INVESTMENT BULLETIN

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How Effective Are My Hedge Funds?

The hedge fund value proposition depends heavily on what it is supposed to achieve, as an alternative to stock funds or bond funds. This piece attempts to address the communication challenge surrounding hedge funds – in simple terms, how to decide what the fund is supposed to achieve. Unfortunately, the term "hedge fund" carries about the same descriptive power as "mutual fund" or "index fund," all of which refer to how assets are pooled and made available for investment, but do not indicate strategy. We all generally know what to expect from a US equity fund just based on the categorization, but we shouldn't know what to expect from a generic "hedge fund" until we understand the investment strategy and goals.

Further, hedge fund results are usually reported once a month directly to you by a third-party administrator who serves to reconcile and check the value of the assets in a hedge fund. Seeing their report on the value and performance of the hedge fund hopefully increases trust in the results. But administrator reporting usually contains no context or comparison to a relevant stock or bond index. Is +1% a good result last month? Does -1% indicate the manager is struggling? A helpful context for hedge fund results isn't always available, except through an investment advisor or industry reports.

Perhaps the greatest challenge arises if the value of a strategy depends on how the fund behaves in periods of equity or bond market stress. As memories of market shocks fade, it takes more analysis to determine if a strategy is the right one and if the manager is doing its job. Just as we forget why we hold bonds yielding 2% when the stock market has averaged 15+% over the past 8 years, we also just as easily forget a similar diversifying role of hedge funds.

Some of these evaluation hurdles will always remain. Nevertheless, we hope this piece will serve as a point of reference for thinking about the role hedge funds can play in a portfolio in straight forward, hurdle-clearing terms. We divide our thoughts between two basic categories: "stock-alternative" and "bond-alternative" hedge funds.

Stock-alternative Hedge Funds

The performance of the BlueArc Quantitative Equity Fund, a new opportunity we launched in February 2017, will be judged in the context of stocks. There are two basic determinants of the fund's returns: 1) the movement of the global stock market and the 2) ability of the five underlying managers to generate returns greater than what the market delivers – "alpha". We believe the market component will be captured at a rate of about 30 to 50%, on average, meaning a 5% global stock market return would typically translate to a 1.5 to 2.5% lift in the fund's performance during the same timeframe, with the balance of the return generally categorized as alpha.

On a month-to-month basis this alpha number could be large or small, positive or negative. However, over longer periods, we expect it to be large enough to make the MSCI All Country World Index ("ACWI"), a global stock market index, the appropriate gauge for the success of the fund. In other words, we expect alpha to make up a significant portion of the 2.5 to 3.5% difference from the 5% stock market return in the previous example. The ACWI will be easier to exceed in down markets (if we are correct that the fund only experiences a third to a half of the market's fall) and harder to beat in sustained bull markets, as the alpha component will need to be consistently significant to make up for the reduced market sensitivity.

With respect to stock-alternative hedge funds, it is important to understand the sensitivity to equity markets during normal and stressed environments, as well as the magnitude and variation of expected alpha. While the *direction* of global stocks should serve as helpful context for the monthly statement you receive. The *magnitude* of the global stock returns should provide a more meaningful comparison for results for a year and beyond.

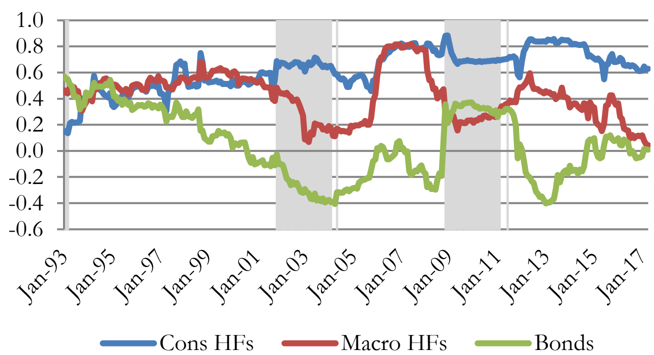
Bond-alternative Hedge Funds

The BlueArc Multi-Strategy Fund (a Regulated Investment Company, hereafter the "RIC"), a fund of various hedge fund strategies, and BlueArc Global Macro Fund ("Global Macro") operate in the context of bond-alternative stock diversifiers. Neither fund is bond-like in terms of the assets they own, but both are bond-like in terms of their defensive role in a portfolio. Helpful context for the performance evaluation of these funds is the Barclays Aggregate Bond Index ("Agg"), the industry standard for US investment grade bonds. Using an HFRI index of conservative fund of funds to proxy the RIC and the HFRI Macro index to proxy Global Macro we undertake more detailed analysis to test the capability of more conservative hedge fund strategies to serve as a bond-alternative in portfolios.

Figure 1, on the next page, plots the rolling three-year correlation of hedge funds and stocks back to 1993. The blue line at Jan-17, for instance, shows that the correlation of conservative fund of hedge funds to the ACWI from Jan-14 to Jan-17 was 0.65. The red and green lines show the same information for macro hedge funds and bonds through time.

Our first observation is that bonds are an effective diversifier; they have the lowest correlation in almost every three-year window and often move in the opposite direction of stocks (exhibiting negative correlation). Second, macro hedge funds offer valuable, but different diversification, with correlations generally in the 0.2 to 0.6 range. During periods of equity stress – shaded in grey on the graph – when stocks lost money over three years, macro's correlation dips significantly indicating that its diversification power increased when stock investors needed it most. Further, macro funds usually adapt to periods of equity strength – the red line shows more coordinated movement with stocks in the non-shaded periods. Bonds, in green, exhibit diversifying characteristics during the tech wreck at the beginning of the century, but travelled through most of the financial crisis as less effective diversifiers than macro hedge funds.

Figure 1: Diversifying Strategies
Rolling 3 Yr Correlations to Global Stocks
Source: Bloomberg

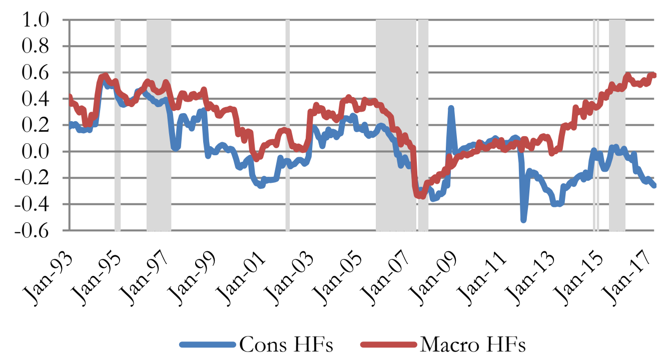


Last, conservative hedge funds, in blue, offer some diversification, but not at the level of macro or bonds. We do have evidence, albeit over a shorter period, that the RIC performs better as a diversifier than its blue line proxy. It boasts a 0.4 correlation to the ACWI over its two plus year life.

Diversifiers are most helpful if they deliver a return stream that is unique among the other diversifying assets in a portfolio. Figure 1 should give comfort that hedge fund returns are differentiated from bonds, but we want to examine the relationship directly. Since bonds perform poorly in rising interest environments, we are particularly interested in the behavior of hedge funds during those time periods. Figure 2 depicts this analysis.

The graph shows the same rolling three-year data but compares to the Agg instead of the ACWI. We observe that both hedge fund categories have maintained low correlation to bonds throughout the period. Macro hedge funds are usually more correlated than conservative hedge funds, and certainly of late. Importantly, hedge funds maintain their uniqueness through periods of rising rates (shaded grey regions show three year periods when the ten-year government bond yield increased 0.25% or more). In fact, in the only sustained period of rising rates, 2005-07, both strategies tended to be less correlated with bonds than the periods immediately preceding and thereafter.

Figure 2: Diversifying Strategies Continued...
Rolling 3 Yr Correlations to US Bonds
Source: Bloomberg



Conclusion

Unfortunately, hedge fund stories are most often about star traders, huge macro calls (e.g., Paulson shorting mortgage securities), or activists' latest boardroom dramas. We don't think this is the proper mindset for evaluating hedge funds within a framework of longer-term contribution to your portfolio. Rather, the relevant question is "How effective is this strategy versus the simple alternative?" Does the Quantitative Equity fund improve on the long-term results of global stocks? Do the RIC and Global Macro perform a diversification role more effectively than bonds, particularly in a rising rate environment? It is also important to note that since all funds examined here are pooling structures, investors are gaining access to multiple hedge funds in each investment - diversifying individual manager risk.

There are important considerations beyond performance characteristics. Hedge funds offer restricted liquidity versus stocks/bonds and have some hassle factor (tax reporting, paperwork, etc.) that should be considered. The RIC and Global Macro, the bond alternatives, don't offer the current income investors associate with bonds. But we believe all three funds play a role in achieving our overall objective of diversifying portfolio risk and maximizing returns for risk taken. Hopefully, this analysis provides more context for deciding if they are helping or detracting from this mission. □