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Searching For Quality in Hedge Funds

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<http://www.ft.com/intl/cms/s/0/a48caf16-0eea-11e1-b83c-00144feabdc0.html>

Most periodic hedge fund surveys that track the \$2,000bn-plus industry highlight the best performing funds, the largest funds, and the top-earning managers. Few such studies look behind the numbers to discern the quality of returns: their accuracy, risk, management, and strategy adherence.

In a more refined look at the industry, FTfm looked back at the trailing five years of performance to the end of June 2011 and undertook significant due diligence to come up with five examples that highlight what hedge funds can best offer: well run, transparent operations that have delivered solid, consistent returns with low to moderate levels of risk relative to their strategies. The selection process started by surveying funds with assets between \$100m and \$500m.

Confirming common sentiment, industry consultant [PerTrac](#) Financial Solutions found smaller funds, especially below \$100m, tend to be the top-performing segment of the hedge fund universe. The reason: managers of smaller funds appear to react more swiftly than do larger fund managers to a wider range of mispriced opportunities without moving markets.

However, most institutional investors, who control nearly two-thirds of hedge fund assets, do not generally venture into so-called emerging managers running less than \$100m because of their frequent lack of dedicated risk and operational oversight, and limited investor services. In a recent survey of 2,500 institutional investors, the alternative asset research firm Preqin reported the average minimum fund size for institutional consideration was \$320m.

Another bias discovered is that industry assets are disproportionately invested in large funds. PerTrac reported the number of funds with more than \$500m represented 7 per cent of all funds, but 88 per cent of all assets.

This suggests mid-size funds with the “bells and whistles” to meet institutional requirements are not attracting much attention.

Despite this low weighting, PerTrac found in its survey of more than 4,800 funds between 1996 and 2010 that those with \$100m-\$500m in assets delivered higher returns than funds managing more than \$500m (10.87 per cent versus 10.00 per cent) with virtually the same annualised volatility (5.94 per cent versus 5.96 per cent).

There are risks associated with funds whose asset size is closer to the lower end of this study's spectrum. If a client whose investment represents a significant portion of a fund's assets decides to

redeem, especially during a severe sell-off, management may opt to gate or suspend redemptions, or be forced to sell investments at a poor time.

Smaller funds also typically fly below most media and industry radars. They tend to be the focus of less formal external due diligence. That does not suggest malfeasance of any kind. But limited independent review may fail to address or challenge less-than-ideal operations.

And when not a part of a larger management firm, smaller funds are less likely to have their own dedicated risk management and compliance officers, and may not be able to afford top-tier service providers.

BarclayHedge, the US-based hedge fund database, customised a survey of these mid-size funds for FTfm. It initially identified more than 100 hedge funds – with assets between \$100m and \$500m and with 60 months or more of verifiable performance history – that had the highest total returns over the past five years through the end of June 2011. This time-frame captured among the most challenging investment environments ever tracked and among the longest surveyed in a periodical hedge fund review. (We excluded sector, commodity, and country-specific funds because of their tendency to produce outlying results. Funds of funds were also excluded.)

Though following 6,000 active hedge funds and 180 data fields, BarclayHedge's database presented a study bias – excluding funds that do not report to this database from being considered.

Reliance on this single source, however, makes the search parameters precise and less arbitrary. It also ensures inclusion and consistent treatment of all specified data fields, including strategy, assets, performance, standard deviation, worst drawdown, Sharpe ratio, firm assets, and fees. Funds that made up this initial list were then sorted by strategy, 12 in all. Equity – including long/short, long-bias, market neutral, and emerging markets – accounted for half the list.

This was followed by six funds each tracking global macro, multi-strategy, and option strategy. Convertible and fixed income arbitrage and event driven funds were each represented by five funds. There were four mortgage-backed securities and emerging market debt funds, and two distressed securities funds. These strategies were then organised by five-year performance.

Ultimate selection of five featured funds was not determined by the best long-term returns, but performance consistency. We also wanted each fund to represent a distinct investment strategy to expand the reach of this story.

Not surprisingly, the initial screening of the top-performing funds revealed a strong correlation between high returns and high volatility across trailing one and five-year periods. High volatility was typically synonymous with high drawdowns, indicating that standard deviation was the product of both up and down performance.

Our screens also looked for consistency of returns across one, three, and five-year periods. Such performance typically correlated with relatively moderate to low volatility. And it identified funds with Sharpe ratios over 1.00.

We did find that over the trailing year when the market went virtually straight up through the end of June 2011, funds with desirable risk-return profiles tended to underperform their respective average

strategy returns. Looking at their performance longer-term, however, suggests that such management often outperforms during down and volatile markets.

After a fund was selected, it then went through a substantial due diligence process. (See “Due diligence: our methodology explained” for details of this review, which included 10 key operational and performance issues).

The process, which rejected several funds initially selected, found instances where valuations were marked to model rather than to market. This under-reports volatility and drawdowns and raises question about accuracy of returns. We also discovered funds that had been suspended or gated, and failed to provide sufficient transparency surrounding these events.

This process does not assure or imply future performance of the selected funds. However, the findings describe characteristics that advisers and investors should be looking for when seeking relatively consistent returns with low to moderate volatility.

These include independent search for undervalued securities, transparent portfolios, and investments that are consistent with fund strategy. Portfolios are diversified, avoiding concentration risk, with positions that are relatively liquid. Managers rely on limited or no use of exogenous leverage, and employ risk management that helps limit losses and drawdowns.

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