Mercer welcome to brighter

Managing a Hedge Fund Allocation

What is the recipe for success?

Hedge Fund investing – Key ingredients

Manager selection is the key determinant of a successful hedge fund investment experience, but portfolio construction runs it a close second, in our view. Hedge fund allocations can be structured to serve a variety of roles within a portfolio (e.g., risk reduction, return enhancement, portable alpha, portfolio hedging); importantly, the portfolio construction methodologies we have found most likely to yield success are consistent across each of these mandates.[1] Essentially, the key to hedge fund portfolio construction is not unlike the key to any successful portfolio comprising stocks, bonds or multi-assets—a disciplined approach and effective diversification.

Diversification is indeed the only 'free lunch' in investing and is particularly critical in hedge fund portfolio construction. Diversification by source of return, strategy and manager is key to improving the probability of a successful outcome. Continuing our series on hedge funds[2], this paper articulates our hedge fund portfolio construction framework, detailing the tenets of diversification we consider essential and summarizes a variety of biases that we believe further increases the likelihood of success. Importantly, this framework can be customized around client-specific objectives, constraints and risk tolerances.

Portfolio approach

Mercer is a strong advocate of applying a "portfolio approach" to hedge fund investing. Implementing a hedge fund allocation is similar to implementing a multi-asset portfolio. The wide variety of hedge fund strategies, sub-strategies and implementations is as diverse (in terms of risk/return characteristics) as the world's asset classes. Just as we do not believe that hiring a balanced (stock/bond) manager represents a robust institutional total portfolio, we also believe no single hedge fund manager represents an optimal implementation for hedge funds. A portfolio of managers, strategies, styles, approaches and factors could maximize the probability of achieving the desired outcome when investing in hedge funds, in our view.

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[1] Each of these designs has unique nuances to manager selection and portfolio construction, the specifications of which are beyond the scope of this paper. Generally speaking, however, the tenets emphasized herein—a "portfolio approach" to manager, strategy and factor diversification are universally applicable.
[2] Investing in hedge funds – Mercer May 2021 https://www.mercer.com/content/dam/mercer/attachments/global/gl-2021-why-hedge-funds.pdf fund

Manager diversification

Mercer maintains a philosophy of "prudent concentration" in determining the appropriate number of managers in a hedge fund program. We believe this concept effectively balances the benefits of concentration (seeking to maximize the manager selection value proposition) and the benefits of diversification (helping minimize the impact of a manager mistake), while avoiding the pitfalls of each, namely concentration risk and over-diversification, which often result in unintended outcomes. We further overlay this with a maximum position size limit of 2% of the total portfolio (not just the hedge fund allocation) to any single manager at cost, as we recognize manager position sizing is the risk management tool of last resort.

Diversification by manager is the most powerful tool available to any hedge fund investor, we believe. While it may be tempting (and "easier") to hold a hyper-concentrated manager mix (e.g., 2 to 5), such an approach is suboptimal. First, given the wide dispersion of returns across individual hedge fund managers and accordingly low cross-correlation, the value of diversification left on the table from excessive manager concentration is hard to excuse.

Importantly, in the realm of hedge fund investing (average pair-wise correlations of 0.0 to 0.5), tremendous risk-adjusted benefit accrues through the addition of at least 10 through up to 20 managers. Thereafter, the marginal risk-adjusted benefit is limited. Long-only managers, on the other hand, tend to have relatively high pair-wise correlations (0.7 – 0.9). Therefore minimal risk-adjusted benefits tend to accrue beyond 2 to 5 managers.

Quantitative theories aside, the primary argument for manager diversification is more qualitative—the business risk each hedge fund carries. Like most skill-based enterprises, the hedge fund business model is subject to a relatively high degree of attrition.

Unsurprisingly, instances of attrition can be associated with capital losses and an extended time horizon to resolution. The impact of this risk can be mitigated through diversification. The practical fact of the matter is that all investors make mistakes, and diversification is a no-cost way to protect against the imprecision of predicting the future in an unpredictable world.

Our preference is to own a prudently concentrated roster of approximately 10 to 20 ultra-high quality managers.[3] Given the myriad of hedge fund strategies (Hedge Fund Research, Inc. publishes 27 different hedge fund strategy indexes), as well as the thousands of individual managers, 10 to 20 managers certainly tilts toward concentrated, rather than over-diversified. Even at the more concentrated end of this range, our experience has shown that diversifying across approximately 10 managers and thoughtfully position-sizing each can significantly mitigate the left-tail event that can be associated with a manager mistake. Minimizing the impact of an unfavorable outcome strikes us as a highly attractive trade-off for additional paperwork, ongoing due diligence, and performance monitoring. Manager mistakes cannot be avoided and far more capital has been destroyed through outsized positions in manager mistakes than in the time lost and resources spent in monitoring additional line items.

[3] In our experience, there are circumstances in which a hedge fund portfolio would optimally include more than 20 managers— primarily, situations related to asset scale or an elongated timeline of inflows. For extremely large allocations (multi- billions), it may be prudent to hold in excess of 20 managers to avoid representing a disproportionate share of any hedge fund manager's business or to achieve access to otherwise closed managers. Further, inflows that must be deployed over lengthy timeframes (years or decades) may result in an elevated manager count. In the case of a commingled fund, for example, successful manager selection will likely result in a material percentage of the underlying managers periodically closing to capital inflows. In such cases, a larger manager count is likely the optimal solution.

Hedge fund return drivers

As a group, hedge funds utilize a wide variety of trading strategies, implemented to various risk tolerances, to isolate a collection of alternative risks. These alternative return sources ("hedge fund return drivers") are summarized in the following table from our prior paper, "Investing in Hedge Funds"[4] (note that this list is not exhaustive).

Exhibit 1. Description of alternative return sources

Alternative return sources	Description
Bi-directional security selection	Seeking to profit from both price appreciation and depreciation or, more practically, the excess returns of long positions over short positions. Common application often involves secular changes by identifying those firms that have or are establishing competitive moats relative to those that may be disadvantaged.
Deal risk premium	Capturing deal spreads and value catalysts; examples include merger arbitrage, spin-offs, split-offs, buybacks, activism, etc.
Complexity premium	Capturing returns created by complex situations and instruments, including credit covenants, litigation, bankruptcy proceedings and structured finance, among others
Liquidity/time horizon premium	Seeking to capitalize on forced sellers across assets often created due to stressed liquidity and captured by employing a longer time horizon, including liquidations, trade claims
Spread risk premium	Capturing the differences or mispricing in relationships through long and short positions across securities, capital structures, sectors, industries, geographies or term structures
Variable beta	Tilting the portfolio and risk in either the long or short direction in an effort to profit from the decision of when to accept market risk and when to avoid it
Macro trends/changes	Taking trading-oriented approaches that seek to deliver uncorrelated returns by trading broad global markets across equity, fixed income, currency and commodities based on macro views and factors

Source: Mercer

In our experience, a solid foundation for successful hedge fund portfolio construction is to diversify the program across these alternative return sources. Such diversification enhances the program's ability to perform consistently regardless of market environment, increasing the likelihood for a successful outcome. The inclusion of a broad range of return drivers allows multiple ways for the portfolio to win and mitigates potential blind-spots and the degree of cyclicality that each hedge fund return driver carries.

[4] https://www.mercer.com/content/dam/mercer/attachments/global/gl-2021-we-hedge-funds-performance-review2020-final.pdf

For example, bi-directional security selection is an attractive, alternative return drivers. However, it requires favorable performance dispersion of individual securities, a condition absent in certain market environments such as dramatic "risk-on / risk-off" moves. Deal and complexity risk premia are generally "short volatility," meaning these risks are susceptible to volatility spikes. Liquidity provision is an attractive return generator over long time horizons, but likely to generate short-term losses when liquidity declines, typically associated with market stress events. Finally, variable beta and trend-following (both discretionary and systematic) are challenged at market inflection points. It is often argued that you cannot time the market (although macro managers as a group have a history of adding value by doing just that); we would argue that timing market conditions, which may represent a second derivative of price performance (trending, whipsaw, dispersion, "vol of vol"), is even more difficult to execute successfully than timing the market. Our experience has shown that diversifying the program by hedge fund sources of return and implementation establishes a framework for success.

Strategy diversification

Allocating to different hedge fund strategies naturally helps achieve a level of return driver diversification:

- Long/short equity and long/short credit provide bi-directional security selection;
- Deal and complexity risk are a primary component of event driven investing;
- Distressed securities benefit from liquidity provision and process risk;
- Timely variable beta and trade structuring drives successful global macro managers.

However, the nature of the alternative return drivers employed depends on the implementation approach of each individual manager. As such, prescriptive solutions (i.e., X% to long/short equity and Y% to event driven) are incomplete; you must look beyond the generic strategy label to the manager specifics in approach and risk-taking. As we will observe numerous times in this paper, it is about the individual manager, not the strategy categorization.

For example, long/short equity is arguably the most straightforward hedge fund strategy, with results typically driven by bi-directional security selection. That assumes, of course, that the manager actively utilizes both sides of their balance sheet and is adept at single- name shorting. Some long/short equity managers actively flex their net and gross exposure, allowing variable beta to become an additional driver of performance. Implementation involves various levels of leverage and concentration, as well as multiple approaches (fundamental or quantitative) and diverse investable universes (region, sector, market cap). Populating the portfolio with your highest conviction long/short equity managers is a good starting point. To the extent those managers are diversified in their implementation tactics, return drivers, style, and/or geography, the likelihood for success improves through the benefits of diversification. Strategy diversification is not just a numeric asset allocation exercise across the primary hedge fund strategies though, it is a process of assembling complementary exposures, approaches, styles, risk/reward profiles, return drivers, and risk-taking tactics within and across those hedge fund strategies best fit for the portfolio's objectives.

Manager position sizing

Given their highly idiosyncratic nature, manager selection is the greatest determinant of success in hedge fund investing, we argue. As such, the “go / no-go” decision is the most impactful risk control in hedge fund investing; indeed, a position size of 0% can be an allocator’s best friend. For those managers ultimately included in the mix, position sizing takes center stage in hedge fund portfolio construction. Generally speaking, managers should not be equal-weighted as conviction, risk-taking, and strategy durability are not equal across individual managers. We believe that manager position-sizing should be a multi-dimensional exercise, with a manager’s risk-taking profile the primary determinant of position size.

Generally speaking, the size of the manager allocation within the hedge fund program should be inversely related to the absolute level of risk. Successful management of a hedge fund portfolio requires an understanding of the extent and magnitude of risk-taking tactics, using position size to manage these (often not yet realized) risks. The absolute level of risk involved in a strategy is often masked until realized. Quantitatively, we can demonstrate this with the “fat left tail” in hedge fund return distributions, where outsized losses occur with greater frequency than suggested by the volatility of returns. In fact, consistently low volatility can be associated with high levels of risk. Highly-levered relative value strategies display low volatility until the risks taken are realized, often during extreme market conditions. Generally speaking, the higher the amount of leverage utilized, the greater the directional exposure, the more extreme the portfolio concentration, or the more esoteric the nature of the portfolio, the smaller the manager position size.

All else being equal, the broader the opportunity set, the more consistent the potential return profile. For example, a global multi-strategy manager should have a more consistent opportunity set than a long/short biotech manager. Position sizing can solve this difference. Moreover, the latter is highly likely to be far more volatile, and a small position size allows the manager to remain impactful, without swamping the prospects of the program’s success when returns trough and allowing the allocator room to defend the positon and add capital. Importantly, while not all risk is captured by volatility, as we have noted, not all volatility is equal. Indeed, uncorrelated volatility can reduce portfolio level risk. However, we caution that correlation can be an unstable statistic. Volatility associated with structurally negative correlation, such as short-biased risk, can warrant a higher position size than the absolute level of volatility would otherwise dictate.

It is in this manner that a truly detailed understanding of the underlying hedge fund manager — their return characteristics, approach to managing risk through different market environments, opportunity set, and implementation must factor into a qualitative assessment of risk to determine fit, as well as absolute and relative position size when constructing the portfolio. That said, conviction in the manager should also factor into the position size. A common pitfall we have witnessed, however, is over-allocating to a higher torque and/or niche manager based on conviction, frequently enhanced by past success. Discipline is required to look past the performance to the risks taken and the likelihood for persistence of a given strategy. Position sizing should in broad terms be inversely related to the absolute level of risk taken, but conviction in a manager can be a useful “tie-breaker” in position sizing at the margin.

Finally, as noted above, establishing a maximum manager position size (at cost) is a useful discipline. Manager mistakes cannot be predicted or controlled. Maintaining the discipline to limit the impact of such low probability, high impact events is prudent.

Balance

In our experience, the most attractive attribute a hedge fund portfolio can display is balance. Balance across the different risks taken, trading strategies, geographic regions, security types, degree of directionally (long and short), exposure to changes in volatility (long and short), illiquidity, risk-taking tactics, and manager risk profiles. Relative position sizing of managers can further add balance, as multiple, high conviction managers with "too much in common" can be sized down to maintain portfolio balance. A portfolio that lacks diversity to hedge fund risk factors and return characteristics is more likely to experience periods of disappointment as market conditions change; a portfolio that is balanced across the myriad dimensions of "risk" is more likely to generate robust returns that are more predictable and persistent.

Biases

Hedge fund portfolio construction is generally as much an art as a science, built within the framework of multiple layers of diversification (as summarized above) and curated around a series of biases developed over multiple market cycles. While these are not hard rules, per se, they inform manager selection and portfolio construction.

- **Multi-strategy over single strategy arbitrage**
  Beginning in the early 2000's, we formed the view that arbitrage strategies were becoming crowded. We expected that this, in turn, would cause the opportunity sets of these strategies to become more cyclical in the aggregate. However, at any point in time, even today, there continue to be attractive idiosyncratic opportunities within an otherwise crowded strategy. As such, our belief is that a well-structured multi-strategy fund can best exploit these idiosyncratic opportunities as they bubble up, while largely avoiding the broader cyclical characteristics of the aggregate strategy. A specialist in a narrow strategy can (only) raise cash or increase risk (as the supply of opportunities declines or improves, respectively), while a multi-strategy manager can hold the highest conviction risk/reward trades across a variety of strategies and increase or reduce the allocation to each strategy in response to perceived opportunities or risks.

- **Global/Generalists/Opportunistic**
  Similar to our preference for multi-strategy managers in the event driven / relative value ("arbitrage") categories, all things being equal, a broad, opportunistic mandate is preferable to a narrow one. Narrow mandates limit a manager to invest in what they believe to be the best ideas available within that mandate, as opposed to the best risk/reward opportunities available. A global remit can be a desirable characteristic, allowing the manager to cross borders with capital in pursuit of the best risk/reward opportunities from the bottom-up. Regional or sector-focused specialists can be constrained from time to time by low dispersion (if well-hedged) or region/sector performance difficulties (if more directional). A combination of global managers augmented by complementary specialists (at smaller position sizes) is often optimal. Further, as traditional long/short strategies become more crowded in nature, these broader, more opportunistic mandates provide the pathway to continue to meet the objectives in much the same way that multi-strategy funds do for crowded arbitrage strategies. Finally, as we discuss later in this paper, we believe this approach is superior to the allocator making tactical decisions across strategies.

- **Funds that actively utilize both sides of their balance sheet (long and short)**
  A primary objective of risk-reducing hedge fund mandates is to diversify, provide downside protection, and focus on risk-relative-to-reward. As such, actively using both long and short positions is a critical component to helping achieve such an objective.

- **Prudent concentration**
  Similar to our desire for prudent concentration in our hedge fund portfolio construction/manager count, we seek prudent concentration in the underlying manager portfolios. We believe that prudently concentrating in well-researched, risk-managed ideas offers a more efficient (risk-relative-to-reward) approach to delivering high-quality returns, relative to other return levers available to hedge fund managers, such as leverage.

- **Low leverage**
  All else equal, leverage is generally a less desirable return lever as it carries a cost, making its impact asymmetric in the wrong direction. In other words, it magnifies losses at a greater rate than it will gains. Further, the return profile of many hedge fund strategies, particularly the arbitrage strategies, tends to carry a fat left tail. Magnifying a left tail with leverage creates material “blow-up” risk. Again, our comments on understanding the nature of risks and position sizing are acutely important. As such, we generally favor a relatively low amount of leverage at the hedge fund program level. However, we note that not all leverage is equal nor is its application. At the individual strategy level, leverage coupled with strong risk management discipline, highly liquid underlying assets, and a healthy respect for the additional risks introduced potentially provides complementary and differentiated sources of return as well as capital efficient hedging.

- **Strategic approach to a dynamic strategy allocation**
  To reiterate, rather than emphasizing specific, narrow strategies, we generally prefer broad mandates and opportunistic manager mindsets. Multi-strategy managers, event driven managers, and credit managers that invest bi-directionally across the spectrum of corporate, structured, and non-performing debt (as opposed to a narrow specialist within each sleeve) can bring a degree of flexibility and dynamism to a hedge fund program that often results in a higher quality portfolio of underlying trades, as specialists are motivated to hold positions in their specialty even when out of favor. Moreover, we believe the use of opportunistic managers provides an additional benefit to the total portfolio, allowing the hedge fund allocation to “double-hat” as a diversifier to traditional asset risks, as well as an opportunistic allocation for the total portfolio.

  Our experience has shown that tactically allocating to “alpha” opportunities, with limited redemption rights, advance written notice and high frictional costs (holdbacks, delayed settlement) is difficult at best and potentially a fool’s errand. Generally, we seek to build a hedge fund program that is long term and strategic, while incorporating a high degree of opportunism at the manager and strategy level. In this way, our programs demonstrate meaningful, performance-accretive strategy changes based on the collective actions of our managers, rather than the time intensive, high frictional cost approach of swapping one manager for another. In other words, the programs are designed with balanced risk exposures that seek to pursue strong absolute returns across a wide variety of capital market environments, but implemented with a collection of managers whose strategies and approach carry a dynamic element. In this manner, we seek to allow our underlying managers’ opportunism to drive over- and underweights to various types of risk and capital markets opportunities, rather than trying to implement an element of market timing from a top-down perspective.

The one exception to this strategic approach relates to hedging strategies, directionally short strategies that are intended to offset a degree of systemic risk in a portfolio. These strategies are “negative carry,” meaning there is a cost to holding the strategies similar to an insurance premium. Over time, these strategies have a negative expected return, but can be effective in reducing risk, particularly if tactically implemented. While we have already flagged the difficulty of timing markets, decisions based on valuation of risk assets and implemented for the purpose of protecting portfolio holdings, rather than generating outsized gains, can have merit. The size of any allocation to hedging strategies can be increased or decreased to target a specific program-level risk/reward and its composition modified to balance cost and convexity. Indeed, such an allocation can be implemented independently, based on the same portfolio construction framework outlined herein, to provide protection for the total portfolio.

Start at the end

On the traditional asset side, asset allocation is step 1, followed by manager selection. In the case of hedge funds, Mercer believes in “beginning at the end.” As we have noted, manager selection is the primary driver of a successful hedge fund outcome. No matter how sophisticated or elegant a hedge fund portfolio construction methodology may be, it will fail if implemented by below-average managers. In our experience, searching by specific strategy mandates will yield a roster of managers, but such a collection may not represent the best of the best. Mercer believes that in hedge funds, step 1 is to identify top-tier, world-class managers that implement an investment strategy that conveys a competitive advantage highly likely for future success. Populating a portfolio exclusively with managers of this ilk, while accumulating complementary, diversifying exposures, return drivers, approaches, styles, etc. is the path most likely to succeed. **In our experience, finding the best managers and assembling them in a diversified framework through disciplined position sizing is the hedge fund recipe for success.**

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