Targeting a better outcome: Hedge fund investing in multi-asset class portfolios

An interview with Jeff Geller, Co-CIO, Multi-Asset Solutions, J.P. Morgan Asset Management

THE ROLE OF HEDGE FUNDS WITHIN INSTITUTIONAL INVESTOR PORTFOLIOS HAS RECENTLY BEEN CALLED INTO QUESTION. In April, the New York City Employees' Retirement System (NYCERS) voted to exit its $1.5 billion portfolio of hedge funds. The move followed last year's decision by the California Public Employees' Retirement System (CalPERS), a bellwether for institutional investor trends, to close out its hedge fund investment program and reallocate its $4 billion hedge fund allocation over the subsequent 12 months. In the first quarter of 2016, Hedge Fund Research (HFR) has reported, investor outflows from hedge funds totaled $15.1 billion, the largest quarterly outflow since the second quarter of 2009.

But even as some investors struggle to assess the costs and benefits of hedge funds, many institutional investors—including many public pension plans—are renewing their commitment to these investment strategies. According to Preqin, in 2015 93% of public pension funds increased or maintained their hedge fund holdings; overall their hedge fund allocations rose from 7.2% of their total portfolios in 2010 to nearly 9.2% in 2016.

For an investor's perspective, we sat down with **Jeff Geller**, Co-CIO of J.P. Morgan Asset Management's Multi-Asset Solutions business. The Multi-Asset Solutions investment team manages $177 billion in multi-asset strategies globally, of which $24 billion is managed on behalf of institutional clients. Expecting more muted returns from capital markets in the years ahead, Jeff and his team have focused on identifying alternative sources of risk and return to help clients meet their return targets. Allocations to hedge funds have been and continue to be a significant part of the team's investment success. In the Q&A below, Jeff debunks some of the misconceptions about hedge funds and explores how investors can most effectively use these investment strategies.

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How should institutional investors approach hedge fund investing, and how does your process differ from others?

Hedge funds span asset classes and typically give investors access to more active or more concentrated expressions of manager skill. For investors with the right resources and experience, hedge funds can provide exposure to risk and returns that is not available in traditional long-only strategies.

Many investors look to build a diversified hedge fund portfolio that hopes to do something almost magical—it's going to deliver return, it's going to reduce risk, and it's going to be diversified. Our approach is very different. Of any hedge fund investment, we ask: Does this add value beyond what we can access in public markets? Employing hedge funds with a specific objective in mind—one that is difficult to achieve with long-only exposure—is the best way to get maximum utility out of a hedge fund for the cost.

Before the financial crisis, most institutions had built hedge fund portfolios as a source of diversification and risk reduction. But as credit markets came under stress and liquidity dried up during the crisis, we learned that low beta, uncorrelated return streams come with other risks: leverage, basis risk and illiquidity. Coming out of the financial crisis and through the end of 2015, the average diversified hedge fund, as represented by the HFRI Fund of Funds Diversified index, delivered returns similar to a 60/40 stock/bond mix, with only marginally lower volatility. In light of the resource commitment required, investors are right to challenge whether these investments, net of fees, are actually worthwhile.

Although it is widely understood that diversified hedge fund allocations have produced disappointing results when measured against equities or a 60/40 portfolio, that's not the only way institutions can view and build these allocations. Increasingly, we have seen that institutional investors are making more targeted allocations. So we're seeing a shift from an "all weather" objective for hedge fund portfolios to allocations that can play a specific role in the context of the total portfolio.

As asset allocators, we examine the impact of every investment on the overall portfolio. We only allocate to hedge funds if we believe the manager will deliver a better outcome, net of fees, relative to the funding source. Today, that means targeted exposure to hedge funds that can deliver a return premium over traditional public market strategies.

How do your hedge fund investments reflect your overall asset allocation outlook?

Let me first emphasize that all of our allocation decisions are grounded in our clients' investment objectives. We may invest in different hedge funds, size positions differently and look for varying outcomes from our hedge fund allocations in client portfolios, depending on clients' specific investment objectives. But the risk we are taking should be aligned with our view. We aim to gain exposures that are in line with our market outlook.

So how do we determine our overall asset allocation outlook? Four times a year, at a two-day-long Strategy Summit, we discuss the economic and market outlook that shapes our asset allocation views. We get into some pretty spirited debates, and we look at a wide range of quantitative and qualitative measures, as we collectively test and challenge our views.

We have been positive on risk assets since August 2009, but we now have expectations of more muted returns than we've experienced in the past couple of years. These expectations are built into our annual Long-Term Capital Market Assumptions, which project capital market returns over the next 10 to 15 years. (The 2016 edition expects a 6% average annual return for a portfolio that is 60% world equity and 40% bonds.)

How do a client's investment objectives shape your approach?

When thinking about accessing alternative investments, it's important to identify the investment problem you're trying to solve. For example, some pension plan clients may be less concerned with total return; their goal is to outperform the return of their pension liabilities. For a pension client trying to improve its funded status while controlling the volatility of its pension surplus, we would aim to identify strategies that can deliver a better or similar return and similar exposure to credit spread and duration with a much narrower range of outcomes. We would typically invest a significant portion of these portfolios in assets that hedge the interest rate and credit sensitivity of the pension liabilities. Where possible, we have shifted assets to less liquid credit strategies. These managers have delivered a meaningful spread vs. extended credit markets, with more predictable payout patterns.

Tell us about your focus on earning a liquidity premium and the opportunities you've been seeing in private credit.

In our hedge fund allocations, private credit has been an important source of value. Our private credit strategies may focus on loan origination or direct lending or the acquisition of loans that banks want to get off their balance sheets. We look for managers who have strong underwriting skills, understand collateral and know how to handle a workout. These managers have experienced several credit cycles—and they've got the battle scars to prove it.

Typically, private credit strategies have a two- to three-year investing period and a two- to three-year harvest period. If things work out as you expect, you get 50% to 75% of your money back in years three and four. We conservatively assume we can earn returns that are three or four percentage points higher than high yield or equity. For that premium, we think it's worth locking up your money for three to five years. Also—and this is an important point—the range of outcomes in these strategies is much narrower than equity outcomes will be. That has very appealing characteristics for any client, especially one targeting a 7.5% or 8% return. How can I reach my targeted return within a narrower range of outcomes? That is a key question they're asking.

What's the downside risk in private credit?

The main downside risk is extension risk. Instead of getting most of your money back in years three and four and all of it back by year six, you get it all back by year eight or nine. So a 10% IRR strategy becomes an 8% IRR strategy.

Other than private credit, what hedge fund strategies work well in the current environment?

Today's market environment is well suited for high-quality stock pickers who can add value on the long and short sides and active managers who can drive corporate outcomes to the benefit of shareholders.

Some people think of hedge funds primarily as diversifiers, and other people consider them as sources of returns. Which do you consider a more accurate representation?

Both are valid. It depends on the market environment and our outlook. If short-term interest rates were at 5% and if our view was particularly bearish on growth and earnings, a sizable allocation to a diversified hedge fund allocation—market neutral, relative value and other strategies that do not rely on market exposure to earn returns—could be appropriate.

We always want to make sure our clients are compensated for the fees and liquidity risk associated with hedge fund investing. We only allocate to hedge funds if we believe the manager will deliver a better outcome, net of fees, relative to the funding source. Today, that means exposure to hedge funds that can deliver a return premium over traditional public market strategies. We are not trying to hide from beta risk, but we are trying to find a smarter way to access it.

RISKS TO CONSIDER WHEN MAKING HEDGE FUND INVESTMENTS*

Limited liquidity	Invested capital is generally accessible for redemption only on a quarterly or annual basis
Volatility	Investment strategies used by the investment adviser and/or portfolio managers, utilizing futures, options and short sales, can be highly volatile
Loss of capital	Investors can lose up to the full amount of their invested capital
Leverage	Hedge funds often use leverage, sometimes at significant levels, to enhance potential returns
Dependence on manager	The fund's success is dependent on the investment manager to develop and successfully implement investment strategies that meet investment objectives
Limited transparency	With little or no public market coverage, investors must rely on the investment manager for periodic information
Conflicts of interest	The investment adviser and/or portfolio managers could be subject to various conflicts of interest, which could influence how those portfolio managers invest the fund's assets

*Not a complete list of risks. Please read the fund's offering memorandum for a more complete list of the risks associated with investing in a hedge fund.

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