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CALLAN INSTITUTE

Hedge Fund Monitor

IN THIS ISSUE

Fourth Quarter 2016

Alternative Facts and the Evolving Role of Hedge Funds

FIDUCIARY PERSPECTIVES

"Prejudice is a great time saver. You can form opinions without having to get the facts."
— E. B. White

Populist Revolt Against Active Management

Last year was a tough one for active management. But so was seemingly every year since anyone can remember. Putting a positive spin on the reality of underperformance year after year has strained the credibility of most active managers.

To magnify this challenge, there is the sobering view of anemic returns expected for stocks and bonds ad infinitum. The extra layer of today's active management fees takes a more noticeable slice of an investor's increasingly precious growth in savings. Representing the pure essence of active management, hedge funds are suffering particularly intense image problems.

Consequently, it is not surprising to see a wave of money flooding into passive, less expensive strategies for stocks and bonds.

As a lightly regulated manager faced with few investment constraints, blessed with patient capital, and motivated by incentive fees, hedge funds have a distinct advantage over traditional

Comparing Hedge Fund Returns

	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 20 Years
Callan Hedge Fund-of-Funds Database*	1.19	1.43	4.91	3.31	6.86
Credit Suisse Hedge Fund Index	1.25	1.54	4.34	3.75	7.06
S&P 500	11.96	8.87	14.66	6.95	7.68
60% S&P / 40% Bloomberg Barclays Aggregate	8.21	6.58	9.68	6.31	7.15
Bloomberg Barclays Aggregate	2.65	3.03	2.23	4.34	5.29

Source: Bloomberg Barclays, Callan, Credit Suisse Hedge Fund Index LLC, Standard & Poor's. Returns for periods ended December 31, 2016

* Returns are net of fees

investments such as mutual funds. However, the confluence of today's increasingly informed markets and massive central bank-controlled capital flows has limited the opportunities for hedge fund profits. Recent history has been particularly cruel to the average hedge fund's track record, leading even the most well-informed advocates to rethink the role of these investment options.

This *Fiduciary Perspectives* will review how the investment opportunity set for hedge funds has changed, for better or worse; consider how these funds can fit into today's well-diversified portfolio; and outline the implications for hedge fund investors. If a hedge fund's strategy has become more of a commodity that is systematically available from less expensive alternatives, investors will seek those liquid alternatives. But alpha (excess returns adjusted for market risks) in today's public markets remains less scalable and less liquid. For strategies focused on idiosyncratic risks less likely to be commoditized, investors must be prepared to pay a lot for that alpha and commit their capital for a longer-term investment horizon.

"Sometimes paranoia's just having all the facts."
— William S. Burroughs

Deconstructing Crowds of Risk Premia

The great unwashed sea of risk premia for investors is huge. Investment opportunities span the four primary elements of risk: equity, fixed income (or rates), commodities, and currencies.

When Risk Is Your Business

Risk premia refer to factors with a positive expected return associated with them. Hedge funds typically target two types of risk premia. One, non-market systematic risks, also known as alternative risks, are those factors with positive expected returns isolated from market risk premia using long-short exposures to any of the following: value, quality, carry, momentum, volatility, or event risks (e.g., mergers, bankruptcies, reorganizations).

The other, idiosyncratic risks, are those with expected returns not related to market risk and non-market systematic risk premia. These premia (e.g., security-specific, issuer-specific) cannot be directly isolated because they cannot be hedged, so they tend to be forms of illiquidity risk.

Almost all investment choices have some combination of these basic market factors driving their expected returns.

But as technology and access to market data improved over the last few decades, information about the four primary buckets of market risk became increasingly transparent. And with tangible improvements in trading efficiencies, such as bid-ask quotes reduced to decimal points, regulatory restrictions on disseminating material non-public information, and competitive fees for trade commissions, the ability to discover better pricing on desired risks has become essentially free and instantaneous for virtually all market participants.

While end investors benefited from this evolution of markets, hedge funds found fewer opportunities to produce value-added performance to rationalize their fees over less costly alternatives, such as passive index strategies. To beat these alternatives, hedge funds need to find trading anomalies, or non-market risks, that are less understood. For example, event-driven managers identify excess returns embedded in the shares of companies being acquired by other firms, stocks of firms being reorganized or targeted by corporate activists, or bonds in a bankruptcy setting. Similarly, managers pursuing equity market-neutral strategies extract excess returns from strategies of long and short positions where risk premia, such as value, quality, and momentum, are underpriced and can be isolated with short-selling or other hedging tools. Other types of secondary risk premia insulated from market risks can be even more complex, such as those related to underpriced options embedded in convertibles and mortgages.

In addition to these non-market but systematic risks, hedge funds can embrace security-specific or issuer-specific risks that are not easily hedged and often have associated illiquidity risks. Pressed by competition to emphasize these idiosyncratic risks, hedge funds are adjusting their focus to operate more outside of market and strategy risks dominated by lower-cost, less actively managed solutions.

"There are no facts, only interpretations."
— Friedrich Nietzsche

Promise of Alpha, Fake or Real

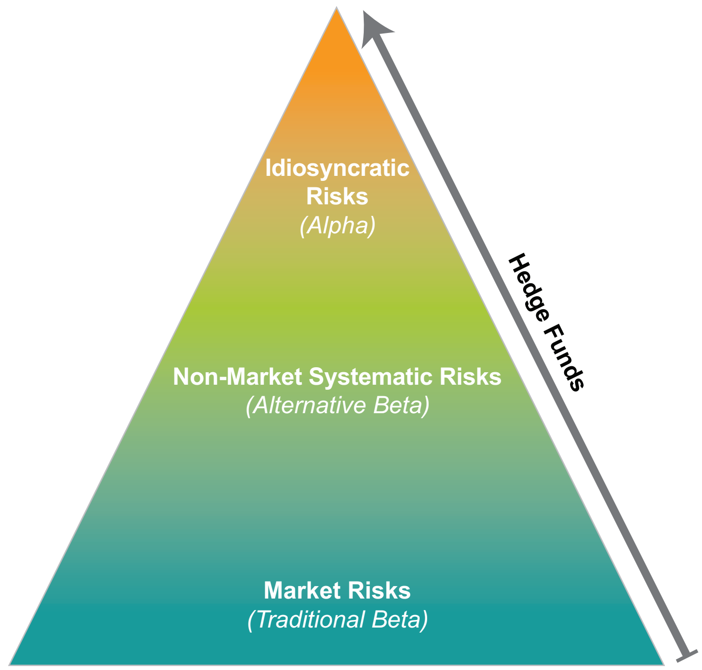
Over the last decade, what was previously considered to be "alpha" has been divided, with non-market systematic risks separated from idiosyncratic risks. The non-market systematic risk premia are accessible by the broad investor community, not just hedge funds. Although trades to isolate these secondary risk factors are often complex, their rules-based approach lends itself to scalable liquid solutions that can be priced at costs much lower than a typical hedge fund's 2% management fee with 20% incentives over net profits. These liquid alternatives do not need to generate better gross returns. As the hedge fund community often cites in defense of its high fee structures, net returns are all that matter to the end investor.

Where possible, leverage is applied to improve risk-adjusted returns on these secondary risk factors that are usually less volatile than primary market risks like equity. Consequently, the bid-ask spreads on these secondary risk factors have tightened, leaving less "alpha" for everyone—including hedge funds. While the rationale supporting these risk premia is expected to be positive over full cycles, they have cyclical risks, just like market risks. As money pours into these liquid alternatives, competition will sharpen. Only managers with quicker and more efficient trading systems will be able to generate above-average excess returns in these more commoditized strategies. Low barriers to entry will ensure that outcome.

Meanwhile, competition among hedge funds for less liquid, more idiosyncratic risks will likely increase. Less-attractive returns for both traditional and alternative betas will push hedge funds into these more obscure opportunities to find better returns. This illustration depicts the evolving scope of hedge funds searching for increasingly rare alpha in today's relatively stable universe of investment opportunities.

"Everyone is entitled to his own opinion, but not his own facts."
— Daniel Patrick Moynihan

In Search of "Alpha"



Trades to isolate non-market systematic risk premia, such as long-short exposures to value or momentum, are complex but their rules-based approach makes it possible for liquid alternative solutions to offer them at lower fees than hedge funds.

As a result, hedge funds have been pushed to pursue more obscure idiosyncratic risks, such as security-specific risk premia, in their search for better returns and less obvious alpha.

Nothing but Net

Another issue weighs heavily on hedge funds trying to meet investor expectations. Since the Global Financial Crisis, returns on cash have been close to zero and are likely to remain there, notwithstanding a central bank or two threatening to raise them. Encouraged by these repressed rates of borrowing, virtually all stock and bond markets have fully recovered from the last crisis, leaving expected returns from market risks at low single-digit levels. Secondary risk premia have been similarly bid up for the same reasons.

These modest return expectations have sharpened investors' focus on fees. Paying "2 and 20" to a hedge fund manager is much less appealing when much of the underlying return, at least that of systematic risks, can be realized with a much lower fee structure. As net returns in recent years have fallen below the fees and expenses taken by hedge funds, today's populist revolt is not surprising.

While most investors recognize they need to minimize fees on identifiable beta, whether market or systematic non-market, the informed ones are prepared to pay higher fees on real alpha, not fake alpha disguised in opaque risk reports. Coupled with the explosion of liquid alternative solutions, the tepid return outlook for all types of systematic risks is forcing hedge funds to compete with lower fee structures or shift their focus into the outer edges of idiosyncratic risks.

To supplement limited returns from cash and market risks, the future return potential for hedge funds from idiosyncratic risks depends on an opportunity set driven by market volatility and dispersion between markets. In recent years, central banks around the globe have routinely injected liquidity into the markets to keep them stable, thereby repressing volatility and limiting dispersion. However, that trend of coordinated efforts among global policymakers may be overwhelmed by the forces behind Brexit, the election of Donald Trump, and other breaks from globalization. This prospect will likely benefit hedge funds that actively buy and sell positions moving around their price targets. While that potential may be encouraging to alpha hunters, today it is only talk.

Now for a Dose of Reality

Given today's modest but uncertain outlook for hedge funds, what roles does Callan see for them and their competing alternatives? In a nod to the Oscars, we will nominate hedge funds for two main roles:

Lead Role in Diversifying Strategies: More than ever, hedge funds are needed for an important role in absolute return-oriented mandates. Strategies less correlated with equities and fixed income that also have positive expected returns help to provide better compounded returns for the total plan. However, that diversifying role now is shared with lower-cost liquid alternatives that are harvesting the previously low-hanging fruit of systematic risks isolated from market risks. In such absolute return mandates, hedge funds with a focus on more idiosyncratic risks can then realize an illiquidity premia that is unique and uncorrelated with broader market risks.

To complement the hedge funds' role of pursuing these more illiquid opportunities, the alternative strategies can be the preferred source of liquidity for the investor's external cashflow or rebalancing needs. When investors want to change their diversifying strategies' allocation, they will need to assess the relative attractiveness of hedge funds compared to the alternatives to find the desirable balance of liquidity, cost, and manager-specific risks.

Further diversification within absolute return strategies can be created with a combination of divergent risk premia, like momentum-based strategies that do well when markets move strongly in stressful conditions, and convergent risk premia that perform better in normal markets priced on fundamentals. The mix of these two kinds of premia can depend on the investor's risk tolerance in the broader portfolio. A greater tolerance for growth risk, or equities, elsewhere can imply a greater need for divergent risk premia to act as a hedge in dislocating markets while still potentially generating positive returns across full market cycles. In contrast, an investor with a more conservative, fixed income-oriented profile can afford a greater allocation to convergent strategies capturing risk premia spreads that accrue in stable or growing markets.

Based on Callan's recent evidence, the realized net returns from hedge funds and liquid alternatives pursuing absolute return mandates have been similar. The lower-cost advantage of liquid alternatives appears to have offset the benefits of the illiquidity premia of idiosyncratic risk. However, the ebbs and flows of capital chasing these different opportunities will likely lead to different performance cycles, meaning both tools can be subject to withdrawal pains. Those cycles will also be strongly influenced by other factors, including the ability to finance leverage in alternative risk premia strategies and the stability of hedge fund capital needed to hold illiquid positions.

"When you have the facts on your side, argue the facts. When you have the law on your side, argue the law. When you have neither, holler."
— Al Gore

Supporting Roles in Traditional Asset Classes: Beyond the role of diversifying strategies that can still perform positively in declining equity or fixed income markets, hedge funds with a typically long bias, however variable with market hedges, are competing for shelf space with traditional active managers. Although hedge funds are likely better motivated and resourced to identify fundamental mispricings among securities, these security-level inefficiencies have become increasingly hard to find, as noted earlier. Regulation FD[1] and instantaneous dissemination of corporate news, among other market enhancements, help to reduce the once powerful alpha-generating abilities of long-short equity managers. Improved compliance in securities markets restricting access to material non-public information has also squeezed what may have been past sources of "alpha" for aggressive traders. As an equity substitute, hedge funds are also less able to justify a long lock-up, so that illiquidity premium is more difficult to pursue in these mandates.

Investors are closely monitoring performance for distinctions of market beta, "hedge fund" beta, and more highly prized alpha. With low return expectations in both equity and fixed income markets, investors are sharply focused on fees and how much of a manager's return is related to beta that is available at virtually no cost. Until hedge funds discount any cheap beta being collected in their incentive fees, they risk becoming marginalized. A manager with strong stock selection skills along with a strong market bias can still win mandates if its net profits are adjusted to account for beta bets taken. Such a discerning fee schedule is not yet common, but client demand for it will increase in this current market environment of lower return expectations and increased investor awareness.

"It is difficult to get a man to understand something when his salary depends upon his not understanding it."
— Upton Sinclair

Choose Your Alternative Reality

With today's competitive market environment coupled with increasing investor demands from active management, the implications for hedge funds are apparent, as they are for any active manager. If your deliverable has become more of a commodity that is systematically available from other less expensive alternatives, reprice your service offering to better match the value proposition. Otherwise, refocus on the idiosyncratic risks that you can identify and then, if appropriate, restructure the fund's terms to match that new strategy's liquidity profile. Darwinian Theory in action will be the final arbiter of that choice.

1 www.sec.gov/answers/regfd.htm

Make Alpha Great Again

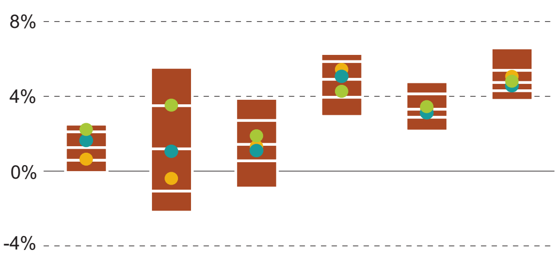
FOURTH QUARTER PERFORMANCE OVERVIEW

In the wake of Donald Trump's election, the reflation trade exploded, as U.S. stocks jumped and Treasuries were dumped. The dollar also strengthened dramatically. The market quickly recognized that U.S. fiscal policy under Trump was more likely to play a bigger role in security pricing than monetary policy. The prospect of earnings growth from more government spending, lower tax rates, and less regulation excited stock investors. The **S&P 500** rallied 3.82% while the **Russell 2000 Index** surged 8.83%. Meanwhile, signs of emerging global inflation weakened the relevance of central banks and their deflation fears. The threat of greater debt issuance punished bond investors, with the **Citi 10-Year Treasury Index** collapsing 6.82%, its biggest quarterly loss since 1980. The dollar also strengthened, lifting the economic prospects of Europe and Japan with cheapened currencies. The spot price for gold fell 12.56%.

During this rapid market paradigm shift, the average hedge fund appeared to gain little over embedded betas, as most conservatively positioned their gross and net exposures going into the election. However, looking ahead, the hedge fund community will likely see this combination of more aggressive fiscal policy and less intrusive monetary policy as a better environment for assets trading on their own merits.

This fundamental shift can lead to more dispersion across assets, as the market sorts out the new winners and losers. Last quarter the correlations among stocks in the S&P 500 fell to cyclical lows. With more conviction in this market dynamic, hedge funds finished the quarter with higher gross and net exposures. Market volatility also spiked last quarter after the election, but it quickly settled back to secular lows, reducing the alpha potential for hedge funds capitalizing on market uncertainties.

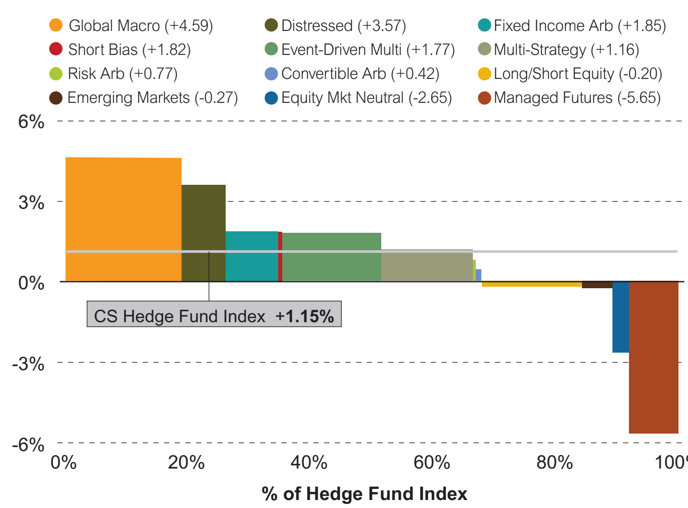
Callan Hedge Fund-of-Funds Database Returns
(periods ended December 31, 2016)



	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
10th Percentile	2.51	5.55	3.89	6.29	4.78	6.59
25th Percentile	2.10	3.50	2.71	5.86	4.13	5.39
Median	1.26	1.19	1.43	4.91	3.31	4.74
75th Percentile	0.58	-1.07	0.55	3.95	2.88	4.30
90th Percentile	-0.07	-2.19	-0.90	2.93	2.15	3.79
Style Group Medians						
Absolute Return	2.23	3.53	1.89	4.27	3.45	4.81
Core Div	1.64	1.06	1.10	5.07	3.12	4.57
Long-Short Eq	0.64	-0.39	1.32	5.44	3.36	5.07
CS HFI	1.15	1.25	1.54	4.34	3.75	5.74
T-Bills + 5%	1.31	5.33	5.14	5.12	5.80	6.34
S&P 500	3.82	11.96	8.87	14.66	6.95	6.69
Bloomberg Barclays Agg	-2.98	2.65	3.03	2.23	4.34	4.58

Source: Bloomberg Barclays, Callan, Credit Suisse Hedge Fund Index LLC, Federal Reserve, Standard & Poor's. Returns are net of fees.

Credit Suisse Hedge Fund Strategy Quarterly Returns
(as of December 31, 2016)

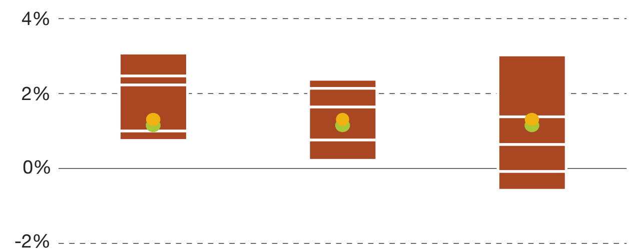


Source: Credit Suisse Hedge Fund Index LLC, based on index weights as of November 30, 2016

Representing the average hedge fund's performance without implementation costs, the **Credit Suisse Hedge Fund Index (CS HFI)** rose 1.15% in the fourth quarter. As a proxy for live hedge fund portfolios, the median manager in the **Callan Hedge Fund-of-Funds Database** advanced 1.26%, net of all fees. For the full year, the average fund-of-funds gained 1.19%, trailing the 8.21% return of a 60/40 benchmark of the S&P 500 and the **Bloomberg Barclays U.S. Aggregate Index**.

Within CS HFI, the best-performing strategy last quarter was *Global Macro* (+4.59%), aided by a stronger dollar against the yen (-13.18%) and euro (-6.14%). *Distressed* gained 3.57% as credit spreads tightened further to the cyclical lows last seen before oil prices collapsed in 2015, suggesting less upside generally for this strategy. M&A activity remained strong with tighter deal spreads, helping *Event-Driven Multi-Strategy* (+1.77%) and *Risk Arb* (+0.77%).

Callan Hedge Fund-of-Funds Style Groups
Quarterly Returns (as of December 31, 2016)



	Callan Absolute Return FOFs	Callan Core Diversified FOFs	Callan Long/ Short Equity FOFs
10th Percentile	3.08	2.38	3.03
25th Percentile	2.47	2.14	1.38
Median	2.23	1.64	0.64
75th Percentile	1.00	0.76	-0.08
90th Percentile	0.75	0.22	-0.58
T-Bill + 5% ●	1.31	1.31	1.31
CS HFI ●	1.15	1.15	1.15

Source: Callan, Credit Suisse Hedge Fund Index LLC, Federal Reserve. Returns are net of fees.

The sharp reversals across currencies, rates, and equities following the election upset the trend-following mantra of *Managed Futures* (-5.65%). *Long/Short Equity* (-0.20%) was also caught flat-footed by the equity rebound, but weak non-U.S. equity markets did not help equity bets abroad. Cyclical stocks outpaced defensive names since new life was breathed into the economic cycle's outlook. Consequently hedge funds focused on higher-quality, steadier growth stocks like consumer staples and technology trailed the broader market.

Underlying fund size mattered less in hedge fund portfolios than it did earlier in 2016. During the fourth quarter, the **HFRI Asset-Weighted Composite Index** gained 2.24% while the **HFRI Fund-Weighted Composite Index** rose 1.31%.

Within Callan's Hedge Fund-of-Funds Database, market exposures marginally affected performance in the fourth quarter. Aided by tightening credits and supportive fundamentals, the median *Callan Absolute Return FOF* (+2.23%) outpaced the *Callan Long/Short Equity FOF* (+0.64%). With diversifying exposures to both non-directional and directional styles, the *Callan Core Diversified FOF* gained 1.64%.

Do you know about Callan's hedge fund advisory services?

- **Education**—Determining if hedge funds are appropriate for a client's overall strategy
- **Investment policy**—Documenting hedge fund goals and guidelines
- **Asset allocation**—Defining the appropriate strategic mix
- **Manager structure**—Assessing a manager's fit within a portfolio
- **Manager search**—Following a defined process for identifying qualified managers of diversified hedge fund solutions
- **Performance evaluation**—Measuring how well a hedge fund portfolio is adding value relative to its peers

For more information, please contact your Callan consultant or Jim McKee at 415.974.5060 or mckee@callan.com.

Hedge Fund Monitor is a quarterly newsletter that gives our clients a current view of industry trends affecting this popular alternative investment. It also provides detailed quarterly performance commentary.

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About Callan

Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are backed by proprietary research, exclusive data, and ongoing education. Today, Callan advises on more than $2 trillion in total fund sponsor assets, which makes it among the largest independently owned investment consulting firms in the U.S. Callan uses a client-focused consulting model to serve pension and defined contribution plan sponsors, endowments, foundations, independent investment advisors, investment managers, and other asset owners. Callan has five offices throughout the U.S. For more information, please visit www.callan.com.

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The Callan Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

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