THE $3 TRILLION QUESTION

By Mark Anson and Ryan Driscoll

THE GROWTH of the hedge fund industry over the past decade has been tremendous, with more and more institutional and retail investors allocating capital to investment strategies that fall outside the boundaries of traditional stock and bond funds. The hedge fund industry, which has gone from managing approximately $240 billion in 2000 to $3.2 trillion at the end of 2015, has grown by 19 percent annually, on average. It is only natural to question whether there is sufficient capacity for this amount of capital to be absorbed and productively invested in these alternative-investment strategies.

Perhaps it is worthwhile to take a step back and observe what propelled the hedge fund growth story. Partly, it was the advent of so-called endowment-style investing. A key principle of endowment investing is to expand the efficient frontier of portfolio construction into alternative assets, where investment strategies are less constrained and have the opportunity to add excess returns while providing additional portfolio diversification. The growth of hedge fund assets parallels the popularity of other alternative-asset classes, such as private equity and real assets.

Another reason for hedge fund growth traces back to the popping of the tech bubble. Once the fantasy of technology stocks taking over the world faded and a global recession ensued, equity markets around the world experienced double-digit declines for three straight years, from 2000 to 2002.

During this time period hedge funds lived up to their name: Many hedged their portfolios and generated positive returns. The Barclay Hedge Fund Index recorded gains of 12.2 percent, 6.8 percent and 1.4 percent during 2000, 2001, and 2002, respectively. Not only did hedge funds produce positive returns during this time, they did so while taking less risk than that generated by the equity markets.

More accurately, using Sharpe ratios, we found that hedge funds far outperformed the global equity markets during 2000–'02. We use risk-adjusted returns because investors often overlook the fact that hedge funds generate their returns with a much more risk-controlled process than the broad financial markets. Specifically, from 2000 through 2002 hedge funds produced large, positive Sharpe ratios compared with the negative returns generated by the stock market. This performance helped to fuel the demand for hedge funds as an important component of a diversified portfolio.

However, since the Great Recession hedge funds have not outperformed the stock market. Again using Sharpe ratios, we found that the risk-adjusted returns of hedge funds are on par with those of the S&P 500 index. This might lead investors to conclude that the hedge fund industry has become capacity-constrained.

The recent performance of hedge funds has ratcheted up the debate about whether these funds deserve their fees. With such a long growth trajectory for hedge fund assets, it would not be surprising to discover that exposure to beta has crept up in hedge fund portfolios over the years.

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Over time, as any active manager accumulates assets, it will become capacity-constrained in its alpha generation; it simply cannot put as much capital to work in its active strategy. As a result, more of an active manager's portfolio may have to be put to work through beta trades — investments that accumulate more market exposure than genuine alpha.

Surprisingly, this does not seem to be the case with hedge funds. We reviewed several hedge fund strategies, and we did not observe any marketable increase in beta exposure over the past 15 years. Although the amount of beta exposure does fluctuate, there has been no discernable uptick since 2000. This provides some comfort that the hedge fund industry is not capacity-constrained.

So where does this leave us? Unfortunately, we are unable to resolve the dispute over whether hedge funds add sufficient value for the fees they charge. On the one hand, it appears that hedge fund managers are not capacity-constrained — the amount of beta in their portfolios has not crept upward over time. On the other hand, the risk-adjusted performance of hedge funds since the Great Recession does not seem to warrant the standard 2 percent management fee and 20 percent performance fee structure that managers frequently demand. This means that the hedge fund industry is best approached with a discerning eye to select those managers who have a competitive edge. Alpha exists, but can it be captured in both a cost-effective and a risk-efficient manner? The debate continues. **a**

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