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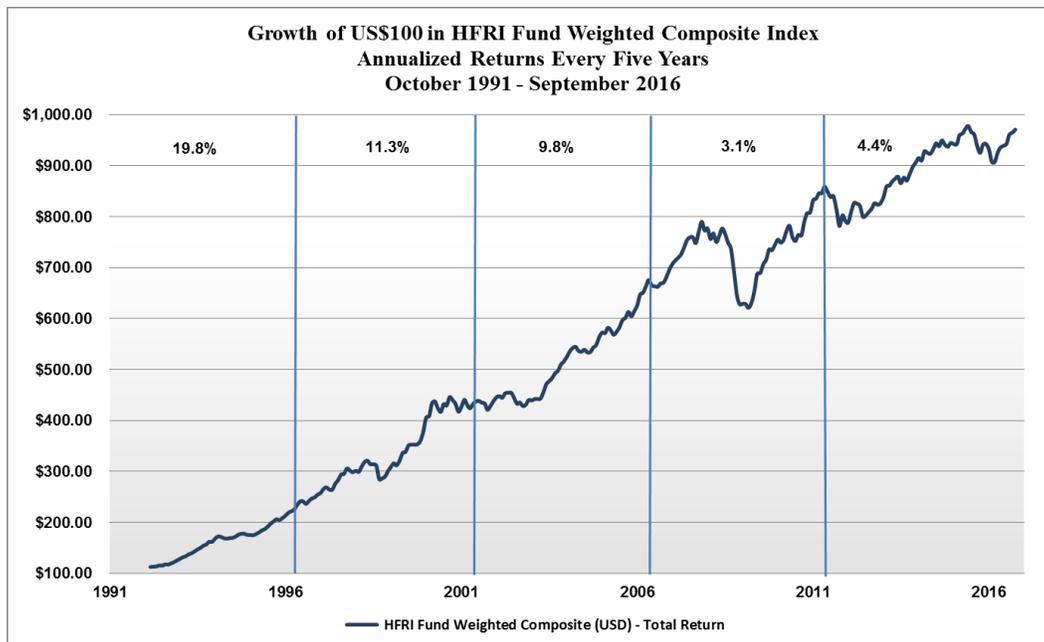
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A Short History of Hedge Fund Returns

November 2016

Hedge funds have played an important role stabilizing and improving risk adjusted returns in portfolios for decades, but recent performance issues have caused many investors to seriously question their value proposition and fee structures. In fact, the performance trend is not new - we graphed a twenty-five year return history of the HFRI Fund Weighted Composite Index below and highlighted a fairly frustrating, long-term decline in five year increments. Some insiders have publicly stated that the hedge fund industry is now in the midst of an epic washout,¹ a culling that will leave a smaller number of survivors earning lower fees or at least facing higher hurdles before incentive fees are paid. Others have suggested that investors should be patient, that the decline in hedge fund returns is cyclical and will eventually revert to historical norms.² We believe both will happen, although smaller numbers of competitors won't automatically raise returns. There are larger forces at work in the capital markets that may need to resolve and return to normal before hedge funds can offer the level of diversification



¹ Saijel Kishan & Joshua Fineman. "Loeb's Third Point Says Hedge Funds in 'Catastrophic' Period." *Bloomberg*. April 27, 2016.

² "We have hedge funds on a short leash. We want to determine if what we are seeing in disappointing hedge fund alpha is cyclical or something more structural. We are making that assessment, and believe it would be rash to cut our allocations further at the current pain-point in the alpha cycle. Cyclical underperformance in an alpha cycle should mean revert, and we would like to capture that mean reversion." Richard Madigan. "Trimming the Sails." *JP Morgan Private Bank*. April 20, 2016.

and performance investors would like. In this paper we provide some perspective on the history of hedge fund returns and explore the deteriorating insurance value of hedge funds over time, which leads us to question whether many investors have been overpaying for downside protection. We also briefly address challenges faced in recent years by all active managers, long or short - issues to be explored in greater depth in a subsequent paper on active versus passive investing.

The landscape of hedge fund choices is vast, with about \$3 trillion invested among thousands of managers, so attempts to oversimplify cause and effect can be counterproductive. However, we believe the study of hedge fund index returns can highlight structural forces in the capital markets that are materially affecting performance. Our observations herein are based on data from Hedge Fund Research (HFR) and personal experience, though we understand that all indices have flaws and individual experiences vary. While there should always be highly talented managers able to generate exceptional returns in adverse conditions, and we continue to seek them out for clients by interviewing and analyzing hundreds of them every year, it must be recognized that the number of “exceptional exceptions” has dwindled in recent years. Has the industry experienced a brain drain? It definitely has not. However, we think it is too simplistic to blame poor performance on record inflows. More likely the market environment itself has become hostile to many hedge fund strategies while the flood of new capital over the years has only made things worse. We do not believe the situation is permanent, but investors must consider the possibility that the current environment of ultra-low or negative interest rates, high levels of monetary activism and periodic debt and deflation shocks may continue for the foreseeable future and thus require a shift in the way portfolios are managed and diversified. While it would be helpful, simply lowering hedge fund fees will not solve the problem.

The Past in Three Acts

The history of hedge fund index returns can be roughly parsed into three eras:

Act I 1992 to 2002

Hedge funds are liquidity providers. They offer equity-like returns with low correlations and bond-like volatility. Absolute and relative performance prior to and throughout the 2000-2002 bear market is excellent.

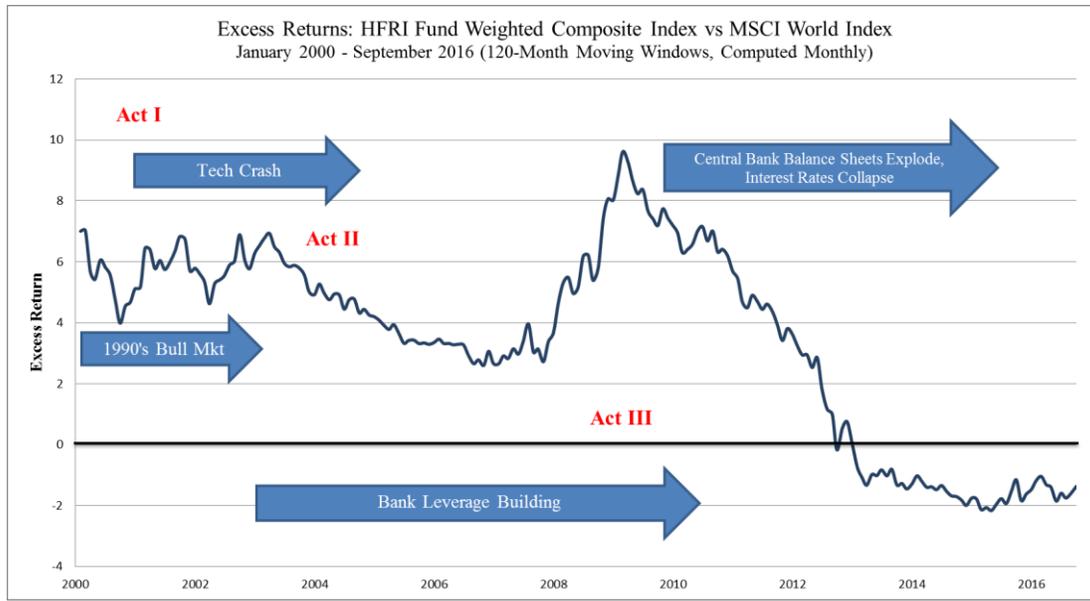
Act II 2003 to 2008

Hedge funds are liquidity takers. Rising inflows, correlations, momentum and leverage trends define the period between the technology and housing bubbles. Many hedge funds become extensions of bank balance sheets as burgeoning derivatives channel and facilitate excessive leverage. Shorting low quality companies becomes riskier thanks to a wave of marginal LBOs and a growing ETF industry. Returns moderate and, while relative performance in 2008 is acceptable, absolute performance is disappointing.

Act III 2009 to Present

Hedge funds are liquidity victims. After markets implode central banks respond in force, battling to revive animal spirits and raise inflation expectations by underwriting risk of loss. Correlations among stocks remain elevated as quantitative easing and accelerating ETF inflows continue to upend short sellers and deemphasize quality spreads. Shorting low quality companies becomes even riskier; returns eventually collapse and are poor on both an absolute and a relative basis.

The graph on page 1 shows the deterioration of hedge fund *absolute* returns in five year increments over a twenty-five year period. What about hedge fund returns *relative* to global stocks? We graphed excess returns of the HFRI Fund Weighted Composite Index versus the MSCI World Index on a ten year rolling basis (on page 3), and the data show stellar outperformance throughout the 1990s.



Total Returns in U.S. Dollars.

While excess returns did decline during that historic bull market, they were still healthy and positive, rebounding when the technology bubble burst in 2000, global stocks collapsed and the hedge fund industry distinguished itself by avoiding losses. Remarkable performance indeed during the period we label “Act I,” or what today looks like hedge fund nirvana. Since the glory days before and during the market crash of 2000 through 2002, however, the graph tells a different story. We see relative returns plunging while bank balance sheets and derivative markets were growing exponentially in “Act II.” Finally, in “Act III” we see an extended and unprecedented period of underperformance after the Great Recession, even as stocks and bonds have rallied and increased regulation within the financial sector has dramatically curtailed the amount of capital available to market makers. It would be easy to imagine this period as a welcome gift to liquidity providers, a return to the ideal conditions of the 1980s and 1990s, but this has simply not been the case. Instead, central banks have crowded them out, providing unprecedented amounts of liquidity by lowering short-term interest rates and buying long-term bonds for good measure. We review each performance era below in greater detail.

Act I (Pre 2003) Nirvana

Before bloated private sector banks and activist central banks began creating problems for hedge fund managers, when Wall Street firms were private partnerships and pools of risk capital were precious commodities, hedge fund managers were able to produce outsized returns with little volatility. There was a relatively small base of capital exploiting arbitrage opportunities, competing against one another underwriting various risks, most getting paid well for providing liquidity and a measure of efficiency to markets.³ During this period, ten year Treasuries yielded 4% to 8%, inflation averaged about 3%, “bond vigilantes” enforced discipline among capital allocators, and bank equity was more prudently leveraged. The largest central banks had perhaps a few trillion dollars on their collective balance sheets, a fraction of the more than \$12 trillion reported in September 2016. However, important seeds that would affect future hedge fund returns were already being planted. First, Glass-Steagall restrictions on banks merging with or buying investment banks were lifted in 1999, beginning a transformational change in risk culture that would eventually infect the entire banking system. Second,

³ See Hunt Taylor. “What Purpose Do Hedge Funds Serve?” Reprinted by *GaveKal Research*. July 2005.

most of the Wall Street private partnerships able to go public had done so (Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns, etc.) by the end of the decade, removing the direct connection between partner capital and risk taking. Third, the OTC derivatives market was developing the legal, trading and marketing infrastructure to support massive scale and breadth across every asset class, raising prospective returns on equity, and leverage, within the global banking system to a new level by shifting more and more risk off balance sheets.

Act II (2003–2008) Bloated Banks, Flawed Monetary and Housing Policy

Over a period of years leading up to the Great Recession, once the notion of a “Greenspan Put”⁴ took hold after the technology bubble and banks ballooned in size and footprint, we can see the hedge fund industry’s role as a liquidity provider get progressively marginalized. If the buyer of last resort is the Fed, and arbitrage opportunities are pounced upon by giant Wall Street trading desks within minutes, what exactly is the utility of a classic non-directional hedge fund? As bank balance sheets expanded and proprietary trading activity increased dramatically, previously attractive spreads contracted. In this way, deteriorating performance may be viewed mainly as a symptom of poorly rationed or misallocated capital within the banking system, not a disease particular to hedge fund managers. Meanwhile, new money pouring into hedge funds after the crash of 2000-2002, mostly inspired by past performance, undoubtedly weakened the opportunity set further. Under these conditions, a certain amount of style drift and leverage increases were probably tolerated by many managers in order to survive and prosper, thus forcing their investors to live with more directional risk, leverage, illiquidity, momentum bets and crowded trades in order to support returns. The rise in correlations between hedge fund and long-only returns during this period and the advent of crowded trades among hedge funds has been well documented, and things didn’t end well in 2008. While some hedge funds were able to capitalize on the massive liquidity squeeze, most were not, and industry returns greatly underperformed the high expectations set during the 2000-2002 bear market.

Act III (2009-Present) Nationalization of Risk

Unfortunately many of the trends in place by the middle of the last decade have since worsened, depressing both absolute and risk adjusted returns. Some observers like to point out that the original marketing narrative that drew so many investors to hedge funds, “equity-like returns with bond-like volatility,” has been flipped. Not quite, but the HFRI Fund Weighted Composite Index has underperformed the Bloomberg Barclays U.S. Aggregate Bond Index for most of the last decade, with about double the return volatility (see table below). One has to incorporate the early years from 1990

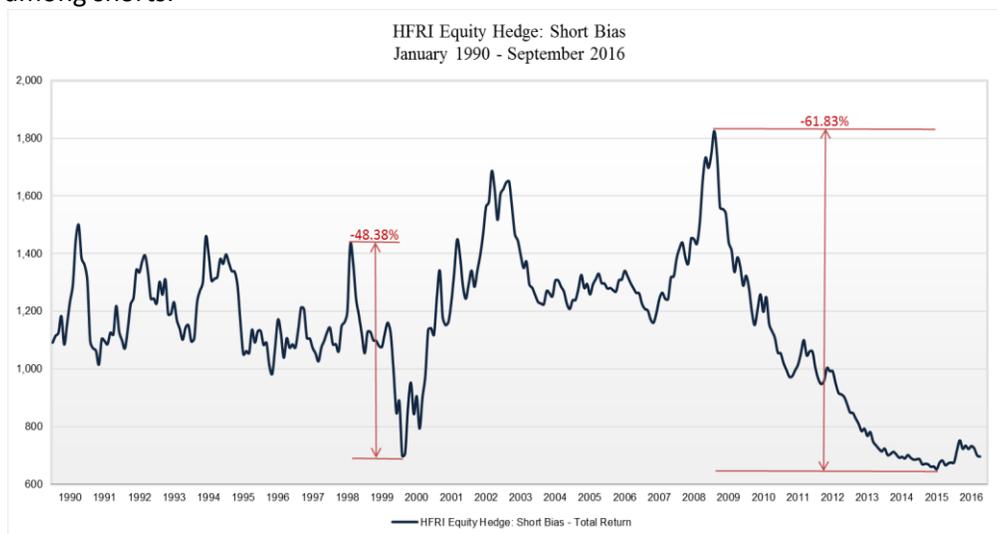
As of 09/30/2016	1yr		2yr		3yr		5yr		10yr		Inception (01/01/1990)	
	Return	Std Dev	Return	Std Dev								
HFRI Fund Weighted Composite Index	4.9%	4.3%	1.6%	4.2%	3.1%	4.0%	4.4%	4.2%	3.8%	6.3%	10.0%	6.7%
Bloomberg Barclays US Aggregate Index	5.2%	2.2%	4.1%	2.6%	4.0%	2.6%	3.1%	2.6%	4.8%	3.2%	6.3%	3.6%
S&P 500 Index	15.4%	11.9%	7.1%	11.5%	11.2%	10.7%	16.4%	11.0%	7.2%	15.2%	9.3%	14.5%

Total Returns in U.S. Dollars. The table shows annualized returns and standard deviations.

⁴ So named for the Fed President’s vigorous interest rate response to the technology bubble and lately expanded by Bernanke, Yellen and others to include bank bailouts and quantitative easing.

to 2006 to show annualized monthly returns significantly higher than the annualized standard deviation of those returns, a common way to measure return quality. As a result, even more humble hedge fund marketing narratives, positioning many strategies as “bond proxies,” fail to resonate. The questions being asked, either directly or indirectly, by investors redeeming from hedge funds today are: if central banks are continuing to offer a free put option, and if bonds continue to outperform many hedged strategies, *why pay for insurance with a hedge fund?* Furthermore, *why pay a manager to short weaker companies when capital is abundant and uniformly cheap?* And if investors are emboldened to commit hundreds of billions of dollars to passive vehicles like index ETFs, aren't bad companies being enabled and supported anyway? We refer to these insidious phenomena as the nationalization of risk, and it is a critical issue to consider when attempting to build robust, well-diversified portfolios.

There is no doubt that unprofitable short selling has been a major contributor to the subpar hedge fund performance shown on page 4. How bad is the environment for short selling? A decent proxy for short performance within hedge fund portfolios would be to look at the returns of the HFRI Short Biased Index over time. As shown in the graph below, the magnitude and the duration of losses since the Great Recession is unprecedented, worse than the final months of the tech bubble, although a slight uptick occurs after June 2015. One might interpret this trend as cyclical, or darkness before dawn for shorting, but the inability to preserve capital versus historical norms is striking. There simply has not been enough outperformance from stock selection on the long side of hedge fund portfolios to make up for losses among shorts.



Active vs Passive Investing During Act III

Hedge funds, like all active managers, try to outperform benchmark indices with some combination of attributes that raises the stakes – for better or worse – on security selection. However, unprecedented monetary policy actions since 2008 have weakened security selection (long or short, stock or bond) as a source of return in a number of ways. First, ultra-low interest rates tend to misallocate capital by lowering the survival bar for bad businesses and mediocre managements, both of which can extend their life spans when borrowing costs are negligible. Second, a lack of differentiation among companies can encourage extraordinary risk taking, working against managers who invest in high quality balance sheets with managements who are talented capital allocators while avoiding, or shorting, low quality. Third, if entire groups of stocks or bonds are rising and falling together without regard to quality, then simple index or ETF exposure often outperforms, vexing active managers further. Fourth, if a bit obvious, most stock markets have gone up a lot since 2008 and with them the opportunity cost of shorting. How interrelated are these phenomena? Former Fed Governor, Kevin

Warsh, writing in the Wall Street Journal, offers a “simple, troubling fact: From the beginning of 2008 to the present, more than half of the increase in the value of the S&P 500 occurred on the day of Federal Open Market Committee decisions.”⁵

Long duration assets like stocks, bonds and real estate are all sensitive to interest rates, but monetary authorities have been buying government bonds in such quantities that a rational investor wonders if “risk free rates” are a true reflection of reality. We think of central banks engaged in quantitative easing as “non-economic buyers,” unmotivated by risk/return, yield, credit quality, growth rates or other concerns of a traditional long-term bond investor. When monetary authorities wish to raise inflation expectations and maximize employment, for example, they are at odds with the typical long bond investor who hopes inflation expectations and wage growth remain subdued. What is different this time is the *degree* of monetary activism. There are no textbooks, no business schools, no long-term interest rate or stock market data, and no money managers with teachable experience to provide in the study of negative interest rates.

Conclusion

We are challenged and motivated to find better ways of thinking about traditional portfolio offsets and construction methods. Having observed mixed results in recent years from less directional hedge funds meant to act as portfolio stabilizers, we need to consider potential solutions that might combine better reliability and efficiency in those core stabilizers with selective risk taking in “satellite” areas that offer higher potential returns. Hedge fund exposure could then be segregated by function, with careful emphasis on the cost/benefit of key hedge fund return components. For example, providing effective, consistent portfolio protection in down markets and adding value through security selection are two distinct skills not always found in the same fund manager. With this in mind, we are evaluating separately managed strategies and/or funds designed to provide direct insurance against drawdowns in client portfolios. These might involve the disciplined and consistent purchasing of out-of-the-money puts or collar strategies (the value of a put option will always move opposite to its underlying reference index), call writing or other ways of managing volatility to offset rising portfolio risks during times of market stress. When the core is more reliable, and more cost effective, the portfolio’s risk budget can be increased elsewhere with greater confidence.

Robert G. Scott
Chairman & CEO

Author’s note: Special thanks to Fraser McLean, E. Douglas Huber, Herbert Cayzer, and Alyssa Elliott for their contributions to this paper.

Source of table on first page: HFR and Wellington Management

Source of data not specifically cited: Fact Set, Bloomberg, HFR

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⁵Kevin Warsh. “The Federal Reserve Needs New Thinking.” *The Wall Street Journal*. August 24, 2016.