Trust But Verify: Do Private Equity and Hedge Funds Deliver Superior Risk-adjusted Returns?

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Introduction

For several decades, the investment industry has promoted the virtues of hedge funds and private equity funds for large instructional investors and ultra high net worth individuals. But over the last few years these products have come under increased scrutiny because the hoped-for benefits have, for the most part, not materialized. The PEW Research Center conducted a study of 73 of the largest public pension funds in the country and the fees and performance associate with "alternative" investments[1]. The report concluded that the shift toward more complex investment vehicles over the last two decades increased management fees by nearly 30% but did not result in a higher success rate for the portfolio that included these alternative investments. According the PEW report, only 2 of the 73 funds included in the study accomplished the targeted return for their portfolio. The report noted that "the funds with recent and rapid entries into alternative markets — including significant allocations to hedge funds — reported the weakest 10-year returns." There is evidence to suggest that any gross of fee benefit being capture by these esoteric investments is eroded by the high fees being charged to access these products.

Hedge Funds

Large, sophisticated investors are abandoning their allocation to hedge funds in record numbers. The CEO of CalPERS, the single largest pool of investment assets in the U.S., noted in her 2015 year-end report, "As part of our ongoing efforts to reduce complexity and cost in our investment program, we eliminated the hedge fund program from our portfolio…" The New York Times reported on October 20, 2016, "[The Kentucky Retirement Systems voted to exit hedge funds over the next

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[1] April 12, 2017 - State Public Pension Funds' Portfolios Increasingly Complex. Heavier reliance on alternatives yields mixed results, highlights need for increased transparency

three years. The New Jersey State Investment Council also announced plans this month to pull nearly $2 billion from 11 hedge funds. MetLife, the New York City employee pension and the American International Group have recently started asking hedge funds for their money back, too."

Private Equity

Not only have hedge funds come under fire, but increased scrutiny is being focused on the private equity asset class as well. The Wall Street Journal reported on April 16, 2017, "CalPERS is sick of paying too much for private equity. The fund's private-equity returns were 12.3% over the last 20 years, but they would have been 19.3% without fees and costs." A study published in the Spring of 2017 Financial Analysts Journal[2] studied the performance of private equity funds compared to small cap publicly traded stocks. The study found that the return from the private equity asset class between 1986 and 2014 did not significantly exceed an equivalently-levered investment in small cap stocks, An earlier study published in the FAJ in 2012[3] concluded that private equity funds do have a relatively low market beta, but the authors could find no evidence for their outperformance. The authors noted, "We find that self-reported net asset values significantly overstate fund values for mature and inactive funds".

Governance for Alternative Investments

Anodos does not advocate for nor against the use of alternative investment in one's portfolio. We believe that is a policy level decision which should be reserved exclusively for the client and the investment manager to whom they have delegated investment responsibility. Rather, we encourage that when these high cost, illiquid and non-transparent products are included in the portfolio, a defined

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[2] FAJ Volume 72, Issue 4, July/Aug 2016, pp 36-48.

[3] FAJ Volume 47, Issue 3 June 2012, pp. 511-535

governance process should be established. This governance process will include 1) what the maximum allocation to these alternative assets will be, 2) how the hoped for benefits from these alternative asset classes will be tested and 3) and how the risk and return performance of these products will be measured. It's not good enough to accept at face value of the claims of those parties promoting these products. A prudent investors with trust but verify the claims.

Benchmarking "Alternative" Assets that Provide Monthly Valuation

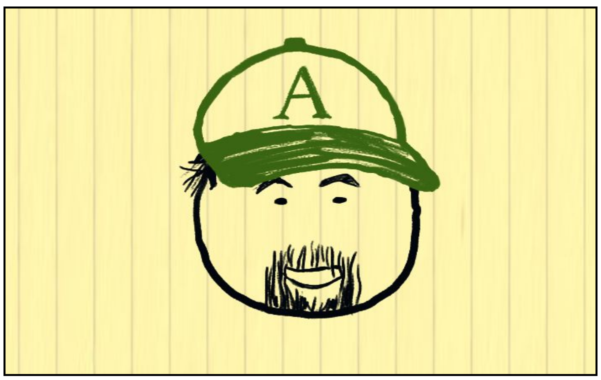
Some "alternative" investments, like many hedge funds, master limited partnerships or structured notes, *do* provide monthly valuations from which time-weighted rate of return (TWROR) can be calculated and risk analysis conducted. If the investment manager's initial proposal includes assets which (1) are considered "alternative" according to the above definition, and (2) *do* provide monthly performance data, the asset should be INCLUDED in the portfolio's regular performance reporting and represented by in the benchmarking process by US Treasury Bill Index rather than an industry promoted hedge fund index. The hedge fund indexes are notoriously flawed (find footnote) and of dubious value. Our rationale for using TBills as a stalking horse to compare that portion of the portfolio allocated to these alternative strategies is that it is presumed that these strategies will both earn a higher return than Treasury Bills, but also contribute greater volatility to the total portfolio. The benefit, as measured by additional return, and the cost, as measured by increased risk, will be observable in the deviation of the portfolio from the benchmarks. This is a fairly simple fix to a long recognized problem of benchmarking alternative assets which *do* provide a monthly returns series, but for which no obvious asset class comparison can be made.

Benchmarking Alternative Assets that do NOT Provide Monthly Valuation

Another class of "alternative" investments, like private equity funds and real estate partnerships, provide valuations less frequently than monthly, which makes return and risk calculations less appropriate. Also, those assets that do not provide monthly valuation tend to give the manager or general partner the ability to control the timing and size of cash flows to the investors. As such, those assets that do not have monthly valuation or where the manager retains the ability to affect the timing of cash flow are more appropriately measured with an internal rate of return (IRR) rather than a time-weighted rate of return (TWROR) calculation. These assets that do not provide monthly valuation will be EXCLUDED from the portfolio's regular performance reporting and will not be represented in the Strategic Benchmark and Tactical Benchmarks. Instead, these investments will have their performance measured against a distinct *Inflation+5%* return benchmark. We suggest a secondary benchmark of that has a reasonably similar underlying asset type (Small Cap Stock as a proxy for Private Equity and REITs as a proxy for Syndicated Real Estate partnerships) have similar risk and return expectations are their more illiquid partnership cousins. A 3%-5% (footnote) performance hurdle would be added to the performance of the liquidity asset index to compensate the investor required to bear with these alternative assets.

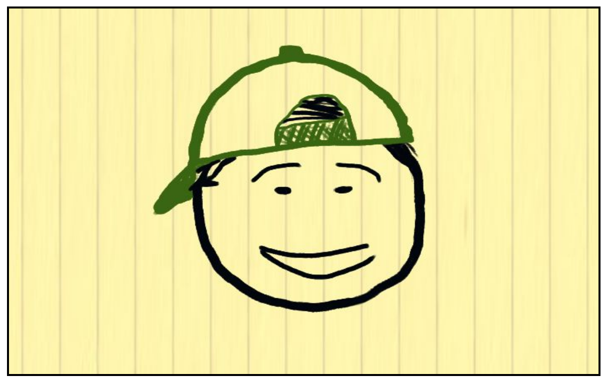
About Anodos

Anodos helps folks answer the question, “Is my investment manager doing a good job?” Many of our clients are trustees and obligated to independently monitor the activities of the agents to whom investment duties have been delegated. Some of our clients are not trustee and are merely interests in getting an unbiased evaluation of their investment managers performance. What makes us unique is this is all we do. We don’t manage money, sell insurance or accept referral fees. We don’t have a horse in the race.



Josh Yager, Esq., CFP®, ChFC®, CLU®

Josh is a recognized content expert on the issues of fiduciary duties relating to the management and oversight of trust as- sets. He lectures extensively on the policies and procedures for conducting investment manager audits to CPAs, attorneys, and professional fiduciaries throughout the country. Josh is Managing Partner at Anodos Advisors and a licensed attorney. Prior to founding Anodos in 2005, Josh worked for fteen years as an investment advisor with Mercer Advisors. Josh likes to read books about dead presidents.



Ryan Wolfshorndl, CFA®, CFP®

Ryan has been with Anodos since 2005. He holds the Chartered Financial Analyst and Certified Financial Planner designations. Ryan has 11 years of experience monitoring the activities and risk/return experiences of investment managers. Additionally, he conducts performance attribution and other statistical analysis relevant to the investment experience. This work ensures accountability, adherence to investment parameters, and clarity of expectations between clients and their managers.

Is your investment manager doing a good job?

Schedule Consultation