HEDGE FUNDS & ABSOLUTE RETURN STRATEGIES IN A LONG-TERM PORTFOLIO

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Where things are heading institutionally

- 61% of hedge fund assets are held by institutional investors
  
  Source: Preqin February 2011 Hedge Funds Manager Survey

- Current developments in the hedge funds and institutional space

Hedge Fund Industry AUM ($ Billions)

Source: BarclayHedge

Proportion of Assets (in %)

Source: Credit Suisse Investment Strategies and Solutions
Asset allocation and risk management – The issues

• Liquidity, Transparency, and Downside Risk Control & Management have become paramount concerns of investors, governments and corporate management

• Diversification helps but that does not mean a well-diversified basket of stocks are as safe in the long run. If they were safe in the long-run:
  
  ➢ they wouldn’t command a risk premium
  
  ➢ longer-term put options (a.k.a. insurance) on stocks with a floor rising at the riskless rate would be cheaper than their shorter-term counterparts

• Absolute return strategies deserve a closer look in the modern capital allocation program
Emerging equity market returns, volatilities and correlations

Based on Historical Returns From Jan 2002 to Aug 2011

Source: Bloomberg

Emerging equity market returns exhibit contemporaneous shifts in volatility regimes

EMERGING MARKETS CANNOT BE ENTIRELY CHARACTERIZED BY THEIR FIRST TWO MOMENTS
Risk management: Hope for the best, prepare for the worst

- Ageing population and changing demographics in Japan, Hong Kong, Singapore and other parts of Asia. Declining “support ratios”

- As a consequence, expect compressed equity risk premiums and disappointing long-only equity returns

- An attendant issue: the development of cutting-edge financial solutions to meet investment and retirement planning needs

- Hedge funds, alternative investments, principal-protected and/or inflation-linked investment products, equity-indexed guaranteed life annuities (a.k.a. ratchet or click funds), etc.
Structuring "matching" and “return seeking” portfolios

Return-seeking (well-diversified) portfolio:
- Equities, hedge funds, portable alpha, commodities, real estate, private equity

Matching (or “hedging”) portfolio:
- Fixed income, laddered bond portfolios (including active management, high yield, EM debt)
- Interest rate and inflation total return swaps

Downside Protection = Insurance

**PERFORMANCE + RISK REDUCTION = DIVERSIFICATION, ASSET-LIABILITY MANAGEMENT AND RISK MANAGEMENT VIA FINANCIAL ENGINEERING**
The evidence: Hedge fund correlations and skew

LOW CORRELATIONS TO TRADITIONAL ASSET CLASSES & POSITIVE SKEW RESULTED IN HIGH INCREMENTAL RETURNS FOR LOW MARGINAL RISKS
On a historical basis, an allocation to hedge funds would have yielded significantly higher returns from:

- Jan 2002 until now (multiple market cycles)
- Aug 2008 until now (Global Financial Crisis)

Optimal allocation to hedge funds:
- The less dependent or correlated the assets, the more the potential gains from diversification
- Addition of uncorrelated assets with high information ratios results in significant expected return enhancement, thus enhancing portfolio risk-adjusted returns

Introduction of alternative strategies improves the portfolio’s potential return per unit of risk even at low overall portfolio risk levels (Sharpe ratio)
Famous last words: Manager selection “common sense” for absolute return strategies

Investors should seek hedge fund managers who have:

- Deep experience in portfolio management and a culture of continuous innovative research
- Robust security selection models tested under live performance, historical backtests, and Monte Carlo simulations, covering multiple economic environments
- Systematic and consistent, yet unconstrained, investment process that applies experience and model analytics to all relevant markets, asset classes, and opportunities
- Disciplined portfolio construction and downside risk management
- Flexible modeling capable of meeting specific client needs