FIDUCIENT Advisors

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Hedge Funds Revisited with Anthony Novara

[00:00:00] Welcome to Nonprofit Investment Stewards with Bob DiMeo and Devon Francis from Fiducient Advisors. Bob and Devon are passionate about helping nonprofit organizations prosper. Whether you oversee endowment, foundation or retirement plan investments, this podcast exists to help stewards improve performance, reduce costs and discover strategies that enable your charitable organization to prosper and advance its mission.

[00:00:26] Now onto the show. Hello, and welcome back to the Nonprofit Investment Stewards podcast. I'm Bob DiMeo, always good to be joined by co-host Devon Francis. Let's call today's episode hedge funds revisited. Folks can be intimidated by alternative investments. Sometimes investment committees might feel they don't understand the alternative space.

[00:00:48] Maybe they don't seriously consider hedge funds and other alternatives, or maybe they consider their options, but they're just not comfortable investing in the space. Well, with volatile markets and stocks and [00:01:00] bonds both facing real challenges, our goal today is to give listeners a foundational understanding of hedge funds so that they can thoughtfully assess the role that hedge funds should play in their endowment or their any, any portfolio they're working with.

[00:01:16] If it should play any role at all. Devon, would you care to introduce our guest? Sure Bob. I'm so pleased that we're covering this topic today. I really think that providing education to our constituents is one of the most important roles we serve at Fiducient, whether those constituents are current clients or prospective clients, or even listeners who are unaffiliated with Fiducient.

[00:01:37] But who serve a nonprofit organization in some respect. So today we are joined by an incredibly well-informed guest. We have our colleague Anthony Novara with us. He's a partner at the firm. He's director of our marketable alternatives group. Anthony has earned his CFA designation, has an MBA from the University of Chicago, and has been with the firm since 2011. [00:02:00]

[00:02:00] He's also a very busy outside of work as both a volunteer and a board member of several organizations, and a father to two active boys. So, Anthony, welcome to the show. Thank you, Devon. Thanks for having me, Bob. Anthony, just absolutely terrific to have you on this show, particularly in this current environment.

[00:02:17] Maybe we just start at the basics, and you can just go ahead and define, give the backdrop on what it is we're talking about when we talk hedge funds. Sure, Bob. Happy to. So, when we think about, uh, the term hedge funds, we think it's certainly more of a legal structure than it is an asset class per se. And the reason we think that is there's a pretty decent spectrum of risk and return across things that would be called hedge funds.

[00:02:43] There are, uh, structures and strategies that are far less risky than let's say public equities. And there's other strategies that are quite a bit more risky in our view than public equities or even up to private equities. So, that spectrum is, is noteworthy. Um, there are some [00:03:00] characteristics that are pretty common that we should draw on here.

[00:03:03] And really the first is that these strategies are not managed to any specific benchmark. So much like an ETF or a mutual fund might be managed to a specific well-known benchmark. These strategies really don't manage to any specific benchmarks, so they can own just about any publicly traded stock, bond or derivative for their positions.

[00:03:24] They can short securities, which is to profit if the security price falls in position that you have short. And they can also use some leverage. So really those are the main basic points that really differentiate the space from other spaces. That's helpful, Anthony. So, as we further kind of set the stage, what are the most common types of hedge fund strategies?

[00:03:48] And can you perhaps provide a brief description of each type of strategy? Absolutely. And, and really in the industry, there's a lot of different ways to classify things. There's, you know, different databases and [00:04:00] the, like that have slightly different classifications. But the way we think of the space is really in five main subcategories, if you will. Those are long short equity, event driven, and we would put mostly credit investments in that bucket.

[00:04:14] Then there's relative value, global macro strategies, and multi strategies. And like you said, Devon, I'll just hit on a little bit on each one. And then we, uh, we can pause and, and talk about more than one in, in depth if we'd like. So as far as long short equity is concerned, this is really a, a pretty basic strategy.

[00:04:33] A particular portfolio manager will go long stocks let's say they think will rise in price and they will go short other stocks they think will decline in price. So, some of these strategies might not have much exposure to markets intentionally. They, they sometimes are called market neutral strategies and they really don't necessarily rely on markets to rise to generate profits for their investors.

[00:04:57] So maybe an easy example on long short is really [00:05:00] the idea of a pair trade. So, when a manager believes that one peer is a lot stronger than another peer and maybe will take market share or is better positioned for a new market, what have you, that manager might decide to be, let's say, long Coke and short Pepsi or vice versa.

[00:05:16] And in theory that trade, because they're both in the same industry have similar risk characteristics, but obviously the way that the two companies are gonna perform is a function of what their positioning is. And so that sort of trade structure would be pretty typical in long short equities.

[00:05:34] Event-driven strategies is our next, and these really result from corporate events that we all see in the newspapers. So, things like an acquisition of a company or a company emerging from bankruptcy. So just a couple little ones here is going long a particular company that's being acquired and then shorting the acquirer would actually be a, a pretty typical merger arbitrage strategy.

[00:05:59] And if the, [00:06:00] that deal ends up going through, you'd end up with a, with a profit. Your long would go up a little bit and your short in theory would, uh, would be pretty flat. And then you'd be able to collect the difference or something like a company just emerged from bankruptcy and some managers specialize in that space.

[00:06:16] So they own the bonds during the bankruptcy process and then might come out the other end with some equity exposure. So those are some pretty typical event-driven type strategies. And again, always rely on corporate events as really the, uh, the opportunity set. Relative value strategies are another one. So, these are a relationship of two otherwise similar assets that trade at different prices for some reason, but not necessarily for an economically justified reason.

[00:06:46] So something like, uh, let's say, a, a treasury bond and a treasury future in theory have just about the same risks associated with them. But maybe one is cheap and one is expensive relative to each [00:07:00] other. In theory, you don't have any default risks. So, you'd end up with being able to keep the spread between those two.

[00:07:06] If that relationship were to collapse with which the manager would make the case, in theory, it ought to at some point. Global macro strategies are next. These are managers that have a particular view on the global economy and typically express that view across let's say a handful of themes. So, an easy example might be a manager might be particularly bullish on a currency or bearish on a country's bonds, or have a short term view on the price of a commodity.

[00:07:33] Those would be relatively typical positions for a discretionary macro manager that would be invested. And lastly, multi strategies are the easy one, which is they can own several different ones, uh, types of strategies that we've just talked about. So, they can easily allocate capital where they think it's the most opportunistic on behalf of their investors.

[00:07:54] They don't have to invest in, in all the spaces that they are exposed to. And in theory, [00:08:00] it would be beneficial in combining many return streams that are not correlated with one another. That means they just don't move in the same direction typically. And if that's done correctly, that can actually reduce the risk of the overall strategy.

[00:08:13] So that's the handful, uh, the sub strategies that the way we define them, Devon. Excellent, Anthony. So, it's been a challenging period for stocks and bonds and, and other sorts of investments. And that could continue for some time. So, when we're in this sort of environment, what are potential advantages that hedge funds might hold for an endowment, foundation, for an investor in this sort of environment and, and why?

[00:08:42] Sure, Bob. So, what would be typical is to say that more volatile environments would benefit managers that are trading more opportunistically and have a wider opportunity set and more levers to create excess return or alpha, or really just [00:09:00] performance that isn't explained by market factors in general.

[00:09:03] And so when we think about these particular strategies, they, they, they aren't necessarily taking on a lot of market exposure. So, when markets go down in value, they won't necessarily go down in value as much, or in some cases will actually go up a little bit in value. So, there can be quite a bit of correlation benefit.

[00:09:23] To other traditional asset classes like stocks and bonds or real estate, let's say. So the volatility can certainly help if traded correctly. And we do see that quite a bit with managers that really do a good job of protecting capital in a market like we're in today, where you see stocks and bonds selling off in the first half of the year, protection of capital is really important, but also offering a different allocation than you'd otherwise see.

[00:09:50] In the market as well. So, not always, and it really depends on how you do it, but we would make the case that the volatility certainly benefits those that [00:10:00] typically trade more and can trade more things that aren't beholden to a specific benchmark. So, Anthony often you hear about fund of funds.

[00:10:09] So can you describe the lay of the land? What is a fund to funds? Perhaps what type of investor might it be best suited for? And what are some of the benefits and drawbacks of a fund of fund structure as compared to a direct investment in a hedge fund? Sure, Devon. So, a fund of funds in our view is used as a single allocation for a client to gain access to a subset of hedge fund strategies that the fund of funds manager has selected.

[00:10:38] And they'd typically be able to do that at a lower minimum than would be required to start a direct hedge fund program. So easy math here would be if a hundred-million-dollar endowment had a 10% allocation to hedge funds, that would be 10 million dollars. That would really be just about the starting point of considering a direct hedge fund program.

[00:10:58] Anything below [00:11:00] that would be, would be better served utilizing, uh, a really good fund of funds instead. So, the positives of a fund of funds is that administration is relatively simple for a client. You only have one single subscription rather than maybe eight, nine or 10 subscriptions, and the client can gain access to a diversified portfolio with that one subscription.

[00:11:20] Fund of fund managers that can show they've had better results for clients are an attractive add to a broader portfolio in our view. But the drawback is the client certainly has to pay a fee to the fund of funds manager in addition to the fees paid to the underlying managers that are in that portfolio.

[00:11:39] So we wanna be mindful of cost for our clients and certainly pay attention to it. But we do work with quite a few fund to funds managers that have generated really good value for our clients and more than justify that second layer of fees, which is the, the, the, the most notable drawback. That's super helpful, [00:12:00] Anthony, and as we're talking about size and where does fund of fund make sense?

[00:12:04] And where does direct investing in hedge funds make sense? These are general guidelines and sort of industry standards and such. And of course, uh, we know that, uh, each investor has unique circumstances. So, listeners shouldn't consider this a specific recommendation. Yep. Thanks. Thanks for throwing that in there, Bob.

[00:12:22] So as we continue along this path of providing the listeners with education, there are a lot of terms within the marketable alternative space that folks may be unfamiliar with. So, things that spring to mind are carry, gates, lockups, high-water marks, those sorts of terms. Can you maybe describe or explain some of the most commonly used terms that people may be unfamiliar with?

[00:12:46] Sure, Devon. So, let's start with carry. So, carry, or sometimes called incentive fee, are really the same thing. And perhaps best described in a hypothetical example. So, 20% carry means that a manager is [00:13:00] entitled to 20% of the gain of the portfolio in any particular, let's say calendar year. So, assuming there is a gain, if the gain were 10%, then 2% of that would go to the manager.

[00:13:12] And 8% of that would be split up. The remaining 80% would be split up amongst the external investors that are in that strategy. So, carry and incentive fee are, are the same thing. And really when you, when you think about why it's called that, you can make the case that if the manager is incentivized to produce positive returns for themselves, then by definition, that obviously aligns them with investors.

[00:13:35] We would mostly agree with that assessment, but there always is nuance to incentives that we spend a lot of time on and understanding, but in general, that's carry. And it's, it's, uh, it's, it's sometimes referred to as incentive fee as well. How about, um, gates, lock ups, high-water marks? Sure. So high-water mark means that a portfolio has achieved its highest value.

[00:13:59] [00:14:00] So another example here for a high-water mark is if a portfolio were to decline by, let's say 20%, the manager cannot collect any of that carry that we just described until the portfolio recovers by 25% to get back to that high-water mark. So, after the 25% gain, that would be the, that would get the, the portfolio back to its high-water mark.

[00:14:22] The manager would then be entitled to carry for new gains above that high-water mark. Devon, you also mentioned gates and lockups. Those are certainly related too. So a typical lockup might be something like a year where the investor can't redeem his or her capital for a full year. A gate might prevent the investor from accessing all of his or her capital at a certain point.

[00:14:46] So a typical gate might be quarterly where a client can get a quarter of their capital for each of the next four quarters if they wish to fully exit the position. This is known as an investor-level gate. And then the term [00:15:00] gate was certainly popular during the global financial crisis. When some hedge funds couldn't pay all the redemptions they received, and in some cases had illiquid holdings, they couldn't sell to fund those redemptions.

[00:15:11] So today, some funds have what's called fund-level gates to combat this where they can decline redemptions if let's say more than 10% of the fund is redeemed by all of the investors in it together in any one quarter. So, Anthony, if we're in an environment going forward, where it's going to be tougher for endowments, foundations to sort of hit their target return, just lower overall return expectations potentially.

[00:15:41] You know, folks need to consider sort of everything available to them to achieve their goals so they can advance their mission and such, right? So, if that's the mindset, I think a stumbling block sometimes when it comes to hedge funds is something you touched on briefly and that's fees. And, you know, sometimes even, uh, half jokingly, [00:16:00] you hear, it's not fund of funds, it's fees on fees.

[00:16:03] And so perhaps you can talk a little bit about fees, the fee structure, and really how investors might think about navigating that. Sure, happy to, Bob. So, a typical hedge fund, certainly fees have come down in terms of what a hedge fund charges these days. And it's certainly notable that the hedge fund charges more than let's say a strategy that might be in small cap growth or in bonds or otherwise.

[00:16:31] And the way the fees work is you used to hear of the two and 20 moniker, which is a 2% annualized management fee plus the 20% carry that we've already talked about. And really that 2% is now down to let's say about 1.5%. So, you've seen fees come down a little bit. Carry really hasn't budged that much.

[00:16:53] If you look at a lot of different data sources, carry might be, you know, in some cases, 17 and a half percent instead of 20. [00:17:00] Every once in a while, you'll see a 15%, but it's certainly higher than just about any other strategy. So, when we think about the analysis associated with what these managers are generating, it's not necessarily, it is what they're generating, but it's also what our clients get to keep.

[00:17:17] So we measure everything net of all fees, and then we can easily compare one fund of funds manager or strategy to another. And so, when we think about the, the, what, what the, the client is gaining, we certainly do believe that in many cases, if you're hiring a good fund of funds with a very good underlying portfolio and a stable team associated with that strategy, it can certainly be a beneficial allocation.

[00:17:43] To a portfolio, especially in an environment when you've seen like this year where you've seen equities and fixed income sell off at the same time. We've certainly seen many managers in the fund of funds space protect capital and be down less than that. Or in some cases, be actually positive for [00:18:00] the year.

[00:18:02] So Anthony, I feel like there's a perception in the marketplace and I don't think I'm alone in, in sensing this, that hedge funds are much riskier than other areas of the market. Can you address that, that concept? Yes. I'd love to Devon. So, this is something we talk quite a bit about and, and really back to that spectrum.

[00:18:21] Right? So, if we think of what the perception is, this is just one person's opinion, but my perception of that spectrum is from low risk to high risk. It goes bonds, real assets, equities, hedge funds, and then finally private equity. From lowest risk and lowest return to highest risk and highest return.

[00:18:43] So we, so the way we think about it is we think that spectrum ought to go bonds, then hedge funds, then real assets, public equities, and finally private equity, again from that spectrum of low return and low risk to high return and high risk. What we're really trying to [00:19:00] achieve, and in some cases, you can define risk and return this way.

[00:19:02] Hedge funds really fit between bonds and equities in that they're really trying to achieve equity-like returns over a full market cycle with bond like volatility. And if you can actually achieve that, then capital that might otherwise be in fixed income that is generating lower returns might be exchanged for slightly higher returns for effectively about the same risk profile.

[00:19:27] And that can be part of the solution to the low return environment that we've been in for many years is the idea of you still wanna keep that correlation benefit away from things like equities and, uh, private equity. And you can do so in a manner that we think is risk controlled without taking on a lot of other risks in the market that you might, you might gain in those other asset classes.

[00:19:50] Thanks, Anthony. So that's helpful. You've dispelled the notion that hedge funds are inherently risky, but you know, we all hear about the big hedge fund [00:20:00] blowups, like the Bernie Madoffs of the world. So, when your team is doing research on potential hedge funds for use in client portfolios, what steps do you take to strive to avoid, uh, exposure to such incidents?

[00:20:14] Yes, that, uh, that infamous legacy remains seared in all of our minds more than a decade later. So, our firm believes strongly in performing operational due diligence on any manager before investment with our client's capital. We certainly think that operational risk is an uncompensated risk for our clients.

[00:20:34] So the goal is really just to minimize it as much as you can. So back to Madoff, if a manager were to come in with a great track record, in that case, I'll put great in quotes, uh, and, but provided us little to no information about how they were generating those returns, we just wouldn't need to move further in our process at all.

[00:20:53] And certainly if we would've, uh, proceeded to do operational due diligence on a strategy like that, a review of the [00:21:00] service providers, what systems are used to trade, how cash is moved in and out of the fund and what the compliance program looks like would certainly highlight potential issues. So, we think operational due diligence is absolutely essential.

[00:21:14] To perform on our own, really to assess whether or not we think there are potentially those risks. And we simply wouldn't allow a manager to invest our client's capital without knowing those aspects about their firm first. So that's helpful, Anthony, and it's, it's interesting because you're sort of demystifying hedge fund investing here and, and there are a lot of parallels to traditional investing, right?

[00:21:38] Like, like the risk of investing in a single hedge fund is akin to the risk of investing in a single stock. And so, you, you just prompted the thought of, Hey, folks can complain a little bit about the cost of, of fund of funds, but boy, the diversification certainly helps. And, and the same is true about direct investing, having enough to invest in a collection of hedge fund [00:22:00] managers and strategies and, and with that.

[00:22:03] I think folks often assume that hedge funds are only appropriate or only available to the largest investors. And perhaps you can comment on at what size Fiducient Advisors recommends, in general, the use of hedge funds in a portfolio. Sure. Uh, there are, there are vehicles that a particular client needs to show.

[00:22:26] They're either a qualified purchaser or an accredited investor to access, Bob, that's to your point about being a more sophisticated, either personal investor or institution. But there's also registered vehicles that have minimums that are in a lot of cases, a lot of times below a hundred thousand dollars.

[00:22:43] And so really, we think if the, if the goal were to either own more stocks and more bonds or own an allocation such as this, for an allocation that isn't dramatically large relative to some of the sums that we see talked about now in, in, in the [00:23:00] endowment landscape and, and with family offices and others, it's really not overly challenging in terms in terms of finding vehicles that really can, that really can benefit those clients at the smaller end of that allocation size.

[00:23:16] So Anthony, if you had to sum it up fairly concisely, what would you say are some of the biggest advantages and biggest drawbacks of using marketable alternatives or hedge funds in a portfolio? Sure. Let me start with the pros and then we'll get to the, uh, the cons second. So, adding an asset with a higher return per unit of risk can certainly improve the results of the entire portfolio.

[00:23:41] You can either add to the return, reduce the volatility, or ideally, we'd like to see inclusion of the asset class achieve both. And that's really a key aspect of how we help our clients prosper is really, we seek potentially both of those with this allocation. Um, a [00:24:00] mindful hedge fund allocation can certainly protect capital during periods of market stress.

[00:24:05] Like we've seen this year while also generating those long term equity-like returns over a full cycle with bond like volatility. And bonds aren't an overly volatile space. So really we think that, that if you pick your spots correctly, you can really end up with a lot of client benefit to show, especially in a volatile market.

[00:24:24] Like we've seen now. Onto the cons, there's certainly more administration involved. So if we were gonna do a direct hedge fund portfolio of, let's say 10 managers, that would be 10 subscription documents and freeing up cash and a lot of other administrative tasks associated with that. So, we're certainly mindful of, of that with our clients.

[00:24:44] The other, the other point I'd make is there's some loss of liquidity. Although we tend to keep this allocation relatively liquid, I mentioned that year lockup. So you've gotta invest in a fund for let's say a year. There's certainly others that are a lot longer than that. But, um, you do lose on, you do [00:25:00] lose some daily liquidity by investing in the space because you can only, uh, get redemptions out of the space.

[00:25:06] Let's say two or four times a year. And you have to be invested for a year in many cases. So that loss of liquidity is something we think a lot about, but we intentionally keep the portfolio, uh, relatively liquid compared to, you know, lockups of let's say two or three years, or in some cases, five years are in the industry these days.

[00:25:24] So that's noteworthy and the last drawback is some of these strategies can be fairly complex. So, there's certainly a risk of investing in something that is harder to communicate with our clients. We're certainly mindful of that. We have a lot of different tools that we think can dispel the notion and really measure things effectively for us to really hit the, the high points in many cases.

[00:25:46] But there is complexity in this space. And I, I certainly do think that is a con all else equal. That's great. So, Anthony you've listened to the podcast before. You know we never let our guests get away without answering a personal question, just kind of [00:26:00] a bonus round. So, we know, Bob and I know, the audience doesn't know that you are an avid guitar player and a lover of music.

[00:26:09] So name your top three deserted island albums. You're stuck on a deserted island. You can only have those three albums. Devon, that's a really challenging one. So, for me, I would have to have three artists on that desert island. Otherwise, it would be absolutely miserable. Those are three really obscure artists called the Beatles, the rolling stones and Stevie Wonder. For the Beatles, for me, uh, it would have to be Abbey Road.

[00:26:36] Um, you could certainly make the case for, for the white album, um, as a double album, but Abbey Road to me is just so perfect. And it's really the, uh, the last album that they recorded. Um, Let It Be for the rolling stones was really when, uh, when they came on into the, it was the second album of what's considered their classic period.

[00:26:56] For me, it starts with gimme shelter. It ends with you can't always get what you want [00:27:00] there's some great deep cuts on it as well. So that one I'd have to have, and then lastly songs in the key of life by Stevie Wonder, really I'm showing my Motown roots certainly. But Stevie Wonder is just unbelievable.

[00:27:12] He is my favorite solo artist of all time. And he had an absolute run of albums that are incredible. And, um, songs in the key of life is really him at his apex with, uh, of his creativity. So, I would certainly say those three. It seems weird not to have a list without Led Zeppelin too who's next or any Jimmy Hendricks or, uh, Michael Jackson.

[00:27:31] I could go on and on, but you, you, you limited me to three, so that's what I would choose. I think it would be hard to argue with any of those choices. Well done. So, Anthony, this has been absolutely terrific and you'll be happy to know, you know my son Danny for a long time. And he's a guitarist and he had a, uh, he was married over the weekend.

[00:27:49] So a new chapter in the DiMeo household. But the Friday night rehearsal was a rock and roll rehearsal. And I think you'll approve, uh, that the concert t-shirt I [00:28:00] wore or the musical t-shirt I wore was an Abbey Road silhouette. So that worked out great. Oh, I love it. Just, uh, so legendary and just about recognizable at any time you see it.

[00:28:11] Yeah. So, thank you so much, Anthony. This was absolutely terrific. It really did provide not only foundational understanding of the hedge fund space, but some of the current environment and go forward consideration. So we really appreciate you being on the show. Thanks for having me, Bob and Devon. I really enjoyed it.

[00:28:28] Thanks. And for those of you who are interested in learning more about alternative investments, you should know we recorded a similar episode on private equity some time ago. That's episode number 29, and our colleague and partner Matt Kaminski. He really provided a great overview of private investing, and you could find that on our website and we'll certainly include links in our show notes.

[00:28:48] So to all you good stewards, thanks for investing time to help your nonprofits prosper. We'll connect with you soon on the next episode. Thank you for listening to the Nonprofit Investment Stewards podcast. [00:29:00] Click the subscribe button below to be notified of new episodes and visit fiducientadvisors.com for more information.

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[00:29:22] Always seek the advice of qualified professionals familiar with your unique circumstances.