

# Hedge funds forced to innovate against ETF invasion

Do exchange traded funds (ETFs), replication products and passive indexes give investors a better option than direct investment into hedge funds? How can hedge funds compete?

Innovation has always been at the heart of the hedge fund industry. With the emergence and proliferation of ETFs, replication products and passive indexes, the landscape is expected to undergo even more radical change. Many expect more of these products

to start drawing assets away from traditional active asset managers while the involvement of retail and institutional investors also grows.

Standardisation and more regulated fund structures – particularly Ucits in Europe – will fuel this growth. Many hedge fund managers are competing against these replicators for assets and are being forced to look at launching their own ETFs or index products to compete.

At the same time they are using the ETFs as proxies

where liquidity is lacking or as a useful hedging tool. In addition more hedge fund managers may think seriously about producing their own ETFs as a way to increase assets and broaden distribution.

Managers can learn important lessons from the success of the other products now on the market. They can compete by offering investors a wider range of options, including managed accounts and Ucits funds, giving the same advantages as ETFs or indexes but with the possibility of better returns.

## Deborah Fuhr, BlackRock

ETFs have fundamentally changed how institutional and retail investors construct their investment portfolios. The landscape will continue to evolve as we see more products from traditional active asset managers and alternative asset class exposures becoming available to mainstream retail and institutional investors through standardised and regulated fund structures such as Ucits in Europe. Hedge funds have historically been difficult for many investors to access with their high minimum subscription levels and maximum investor limits. We expect to see more hedge funds looking to create ETFs with their own funds as the underlying exposure in an effort to broaden their distribution capabilities. This will give more investors access to the asset class and the ability to do so in small sizes with daily liquidity but will also make it challenging for them to understand what they are investing in compared to the historical daily transparency of the underlying portfolio in low-cost index based exposures for which ETFs have become known.

## Robert Watson, Lyster Watson

In 2008 many hedge fund investors learned painful lessons about liquidity, transparency and fraud. In response, products offering the prospect of absolute returns similar to those of hedge funds began to attract investors. Products designed to replicate the return profiles of hedge funds can offer investors better liquidity, transparency and fraud protection than hedge funds and FoHFs. In exchange for those benefits, investors should expect slightly lower returns over time. In efficient markets any other result would not make sense. It would also not be possible to track or replicate hedge fund returns if there were no funds to analyse. Large institutional investors with the resources to analyse and monitor individual funds and the investment horizons necessary to tolerate their sporadic liquidity will continue to allocate capital to hedge funds and FoHFs. Those with fewer resources or less tolerance for risk will allocate capital to products that capture most of the absolute returns of hedge funds. Differences in returns between hedge funds and hedge fund replication products will reflect the value investors place on the attributes that distinguish one from the other.

## Caelim Parkes, MSS Capital

ETFs, replication products and passive indexes require suitable governance, transparency and infrastructure to give the users certainty that the risks they are being exposed to are as advertised. Managed accounts could be the tool that best provides the infrastructure to safeguard investors' fiduciary interests. Hedge funds offer a different investment proposition. They provide concentrated risks, relying on an individual trading advisor's skill and judgement to plug a specific risk-adjusted return gap in a portfolio. Managed accounts provide investors with the tools to use both types of instruments. Investing in a collection of hedge funds through a managed account would provide better transparency and governance than investing in a collection of ETFs, replication products and indexes that offer only diversification as protection from single-strategy hedge fund blow-ups. Both propositions could co-exist within a portfolio with the less experienced, more risk-averse investor more heavily weighted to ETFs, replication and index products. These provide that 'safer', manageable entry point into the alternative world.

## Michael Howell, CrossBorder Capital

The status of hedge funds has been challenged by the rapid growth of ETFs. Through these cheap and liquid securities, ordinary investors can regain control of their assets, undertaking speedy and cost-effective realignments of market and currency exposure. Will ETFs sound the death-knell of hedge funds? Probably not but this does not deny the great attractions of ETFs. They offer the flexibility all fund managers should relish. They facilitate better risk control and now cover such a wide array of markets that even global investors can use them. Trading in ETFs removes stock-specific risk. Many hedge funds' poachers are fast becoming gamekeepers. They cannot ignore the attractions of ETFs. Recent crises have shown that the liquidity of ETFs rises rather than falls in market turmoil as more investors use them. Although they still trail behind futures markets in cost and liquidity, ETFs demonstrate far wider market coverage. They are ideal for all asset allocators: exoteric, esoteric and exotic. If you cannot beat ETFs, why not join them?

## Michael Markov, Markov Processes International

Quality replication work requires some serious talent. For example, it took a significant research effort to create the first official pet clone that was able to reproduce. Hedge fund replication has presented a similar challenge. While hedge fund clones have been around for some time, their quality remains an issue, limiting their potential to pollinate and multiply. Average hedge fund returns are indeed an attractive target. Long term they outperform almost half of all hedge funds and dwarf most mutual fund categories in performance efficiency. If one could replicate their returns with sufficient precision, such a liquid and transparent investment vehicle representing a collective wisdom of all funds could be used by many investors. Unfortunately, most of the available replicator products have demonstrated they cannot track hedge fund indexes sufficiently well. This should not come as a surprise as most existing replication approaches are trying to fit such collective wisdom of thousands of funds with just a handful of broad factors using simple regressions. When GPS is becoming free, investors deserve a better tracking technology.

## Andrew Allright, Butterfield Fulcrum

Replication products provide a lower-cost route to hedge fund returns without the operational, investment and business risks of direct hedge fund investment. It is unclear if they can capture the full distribution of risk/return. They cannot mirror the dynamic trading performed intra-month by most hedge fund strategies. Passive hedge fund indexes do give exposure to hedge fund risk and return characteristics. Studies have shown the persistence of the many types of bias in hedge fund indexes leads to a general underperformance against direct hedge fund investing. The key issue with ETFs that can also be extended to hedge fund Ucits products is offering the investor liquidity, often on a daily basis, which is just not possible for a large number of hedge fund strategies. This is only likely to be one part of an investor's hedge fund portfolio. Increased requirements for liquidity, transparency and control are leading many investors to invest in hedge funds via managed accounts which tend to offer enhanced liquidity to direct investments but allow them to use the full range of strategies for hedge fund portfolio diversification.

## Adam Patti, IndexIQ

As more managers set up shop, an increasing number of funds are chasing the same alpha and industry-wide returns have lagged. Research shows that in aggregate the majority of hedge fund returns are a form of beta exposure. While this exposure is very valuable, it can be replicated by using commonly available liquid securities. Meanwhile, the structural limitations of hedge funds have become more pronounced. ETFs, replication products and hedge-style passive indexes allow for the introduction of hedge fund beta exposures into various portfolios with greater transparency, improved liquidity and lower costs. Particularly in the case of ETFs, barriers to investment have been lowered, in effect democratising the investment landscape. These new products are designed to provide the diversification benefits of hedge funds without saddling investors with those structural limitations. So while the value of hedge fund investing remains clear and investor demand is unlikely to ebb anytime soon, the industry and investors should take note of the problems being solved by the innovative passive solutions being brought to market.

## Phil Tindall, Towers Watson

Passive replication and alternative beta have thrown down a gauntlet to the industry by reproducing some of the returns of hedge funds through beta exposures. As well as traditional market betas, more strategies are now accessible in beta form. The best managers can still generate high returns even after fees but manager selection is key. We are always careful to understand what, if any, beta exposure managers have. We do not want our clients to pay alpha fees for this. Hedge fund beta provides a particular challenge for FoHFs, as the average FoHF underperforms a broad hedge fund index with an extra layer of fees. Hedge fund replication is not important per se. We are interested in alternative betas that have a clear economic rationale, are diversifying and cheap and easy to access. So we do not favour top-down, backwards-looking replication. For clients with high governance, a direct allocation to individual hedge funds makes sense and individual alternative beta ideas should also add diversity. For clients that have traditionally used FoHFs, packaged hedge fund betas could be considered an alternative for some of the allocation.

## Manooj Mistry, DB X-Trackers

For those investors looking for diversified hedge fund exposure, an ETF tracking a hedge fund index can provide an alternative to investing in traditional FoHF products. This is because the ETF provides exposure to the actual performance of a diversified portfolio of hedge funds combined with transparent pricing and intra-day accessibility. In my view it is not a question of the ETF competing against hedge funds. Instead the ETF is a very complementary product that can actually increase investments into hedge funds. Institutional investors who invest in hedge funds or FoHFs will continue to do so but if they want a product to manage liquidity in their hedge fund portfolio then the ETF would be ideal for this. Secondly, there are many categories of investor who cannot invest directly in hedge funds, so an ETF that is compliant with the Ucits regulations is a good way for them to achieve hedge fund exposure. In both cases, there would be a benefit to hedge funds as the ETF is hedged by investment into hedge funds.