Five Questions

Episode Two | To Hedge or Not to Hedge

Pete: Hi. My name is Pete Mann, and I'm the President and Co-Chief Executive Officer of Grayhawk Wealth. Welcome to our second episode of our second season of Five Questions. Our podcast pairs one Grayhawk partner with another to touch upon relevant topics as they relate to the economy, investments, and generally what's happening in the world as we see it. And sometimes we'll invite special guests to join us so you can also hear their views. With me today is Greg Gipson, Grayhawk's Chief Investment Officer who's responsible for shaping our investment philosophy and portfolio strategy. Welcome, Greg.

Greg: Thank you, Pete. Great to be back for Episode Two of Season Two.

Pete: So, Greg, why don't we dig right in our topic today is hedge funds. This is this term that people hear all the time. And to most it means a lot about nothing. And so, I thought today we could really dig into what is a hedge fund. What are some of the experiences? Where have the challenges been? How have they emanated? It's an incredibly interesting topic, but it really happens at this point in time where there's a lot of volatility in the world. And this is supposed to be where hedge funds do so well. So maybe we can start at the very top of the fold and discuss what is a hedge fund and what is it that they are trying to achieve.

Greg: Absolutely. When you hear the term hedge fund, it's a very nebulous term and it encompasses in some ways, as we discussed in season one any public market strategy that incorporates the ability to short the security.

Pete: What is a short of a security? Why don't we define that right off the top?

Greg: Good question. And it's something that gets a lot of press and in some ways, I think unfair press. So, the ability to short the security is when an investor borrows stock or borrows shares of a company and then sells those securities. So, they're effectively selling something that they don't own. Now, in the media, there's a lot of stories about shorting and how shorting is bad for a market or bad for a company. But in my opinion, shorting plays an important part of price discovery. It allows an investor to bet against the company they believe or underperform another company. So, in some ways, it is simply the inverse of buying a stock.

Pete: So, you sell it first on the expectation that you are buying it at a lower price in the future, which is, as you said, the opposite of what most people do, which is buying a security on the expectation that they will sell it at a higher price in the future.

Greg: Correct. So, a typical hedge fund, like any other actively managed strategy, is, is often targeting a return in excess of some reference level. And that could be cash, or it could be a public market index like the S&P 500. But because of their ability to short stocks, the volatility of their returns tends to be much lower in broad public markets. Within hedge funds, and again, it's this all-encompassing term that covers a myriad of different strategies. But the types of strategies that we look at within hedge funds would focus on three different categories. One would be market neutral funds, so this would be like Millennium International. These are funds or strategies that are looking to generate positive returns without taking on any directional market risk. And what that means is if the market goes up or the market goes down, it has less of an impact on their returns. The second broad category is an activist or event driven strategies. So, this would be the Pershing Square's or the Third Points of the world. And in this case, they're looking to generate positive relative returns often to, again, an index like the S&P 500 by seeking to effect positive change in publicly listed companies. The third broad category, and these are often the ones that get the most press are long-short funds. So, examples of these would be like a Case Capital or Tiger Global. These are strategies that are looking to generate positive returns effectively through relative value. So, they buy stocks they believe will outperform, they short stocks that they believe will underperform. And again, not just stocks, but bonds credit across the entire spectrum of investable options.

Pete: That's great. Really helpful. And as you said, it really is this very broad base. There are so many. There are statistical hedge funds. There are as you said, it's gotten to the very minutia of detail and differentiation and segmentation. That's very helpful. Thank you very much. So why don't we talk a little bit about hedge funds and performance because in the early days, the days of Michael Steinhardt, in the late seventies and early eighties, these funds were largely much smaller and there weren't nearly as many of them. And so, the ability to outperform was far greater in that period of time. Now, the efficiency of information played a role in that. The edge of knowledge and understanding and more disclosed information about what the goings on were in a company. But they go to the very heart of why there was so much outperformance. The fee structure has also played a very big role, which I know that you'll talk a little bit about, but maybe you can talk about why the last decade has been so challenging for hedge funds.

Greg: It's an interesting question, and I think that it raises some good topics. The first you nailed flat out, which is what I think the benefit of hedge funds, is effectively information arbitrage. So, capitalizing on information that you are able to acquire, that other investors are not. What has happened certainly since the seventies, certainly over the last decade, is that information has become much more commoditized, and the disclosure of information has brought a large amount of regulatory oversight and control. So, the edge that hedge funds have had has diminished over time. And what it has done is effectively pushed more and more strategies into similar positions. So, you'll still hear words like crowding, so a lot of investors in the same position. It's also pushed many hedge funds down into smaller cap securities where there is a disjoint or an informational advantage that an investor can take. But there's also a much higher level of volatility. With this increased competition, you've also seen many stories out. In fact, there was one out last year about bad actions by hedge funds. So, the negative rent seeking of trying to acquire information through nefarious means certainly gains headlines around the world. And yes, the fee structure, I think, you know, is part of that challenge as well. But it's really a compression of the fee structure as a result of this diminished informational advantage that the hedge fund complex has traditionally had.

Pete: You know, maybe and I would just add, I think probably two other really important points. The fee structure has been so beneficial to the manager that more and more people have gone to sort of start their own hedge fund. And of course, there are a few greats in the world, but there are not thousands of them. And so, the reality is, is that, you know, you revert very quickly to the mean when the preponderance of people that are entering are not significantly better than the next person.

Greg: Absolutely. And the average hedge fund then typically underperforms and as they grow, the ability to implement that informational advantage diminishes with size. So, in effect, many hedge funds can find it challenging that they then become an acquirer of client assets as a fee revenue source as opposed to an outperformance revenue source. Right.

Pete: No question about that. We've seen that too many times to count. So, Greg, maybe the most important question I have is how it in the environment is in which we're in today where there is obviously heightened volatility and as a collective, that is typically where hedge funds have proven themselves to add more value, they lower the volatility of the clients returns stream, thus reducing the potential for losses while simultaneously being able to capture returns in both securities that are going up and securities that are going down. So, could you share a little bit with us what has really changed fundamentally to the environment in which we're in today that should enable high quality hedge funds to add value to portfolios now and into the future?

Greg: Well, Pete, I feel like you set me up to use one of my favorite quotes, which is buy into the sound of cannons sell into the sound of trumpets. For sure, though, there are certainly many opportunities that exist in the market today. And when you look at over the last decade, the last 15 years, 14 years of a strong bull market in public market equities, it can be very challenging for these types of strategies. Shorting into a rising market is a challenge, and the media does everyone a disservice in that in the hedge fund space, they will often compare hedge fund returns to an index like the S&P 500. The S&P 500 in a year when it is up 20 or 30%, you should not expect your hedge fund strategy to outperform. It is not designed to do that. What it is designed to do, as you correctly indicated, and I would agree, is provide that level of return at a reduced level of volatility. So, the ability to short, the ability to have a reduced impact on the direction of markets can function as a shock absorber during periods of market stress. And certainly, the last three months, maybe even the last four months have been an environment, certainly with increased volatility, the potential for lower returns, certainly in the short to medium term after the last three years of excess return in public markets. And also, what we're seeing is an increase in and again, we don't like using fancy words, but I'll use them and then describe them, words like increased dispersion or less correlation. So, in a market where everything is going up together, separating the wheat from the chaff can be very challenging. But in markets where you don't have that coincidence in movement or you have a greater dispersion or difference between returns presents that potential to capture alpha or excess return, both on the long side of portfolios as well as the short side of portfolios.

Pete: It really is an environment where when people get nervous like we've seen over the last couple of months in particular. For great hedge fund managers, they see it all as opportunity because the Nirvana state for them is an environment that is actually quite muted in terms of tailwind of returns, markets going up meaningfully. But as you said, there is a very, very dispersed differentiation in how returns can be captured such that they're able to add value in those pieces. And so, it is a very interesting time. And when you look at the world today, it's without a doubt the reason why we are contemplating this as an ever-growing component of our clients' portfolios. So maybe with that we can jump a little into us specifically, Grayhawk, and why don't we talk about how we construct a portfolio as it relates to hedge funds? We have typically not gone and put a large portion of any one client's capital into a specific hedge fund. We've designed a strategy around it. Maybe you can talk a little bit more about that.

Greg: Yes, I think similar to any strategy and really any stock putting all of your eggs in one basket can be quite challenging, particularly in the hedge fund space. Any one strategy could have a bad quarter or a bad year. So similar to building a diversified exposure to public market equities or public market fixed income. We believe having a similar approach to hedge funds provides a more consistent return stream. Our focus in constructing our hedge fund portfolio is on building a total return-oriented portfolio.

Pete: Why don't you define what a total return portfolio means?

Greg: Absolutely. So again, you know, I find I'm using words now that we say we don't use so think of, think in return spaces is how much money are we going to make. A total return portfolio is the absolute dollar level that you target. So, if you have $100 and your total return objective is an 8% return annualized, it means that in year one you would expect to make $8 and you would have $108. In a relative return portfolio, it's exactly like it says it is. It is relative to something else. So, this is how the typical public market equity portfolio would be managed. Think of U.S. equities, a U.S. equity manager may manage their portfolio relative to the S&P 500. The focus is not on the absolute return of the strategy. It's on the excess return of the strategy relative to its benchmark, in this case, the S&P 500. So, when we construct our portfolio what are we looking to solve for our investors? Three main pillars: access, analysis, and portfolio construction on the access side, we're looking to partner with world class managers who are typically not available to investors and bringing them into our portfolio. Here are the challenges investors face. Right. It's always access opportunity analysis. Can you find it? Can you access it? Will they let you in? Those are the challenges that investors face, whether it's hedge funds, public market equities all the time. On the analysis side, we incorporate proprietary modeling founded in data science and machine learning, with a focus on finding opportunities that have specific fundamental attributes and a sustainable level of performance, which cannot be replicated. And in portfolio construction, we're looking to pull all of these pieces together to build a diversified portfolio backed by in-depth research, backed by independent due diligence to provide investors with a more consistent, smoother level of returns in a hedge fund investment portfolio. The challenge of investing in hedge funds is similar to the challenge investing in any fund. It's finding those managers that can consistently add value, can consistently add excess return to your overall portfolio. Our goal is to separate the wheat from the chaff and bring to our portfolio world class managers who can consistently add value over time through different market cycles and different market environments. The role of hedge funds in an overall portfolio can really function as a means of charting a smoother course through choppy seas.

Pete: There is an exclusivity and accessibility component to all of this. There are not a lot of great hedge funds, and by the very nature of there not being a lot of them, it means that it's hard to get in the ones that are very good because there are so many that are average and below. And I think from our perspective, spending the time doing the fundamental work that enables us to source that, and then it's all well and good to know who the great managers are. It's quite another to be able to get access, to be able to utilize them in your portfolio for a more optimal outcome.

Greg: So, when we think about portfolio construction, think back to our first question, really having those three main pillars: market neutral, activist event, and long short. The core of our portfolio, the ballast, so to speak, or the anchor is built around market neutral strategies. It's designed that way in order to not have a degree of variability with whether markets go up or go down and is built around strategies that have shown a consistent level of return over time. So again, think of a manager like Millennium International, from inception, that strategy net of fees has annualized in excess of 13% at an annualized level of volatility of around 4%. Think of it this way for every dollar of risk you spend, you get more than $3 in return when you compare them to the S&P 500 over the same exact time frame, S&P 500 has returned about 10% with about 15% volatility. So not only has Millennium, and again market neutral strategy outperformed in return space, it has done so at a materially lower level of volatility. That is what we want to build the core of our portfolio around are strategies, like Millennium and others in the market. Now because we have that lower volatility component of the portfolio, it allows us then to allocate risk to other strategies that may have an exposure to public market equities. This would be activist or event driven strategies. So again, think of Pershing Square Bill Ackman's Fund. Again, from inception, that strategy net of fees has annualized almost 16% over the same time period, the S&P 500 has annualized around 10% at about the same level of volatility. So that ability to add consistent alpha is something that we want to add to the portfolio but do so in a very well managed approach to risk.

Pete: And if I can say it sounds like you're also aggregating the piece that is Millennium, for example, and the piece that is Pershing Square and adjusting the total volatility of the portfolio and return, but also changing, you're kind of pivoting the curve around the input that is risk. Is that a fair assessment?

Greg: Absolutely. So, combining all of these pieces, including the ones I will speak to on long short, you can actually construct a portfolio that has the risk profile of market neutral. But the return profile that is closer to public market equities. So, it is capturing for every dollar of risk you invest, it's capturing a relatively higher degree of return. And the third piece I would mention is in long short. So again, long-short equities, you know, simply buying stuff that goes up, selling stuff that you hope goes down or at least does not perform as well. And in that space, we are investing in very targeted exposures. One of our current positions is with Caius Capital. It is a London based fund focused in long, short distressed. As you can imagine, this type of market environment is truly an opportune time for them. Similarly, their return from inception is upwards of 14% annualized net of fees. The S&P 500 over that time frame is upwards of 16%. So yes, the news media will tell you in this particular case it underperformed the S&P 500. It is important to remember is Caius has done so at two thirds of the volatility of the broad market. When you take all of these different pieces and put them together into an overall portfolio, you end up getting diversification. But more importantly you end up getting the potential for long term returns similar to or in excess of public markets. But a materially lower level of volatility. So that downside protection or the lower exposure of markets when they go down, allows you then to compound at a higher rate in the future.

Pete: Maybe another important aspect to all of this is that it being a component of the portfolio, it also affords you the ability to assume risk or volatility in other parts of the portfolio that you might not otherwise be able to do without this as a component. Is that a fair question?

Greg: Absolutely. So, when you think of the top of the house of a portfolio, so if you are investing across public market equities, fixed income, and hedge funds. This component can actually provide the return, but more importantly, the risk protection or the ballast of your portfolio against your public market exposure.

Pete: And then in this current environment, it's easy and clear to see why this is an ever-growing component of a client portfolio at Grayhawk.

Greg: Absolutely, yes. So, in this environment, rising interest rates, increased inflation, increased volatility, of markets, having a piece of the portfolio that can be that balanced is important. And traditionally, that protection has been in the form of public market fixed income, but given, again, rising interest rates, elevated inflation, public market fixed income has been challenged, and we would expect to continue to be challenged in certainly in the short to medium term.

Pete: Greg, for our final question of the day, I wanted to ask you something a little bit more personal as we try to deal with this question. And clearly, we are in a period of incredible volatility and uncertainty in the world. We have just finished a pandemic. We now have this crisis going on in the Ukraine. How is it that you are able to remain this level of steadiness and calm in terms of the decision-making process around a portfolio? Because it is very easy to get fraught with nervousness and uncertainty. What are some of the things that have enabled you to be able to remain calm? And how do you really think about this through such an optimistic lens?

Greg: I started my career in the mid to late nineties, and so I was introduced very quickly to the dot com bubble in the late nineties. I spent ten years in Japan where markets only went one way.

Pete: In which way was that the way you go?

Greg: The way you don't want. And so, and now for the last 12 years I have been here in Canada, which has been arguably one of the strongest periods of market performance in in history. And I think what is important to remember is similar to charting a course at sea, you know where you are, you know where you want to get to. You know that at some point in time you are going to hit a rough patch or choppy seas. But having an investment portfolio that provide to you the ability to get from where you are to where you want to be provided protection during these periods of stress or frothy markets or frothy sea, being able to tactically adjust your sales to capture those tailwinds during periods of stress allows one to have a much more discipline and consistent investment experience. Emotion can be one of the biggest challenges to long-term investing and think of it similar to your life. As you grow up, as a child you are very optimistic, the world is your oyster, you meet people, people come into your life, come out of your life. You want to learn from all of those experiences. There will be highs and lows but at the end of the journey, you want to be able to look back and say, I have done what I set out to do. And it is not always the path you think you'll follow that you end up on. And similar in investments, you know with certainty, you will follow a course that will have ups and downs how you react and how you manage through periods of stress ultimately determines where you end up at the end of the game.

Pete: I think one of the things that both you and I have learned through the decades in this business is that there has to be an underlying basis of optimism. Effectively, what you are doing when you purchase a security or a business is you are present valuing the next 50 years of its cash flows and if you believe that they are going to be declining in the future, why on earth would you ever deploy that capital? And so, I think one of the things that's most important is the rationality that comes from understanding how a business builds and grows over time and the benefits that accrue to the shareholder. Those are not things that people contemplate in the midst of panic and crisis. What they worry about is what they have will go to zero. And invariably, things very rarely go to zero. In fact, the world has not yet ended, nor do we expect it to anytime soon. I think there's a really, really important element to being able to sort of keep your wits about you when the rest of the world is losing theirs. Well, that's it for our second episode of season two of five questions. I'm Pete Mann, President and Co-Chief Executive Officer of Grayhawk. On behalf of my partner, Greg Gipson, our Chief Investment Officer, we want to thank you very much for listening. We'll be back in two weeks with our third episode This podcast is for informational purposes only. It is not meant to be relied upon for investment or tax advice. It is the opinions of those on the podcast and does not necessarily reflect the opinions of Grayhawk Wealth. If you'd like to offer any feedback or pose a question for inclusion on the podcast, please reach out to our chief experience officer, Allison Comeau at acomeau@grayhawkwealth.com. We look forward to talking to you in a couple of weeks.