Mercer

Hedge fund portfolio construction refresh

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Introduction

A hedge fund allocation can be structured to serve a variety of roles in an investment portfolio. We believe the best use of hedge funds is as a diversifier from traditional equity and fixed income risks. This paper aims to highlight important considerations (and pitfalls) in successful hedge fund portfolio construction.

Key takeaways

Portfolio approach

Managing the allocation as a portfolio of complementary exposures can potentially improve the probability of success.

Manager/strategy diversification

There are no shortcuts! A range of 12 to 18 managers across a variety of complementary strategies is recommended in a hedge fund portfolio.

Risk-aware position sizing

Allocations should be inversely related to the absolute risk of the fund.

Defining objectives

Each investor has unique objectives for their investment portfolio. Therefore, it is essential to start from first principles and review portfolio objectives and constraints when constructing a portfolio. Factors such as tolerance for complexity, illiquidity and risk-taking will shape the allocation and implementation to underlying strategies and managers.

Generally, a hedge fund portfolio will be constructed against a long-term benchmark of cash (often defined by 90-day T-bills for US investors) plus a return premium of three to five percentage points per annum, with a primary goal of diversification. The recent rise in short-term rates in turn increases the absolute return expectation of hedge funds, without dampening diversification potential.

The portfolio approach and diversification

Mercer maintains a philosophy of prudent concentration in determining the appropriate number of managers and strategies in a hedge fund program. Balancing the benefits and pitfalls of extreme diversification and concentration, we typically recommend allocating to approximately 12 to 18 managers. Mercer utilizes the portfolio approach to hedge fund investing, blending various approaches, styles, strategies and return drivers. Diversification is important in any asset class, and hedge funds are no exception; in fact, this is the foundation of the portfolio approach. Since hedge fund program objectives are most commonly diversification against the downside risk of equities and interest rates, an overly concentrated manager mix leaves an insufficient margin of safety to deliver this important capital preservation mandate. Owning more line items will increase the administrative and operational burden for a client, but Mercer can provide administrative support, performance reporting and manager monitoring to mitigate this concern and ensure ample diversification.

While it may be tempting to allocate to a few higher-octane managers with impressive short-term performance, hedge fund return distributions often exhibit left-tail skew. This means the strategy's previous outperformance might be indicative of excessive risk and hold potential for large drawdowns. Paradoxically, low beta strategies often utilize high degrees of leverage and lose their diversifying properties in times of market distress. Investors must be disciplined about looking into the risks taken, inherent leverage used and probability of persistence in a given manager or strategy. It is usually best to avoid crowd-chasing strategies that often come with limited redemption rights and high frictional costs.

The portfolio approach embraces the disparate risk/return characteristics of the underlying managers to create a robust allocation balanced across strategies, styles and factors, thereby maximizing the likelihood of achieving the long-term goals of the program.

Manager selection and strategy composition

The most important component of a successful alternatives portfolio is manager selection, given the highly idiosyncratic nature of the asset class. Investors should never compromise on a low-conviction manager even if the strategy fits their portfolio. The wide dispersion of returns in hedge fund strategies may mean poor performance even if the portfolio construction philosophy is sound.

There are myriad of differing hedge fund strategies: long/short equity and credit, event-driven, distressed and global macro, to name a few. It is important to look beyond the strategy label, however, as even within a given category the risk/return profile can differ greatly. Performance attribution can reveal the different approaches to a strategy, subsequent return drivers and potential risks.

Investors should seek out complementary exposures across managers to ensure they are not allocating to superfluous funds and achieving true diversification within the portfolio. Pairing counter-cyclical strategies will smooth the return stream; when your event-driven strategies are suffering, your long-volatility exposures should balance out the loss and vice versa.

Mercer prefers managers with broader mandates of searching for attractive opportunities as they arise, as opposed to narrow mandates that may go through cycles with a dearth of compelling investment opportunities. Managers will have capital ready to deploy or rebalance across strategies, lowering the frictional costs of reallocating to new managers around a cycle. We prefer global mandates for similar reasons. They allow managers the flexibility to trade in local markets when they find interesting opportunities. For example, an ideal credit manager should be able to use both the long and short sides of their book and look for the best opportunities in performing, distressed and structured credit across a variety of geographies.

Position sizing should be inversely related to the absolute risk of the manager. Higher-risk funds, whether through their underlying strategy or use of leverage, should garner a lower relative allocation in your hedge fund portfolio.

Summary

Building a hedge fund portfolio requires a disciplined approach. There are no shortcuts. The portfolio approach to hedge fund investing prevents overly concentrated or redundant portfolios. Prudent allocations, along with manager and strategy diversification, are key components of hedge fund portfolio construction. Manager selection should take precedence as mediocre managers will be unable to implement their strategy successfully. By beginning with a roster of world-class managers and assembling them in a diversified way to meet investors' needs, successful hedge fund portfolios can be constructed to meet long-term objectives.

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For over 75 years, we've been providing trusted advice and solutions to build healthier and more sustainable futures for our clients, colleagues and communities.

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Portfolio expectations are forward looking and reflective of Mercer's capital market assumptions, as defined by asset class and incorporating return, standard deviation, and correlations. Our process for setting asset class expected returns begins with developing an estimate of the long term normal level of economic growth and inflation. From these two key assumptions, we develop an estimate for corporate earnings growth and the natural level of interest rates. From these values, we can then determine the expected long-term return of the core asset classes, equity and government bonds. We combine current valuations with our expectations for long term normal valuations and incorporate a reversion to normal valuations over a period of up to five years. Volatility and correlation assumptions are based more directly on historical experience except in cases in which the market environment has clearly changed. Manager impact on performance is not incorporated into expectations. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future returns.

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