Investor twists, turns and trends

BY **JASMIN LEITNER**

From seeking high-octane returns to the growth of Ucits and risk premia; the modus operandi of European allocators has changed significantly over the last two decades

When I started, hedge funds were leveraged. Now they are hedged. In the past, managers were traders from brokerage houses; today, they have MBAs. They were willing to bet the ranch and investors were willing to tolerate a drawdown of anything up to a third of NAV. No investor today would tolerate anything like that level of volatility."

These are the recollections of the late Georges Karlweis, the legendary Edmond de Rothschild banker who gave George Soros's Quantum its start, and who founded one of the early fund of hedge funds, Leveraged Capital Holdings.

"Investors understood that their managers were taking risks. [During an] exceptional crisis, I remember one manager having, in one day, turned his, maybe, 400 long currency, gold and stocks into the equivalent short position," Karlweis recalled.

"We had fantastic performance. Today, I still own hedge funds, but I have reduced my return objectives... quite dramatically."

Karlweis was retired in the Bahamas when he gave *EuroHedge* sister title *InvestHedge* this somewhat melancholy interview in 2002, reflecting on what had changed since he started out in the 1960s. His descriptions don't seem radically out of place today.

Of course, plenty has changed in the last 20 years, from the underlying investor base and due diligence practices to strategy appetite and the way investors engage with hedge funds.

"If you think about the last 20 years, it's been a big change from something that was more of a high-net-worth, private bank industry that not many people actually knew about, it wasn't really reported on in the mainstream press, to one which is regularly reported on," explains Robert Howie, a principle in the hedge fund team at Mercer.

While the investment consultant has been a behemoth in the broader financial services industry for several decades, in the late nineties and early noughties, it didn't have a dedicated hedge fund team.

In 1998, family offices and HNWIs made up almost two-thirds of the industry's assets globally, while FoHFs made up another 24%.

Far less concerned about month-to-month liquidity and volatility, the nimble HNWIs and entrepreneurial family offices were an ideal match for Europe's fledgling managers, who were, in Karlweis's words, willing to "bet the ranch".

An *InvestHedge* survey in May 2002 of nearly 50 managers, of which 21 were European, revealed that pension funds and insurance companies accounted for only 4% of small start-ups, 5% of medium-sized funds and 12% of larger, hard-closed funds.

The research polled star Merrill Lynch trader Adrian Holmes' Cambrian Capital Management and CSFB, the unit formed earlier that year to invest in prop desk start-ups such as the one Alan Howard went on to form.

Even when institutional investors made larger forays into hedge funds, they did so predominantly through FoHFs.

An early mover in the UK was the Railways Pension Scheme, which started exploring the space in 2001.

The then-$30bn scheme didn't deploy any capital until 2004, when it split a $1bn mandate between US groups Blackstone, the Rock Creek Group and Grosvenor Capital Management. Investment director Brendan Reville explained at the time that they selected firms across the pond simply because there was more choice, and because European FoHFs were not as mature.

"The UK-based firms at the time did not have enough coverage of the US, and vice versa for the US firms, but the majority...were based in America."

The road to transparency

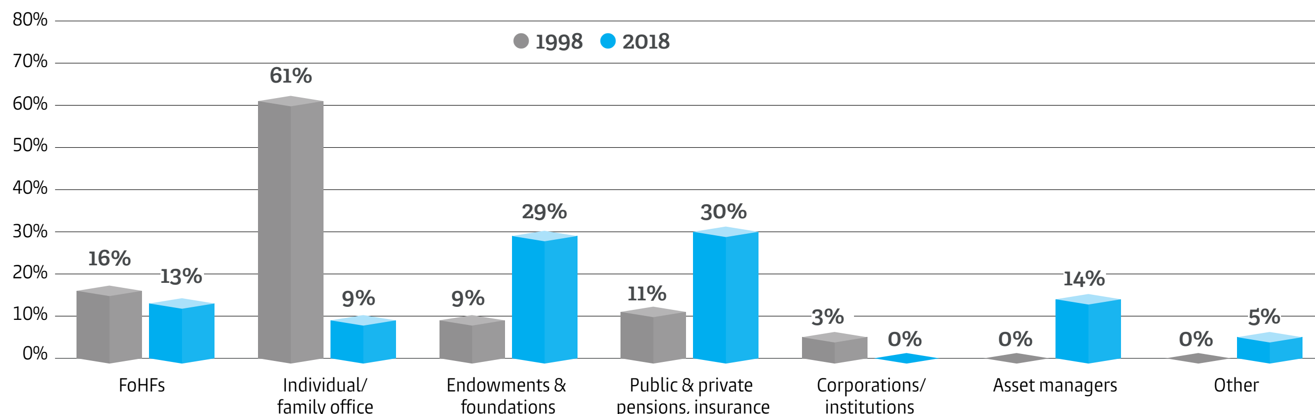
The financial crisis and the years that ensued were seminal for European hedge funds and their investors.

The scale of Bernie Madoff's $65bn fraud was revealed and its impact was far-reaching, explains Kevin Gundle, CEO of Aurum Research, the FoHF group that provided data to *EuroHedge* when it first launched.

KEVIN GUNDLE

ROBERT HOWIE

The changing investor base: 1998 vs 2018



Sources: Estimates based on data from Hennessey Group, investment bank cap intro surveys, Preqin and HFM data

"Capital from the Swiss private banking sector was exposed to Madoff, and this sector had significant allocations to hedge funds.

"Madoff really put a shot across most investors' bows even if they did not have exposure to Madoff, which was the majority. There was a sense that there was a risk that they could become contaminated by an industry that clearly had problems."

Following Madoff and other crisis-related revelations around redemption terms and side pockets, investors realised that much more focus on operational due diligence was needed, ushering in expanded roles for specialist and generalist consultants.

That also coincided with the start of a continued contraction among FoHFs.

Many larger institutional investors making their hedge fund debuts after the crisis bypassed FoHFs in favour of making direct allocations with the help of consultants, including the UK's pension fund for Royal Mail postal workers.

"If you look back perhaps 10 to 15 years, most UK pension schemes that bothered investing in hedge funds, which wasn't many, used FoHFs and of course with that, they were paying an extra layer of fees," explains CIO Ian McKnight.

He says the board considered fees, transparency and liquidity and concluded that making direct investments was preferable, with the caveat that internal governance needed to be robust to manage a portfolio well.

"What we wanted was low correlations to equity, credit or anything else we held in our return-seeking assets and we wanted [the portfolio] to have low volatility, which hedge funds should be and generally are. We wanted to get away from this perception that [hedge funds] are all very risky investments.

Hedge funds really started to struggle and not deliver the returns that they promised.

CLAUDIA STANGHELLINI

"I think after the Madoff scandal people thought hedge funds were risky, dangerous and expensive. They might well be expensive, but you have to pay for skill," he says, adding that they were able to get comfortable with fees but that it was "a big deal back in the day".

On the internal governance front, Royal Mail hired Bev Durston, the former head of alternative investments at British Airways Pensions, to lead its implementation in 2013.

McKnight says they wanted to create a concentrated portfolio of specific themes, ideas and investments which delivered on their goals.

They initially split $100m between Halcyon Asset Management, MKP Capital and Swiss commodity specialist Krom River, Elementum and Pacific Alliance Asia Opportunity Fund. Krom was dropped the following year, with Brevan Howard, Och-Ziff and Taconic Capital Advisors added instead.

Today, the hedge fund portfolio of the £10bn-plus pension fund is worth just under $500m, although that could double over the next few years, McKnight says. Brevan Howard remains the only European manager on the roster.

"We're not bothered where [managers] are based, if they've got the characteristics we want and the opportunity set is better, it's more [about] looking at whether it's an event or macro or commodity hedge fund, that's a more important decision in terms of relative difference than exactly where they are running that strategy," he says.

He adds that fund jurisdictions must meet Royal Mail's requirements from a compliance and legal perspective.

Other institutional allocators approached by *EuroHedge* agree.

"We have a mixture of managers and strategies, we don't select by geography," explains Claudia Stanghellini, head of external management at SEK 351.1bn ($39.5bn) Swedish pension fund AP3, although she adds that they find managers in Europe and the US to be more institutional and able to cater to its needs than Asian ones.

"We started our portfolio in 2007 with exposures to CTA and macro

CLAUDIA STANGHELLINI

managers, gradually building a more diversified portfolio, with long/short equity, long/short credit, event-driven and emerging markets strategies."

AP3 had exposure to some 20 managers at its peak but reduced this significantly over the last few years as performance has been disappointing, Stanghellini explains.

"Hedge funds really started to struggle and not deliver the returns that they promised and so after many internal discussions, two or three years ago, we decided to start taking down risk from the portfolio."

She adds that they have reduced the number of managers as well as the amount invested, retaining only a few with whom they have long-standing partnerships.

A recognition that big is not always better has also prompted other sizeable European allocators to rethink their investment approach in hedge funds.

"Most people that invest in this area tend to go for the largest established managers," says Roy Kuo, head of alternative strategies at the Church Commissioners, which manages the Church of England's £8.3bn endowment.

"The problem with that is that if you're trying to generate any sort of alpha or outperformance over the industry, you are bearing the hefty cost of fees charged and generally lower market beta, both of which put you at a performance disadvantage.

"The outperformance needs to be very material and that is very difficult to achieve when you're a large shop," he adds.

"You have to be fairly small and specialised to actually deliver that type of return, so we've been transitioningsome mandates to smaller managers – more sector or country-specific."

Kuo caveats that they don't really invest with emerging managers, but many of the holdings in their portfolio run less than $2bn.

Concentrating manager relationships and placing more emphasis on partnership are two trends that have played out across Europe, as well as other markets, particularly as performance has been challenged.

Looking for liquidity

The demand for greater liquidity has been especially prevalent in Europe – a hangover from the financial crisis – and the move to further regulating the industry has led to an influx of onshore products in the form of Ucits.

Appetite for these funds was relentless after the crisis, bringing alternative strategies into the portfolios of conservative institutions and retail clients that wouldn't otherwise get exposure to them.

Alternative Ucits funds managed less than €20bn in 2003, when Ucits III was enacted. Assets crossed the €100bn mark in 2012, had grown to some €350bn in 2016 and as of 30 November 2018, stood at €426bn ($487bn), according to data from *Morningstar* and Deutsche Bank.

Many of the blue-chip managers profiled in this special edition of *EuroHedge* have been front and centre of this trend, including Marshall Wace, Aspect and IPM, although not everyone views it as positive.

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"Many investors, from a compliance and regulatory standpoint, are compelled to buy Ucits. I think the tax framework has made it more difficult to potentially own offshore funds," Aurum Research's Gundle says.

He adds: "The essence of what hedge funds are all about is an unconstrained approach to investing and as soon as you put constraints [on that], you diminish outcomes and opportunities."

Another trend that has characterised the industry over the last few years is alternative risk premia.

Seeking to provide systematic exposure to various risk premia that have an academic, economic or behavioural rationale underpinning expected returns, these strategies have arguably been a blessing and a curse for managers, who need to weigh up the investor diversification and asset-raising benefits against the threat of cannibalisation and overall lowering of fees.

An additional consequence is that simpler, cheaper, more liquid products increase the pressure on managers to demonstrate that their high-octane, higher-fee products can deliver the alpha they promise.

"There was kind of a feeling that hedge funds had some sort of magic in the past, whereas now the growth of alternative risk premia has shone a torch on some of the things that hedge funds were doing that were inherently capturing a risk premium out there," says Mercer's Howie.

He adds that mainstream asset managers launching hedge fund-like products also compounds that pressure.

Indeed, the convergence between mainstream and alternative has been two-way, with firms such as CQS, Man Group and Lansdowne becoming as well known for their long-only offerings as their hedge funds.

The Church Commissioners' Kuo argues that many investors are better off investing in risk premia products than traditional hedge funds due to the limited alpha generated by the latter compared to their costs, but he cautions that implementation needs to improve significantly to be effective.

"If you do [alternative beta] as a dedicated allocation you will underperform everything, you need to do it as an overlay on your existing holdings. If you buy passive equities and then overlay it with alternative beta then you can actually create a better risk and return profile over the market."

He suggests this is one area where allocators in Europe can learn from their US counterparts.

Others predict that continental hedge fund appetite may increase if managers can deliver outperformance during the next market downturn and beyond.

The European hedge fund industry has undergone a remarkable transformation over the last 20 years.

The next two decades will no doubt bring about more change in Europe, which managers and allocators will have to adapt to and embrace. ◘