Hedge funds

Finding opportunity in uncertainty

HSBC Global Asset Management

For professional clients only

As illustrated by recent headlines, the hedge fund industry has been a lot more resilient during the COVID-19 crisis than in 2008, both in terms of performance and assets – with redemptions representing around 1% of industry assets, against more than 15% in 2008.

Clearly, hedge funds have gained in quality, transparency and liquidity. They have also demonstrated their ability to play a greater role in investors' allocations, especially since lower interest rates won't support more traditional 'diversifiers' such as bonds.

What we have seen so far

Hedge funds have shown resilience through the first quarter downturn, with a decline of roughly 8% across the industry. This notably compares favourably to other asset classes, considering that a 60/40 portfolio for instance, was down roughly 13% in Q1.

Nevertheless, it is important for investors to keep in mind that there is a significant amount of dispersion across hedge fund styles. The recent pick-up of volatility highlighted that some hedge fund strategies are slightly correlated to bond and equity markets. In addition, as hedge funds are not all created equal, we also observed a wide dispersion of outcomes amongst each hedge fund style, in both bull and bear markets – confirming that a multi-style / multi-manager approach is a reasonable option to navigate fast changing market conditions.

Performance of hedge fund strategies (indices)

HFRI Indices	2017	2018	2019	2020 YTD
HFRI Fund of Funds Composite Index	7.77%	-4.02%	8.33%	**-5.47%**
HFRI Equity Hedge Total Index	13.29%	-7.14%	13.74%	**-7.96%**
HFRI Relative Value Multi-Strategy Index	4.09%	-0.23%	5.27%	**-4.09%**
HFRI Macro Systematic Diversified Index	2.12%	-6.62%	7.11%	**-0.75%**
HFRI Macro Discretionary Thematic Index	0.29%	-0.92%	5.46%	**-0.42%**

Sources: MSCI, JP Morgan, HSBC Global Asset Management Fixed Income Quantitative Research calculations.

Within hedge funds, relative value (RV) strategies struggled this year, with declines across fixed income RV, merger arbitrage, statistical arbitrage and structured credit. Negative performance was driven by massive dislocations, as elevated volatility and a collapse in liquidity, combined with leverage, provided the ingredients for the resulting declines. Long/short equity strategies fell by 11%-12% over the first quarter of 2020, but mitigated roughly half of the downside experienced in long-only equities.

Notably, there were various hedge fund segments which were able to preserve capital quite well through the downturn. For instance, market neutral and multi-strategy managers were flat over the first quarter of 2020. Even more impressively, systematic and discretionary macro managers posted positive performance, rising 3% over the period. These managers have taken advantage of opportunities amidst the heightened volatility to drive positive returns across styles (directional trading or relative value), asset classes and regions.

What's in store

At this stage, Credit and Macro strategies are poised to benefit from interesting investment opportunities and should provide returns that are uncorrelated to one another.

Hedge fund managers capitalised on credit's weakness, favouring investments in high quality credit assets. Regardless of the possible economic scenarios, some industries will struggle on a medium to long term basis. De-ratings and defaults are likely to rise in the coming months, potentially creating opportunities in stressed and distressed credit later in the year.

Macro managers' success is based on volatility and trading flexibility. Given the wide potential outcomes of the current crisis, volatility should remain elevated and the trading ability of Macro managers dovetails nicely into this environment.

Regardless of which economic rebound scenario comes to fruition, we believe hedge funds can continue to deliver consistent returns, as they have demonstrated, capturing the market upside of 2019 while limiting declines in 2020. This can be explained by the diversity in sources of returns across the various strategies and proves that in hedge fund investing, selecting the right strategies and the right managers is absolutely crucial.

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Key risks of investing in Hedge Funds

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested.

There are several key issues that one should consider before making an investment into hedge funds. The risk specific to this type of investment may include, but are not limited to:

Regulation: The hedge fund industry is lightly regulated, with the majority of funds domiciled in offshore jurisdictions. Regulation is more prominent at the investment adviser level, those based in the UK are regulated by the Financial Conduct Authority and/or the Prudential Regulation Authority and many in the US are regulated by the Securities and Exchanges Commission. However, it should be noted that these funds themselves are generally classified as “unregulated” and are not typically subject to the same levels of scrutiny and protection as a traditional investment fund. A thorough due diligence process can mitigate these concerns. For these reasons, these funds can generally only be offered to experienced and sophisticated investors.

Gating: In event that redemptions requests on a particular dealing date is much higher than the normal level and full satisfaction would jeopardize the longer term portfolio balance, a gate or partial execution of redemption requests may be implemented generally on a pro-rata basis. Gating essentially provides a floodgate to temporarily relieve the pressure of unloading fund assets in big amounts at inappropriate market conditions.

Side pocket: There may be instances when certain assets in a fund portfolio could become less liquid and the fund manager may segregate these illiquid positions from the main portfolio into a side pocket (or a separate vehicle). Generally, the side pocket is self-liquidating, i.e. selling down the illiquid positions once market liquidity returns. There may not be a fixed timeline for the redemption of the side pocket and investors may receive no payments in some cases.

Suspension of redemption: Suspension of redemption is a temporary halt in exiting the fund during a given redemption window. This is a stronger measure than gating because there is no dealing for the fund. This is generally used under special circumstances such as when liquidity conditions have markedly deteriorated in a short period of time or when there are heavy asset outflow such as the loss of a core investor. Typically this would lead to a restructuring of the fund or other plan to ensure an orderly liquidation of assets on basis of equal and fair treatment to all investors.

Capacity: Hedge fund managers identify a certain amount of capital where they can effectively and successfully manage the fund on behalf of their investors. Once the assets of the hedge fund reach this level, the managers tend to close the fund to new investment in order not to dilute the return to the existing investors. Therefore, the majority of the longer-running “star” hedge funds are now closed to new money and investors are not able to access them. However, long term investors who have built a strong relationship with the hedge funds over time are often favoured when capacity becomes available.

Transparency: Many hedge fund managers are wary of regularly publishing their positions in the belief that this will remove any advantage that they have over their peers. This can pose a problem to the investor, as he or she cannot be certain to which stocks, geographies, markets or even strategies he or she will be exposed to when investing in the hedge fund. However, trusted investors who have built strong relationships with the hedge funds can access this information for the majority of funds, enabling thorough monitoring of the investment.

Tax: Due to the nature of hedge funds and their domicile, an investment in one of these vehicles could have tax implications for the investor. Therefore, tax advice must be sought by the investor prior to investing in any hedge fund.

Manager failure: Over time, a number of hedge funds will close or fail, due to weak performance or operational difficulties. An investor must take this into consideration before making an investment, seeking professional advice to help minimise the risk of investing in a fund that is likely to fail.

Liquidity: Hedge funds typically have much longer dealing cycles than traditional investment funds. Depending on the strategy being utilised, a hedge fund may only allow subscriptions and redemptions on a monthly or quarterly basis. Furthermore, some hedge funds have long lock-up periods, where an investor is not permitted to redeem from the hedge fund unless a period of 6 months, a year or even 2 years has passed. Some may allow a redemption before the lock-up period is over, but the investor would have to pay a hefty penalty to be able to do this. Some hedge fund managers may also operate a redemption gate, where they place a limit on the amount of shares that can be redeemed during any set period. The objective of these terms is to provide the manager with a stable capital base that enables them to execute strategies they would not otherwise be able to. Such strategies can provide a better risk reward ratio than would be available to a more liquid fund.

Access: Hedge funds operate larger investment minima than traditional investment funds. Investors are often unable to access a hedge fund unless they were willing to invest USD500,000 to USD2million, implying that only wealthy individuals, who can meet those minimum investment requirements, would be able to access hedge funds. However, investing through fund of hedge fund products or managed accounts can provide access to these managers with greatly reduced minima.

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