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Defecting from Hedge Funds to Mutual Funds: It's Not That Complicated

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The only constant is change.

When you get old enough to accept this fact, you are really starting to understand the universe.

I'm old enough to remember when the financial industry was the number one desired destination for college and business school graduates. Before Silicon Valley existed as it does now. When Wall Street was the top dog and held a degree of mystique for those on the outside. Not anymore.

These days, I'm always surprised at how few people outside of the industry realize just how uncomfortable this business is right now.

"No," I explain patiently, "the markets going up every year is NOT good for our business, nor is the market going DOWN every year good for our business." And so on.

That got me thinking. What exactly IS good for our firm at this point? What do we want to happen in the marketplace to justify our presence in the system and in client portfolios? I think that's a question many in this business are reflecting on right now. And if you aren't asking it, then you should be.

Boston is feeling the pain of this conundrum. We are an active management town. The original mutual fund giants originated here which precipitated years of growth in the sector, leading to some of the largest and most well-known firms of all types flourishing both within Boston and in the surrounding environs. Despite Boston's traditional old school roots and perceived (though sometimes real) stuffiness, the fact is we have a tremendous amount of innovation which begins with the world- renowned schools, hospitals and universities in the area. This has attracted some of the world's largest companies to relocate here in order to take advantage of the ecosystem. The point being, we aren't sticking our heads in the sand as to what's happening and we've thought hard about how we adapt to it.

When I started in the financial business, equities traded in 1/8th increments. Research was unfettered by regulation (back then too little, now too much), and human-to-human interaction drove most of day-to-day business. A domino process began when the SEC moved equity markets to decimalization and as a result (to make a long story short), provided the structural impetus for high frequency trading driven by algorithmic computer programs, typically with incredibly high leverage. This in turn has led to both index and individual equity trading patterns that often defy fundamentals.

The process of "price discovery" – that is, what should a security correctly trade at – like many industries over the past 50 years has seen incredible changes, particularly in the "information dissemination" business. According to a January 2017 Financial Times article titled, "The End of Active Investing?" today's leading security firms have as many as 300 company analysts, industry analysts, market analysts, commodities and foreign exchange experts, economists, demographers, and political analysts located in major cities all over the world. Instant communication of all sorts via 320,000 Bloomberg terminals, the internet and blast emails ensure that all investors worldwide have immediate and equal access to a global cornucopia of information, analysis and insight.

We all understand this and that you can't close Pandora's box. The industry has changed, and you need to either adapt and change with the industry or die. We choose to adapt.

In May of 2016, the Financial Times published an article titled, "Liquid alternative mutual funds leave investors disappointed", with the follow-on statement that the asset management's industry's hopes of bringing hedge fund strategies to the American mass market have stalled in the face of miserable returns and skepticism from investors. Assets had doubled from 2011-2014, reaching a peak of $183B in August of 2014 but stagnated going forward (and as of the writing of this letter). The article also states that liquid alts have underperformed the hedge fund industry over three and five years" in a period where institutional investors are questioning the value of hedge funds themselves.

A Morningstar analyst commented in the article that "investors would have been better in a plain old 60/40 balanced fund" [over the past 5 years]. He's not wrong but that comment applies to just about every unhedged investment in existence. The best portfolio decision you could have had since 2009 (and since we entered the liquid alts business in 2014) was being 100% long large cap stocks and ideally highly levered. On top of that, equity long/short as a category in particular has been a whipping boy for the industry. And with good reason.

The environment for money managers has reached a fevered pitch of pain. Price sensitivity has reached an all-time high. Time frames have reached an all-time low. Indices have reached an all-time high. Volatility has reached an all-time low. Make no mistake about it; active management is in a whopper of a bear market and the ripple effects are felt across the industry, from the trading desks to the financial advisors and consultants facing their clients.

It is the perfect storm.

My timing has always been impeccable you know. We launched our firm in 2006 as an emerging manager fund of funds, only to find ourselves battling for survival when the double whammy of 2008 and Madoff hit our industry. Emerging bruised but alive, we began offering customized hedge research to family offices and institutions. We built hedge fund portfolios, performed all sort of intensive operational and research projects, built our contact base within the industry further, and met with manager after manager across any number of strategies. We developed a name for ferreting out both large and small managers, as well as performing high quality deep research for our client base. The pivot to lower fee/consulting/customization was the correct tactical move and we were rewarded with a significant asset growth, eventually growing from $25mm to $1.4B as we embraced this adjustment to our model.

But structural problems remained as we persisted as a hedge fund specific shop. How could we justify the fees? Why were clients angry at me about K-1's? Am I paying an incentive fee for beta? Where is my higher return due to the illiquidity premium via lock-up? What about hurdles? Why did that manager just buy a $17mm apartment after providing me sub-par returns for 3 years? And so on.

By year-end 2011 I became highly concerned as to the long-term viability of our business. The markets had ended the year broadly higher and hedge funds were slightly negative. As the market ramped higher into 2012, we realized we had the capability and need to change our business structurally and still stay within our chosen expertise, on top of the desire to effect change in the industry in an area where change was sorely needed.

So, here's how I see it:

The hedge fund industry (Limited Partnership structure, lock-up, K-1 tax reporting and incentive fees) is forever changed. This is not the end of the hedge fund industry or the structure itself. But by and large, as we have consistently said after observing the industry for close to 25 years, most traditional hedge fund strategies (particularly long/short equity) translate quite nicely into a mutual fund structure.

Additionally, it is the underperformance of long/short hedge funds over the past 8 years in aggregate that has opened the door for superior structures and a more investor friendly regime. Ironically, the very forces that are making this such a difficult time to be in the business are the ones that have allowed Alternative Mutual Funds to evolve into a higher quality offering. Hedge funds that had previously dismissed the idea of participating/managing such vehicles have graduated from outright dismissal, to grudging acceptance and in many cases, a full embrace and adoption of the space.

What about the end market? The advisors, the analysts, the consultants and so on. The end market itself is highly complex with multiple constituents and varying viewpoints. For example, I can sit down with a $20B consultant and hear them say, "we are starting to look at liquid alternatives for our smaller clients and that's where we'd slot you in because the larger clients can use the hedge fund wrapper (limited partnership)." Why does it make a difference whether the client is large or small? If the strategy exists in a wrapper that is structurally more efficient, why not use it across all clients?

I could give 100 different variations of this conversation throughout the past few years. It is very clear that the direct translation of moving from a hedge fund to a hedge fund inside a mutual fund doesn't follow a straight line as one would logically think. For example, large scale institutional consultants are reacting to the berating from their client base on hedge funds by moving to longer lock-up private equity structures where arguments over performance become moot in the short term. That is in direct opposition to what I would have expected to happen. From the consultant's point of view, what better way reduce the decibels of complaints by moving to a structure where there is no liquidity and performance can only be assessed over 10-year time frames?

In the years to come, I believe we will see significant growth from the Alternative Mutual Fund industry and, in particular, from smaller boutique managers. It will require more market dispersion and some popping of the ETF bubble to see a return to active management. In fact, the passive management wildfire has cleared the way for boutiques like ourselves, offering a genuine alternative as opposed to brand name managers who offer closet indexing options. The importance of capacity constraints on any given strategy remains of paramount importance to us when constructing high quality mutual fund vehicles and the industry would be better served to see more funds closing to new capital than accepting unlimited amounts of capital. The future could very much look a lot like … us.

Please reference our Inaugural Letter written in 2014 for additional background and insight - http://www.balterliquidalts.com/wp-content/uploads/Balter_Liquid_Alternatives_Inaugural_Letter_Retail.pdf

Long/short equity is an investment strategy that involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value.

Volatility is the statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. The higher the volatility, the riskier the security.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

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