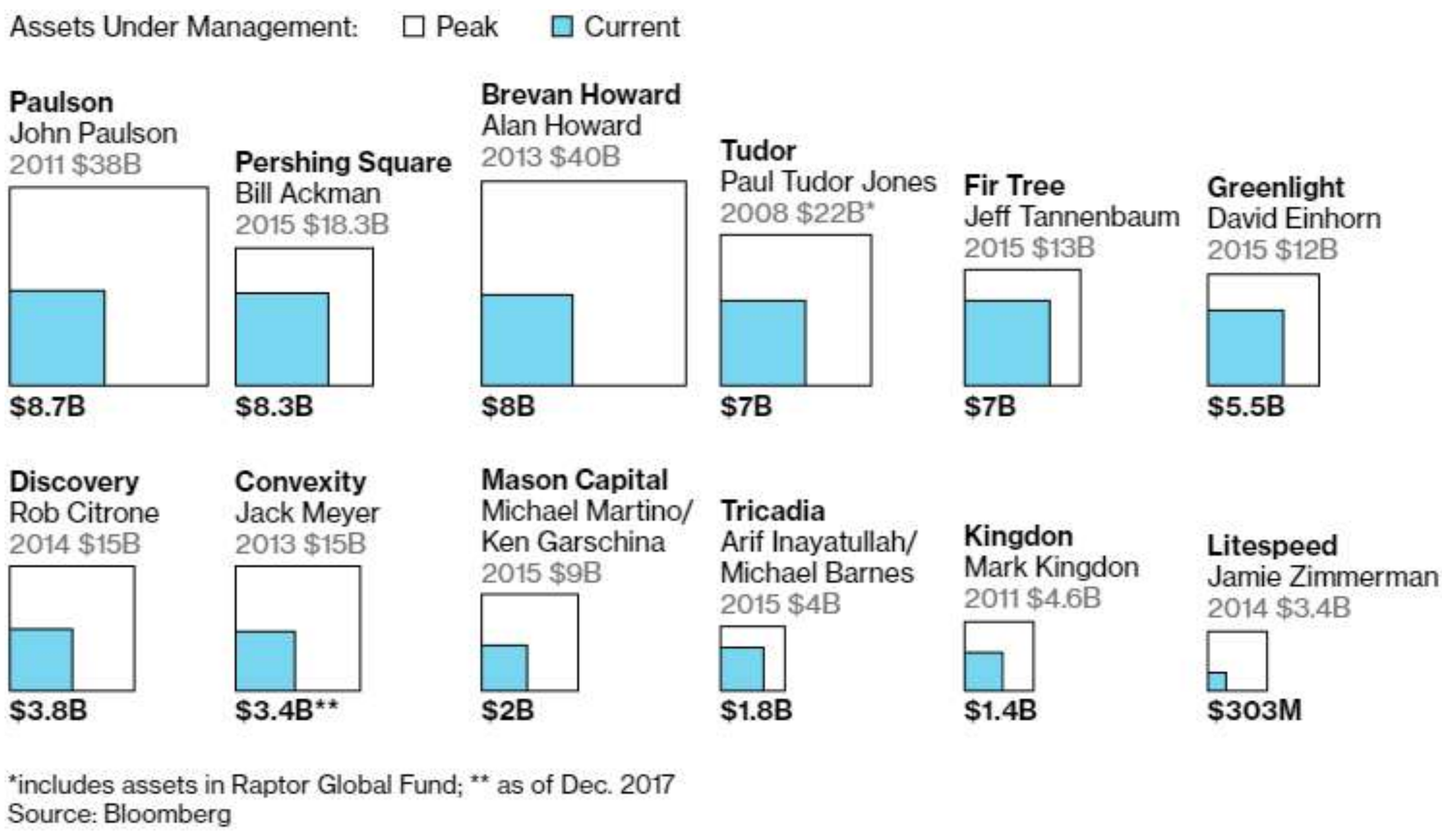
September 11, 2018

You'd be forgiven for thinking the hedge fund industry might be starting to rebound. Industry assets are at a record $3.2 trillion this year, and a brand-new firm just brought in an unprecedented $8 billion.

But the reality isn't so rosy. Inflows into funds, on the whole, are non-existent and the number of startups has slowed to levels not seen for nearly two decades.

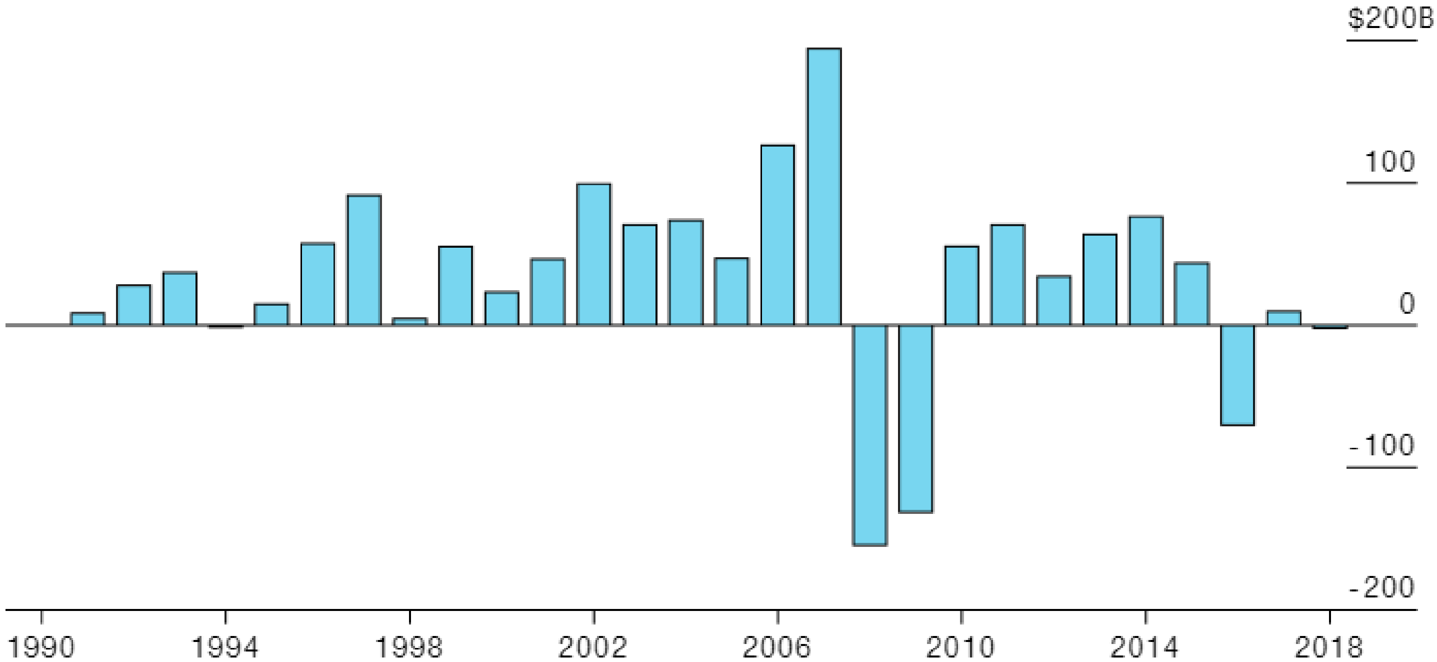
Melting Ice Cubes

Once high-flying powerhouses run by David Einhorn, Bill Ackman and Alan Howard are mere shadows of their former glory after posting years of returns that ranged from uninspiring to downright awful. John Paulson has crashed so badly and seen assets plummet so far that he's largely left managing his own money.



Inflows Stagnate

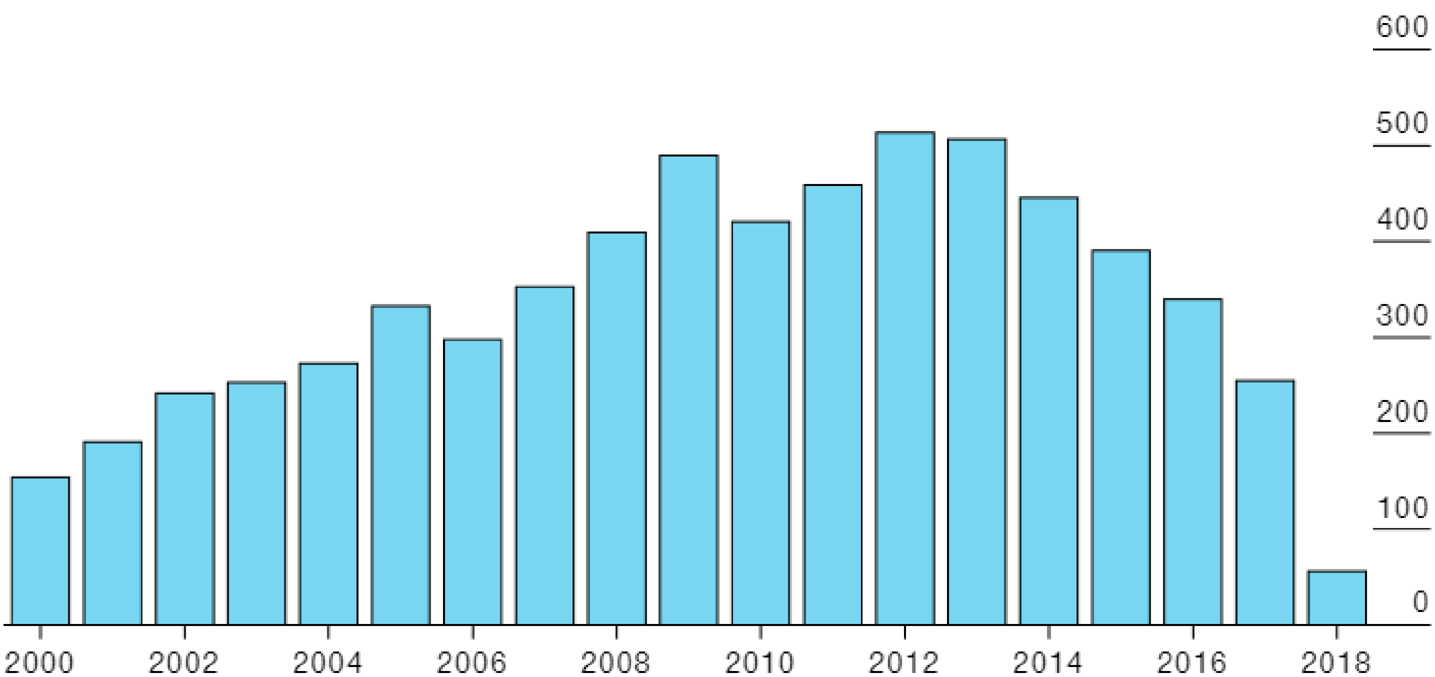
Overall, firms' assets are barely growing. Net inflows since the end of 2016 have equaled just $7.8 billion.



Source: HFR

Startups Plummet

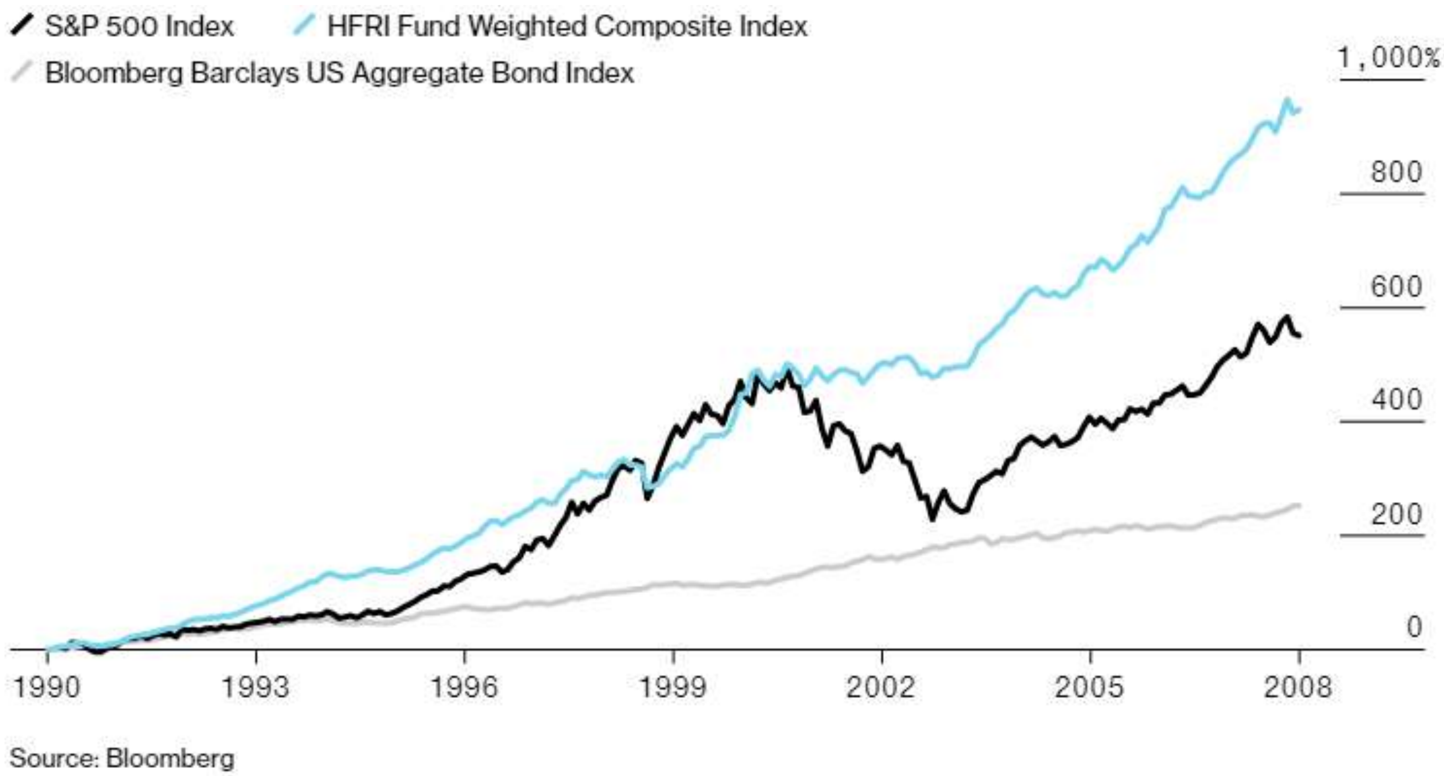
With inflows stagnant, the number of new firms has plummeted.



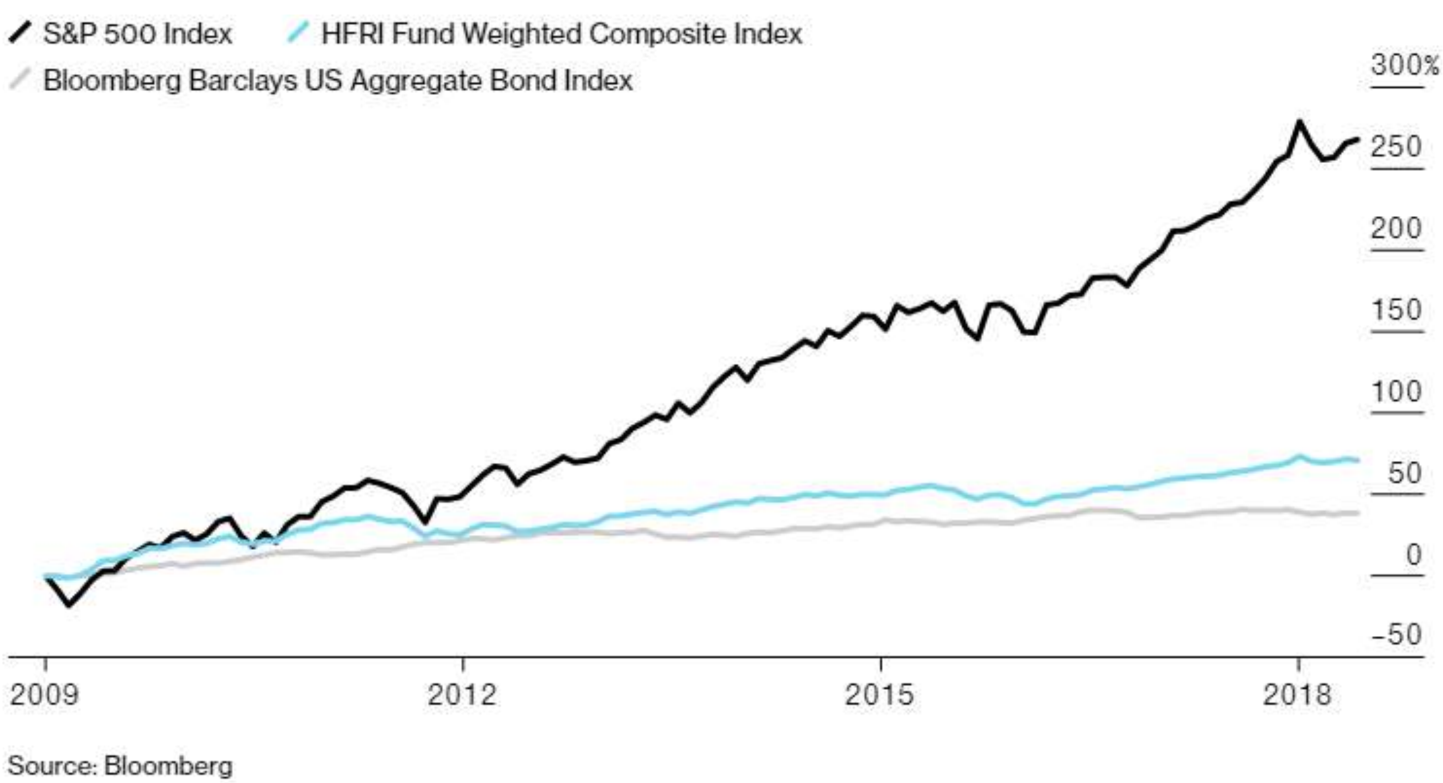
Source: Preqin

Hedge Funds Trounced Markets Over the Long Term

Going back to the 1990s (18 years is not "Long Term"), hedge funds were a standout investment. In the early days, competition was slim and many hedge fund managers were able to post double digit annualized returns.



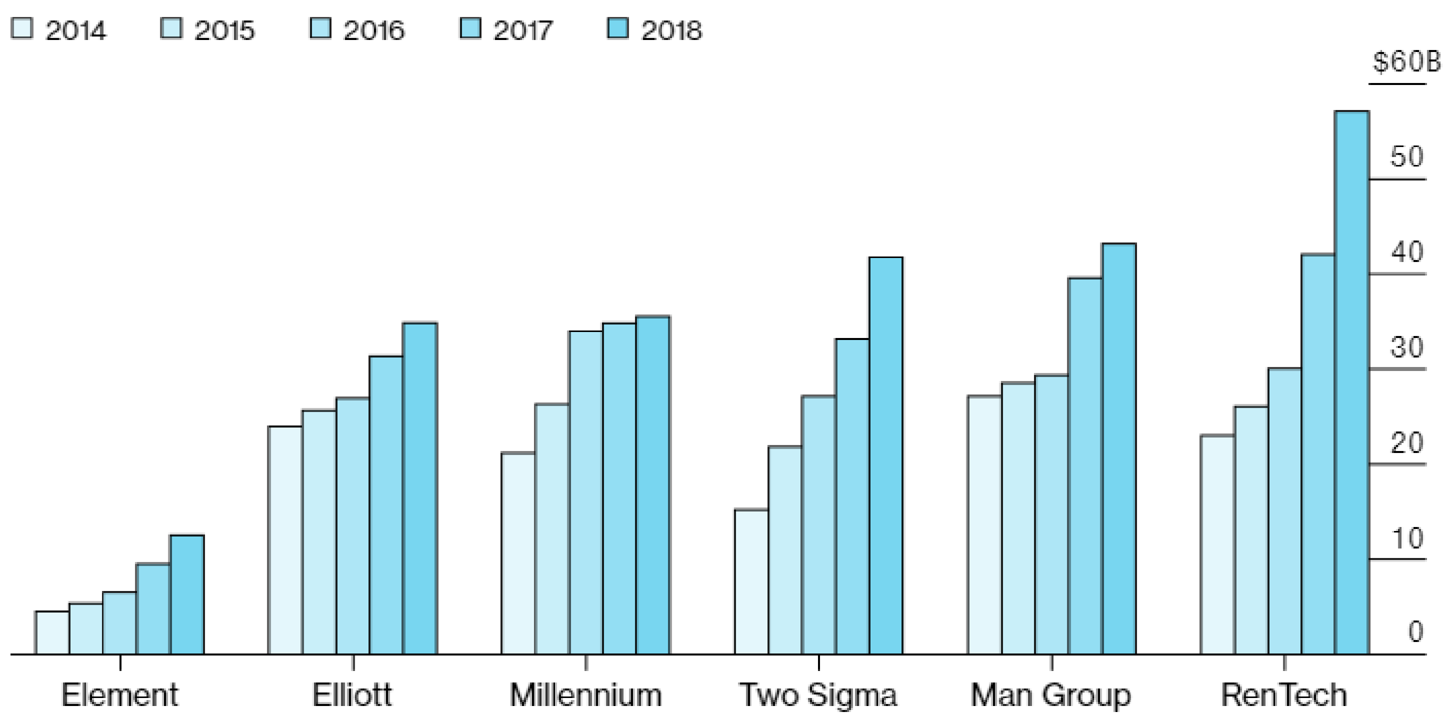
Short Term, Not So Much



Since the financial crisis, historically low interest rates and the rise of quantitative and passive investing have made it hard for many managers to make money. While hedge funds, on average, have outpaced bonds, they've massively underperformed stocks.

A Few Bright Spots

While many pension funds and other institutions have given up on hedge funds after years of disappointing results, a core group of investors continue to shovel money to a few managers with the best performance. Macro fund Element Capital Management, run by Jeff Talpins, has seen assets rocket 178% from the beginning of 2014 to the beginning of 2018 (and he's raised another $3 billion since). Two Sigma and Renaissance Technologies both saw assets more than double as investors flocked to algorithmic traders. **(“If you do fundamental trading, one morning you feel like a genius, the next day you feel like an idiot…by 1998 I decided we would go 100% models…we slavishly follow the model. You do whatever it [the model] says no matter how smart or dumb you think it is. And that turned out to be a wonderful business.**” - Jim Simons, Founder, Renaissance Technologies. Its flagship Medallion Fund was closed to outside investors in 1993. "From 1994 through mid-2014 it averaged a 71.8% annual return. ... From 2001 through 2013, the fund's worst year was a 21 percent gain, after subtracting fees. Medallion reaped a 98.2 percent gain in 2008, the year the Standard & Poor's 500 Index lost 38.5 percent."— *Rubin and Collins. June 16, 2015. Bloomberg*)

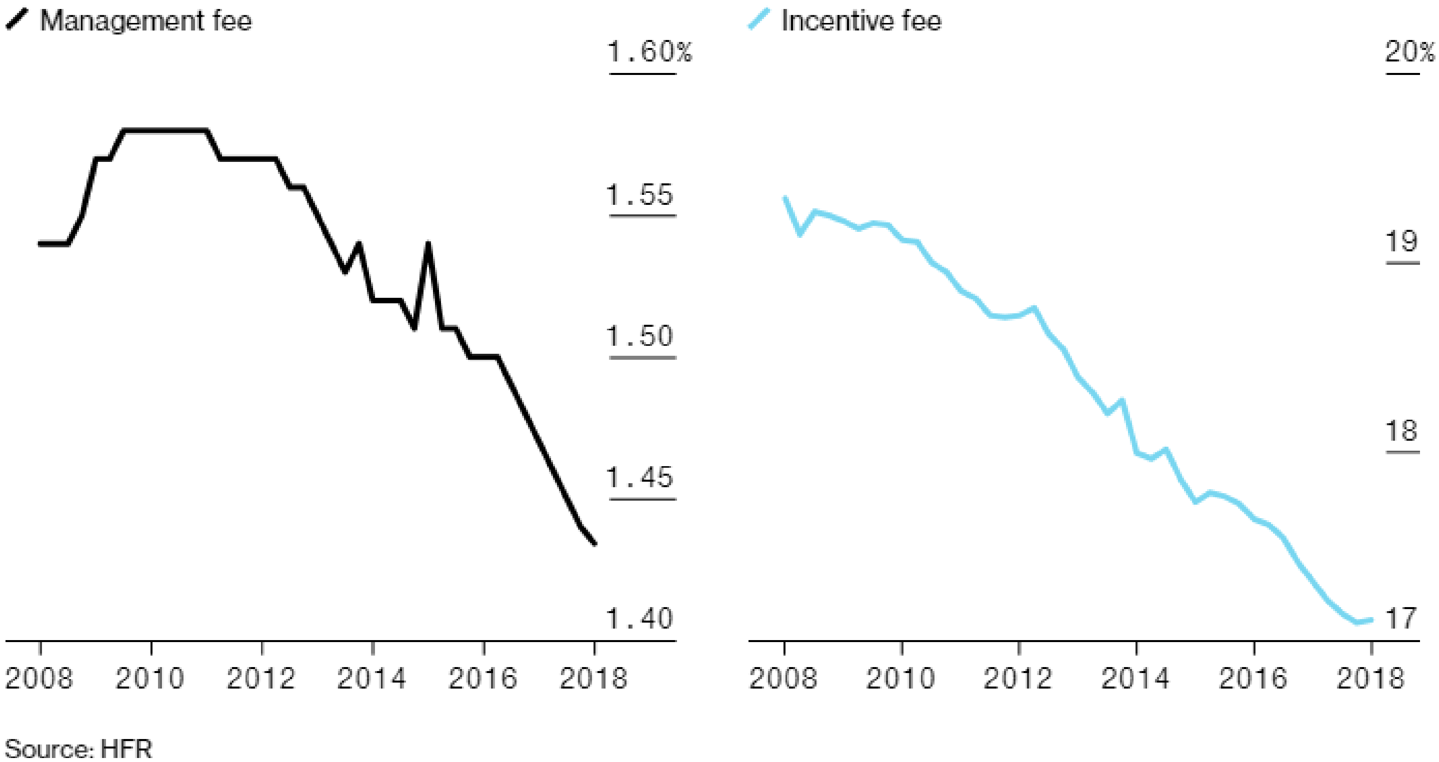


Note: Assets under management as of Jan. 1 each year
Source: Bloomberg

Two new funds were able to buck the trend and attract billions because the founders previously held senior roles at top-performing firms. Michael Gelband started ExodusPoint with a record $8 billion after leaving Millennium Management. Dan Sundheim opened his D1 Capital Partners with $4 billion, after managing almost half the assets at his old firm Viking Global Investors.

Fees Shrink

As institutions flocked to funds and handed out bigger slugs of cash, they've pushed for lower fees.



Looking Ahead

As for the future of the hedge fund industry, a lot depends on the markets, said Rob Christian, head of research at K2 Advisors, which invests $11.6 billion in hedge funds. Low interest rates globally have sent stocks higher over much of the last decade, causing institutional investors to flee these private partnerships in favor of low-cost index funds and ETFs.

Once rates start rising "we would expect volatility to increase and active management to be rewarded with increased inflows," he said. "It's just hard to predict when it will happen." ...

Our thoughts

February's Newsletter shared some of Berkshire Hathaway's Annual Letter, including the final results of Warren Buffet's famous million dollar bet against Hedge Funds:

"The Bet" is Over and Has Delivered an Unforeseen Investment Lesson

Last year, at the 90% mark, I gave you a detailed report on a ten-year bet I had made on December 19, 2007. ... Now I have the final tally – and, in several respects, it's an eye-opener.

I made the bet ... to publicize my conviction that my pick – a virtually cost-free investment in an unmanaged S&P 500 index fund – would, over time, deliver better results than those achieved by most investment professionals, however well-regarded and incentivized those "helpers" may be.

Addressing this question is of enormous importance. American investors pay staggering sums annually to advisors, often incurring several layers of consequential costs. In the aggregate, do these investors get their money's worth? Indeed, again in the aggregate, do investors get anything for their outlays?

Protégé Partners, my counterparty to the bet, picked five "funds-of-funds" that it expected to over perform the S&P 500. That was not a small sample. Those five funds-of-funds in turn owned interests in more than 200 hedge funds.

Essentially, Protégé, an advisory firm that knew its way around Wall Street, selected five investment experts who, in turn, employed several hundred other investment experts, each managing his or her own hedge fund. This assemblage was an elite crew, loaded with brains, adrenaline and confidence.

The managers of the five funds-of-funds possessed a further advantage: They could – and did – rearrange their portfolios of hedge funds during the ten years, investing with new "stars" while exiting their positions in hedge funds whose managers had lost their touch.

Every actor on Protégé's side was highly incentivized: Both the fund-of-funds managers and the hedge-fund managers they selected significantly shared in gains, even those achieved simply because the market generally moves upwards. (In 100% of the 43 ten-year periods since we took control of Berkshire, years with gains by the S&P 500 exceeded loss years.)

Those performance incentives, it should be emphasized, were frosting on a huge and tasty cake: Even if the funds lost money for their investors during the decade, their managers could grow very rich. That would occur because fixed fees averaging a staggering 2 1⁄2% of assets or so were paid every year by the fund-of-funds' investors, with part of these fees going to the managers at the five funds-of-funds and the balance going to the 200-plus managers of the underlying hedge funds.

Here's the final scorecard for the bet:

Year	Fund-of-Funds A	Fund-of-Funds B	Fund-of-Funds C	Fund-of-Funds D	Fund-of-Funds E	S&P Index Fund
2008	-16.5%	-22.3%	-21.3%	-29.3%	-30.1%	-37.0%
2009	11.3%	14.5%	21.4%	16.5%	16.8%	26.6%
2010	5.9%	6.8%	13.3%	4.9%	11.9%	15.1%
2011	-6.3%	-1.3%	5.9%	-6.3%	-2.8%	2.1%
2012	3.4%	9.6%	5.7%	6.2%	9.1%	16.0%
2013	10.5%	15.2%	8.8%	14.2%	14.4%	32.3%
2014	4.7%	4.0%	18.9%	0.7%	-2.1%	13.6%
2015	1.6%	2.5%	5.4%	1.4%	-5.0%	1.4%
2016	-3.2%	1.9%	-1.7%	2.5%	4.4%	11.9%
2017	12.2%	10.6%	15.6%	N/A	18.0%	21.8%
Final Gain	21.7%	42.3%	87.7%	2.8%	27.0%	125.8%
Average Annual Gain	2.0%	3.6%	6.5%	0.3%	2.4%	8.5%

Footnote: Under my agreement with Protégé Partners, the names of these funds-of-funds have never been publicly disclosed. I, however, have received their annual audits from Protégé. The 2016 figures for funds A, B and C were revised slightly from those originally reported last year. Fund D was liquidated in 2017; its average annual gain is calculated for the nine years of its operation.

The five funds-of-funds got off to a fast start, each beating the index fund in 2008. Then the roof fell in. In every one of the nine years that followed, the funds-of-funds as a whole trailed the index fund.

Let me emphasize that there was nothing aberrational about stock-market behavior over the ten-year stretch. If a poll of investment “experts” had been asked late in 2007 for a forecast of long-term common-stock returns, their guesses would have likely averaged close to the 8.5% actually delivered by the S&P 500. Making money in that environment should have been easy. Indeed, Wall Street “helpers” earned staggering sums. While this group prospered, however, many of their investors experienced a lost decade.

Performance comes, performance goes. Fees never falter."

Hedge Fund performance when broken down by strategy: