Hedge Fund Investing: Approach, Process, and Portfolio Implementation

Hedge Funds are an investment strategy that, when implemented deliberately within a broadly diversified portfolio, can dampen the variability of returns and total asset values. The term “hedge fund” has become somewhat of a catch-all label for a variety of investment strategies, all of which seek to provide differentiated sources of total returns to their investors. Today, the global hedge fund industry comprises more than 8,000 individual strategies and more than $2.5 trillion of assets under management.

Typically, hedge funds have the ability to invest in a variety of different asset classes, and the flexibility to vary the degree to which the combination of assets produces periodic returns that move in the same direction (“correlated”), in the opposite direction (“inversely correlated”), or independent of (“uncorrelated”) individual asset classes. A successfully implemented hedge fund program should be expected to produce total returns that are both positive and not highly correlated with the returns produced on other asset classes in which a portfolio typically invests.

One of the greatest impediments to executing a well-diversified program of hedge fund strategies is the large minimum initial investment required by a majority of hedge funds. Most of the investors for whom a targeted allocation to hedge funds makes sense are better served by investing in a fund that commingles their assets with those of other investors, thereby enabling broad diversification by strategy and manager. But in our view such a Fund of Funds structure only works well if its sponsor is performing careful due-diligence on the underlying hedge fund strategies and managers, and works best if the sponsor is not also layering on a high level of additional fees to an already expensive investment category.

Mill Creek Capital Advisors (MCCA) began managing hedge fund programs on behalf of its clients shortly after the firm began in 2006. Our deliberate process – a thoughtful top-down and bottom-up approach to hedge fund portfolio construction, a resource-intensive evaluation of the underlying funds and managers in which we invest – enables us to offer a robust hedge fund program to those clients for whom it is an appropriate component of a broadly diversified investment portfolio.

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Mill Creek Capital’s Approach to Hedge Fund Investing

Over the years the term “hedge fund”, as it is used in an investment context, has become something of a misnomer. The label was initially used primarily in reference to investment portfolios structured in such a way as to protect against declines in the value of investors’ capital – a hedge against possible losses – in declining stock markets. Thus, the earliest hedge fund strategies typically invested a portion of their investors’ capital in assets that would potentially preserve value (or even increase in value) when stock markets sold off.

Today, the hedge fund industry is comprised of more than 8,000 individual strategies (or “Funds”) and more than 1,700 Fund of Funds (investment vehicles that diversify investors’ capital across several underlying Funds and types of strategies). Worldwide investments in hedge funds, just under $1 trillion in the early 2000’s, now total more than $2.5 trillion. The explosion in funds and assets has gone hand-in-hand with an increase in the types of strategies that are now executed within hedge fund structures. Hedge funds are now offered in multiple “flavors”: Equity Hedge, Event-Driven Hedge, Macro Hedge, and Relative Value Hedge are four often used (by fund managers, and by the external users and evaluators of such funds) categorizations of these investment vehicles. There are also sub-categories of strategies within each category; Equity Hedge, for example, includes strategies frequently described as Market Neutral, Short-Biased, and Fundamental Value to name just a few. But these hedge fund categories are, at best, an imprecise way of grouping similar funds. Unlike mutual funds (for which there are SEC rules governing the names by which funds can call themselves), not every hedge fund fits neatly into a specific sub-strategy category.

Hedge fund investment vehicles are not subject to the same SEC regulations as are publicly traded investment securities and investment vehicles such as mutual funds. As such, hedge funds are available only to so-called accredited investors (generally speaking, individuals with a net worth over $1 million or institutional investors with more than $5 million of total assets). Although this puts hedge fund investing off-limits to the majority of investors, most of Mill Creek Capital Advisors’ clients are eligible to invest in these strategies. For many – but not all – of these clients, a targeted allocation to hedge fund strategies can be an important component of a well-diversified investment portfolio. But, as discussed herein, once a decision is made to allocate portfolio assets to hedge fund strategies, the equally critical parts of the process are how to best select hedge fund managers and how to execute such an allocation across time.

Asset Class or Investment Strategy

Unlike, for example, U.S. equities and U.S. Treasury bonds, MCCA does not view hedge funds as a distinct and investable asset class or sub-asset class. Asset classes are, to our way of thinking, groups of similar securities with like investment attributes (e.g., fixed income securities are debt instruments issued with a specific par value, coupon rate of interest, and maturity date) and with similar if not precisely identical patterns of long-term total returns. By way of contrast, investment strategies are characteristically a means by which securities drawn from one or more asset classes are combined to produce a targeted level of return and/or risk (variability of returns).

Hedge funds are investment strategies, and as such may (or may not) have a specific role in an investor’s portfolio. Typically, hedge funds have the ability to invest in a variety of different asset classes, and the flexibility to vary the degree to which the combination of assets produces periodic

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1 The typical hedge fund strategy is executed within the legal framework of a “Limited Partnership”, in which the organization providing the investment expertise is typically the fund’s General Partner and the investors therein are the fund’s Limited Partners. The fund’s Partnership Agreement is a legal document that details the rights – including specific restrictions on the timing and amount of withdrawals from the fund – and responsibilities of the various parties to the agreement.

2 In 2001, the Securities and Exchange Commission adopted a rule under the Investment Company Act of 1940 to address certain categories of mutual fund names that were “likely to mislead investors about an investment company’s investments and risks”. The rule requires funds that use a name that describes in part their investment policies (e.g., the “XYZ Large Cap U.S. Stock Fund) to invest at least 80% of their assets in the type of investment suggested by such a name.

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returns that move in the same direction (“correlated”), in the opposite direction (“inversely correlated”), or independent of (“uncorrelated”) individual asset classes. Not all strategies – and certainly, not all hedge fund managers – invest in the same mix of assets or seek to accomplish the same risk and return objectives.

Behavioral science (and MCCA’s real-world experience) suggests that most investors’ risk tolerance is asymmetric. Or, to put it in plain English, if pressed most investors would say they want “all of the market’s upside but none of its downside”. Academic research over the years has demonstrated the near impossibility of consistently adding value by market timing the highest risk asset classes (i.e., selling and re-buying equities in anticipation of major market declines and subsequent rallies). In our view, then, the objective of a successfully implemented hedge fund program should be, over time, to seek total returns that are both positive and not highly correlated with the returns produced on other asset classes in which portfolios typically invest.

A Hedge Fund Program
We believe that, as with all most other portfolio investments, a key to the long-term success of investing in hedge funds is to diversify across multiple underlying strategies and, ideally, with multiple fund managers. But for all but the wealthiest individuals and the largest institutional investors, the $3 to $5 million minimum initial investment required by a majority of hedge funds is one of the greatest impediments to executing a well-diversified program of such strategies. At a minimum, we think that a single investor entity (whether an individual or institution) would need to dedicate upwards of $20-$30 million to hedge fund strategies on a stand-alone basis to achieve a reasonable level of program diversification.

The financial services industry recognized this impediment to widespread usage and asset growth while hedge funds were in their infancy. So-called “Funds of Funds” were created to provide smaller (but still accredited) investors with access to diversified, professionally managed portfolios of hedge funds. Though not entirely a panacea (insufficient and inadequate due diligence on the part of some Fund of Funds managers has, on occasion, resulted in unfavorable outcomes), the commingling of investor assets in such fund structures permits hedge fund access to a broader group of investors.

Beyond the obvious examples of some Fund of Funds managers having provided poor selection and/or oversight of the hedge funds and strategies to which they directed their clients’ assets, incremental fees are the biggest drawback to these programs. Fund sponsors often add as much as a 1.00% annual fee and a 10% “carry” to the underlying hedge funds’ already ample fee structures. In most market environments, this layering-on of costs makes it very difficult for the end-investor to earn a total return net of fees that meets portfolio needs. We believe the best solution to this issue – and the approach MCCA took when we first began to invest client assets in hedge funds – is to create commingled investment vehicles that mimic the Funds of Funds approach but without the incremental fee burden (and the “agency problem” that can be created when advisors receive higher advisory fees on client assets directed into certain asset classes or strategies).

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3 Although hedge fund fees vary somewhat by strategy, and have trended downward in recent years, the convention is for funds to charge a 1.50% to 2.00% annual fee on assets managed plus a 20% “carry” on the annual total returns (or on the excess returns over a targeted return) produced on the assets managed. A strategy that produced a gross return of 8.00%, for example, might return only 4.80% to its investors net of fees and the carry.

4 In MCCA’s case, client assets invested in these commingled vehicles incur a pro-rata share of the annual fees and carry costs on the underlying strategies plus the same MCCA advisory fee rate as is applied to their other portfolio assets. Certain administrative fees (including fund recordkeeping, accounting, custody, and audit costs) are also charged at cost to the commingled vehicles.
Building Portfolios of Hedge Fund Strategies

In many ways, the process of constructing a portfolio of hedge funds or equivalent strategies differs little from the way in which diversified equity or bond portfolios are built. The process has both a top-down element (i.e., what are the return and risk objectives of the portfolio?) and a bottom-up element (i.e., which combination of managers and strategies is most likely to deliver on the targeted return and risk objectives?). However, two distinguishing hedge fund characteristics – the incomplete and/or delayed transparency into portfolio holdings and constraints on investor liquidity – make for a due diligence process with added complexities in comparison to other types of managers.

MCCA manages hedge fund programs with distinct total return and risk objectives for its clients. This means that, from a top-down perspective, certain hedge fund strategies are usually a better “fit” for one program versus the other. Long-biased Equity hedge fund strategies, for example, should deliver the types of returns (with the types of risks) we target inside MCCA’s Strategic Return program. And Market Neutral Equity hedge fund strategies are a better fit for our Absolute Return program.

Our evaluation of hedge fund strategies and managers in which to invest reflects some MCCA-specific biases, which include the following:

- **Returns Dispersion**: Invest in sub-segments of global capital markets in which wide return dispersions (clear “winners and losers”) are a persistent outcome, and where portfolios can be built to take advantage of those disparities.

- **Capacity**: Invest in market segments that are broad yet capacity-constrained (e.g., small and mid-cap stocks). Limited competition, a lack of sell-side coverage, and an absence of “groupthink” in some market segments creates an opportunity to earn superior returns.

- **Leverage**: Strategies that require multiple turns of leverage (borrowing) to provide compelling returns are unattractive. In our experience, poor investment outcomes are often the consequence of leveraged strategies that become forced sellers when a market moves against them and there is a need for liquidity.

- **Asset Size**: Managers should target a level of capital that maximizes their ability to generate attractive returns. Given our preference for investing in spaces that are characterized by a high dispersion of returns or that are capacity-constrained, we are sensitive to the total assets being managed in a strategy, and to a manager’s commitment to not derail future outcomes by exceeding their stated maximums.

- **Terms and Conditions**: Management and incentive fees, although they are beginning to recede due to rising competition and (of late) somewhat lackluster hedge fund performance, must be appropriate to the strategy. For many hedge fund strategies, lock-up periods are a necessity, but so-called “gates” and “side pockets” that limit investor liquidity are unfavorable from a client perspective and where possible we seek to avoid such provisions.

Lastly, the individual strategies brought together inside a managed hedge fund program need to be weighted appropriately. The process of combining various strategies involves quantitative analysis of both past performance (historic returns and variability of returns in comparison to relevant asset classes) and current holdings to assess how the programs might be expected to perform given our firm-wide views of current and future capital market trends.

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A majority of hedge fund strategies seek to curtail external visibility into their fund investments and tactics by providing limited or delayed transparency on portfolio holdings. Additionally, most hedge funds provide only limited liquidity (e.g., monthly or quarterly redemptions, often only with advance notice) to their investors. Private Equity investments similarly tie-up investors’ capital (generally for 10 or more years) thus also necessitating substantial up-front due diligence on such programs and their sponsors.

Potential investors are asked to please contact Mill Creek Capital Advisors for additional information on the MCCA Strategic Return and MCCA Absolute Return hedge fund programs.
Manager Evaluation and Selection

The individual manager selection and evaluation process is not unlike the approach taken to other portions of clients’ investment portfolios. Individual managers are hired for a particular mandate, periodically evaluated on their performance versus expectations, and occasionally terminated (for poor performance, for organizational-related issues, or to fund a more attractive strategy).

Sourcing potential managers – partially to have a strong bench to take advantage of changing market environments – consumes a large portion of the day-to-day activities of our investment staff. Given the significant growth of the hedge fund industry, the number of funds available to investors is now larger than it has ever been. So called Capital Introduction (“Cap Intro”) groups managed by the large investment banks (i.e., Goldman Sachs, J.P. Morgan, Morgan Stanley, etc.) play a significant role introducing professional investors like MCCA to hedge fund firms. Additionally, third party marketing firms are often retained by hedge funds that do not employ marketing staff to bring potential managers to investors’ attention. Hedge fund industry databases (such as Preqin) are another source of manager leads.

Although MCCA uses these resources, we have also found success identifying potential managers through our own networking efforts, which include conversations with other investment professionals, industry peers and referrals made by other hedge fund managers. Phone conversations and face-to-face meetings with potential managers (in their offices, at our offices, at industry conferences) are a critical part of our process. We rarely hire a manager without having talked with/met with them on numerous occasions across a period of months or, sometimes, years. Spending time with portfolio managers and their analysts give us a more well-informed sense of how they think, how they generate returns, and how attuned they are to serving their clients’ best interests.

Performing a detailed attribution analysis on a manager’s historical track record is an important part of our evaluation process. Although our evaluation metrics may vary depending on the strategy being evaluated, we are generally interested in determining how much of a strategy’s returns have been the result of market exposure (or “beta”) and how much is the result of manager skill (“alpha”)7. Excess returns above an exposure-adjusted benchmark across multiple time periods and in various market environments are the hallmarks of a successful manager. Managers must also display the ability to navigate through periods of market stress without significant drawdowns; we review how portfolios have performed during notable periods of capital market volatility. Managers’ periodic written reports to clients provide important insights into the thought process that informed past portfolio decisions, and we review this correspondence alongside concurrent portfolio statistics and (when available) information on individual positions and net portfolio exposures.

Operational due diligence is another critical step in the manager research process. Key review areas of the fund management company include its corporate governance, business continuity, compliance policies and practices, and security valuation policies. We review the roles, responsibilities, and backgrounds of a manager’s non-investment personnel, we review audited fund financial statements and insurance policy coverage and amounts, and we independently confirm outside service providers (i.e., legal, accounting, custody). Reference checks also serve as an opportunity to gain insights into a manager’s ability and integrity; current clients and former colleagues generally provide candid feedback that validates (or, rarely, contradicts) our opinion. For a specific vehicle run by the manager, we also evaluate seeding arrangements (i.e., sources of initial funding), client concentration and types of current limited partners, and employee capital invested in the fund.

7 Alpha is calculated by adjusting the monthly benchmark returns for the net exposure of the fund over that period. Depending on the strategy, we also analyze whether a manager’s portfolio hedges (typically “short” positions in individual securities or market indices) are a source of positive returns.
After fully vetting and preliminarily approving a manager and fund for inclusion in one of MCCA’s hedge fund programs, a write-up detailing the investment thesis and qualifications of the prospective manager is distributed to the firm’s Investment Committee for its consideration. The proposed manager – and the proposed size of the investment – is then discussed at an Investment Committee meeting, and a majority vote of that committee’s members is required for approval.

**Portfolio Implementation of Hedge Fund Programs**

We believe that the role of hedge funds inside a broadly diversified investment portfolio is to temper portfolio risks created by other investments without unreasonably compromising long-term total returns. Viewed in this light, the first decision to be made by an investor and/or an investor’s advisor is what percentage of portfolio assets (if any) to allocate to these strategies.

A base case for making such an evaluation might be to compare the long-term returns and “worst case” outcomes of various mixes of two commonly used asset classes, equities and fixed income, on an unhedged basis. An example of one such analysis, using market data drawn from the most recent 20 years, is shown below:

**Hedging Against Potential Equity Market Losses with Bonds**

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<tr>
<td>100% Equity</td>
<td>6.37%</td>
<td>-46.3%</td>
<td>-54.6%</td>
</tr>
<tr>
<td>70% Equity/30% Fixed</td>
<td>6.59%</td>
<td>-28.1%</td>
<td>-38.9%</td>
</tr>
<tr>
<td>60% Equity/40% Fixed</td>
<td>6.55%</td>
<td>-21.3%</td>
<td>-33.3%</td>
</tr>
<tr>
<td>50% Equity/50% Fixed</td>
<td>6.46%</td>
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<tr>
<td>100% Fixed Income</td>
<td>5.34%</td>
<td>28.6%</td>
<td>6.1%</td>
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As shown, fixed income assets have historically been a good hedge against periodic (and unpredictable) bear markets in global equities. Generous interest income (coupon interest on taxable bonds averaged 5.13% per year from 1996-2015) and price appreciation when stocks fell has made for less precipitous declines in portfolios that balanced risks by investing in both stocks and bonds.

Historically, adding a hedge fund allocation to a portfolio mix has also produced superior long-term outcomes, as shown in the table below. Though these portfolios gave up a small amount of annualized long-term total returns in comparison to the unhedged equity and bond-only mixes shown above, they provided better “downside” protection in falling equity markets:

**Hedging Losses with Bonds and Hedge Fund Programs**

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<tbody>
<tr>
<td>100% Equity</td>
<td>6.37%</td>
<td>-46.3%</td>
<td>-54.6%</td>
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<tr>
<td>70% Hedged Eq./30% Fixed</td>
<td>6.52%</td>
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<td>-35.9%</td>
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<tr>
<td>60% Hedged Eq./40% Fixed</td>
<td>6.47%</td>
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<td>-30.5%</td>
</tr>
<tr>
<td>50% Hedged Eq./50% Fixed</td>
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<td>-11.4%</td>
<td>-25.0%</td>
</tr>
<tr>
<td>100% Hedge</td>
<td>5.64%</td>
<td>-19.4%</td>
<td>-26.8%</td>
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8 Beyond evaluating how the inclusion of hedge funds in a portfolio might affect overall returns and risks, other considerations that investors need to factor into their analysis include a) hedge funds’ lack of daily valuation/daily liquidity, and b) the specialized Schedule K-1 partnership accounting required on such funds, which can both complicate and delay an investor’s annual tax return filings.

9 Gross of fee returns on portfolios comprised of global equities (MSCI All Country World Index) and U.S. investment grade taxable bonds (Barclays Aggregate Bond Index) for the 20 year period ended December 31, 2015. For comparison purposes, asset allocations are rebalanced to target weights annually as of December 31. Bear Markets (declines of -20% or worse): March 2000-September 2002, October 2007-February 2009. Past performance is not an assurance of future results.

10 For illustration purposes, table assumes that 15% of the assets earmarked for “Equity” exposure were invested in a program comprised of hedged equity and other modestly risky hedge fund strategies (based on the HFRI Strategic Hedge Fund Composite Index). Performance of the HFRI Index is net of hedge fund manager fees. Past performance is not an assurance of future results.
Portfolio Hedging and Investment Horizons

Investors who remain in a “net accumulation” (no spending) phase across a decades-long horizon should endeavor to care little about the impact of periodic sharp global equity market downturns on portfolio values. In most cases, these investors should take as much portfolio risk as is palatable (and, ideally, take advantage of market declines to add money to their portfolios) until such time as spending from the portfolio becomes imminent. But investors who are drawing against portfolios – i.e., individuals in retirement or planning a large expenditure, institutions that are required to spend a portion of portfolio assets annually – may need to worry about spending during bear markets. For these investors, some type of portfolio hedge (using bonds, or using bonds and hedge funds) can mitigate the impact of declining total assets on their near-term spending.

The chart below shows the accumulated total value of three different portfolios (100% equity; 60% equity and 40% bonds; 60% hedged equity and 40% bonds) across the most recent 20 years. In all three cases, we assume that a constant dollar amount (5% the initial portfolio value per year, taken quarterly) is withdrawn without consideration as to the portfolio’s current value. As shown, net of cash withdrawals there were two time periods when the 100% equity portfolio’s total value surged; there were also two bear market periods when it fell below its initial value. The total values of the two less risky portfolios, not surprisingly, rose and fell less dramatically. Both approaches produced superior long-term outcomes – even as they supported the same level of annual spending. Notably, across almost all time periods the portfolio with an allocation to hedge funds was marginally more valuable than a 60% equity/40% bond mix:

![Cumulative Net Values by Portfolio Type, 1996-2015](chart)

Few investors would likely withdraw the same amount of money annually from a portfolio across a 20-year horizon. Most would likely want to increase withdrawals to, at a minimum, keep up with the impact of inflation on spending. The chart below applies the same spending rule (i.e., 5% of assets annually) as the earlier example, but applies it to the current value of portfolio assets as each quarter begins. In this example, the lines show the resulting variability of annual spending for each of the three portfolios. Although the average annual spending for all three across 20 years is comparable ($60,000 to $61,000), there is less year-to-year variability from the two less risky portfolios. In the case of the more volatile (100% equity) portfolio, annual spending varies from a high of $80,000 to a low of $43,000 (notably, moving from high to low within a three year period)11.

11 Assumes initial portfolio value of $1 million; portfolio returns based on relevant market indices (see footnotes 9 and 10) and are gross of fees. Past performance is not an assurance of future results.
Conclusions

Hedge fund strategies are a different means to an end for many, but not all, investors. They can be particularly valuable during periods of global market stress, helping preserve investor capital by virtue of having invested in assets whose prices move less than, or in the opposite direction as, riskier portfolio allocations. A well-executed asset allocation to hedge funds should diversify across several underlying strategies and should diligently evaluate the managers with whom it invests. And a well-managed hedge fund program should remain conscious of the fact that liquidity constraints and sometimes esoteric strategies can make for a much different set of investment risks than is found elsewhere in most portfolios.

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