

HEALTH WEALTH CAREER

# EBB AND FLOW OF THE HEDGE FUND INDUSTRY

APRIL 2016

Based on articles in numerous periodicals and given the actions of a few prominent investors, it would be easy to view 2015 as a forgettable year for the hedge fund industry. Uncertainty in China, dramatic downward pressure on commodity prices, shifts in federal policy, and other factors rolled the capital markets during the second half of the year. Such instability seemingly should have been of benefit to hedge funds given their supposed idiosyncratic approaches and their ability to be short to capture return while others are suffering losses. So, on the surface, it was somewhat surprising that the year ended on an uninspiring note for hedge funds as a whole, with the average portfolio declining slightly. Year-end 2015 also marked the first quarterly outflows from hedge funds since the fourth quarter of 2011 — and the largest number of fund closures in any year since the financial crisis. As a result, we believe it is appropriate to address many of these concerns specifically.

Although the absolute performance of hedge funds was disappointing in 2015 and continued to lag in the first quarter 2016, the average portfolio of hedge funds (as measured by the HFR Fund of Funds Composite Index) declined only modestly, protecting capital during what was an unfavorable period for global risk assets as a whole. Hedge funds continued to post favorable risk-adjusted results during difficult months for the equity markets and added value over a traditional 60/40 mix for the year. In other words, hedge funds actually delivered as an accretive alternative to stocks and bonds, which is the ultimate objective. At Mercer, we believe this degree of downside protection illustrates a key tenet of a hedge fund portfolio approach, and from this perspective the average hedge fund investor's experience in 2015 should be viewed as being in line with expectations.

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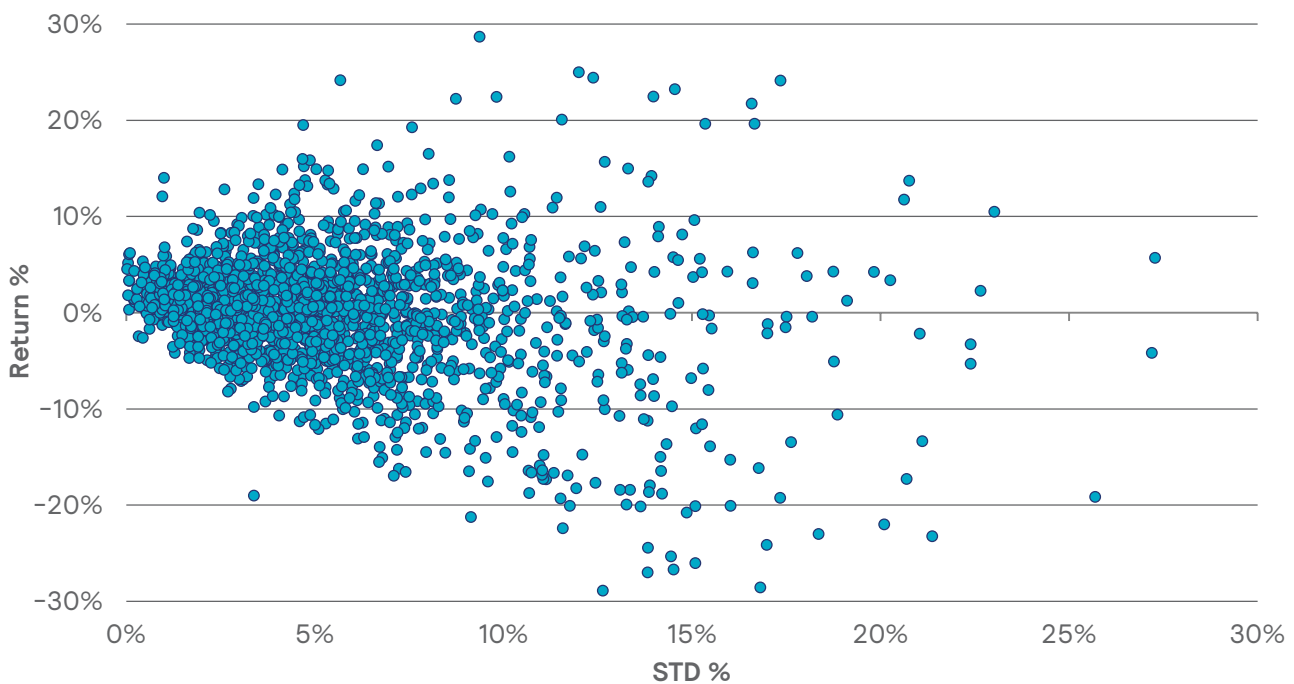
When considering  
downside  
protection hedge  
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Manager selection remains one of the most important considerations when constructing a hedge fund portfolio

Aside from performance, outflows in the hedge fund industry have also gained attention, as investors withdrew roughly \$1.5 billion from these strategies at the end of 2015. Although the amount certainly grabs interest, this level of redemptions represents just a fraction (less than 1%) of industry assets, and for 2015 as a whole, net flows were actually positive. Additionally, articles mentioning specific investors' decisions to redeem from hedge funds are not noteworthy, in our opinion. We understand that when a large investor publicly eliminates its hedge fund program the action is considered newsworthy. However, more factors than are mentioned publicly (such as political pressure) are often what drive such decisions. An investor's determination to redeem from the space is based on their individual experience with hedge funds and unique objectives, constraints, risk tolerance, and investment beliefs. Manager selection remains one of the most important considerations when constructing a hedge fund portfolio, and given the large universe and variety of hedge fund offerings, one investor's experience can (and most commonly will) differ greatly from that of another investor. The wide range of individual fund returns for 2015 illustrates this point.

**FIGURE 1**  
**RISK RETURN COMPARISON OF HFRI FUND WEIGHTED COMPOSITE**  
**CONSTITUENTS**  
 12 Months End of 2015



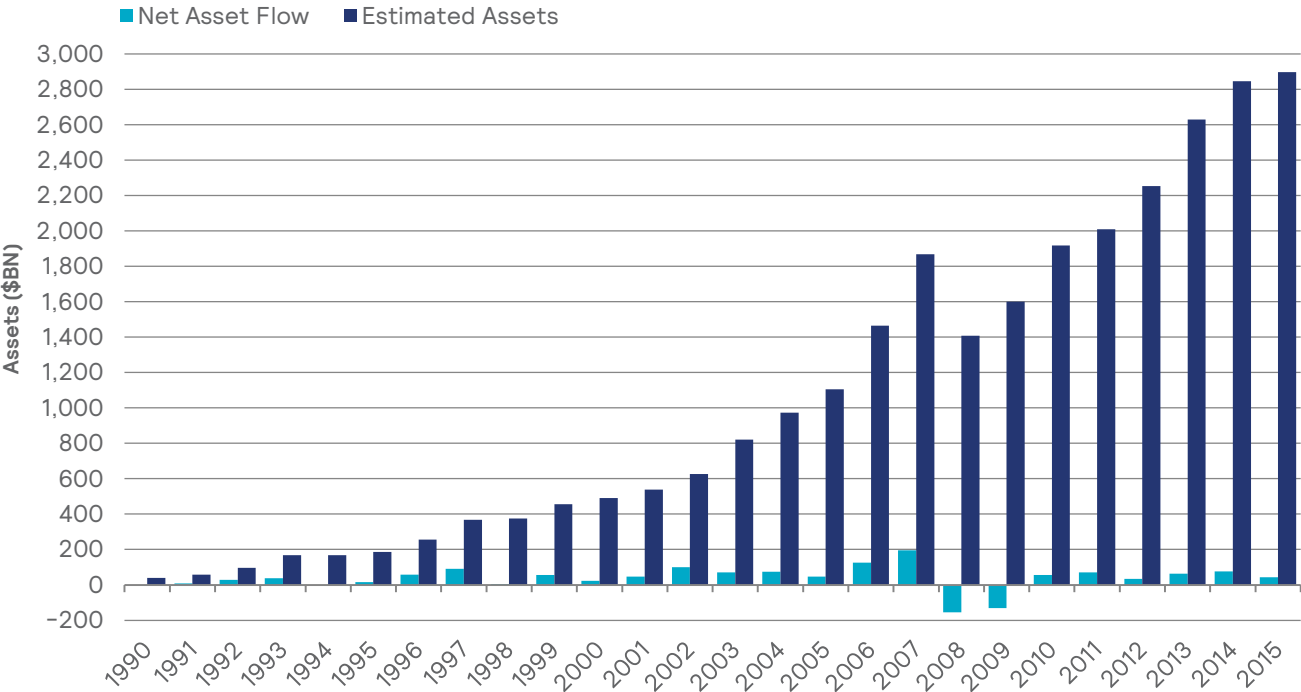
Source: HFR® Global Hedge Fund Industry Report – Year End 2015

Investor redemptions are common in the hedge fund industry, just as they are with most types of investments in general. Despite the outflows from hedge funds witnessed late last year, investors have actually been net buyers of such strategies for years now, with only three years of net redemptions in hedge funds since 1990.

Despite recent outflow flow news investors have been net buyers of hedge fund strategies for years

**FIGURE 2**  
**ESTIMATED ANNUAL GROWTH OF ASSETS / NET ASSET FLOW**

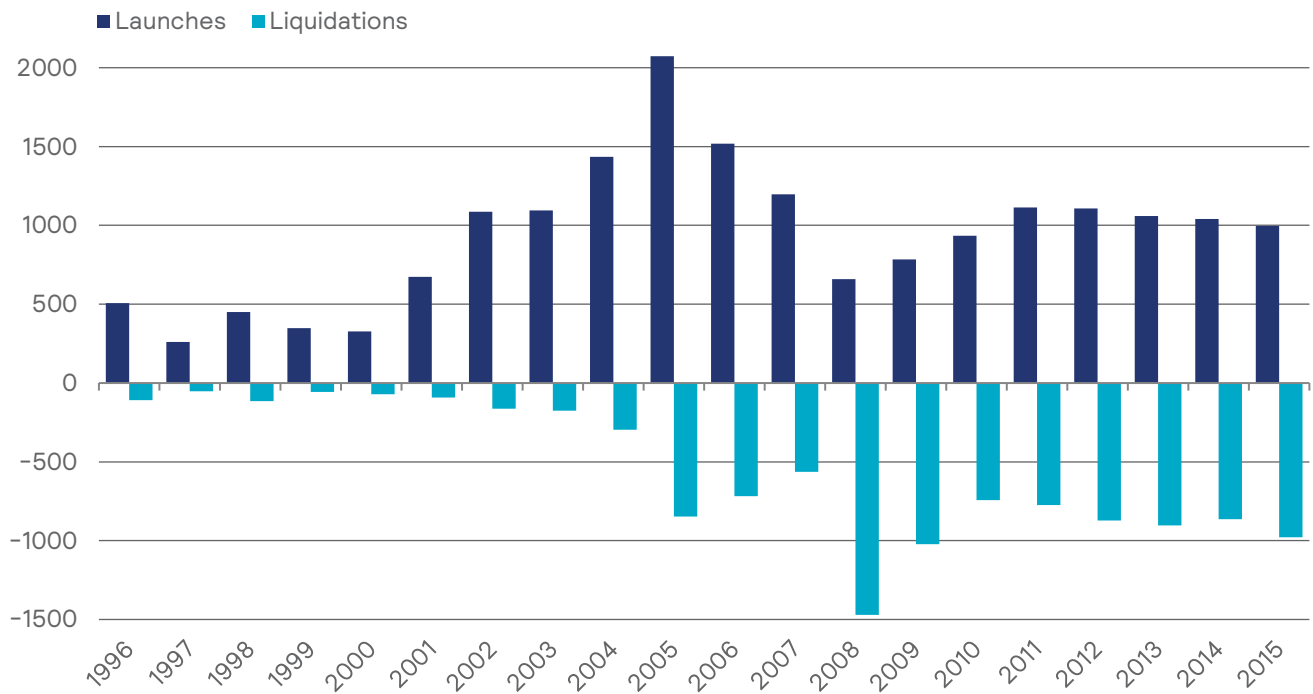
Hedge Fund Industry 1990 – 2015



Source: HFR® Global Hedge Fund Industry Report – Year End 2015

Additionally, we believe that concern about a “record” amount of hedge fund closures in 2015 requires perspective. Although more fund closures occurred in 2015 than in any year since the financial crisis, the margin of difference actually was minor. Since 2008, a year that experienced a record 1,500 funds closing, the number of fund liquidations has averaged 864 per year. With roughly 980 fund liquidations in 2015, closures were only 13% higher than average and represented less than 10% of the industry’s 10,000+ funds.

**FIGURE 3**  
**ESTIMATED NUMBER OF FUNDS LAUNCHED / LIQUIDATED**



Source: HFR® Global Hedge Fund Industry Report – Year End 2015

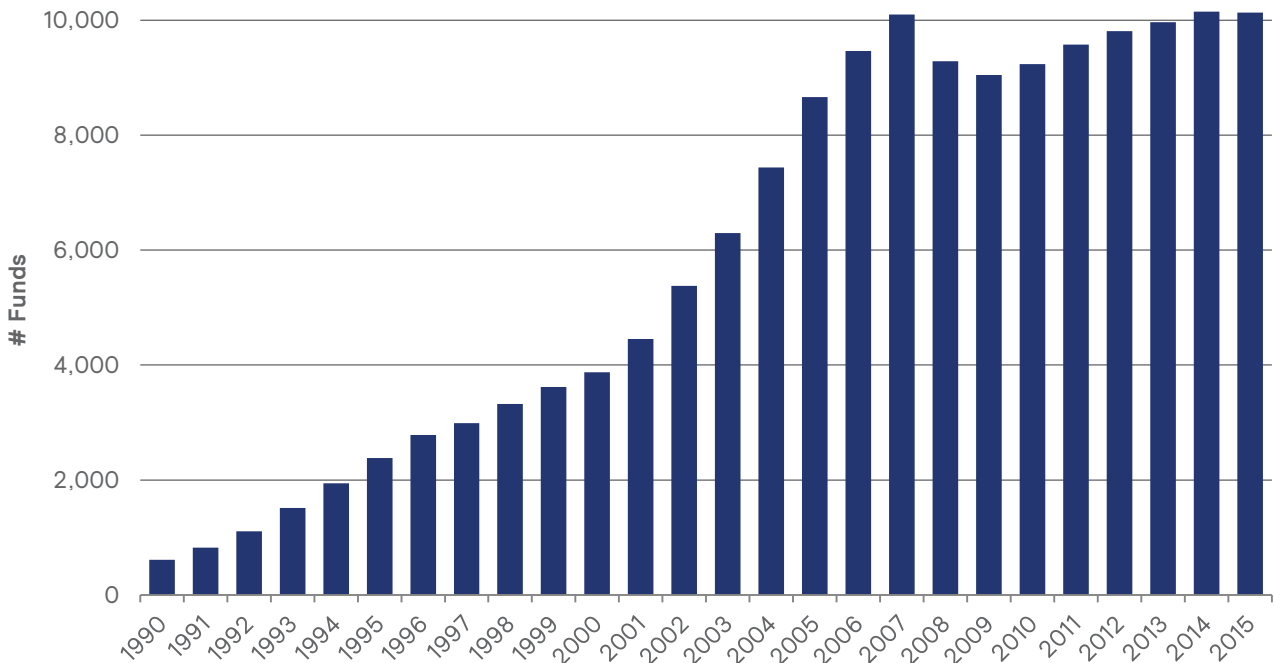
It is also important to note that these liquidations have been accompanied by a growth in the overall hedge fund industry as well as growth in a number of new launches. Given a relatively consistent rate of closures over the past decade, we are ultimately not surprised to see the number of fund liquidations rise in line with a growth in the industry and new fund launches. Additionally, as inflows into hedge funds have been concentrated in the industry’s largest firms (greater than \$1 billion), it has become harder for smaller, newer funds to reach critical mass, leading to further fund closures. Importantly, we also do not believe that mentions of investor redemptions or fund closures are directly tied to a lack of, or change in, the opportunity set available for investors. Looking back to 2008 and 2009, the two highest years for hedge fund redemptions and liquidations, there was no shortage of investment opportunity. As was the case at that time, manager selection today remains critical to investor success, and we see closures as a natural event in the cycle, as within most industries.

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We do not believe that fund redemptions and closures are directly tied to a lack of, or change in, the opportunity set available for investors

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**FIGURE 4**  
**ESTIMATED TOTAL NUMBER OF HEDGE FUNDS AND FUND OF FUNDS**  
 1990 – 2015



Source: HFR® Global Hedge Fund Industry Report – Year End 2015

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Properly constructed hedge fund portfolios deliver attractive, risk-adjusted returns while providing diversification during challenging environments for risk assets

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Despite attention-grabbing headlines proclaiming the decline of the hedge fund industry, we do not believe that much actually has changed. In our opinion, a historical perspective diminishes many of these concerns. Given the size of the hedge fund universe and the degree to which manager selection influences results, the experience of any one investor is not indicative of the opportunity (or lack thereof) within the industry as a whole. Properly constructed hedge fund portfolios have continued to deliver attractive, risk-adjusted returns while providing diversification and defensiveness during challenging environments for risk assets. Given the importance of manager selection in achieving this objective, our aim at Mercer continues to be focused on finding the best talent in the space. Looking ahead, we continue to believe that hedge funds offer a very attractive value proposition.

## IMPORTANT NOTICES

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