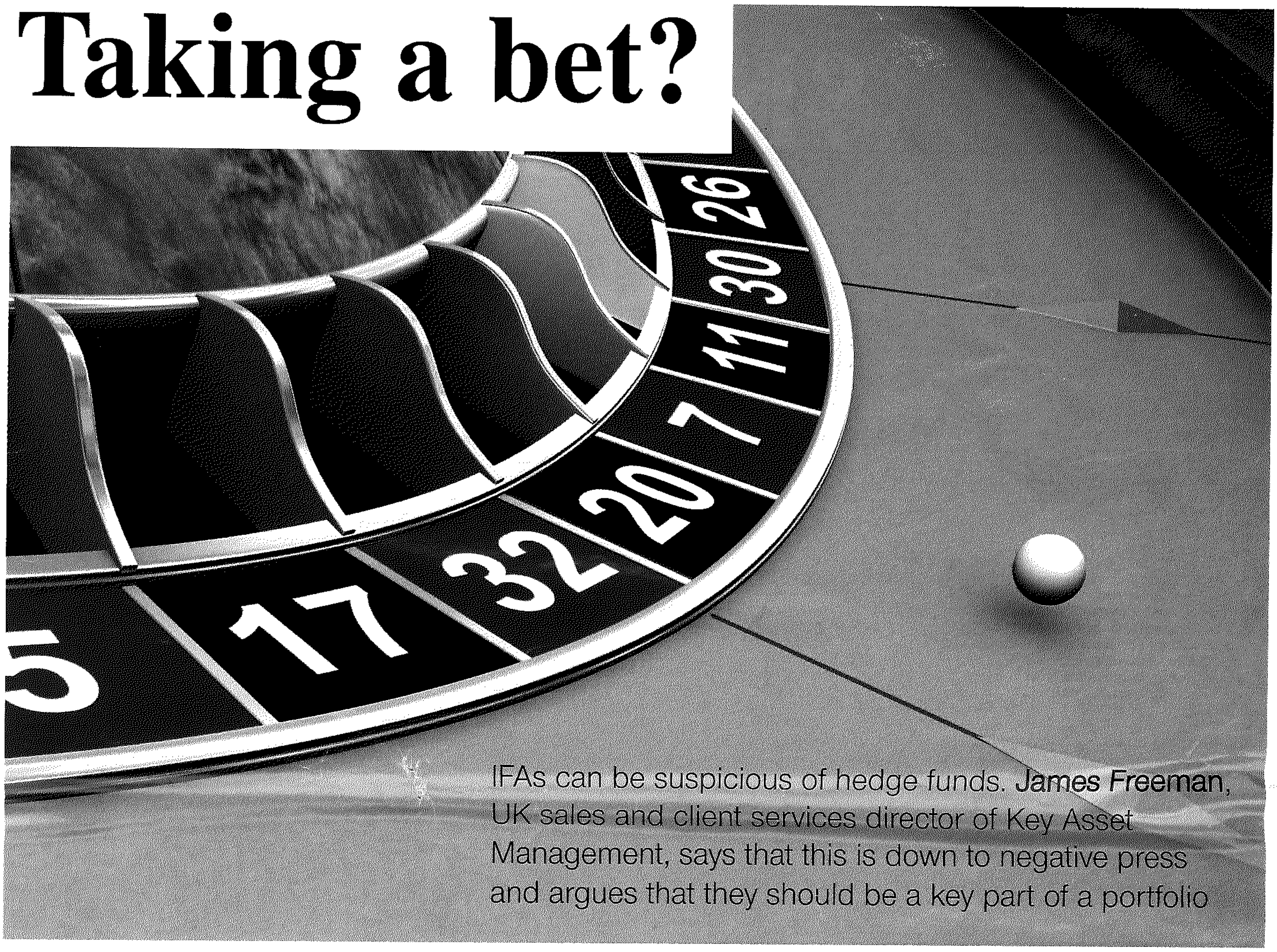
Taking a bet?



IFAs can be suspicious of hedge funds. James Freeman, UK sales and client services director of Key Asset Management, says that this is down to negative press and argues that they should be a key part of a portfolio

I remember when I first started as a raw recruit in the fund management business, having decided that life as an IFA was not for me. I could never understand the need to manage private client money relative to a benchmark which bore little relationship to a client liabilities. Would a client willingly invest in the FTSE 100 if he knew he or she knew they could lose 48pc of his money? That might go some way to explain why Absolute Investing is now gaining ground. As an IFA, I knew that clients simply wanted to make more than they could earn in the bank and while everything went up in value during the 1980's and 1990's, no one worried. As an IFA I never relished the thought of going to see a client whose investments had dropped, even if it was just a short term blip. I quickly learnt that clients can change their tolerance of risk as markets change direction. Such a client can become remarkably disloyal if you are losing their money. It might not be your fault that you invested in your favourite star manager just as the economy hit a rough patch – your client doesn't care whose fault it is, but the buck stops with the adviser.

Which leads me to wonder why IFA's and wealth managers have not taken to hedge funds, given their absolute return focus and diversification benefits relative to equities or bonds.

Slow to catch on?

Forget using data from hedge fund indices to represent the merits of the industry. This data is notoriously flawed by issues such as survivor bias, where only the managers who are still in business report their numbers, and backfilling, which arises when managers wait to report figures once they are sure they will attract the attention of an index provider.

Key Asset Management has been managing hedge fund of funds for 17 years, so when we talk about our track record there is no need to rely on hypothetical figures supplied by any number of hedge fund index providers. Our oldest Multi Strategy fund of funds has recorded 16 years of positive returns. This doesn't strike me as risky when I compare it to investing in the FTSE 100. More importantly, because of the lack of losses in the track record the compounded effect of these returns has meant that our multi strategy fund has out performed equities over that period and that's during one of the most spectacular bull markets of the post war era. The critical point to grasp for advisers is that this performance has been achieved with a strong focus on the downside risk as evidenced by the lack of losses.

Why is it that the wealth management market in the UK has been so slow to wake to the changing landscape in asset allocation? After all, UK pension schemes are now beginning to change the way they allocate client money. The days of 70pc in equities, with the rest in bonds are coming to an end. Today we hear that BBA, the operator of Heathrow and Gatwick etc is moving its £2bn Pension Scheme towards a liability driven investment approach. Put simply, they are trying to match the scheme liabilities to its assets. It is not rocket science, it is pure common sense, but it does mean that they are selling equities down from 70pc to 40pc of the portfolio. Are they alone? Well, look at where long bonds (maturities over 20 years) are trading. The primary reason yields are being driven so low in long dated gilts is because pension funds need to keep buying them to better match their assets against their liabilities.

Perceptions of risk

Wealth managers are in a very strong position when it comes to implementing hedge funds as part of asset allocation given their use of SIPPs, offshore bonds and a wide variety of wrap accounts. The big log jam appears to be the perception of hedge funds as risky. When we run training courses for pension scheme trustees and wealth managers, the first question we pose is "Do you think hedge fund of funds are risky?". Sadly we always get a majority who think they are. This ill informed view is based on press comment which up until recently has been almost exclusively negative. Those that choose to build an informed view more often than not change their minds once they have done their research.

Fees an issue

The other thorny issue often stated is fees, both at the single manager level and at the fund of funds level. It might surprise most investors but hedge fund fees are actually remarkably cheap when you consider them in the context of mutual fund fees.

A traditional investor invests on the basis of expectation and hope. The expectation is that they will enjoy the market return (Beta) and the hope is that their manager will produce something on top of that (Alpha).

The problem is that Beta is now commoditised, and can be accessed for as little as 0.2% annually. Consider this in the context of a typical active long only manager where 90pc of returns are derived from market exposure (Beta). That means the client is paying about one pc annual management fees yet receives only 10pc potential Alpha. That translates into an overpayment for Beta of somewhere in the order of four and a half times. In practice that potential Alpha is also something of a mirage. If we look at the recent figures from the S&P Indices versus Active Funds Scorecard (SPIVA) we see clearly over three and five years the average active manager fails to deliver any Alpha. So not only are investors overpaying for their Beta, the average active long only manager fails to deliver any consistent Alpha. The SPIVA report shows that the S&P 500 outperformed 65pc of active large cap managers over three years and the position doesn't improve any over five years.

If we use the above example where we pay one pc annual management fee for a return which is 90pc derived from Beta (market exposure) and 10pc is active risk, we are effectively paying 8pc annual management fees for our potential Alpha, for we could source the Beta, as we have seen earlier, at 0.2pc. That sort of fee differential makes hedge fund of funds fees look cheap by comparison.

We are now seeing a growing interest in hedge fund education from pension fund trustees who are under a growing regulatory pressure to at least consider the case for hedge funds. Wealth managers don't face the same regulatory pressure but for those who believe in a balanced approach to portfolio construction, hedge funds are an ideal way to diversify returns, protect the downside and keep your clients happy.