HIGHLAND

INSIGHT
MAY 2016

CONFORMISTS, REBELS, AND REALISTS: ARE HEDGE FUNDS STILL VIABLE?

When it comes to investing, we can take different paths. The most common path is the one of the conformist, which follows the road well-traveled. This is the safest route as success and failure with the crowd often brings little criticism. The path of the rebel goes against the crowd at every turn and many times without a fully informed view. Highland chooses to take the third path, that of the realist. This road requires a great deal of perseverance to ensure success, but can be very rewarding.

Our independent analysis is the cornerstone of our investment process. Even after a decision is made, we continue to underwrite investments to ensure we are on the right path. Highland began investing in hedge funds in the 1990's as a means to smooth out volatility for our clients who have liability streams they need to meet. Our goal was to participate in the equity market while protecting capital during market drawdowns. Currently, it seems the crowd is turning against hedge funds, as many recognizable public pension funds have liquidated their hedge fund portfolios. This move seems justifiable, as the hedge fund industry is coming off its worst start to a year in terms of performance and investor withdrawals since 2009. In fact, according to the Hedge Fund Research Institute, hedge funds had net outflows of $16.6 billion the last two quarters and the number of hedge funds that closed last year was the most since 2009. Explanations for recent hedge fund weakness often focus on more abstract concepts, including:

- the increased size of the industry and corresponding dilution of the talent pool;
- larger individual fund sizes and their association with lower alpha opportunities;
- groupthink or crowding of similar trades;
- limited transparency, and
- incentive fee structure.

These issues seem to have been exacerbated over the past year as some of the most well-known and best performing hedge funds are reeling from big losses and large redemptions. We believe that these general concerns for the asset class as a whole are not applicable to all hedge fund strategies and managers. In fact, diverging monetary policy and higher equity volatility have actually created opportunities for potential outperformance in several segments of the market. Our focus remains on identifying the drivers of alpha generation at the individual strategy level, and we remain convinced that a strategic allocation to a diverse mix of hedge funds is essential to generating superior long-term risk-adjusted returns.

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *Business services*

ABOUT OUR FIRM

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of December 31, 2015, we serve as investment consultant on approximately $17.2 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

TOO BIG TO FLOURISH: DO ASSETS AFFECT PERFORMANCE?

The hedge fund industry has become crowded with too many managers following similar strategies. A hedge fund manager recently quipped at a conference that it's very hard to maximize returns and maximize assets. Highland agrees with that assessment, our caveat is that historically both the largest and the smallest hedge funds are the ones that underperform.

A study by the Cass Business School's Centre for Asset Management Research looked at hedge fund performance by asset class size from 1994-2014 and found a clear negative relationship between hedge fund size and performance. The study showed that on average the greater the size of the fund the worse the performance. Other things being equal, the results showed that on average a $200 million hedge fund could be expected to outperform a $1 billion hedge fund by 0.61% per annum and outperform a $5 billion hedge fund by close to 1.25% per annum. The study also uncovered that on average smaller sized hedge funds outperformed larger sized hedge funds during the 2000 tech bubble collapse and the 2008 Global Financial Crisis. This is partly attributable to the fact that many large fund managers "talk their book" or publicly inform investors of their positions, both on the long and the short side. This makes them more susceptible to being caught in a short squeeze. The study also concluded that larger hedge funds had more market risk embedded in their portfolios than smaller hedge funds. These mega funds have historically been less nimble during market distress due to their size.

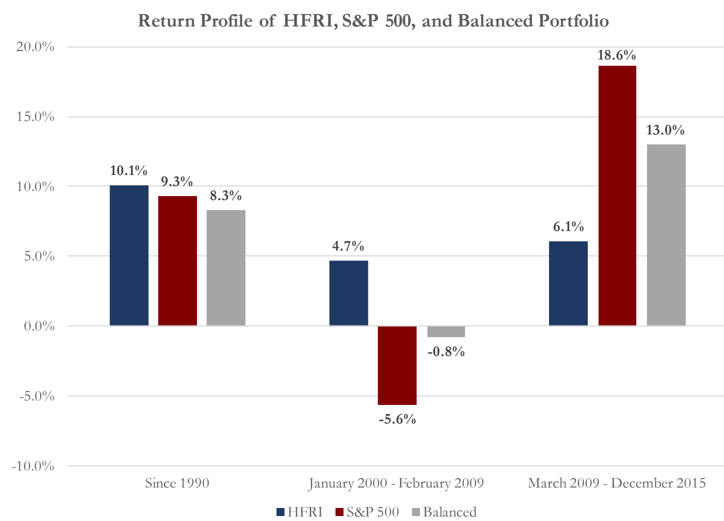
> *In the hedge fund industry having some critical mass does make a difference.*

The funds with the smallest amount of assets have their own issues. According to HFR Market Microstructure Industry Report, over half of all hedge funds are under $100 million, which we would generally consider to be below our threshold for investment. In addition, it is estimated that only 44% of hedge funds are registered with the Securities and Exchange Commission ("SEC"). A pre-requisite for us to invest in a hedge fund is that they must have institutional infrastructure in place, which essentially necessitates they report to either the SEC in the U.S. or a similar regulatory body in other countries, such as the U.K.'s equivalent, the FSA. It is not just operational risk that keeps us from investing in smaller funds, but historically funds with less than $50 million funds have significantly underperformed their peers. In fact, on a 5 year and 10 year annualized basis, funds less than $50 million have underperformed funds greater than $1 billion by 2.9% and 1.7% annualized, respectively. In the hedge fund industry having some critical mass does make a difference.

TOO MUCH BAD BETA: DOWNSIDE CAPTURE HURTS

Although asset size may explain some of an investor's displeasure with recent hedge fund performance, it only tells a part of the story. Aggregate hedge fund returns have clearly frustrated investors since U.S. equity markets bottomed in March 2009. Annualized returns for both U.S. stocks and a traditional balanced portfolio have dwarfed returns of the HFRI Fund Weighted Composite Index (see Figure 1).

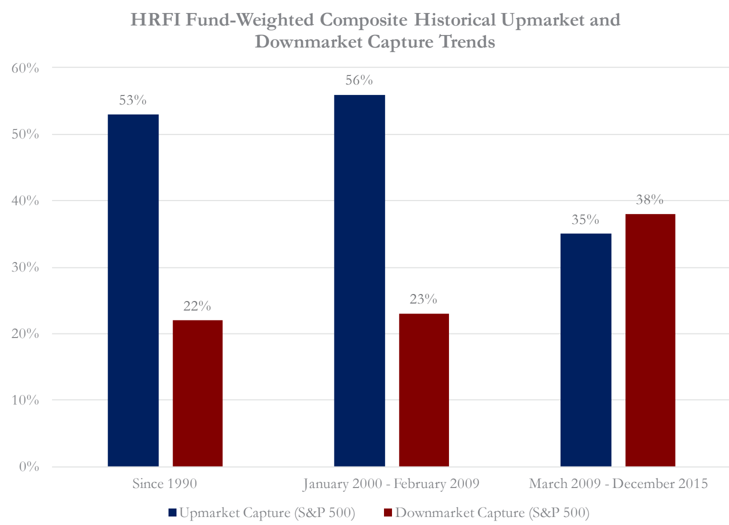
FIGURE 1



SOURCES: HFRI; S&P; BARCLAYS; HIGHLAND ASSOCIATES.
**THE "BALANCED PORTFOLIO REPRESENTS A 60% ALLOCATION TO THE S&P 500 AND A 40% ALLOCATION TO THE BARCLAYS AGGREGATE*

This recent return profile represents a clear break from prior history, where hedge funds more than held their own against equities. Through the course of our analysis, we discovered that changes in market participation provide excellent insight into the difference in hedge fund performance in each cycle. A new trend has emerged in the aftermath of the global financial crisis (see Figure 2). Hedge funds, as measured by the HFRI Fund Weighted Composite Index, have reported substantially lower participation in up markets and significantly higher participation in down markets relative to the S&P 500 (market capture analysis is performed by calculating the average monthly performance during the "up" and "down" months of the broader equity market, using the S&P 500 as the benchmark). While the spread between the upmarket and downmarket capture ratios amounted to 33% from 2000 through early 2009, that spread has actually turned negative over the last seven years, coinciding with a record bull market in equities.

FIGURE 2



SOURCES: HFRI; S&P; HIGHLAND ASSOCIATES

These compounding market capture effects clearly demonstrate the futility of recent aggregate hedge fund returns. Hedge funds have given up too much of the upside in order to protect on a downside that never materialized during this time frame of coordinated global monetary policy. The increase in downmarket capture also indicates that, during rare periods of market stress post-crisis, hedge funds in aggregate have failed to deliver sufficient tail risk protection. Importantly, we must stress that this is aggregate data, and several individual hedge fund strategies have continued to thrive despite the challenges for the category as a whole.

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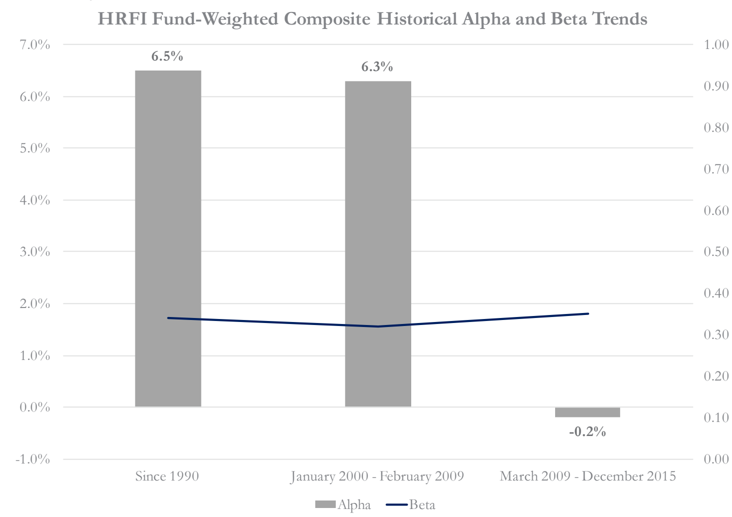
Beyond market capture, an analysis of alpha (or manager skill) and beta (or exposure to the market) is also instructive. Historically, hedge fund strategies have relied far more on alpha and far less on equity market beta to generate returns. Hedge funds have much more flexibility utilizing different tools and instruments versus traditional markets and it is their ability to leverage these tools that contribute to their alpha generation. Recently, while equity market beta has remained consistent, alpha has essentially evaporated at the index level. In fact, the HRFI reported negative alpha in the seven years following the S&P 500 bottom in March 2009, as illustrated in Figure 3.

FIGURE 3



SOURCES: HFRI; S&P; HIGHLAND ASSOCIATES

Historically, stock selection, market timing, and short volatility strategies have been among the primary sources of alpha for hedged equity returns. Recently, however, high stock-to-stock correlations have made stock picking more difficult, while gyrations between "risk on" and "risk off" market sentiment driven by unprecedented monetary policy have impacted market timing trades. In addition, the Fed's low interest rate policy has negatively impacted cash carry returns, an important source of return contribution in prior market cycles. From 1990 – 2008, the 3-month Treasury bill averaged 4%, unlike 2009 – 2016 where it averaged 0.08%. Importantly, most of these phenomena are likely more cyclical than structural.

CAN HEDGE FUNDS OUTPERFORM IN TODAY'S MARKETS?

The performance issues discussed above have impacted hedge funds in aggregate, however, there are many skilled managers who are able to navigate these unusual times and take advantage of market dislocations. Hedge fund processes and philosophies are typically characterized by flexibility and variability, resulting in extreme dispersions in performance among managers. As shown in Figure 4, the difference in annual return between top quintile and bottom quintile hedge fund managers has been at least 30% and averaged over 50% over the last several years. The implication is that opportunities to outperform tend to persist; of course, the opposite is also true.

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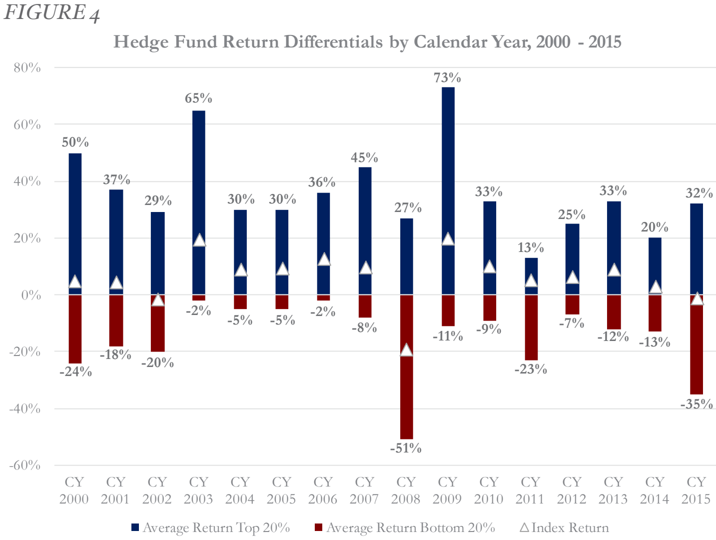
FIGURE 4

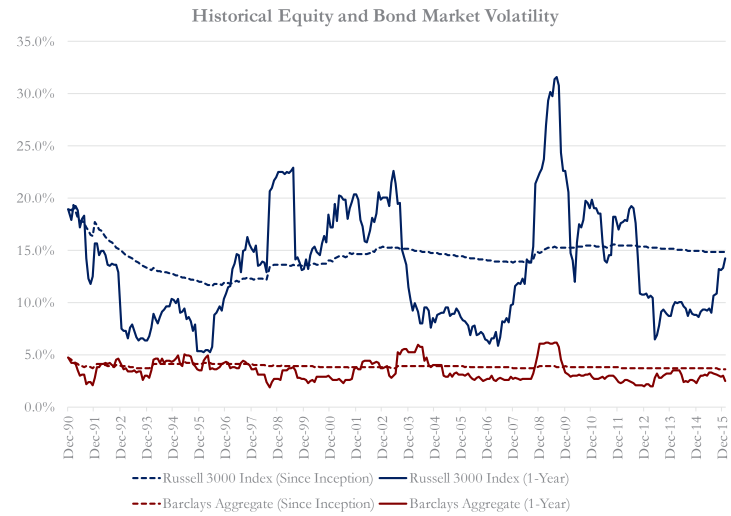


SOURCES: HFRI; HIGHLAND ASSOCIATES

Regarding the current environment, several ongoing shifts in the equity and credit markets should be supportive of hedge funds. For many years following the global financial crisis, central bank policy in the U.S. served as a shock absorber for the market. In fact, during these quantitative easing phases, equity market volatility was nearly 25% lower than in less accommodative environments. With the Federal Reserve now in the early stages of a tightening cycle, volatility has returned to the market. In an environment more prone to economic and market shocks, Highland anticipates that hedged equity should perform well on a risk-adjusted basis and serve as a valuable allocation in a well-diversified portfolio.

As indicated in Figure 5, recent increases in volatility have coincided neatly with the transition from accommodative to restrictive monetary policy. Higher volatility is symptomatic of a shift in investors' focus from broad macroeconomic drivers to more specific underlying industry and company fundamentals. As a result, long/short hedged equity strategies and relative value strategies are now better positioned to deliver alpha.

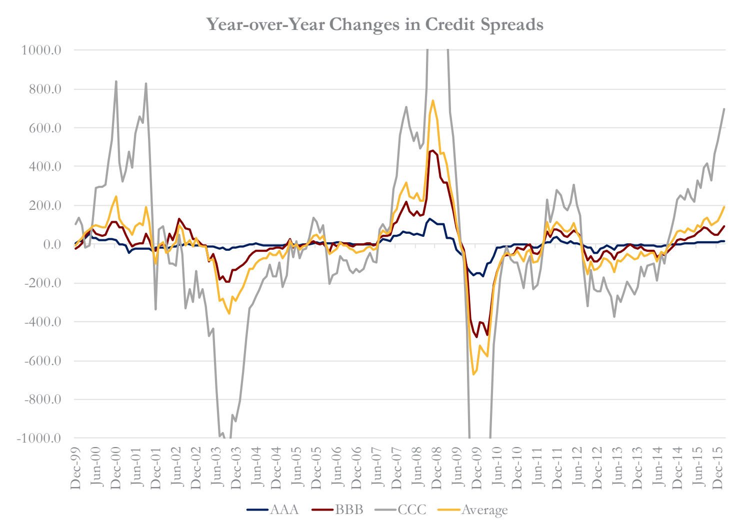
FIGURE 5



SOURCES: RUSSELL; BARCLAYS; HIGHLAND ASSOCIATES

Weakening credit conditions also present attractive opportunities for hedge fund strategies. Credit spreads for lower rated corporate debt have widened considerably in recent months (see Figure 6). These conditions – brought on largely by weakness in energy and metals markets – should allow distressed debt managers to generate alpha by acting as liquidity providers to underserved markets. While onerous financial regulations generally discourage traditional banks from lending to these lower quality issuers, opportunistic hedge fund managers should be able to lend at increasingly favorable terms.

FIGURE 6

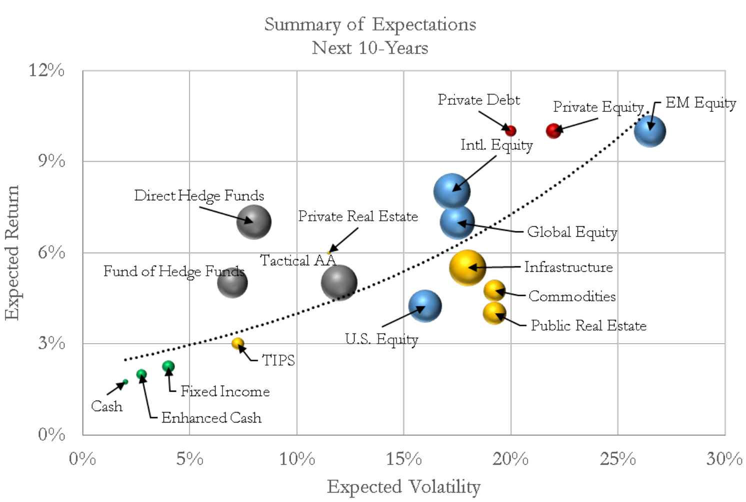


SOURCES: FACTSET; BARCLAYS; HIGHLAND ASSOCIATES

Lastly, nearly $400 billion in mergers and acquisitions have fallen through this year. This includes two high profile mergers, Pfizer/Allergan and Halliburton/Baker-Hughes. This has caused merger spreads, or the difference in the current price and the announced acquisition price, to widen to an annualized 7-8% on an unlevered basis, which are levels not seen since 2011. Deal spreads are not expected to subside any time in the near future, especially with the U.S. Presidential election hitting full swing and congressmen continuing to scrutinize many deals. This is advantageous for event-driven managers that specialize in merger arbitrage.

The Federal Reserve's actions of driving down both short and long-term interest rates and encouraging investors to take on additional risk has impacted forward future return expectations. With bonds only expected to provide 2-3% returns and U.S. equities 4-5% returns, we like hedge funds on both an absolute and risk-adjusted basis (see Figure 7).

FIGURE 7



SOURCES: HIGHLAND ASSOCIATES

HIGHLAND'S HEDGE FUND PATH

Highland's approach to hedged equity is to deliver sustainable alpha through multiple sources. First, we pursue "structural alpha" through portfolio construction. Secondly we target "manager alpha" by finding skilled managers that can generate returns in all kinds of market environments.

We deliver structural alpha by targeting a materially positive spread between upmarket and down-market capture. As a result, our clients should be better insulated from poor returns. Consistent achievement of this spread is a function of both portfolio construction and manager selection.

When evaluating and investing in hedge fund strategies, Highland focuses on identifying managers with structural or informational competitive advantages. Structural advantages exist in the form of technology, economies of scale in opaque markets, and sourcing advantages, among others. Informational advantages exist in the form of differentiated data processing and analysis, as well as the use of unique perspectives. Usually, these managers rank in the top quartile among their peer group according to many different metrics. Specifically, we emphasize stable organizations with abundant resources, strong risk management practices, long-tenured management teams, and clear alignment of interest between investment professionals and clients. At the same time, Highland looks for consistent and repeatable processes, as demonstrated by a consistent positive skew in return distributions. In layman's terms this means when a strategy loses money, they lose a little, but when they make money, they make a lot more than they have lost. This is a good indicator of their risk management procedures and how they handle preserving capital during a drawdown. Indeed, consistency of return characteristics does tend to have predictive power in assessing potential future performance.

We are especially attracted to managers that invest in markets that are inefficient or otherwise constrained to new participants. Furthermore, we favor managers whose source of excess returns is mostly independent of their market exposure. These types of strategies are less market driven and their trades are usually propelled by company-specific catalysts. Finally, we focus on paying reasonable (but not excessive) fees in a structure that is fair and transparent. The truth is that the widely accepted 2% management fee and 20% incentive fee for hedge funds is not what most investors pay. According to HFR, over a quarter of funds have management fees lower than 1% and another 33% have management fees between 1-1.50%, whereas the average incentive fee is 17%. It is important and an integral part of our due diligence process to negotiate lower fees with managers.

CLARITY FROM CONFUSION

As the world truly begins to address the after effects of policy intervention, Highland sees an environment that will be ripe with volatility and where traditional investments will be challenged to produce "normal" returns. We continue to view hedged equity as an important component of a client's overall asset allocation. The truly skilled managers will be able to navigate this challenging market environment and capitalize on market dislocations as well as protect client capital as we travel down what will undoubtedly be a very bumpy path. While this may not be the path commonly traveled, we believe it is the best path to guide our clients, enabling them to achieve their long-term return objectives.

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