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The Death of Equity Hedge

Can long/short survive in the modern era?

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8/22/2012

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The past four years have been difficult ones for the hedge fund industry. A quick Google search of "Hedge Fund Underperformance" yields 8,370 hits; all with a common theme. Since the nadir of the financial crisis, hedge funds as an asset class in general, and equity hedge (long/short) have underperformed the stock market (as measured by the S&P 500). This paper intends to answer two questions in that regard: 1) What are the underlying causes of this underperformance, and 2) Is this underperformance a temporary phenomenon or has the asset class permanently lost its luster.

For the sake of this paper, since equity hedge has been a staple for our firm since the mid-1990's, equity hedge will be used for the analytics.

Underlying Causes

- Central Bank Intervention
- Increasing Correlation
- High Frequency and Algorithmic Trading
- Management and Performance Fees

Central Bank Intervention

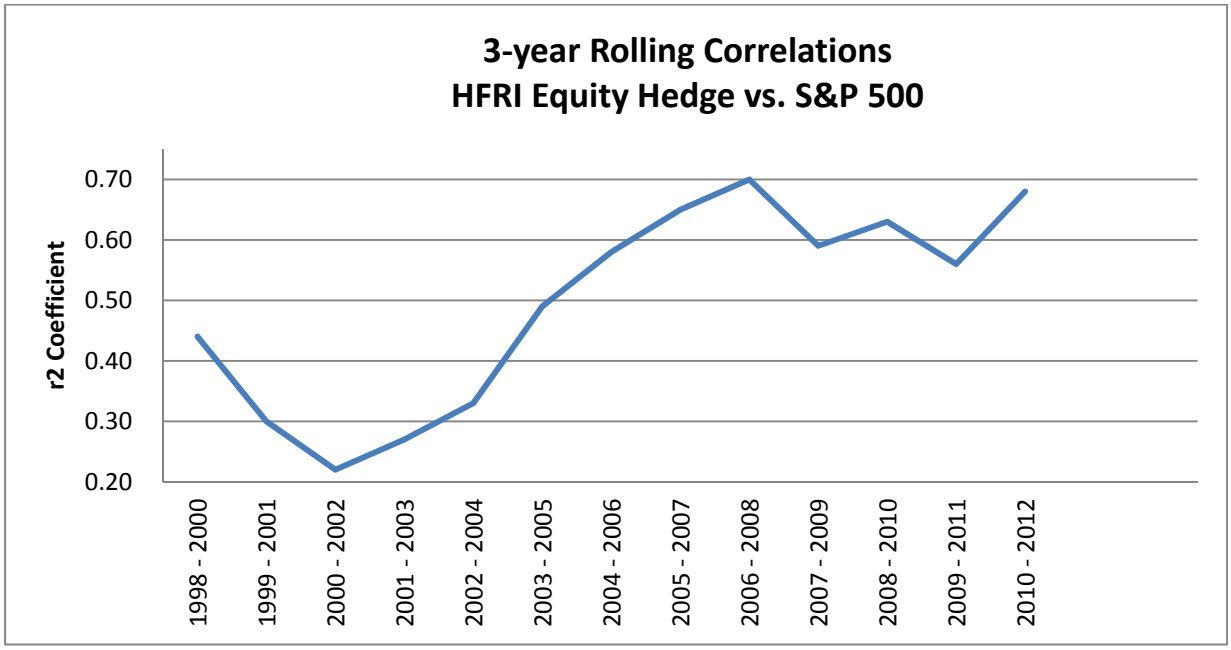
The impact of central bank intervention on equity hedge funds can be seen both in broad policy initiatives and targeted, micro effect. In the broad policy category, central banks pegging short-term interest rates at zero (ZIRP) created an artificial interest in risk assets. Whether seeking yield or being forced into riskier assets to meet financial obligations, ZIRP has blurred the differentiation in valuation between high quality equities and those of lower quality. At its core, equity hedge is about holding high quality stocks long, while selling low quality stocks short. The monolithic movements across all stocks inherently mean that, at any point in time, the equity hedge manager is either losing money in his longs or his shorts. In other words, generating "double alpha" is nearly impossible in the ZIRP market environment.

On the micro side, singular events have been punishing equity hedge managers more frequently and more severely than in the past. For instance, August 2012 saw the largest unwinding of shorted European stocks in over three years. The catalyst was the European Central Bank's President Mario Draghi's announcement that he would do "whatever it takes" to defend the Euro. This reversal was so severe, that the Euro Stoxx 50 Index rose 12% in a mere three weeks – forcing both macro and equity hedge managers to capitulate on their shorts.

Other micro events that can be cited include Bernanke's 2010 Jackson Hole announcements, QE1 and QE2, Operation Twist, and extension of ZIRP into 2014. None of these events materially altered the fundamentals of publically traded corporations, but they did manage to distort price discovery and create a perilous environment for equity hedge.

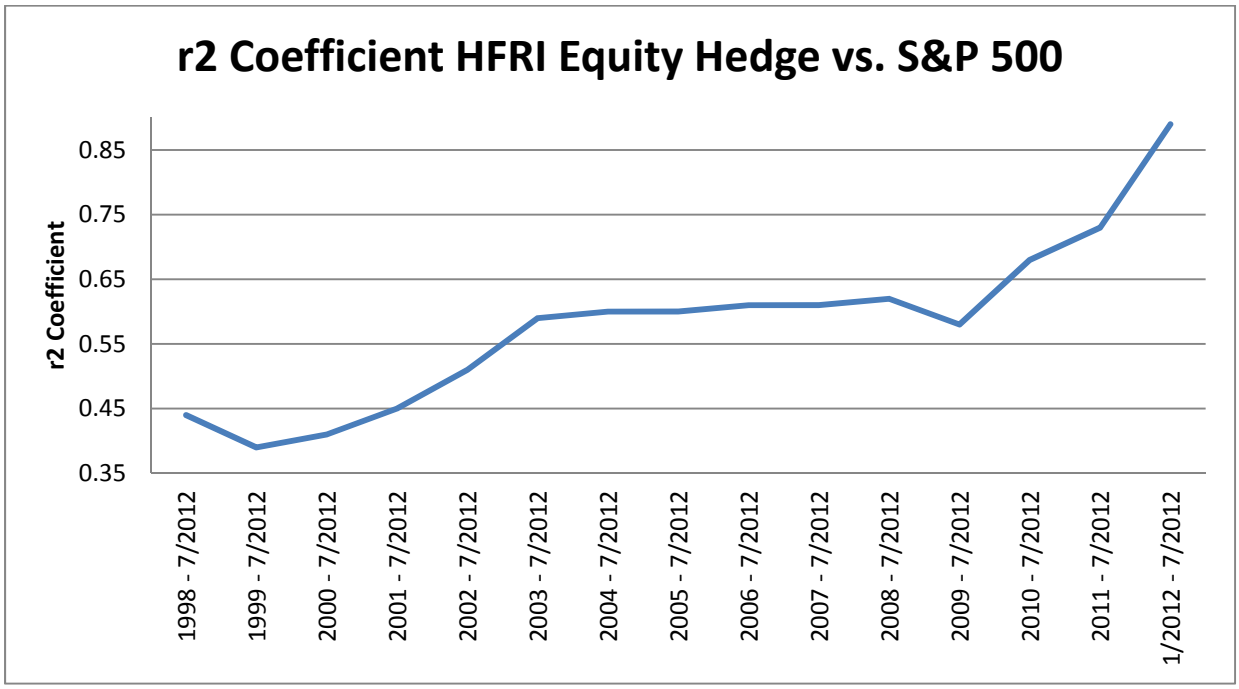
Increasing Correlations

In addition to the previously-mentioned increasing correlations among equities, there has been an increase in correlations between the equity hedge universe and the S&P 500. The chart that follows shows rolling 3-year correlations between the HRFI Equity Hedge Index and the S&P 500. The indexes inception date is 1/1998.



As you can see, the correlations in the years leading up to the end of the Internet Bubble were quite low. Then, as the stock market recovered into the housing bubble, correlations steadily increased peaking at 0.70. As the financial crisis unfolded, correlation began loosening (albeit only slightly), only to increase steeply in recent years.

While the rolling three-year chart is somewhat revealing, its smoothing effect masks more vivid underlying trends. The next chart may be more enlightening. This chart should be read as follows: The first data point is the correlation between the HFRI Equity Hedge Index and the S&P 500 from the inception of the index through July 2012. Each subsequent data point moves the inception date forward by one year. In other words, the first data point analyses correlation from 1998 through 2012, the second data point covers 1999 through 2012 and so on. Views through this lens, the increase in correlation is even more dramatic – culminating with a 1-year correlation just under 0.90.



Such high correlation begs the question: "What is the opportunity to generate alpha in an environment where the equity hedge manager is 90% correlated to a passive index?"

High Frequency and Algorithmic Trading

In one recent week, 60.8% of the NYSE's average daily volume of 1.9 billion shares was algorithmic. That amounts to nearly 1.2 billion shares daily. Across all exchanges, the estimated volume percentages generated by algorithms is closer to 80%. Why do these programs present a threat to the equity hedge manager?

- Algorithms rarely focus on fundamentals. Rather, they trade on technicals or the ability to legally "front run" large trades. Bottom-up equity hedge managers are severely disadvantaged in such an environment.
- "Quote stuffing" by high frequency traders (HFT) creates an illusion of liquidity that can disappear quickly, as was seen in the May 2010 Flash Crash.
- "Sniffer" programs sniff out large buy or sell orders by pinging the market with small orders to buy or sell. If a number of these small orders are filled, the sniffer has identified a large order and capitalizes upon it using HFT. Sniffing is less of a concern for small funds, but is of significant concern for their larger brethren.

Management Fees and Performance Allocations

Recently, Financial Times did an analysis of hedge fund fees and over the last 12 years. Over that entire period, 38% of hedge fund aggregate returns were paid out as management and performance fees. Over the most recent 5 years, that percentage has increased to 47% (largely owing to the substandard gross returns of the funds). Over those 5 years, hedge fund investors made a total of $414 billion while hedge fund managers earned $363 billion.

While net returns should be the investor's primary concern, in lean times the high percentage of performance being allocated to management fees becomes front and center.

How big is the problem?

Year to date (from Barclay Hedge), only 11% of hedge funds are besting the S&P 500.

But drawing any conclusions from such a short time frame would be difficult. In the table that follows, five distinct time frames are reviewed. In this simple analysis, each time frame was measured in both cumulative returns and maximum drawdowns. If equity hedge has enduring value, it should be noticeable through this simple analysis.

	Cumulative Return		Max Drawdown		Time Frame
	HFRI	S&P 500 TR	HFRI	S&P 500 TR	
1/2001 - 7/2012	**15.64%**	**30.44%**	**-29.52%**	**-50.95%**	**Tech Bust, Financial Crisis and Recovery**
9/2007 - 3/2009	**-25.45%**	**-43.78%**	**-29.51%**	**-50.95%**	**Financial Crisis**
9/2007 - 7/2012	**-24.94%**	**4.21%**	**-29.51%**	**-50.95%**	**Financial Crisis and Recovery**
3/2009 - 7/2012	**2.92%**	**101.59%**	**-19.12%**	**-16.26%**	**Post Financial Crisis Recovery**
1/1998 - 7/2012	**123.45%**	**84.52%**	**-29.52%**	**-50.95%**	**Full Cycle**

Data available beginning 1/1998

The first line captures the bursting of the Internet Bubble, the subsequent bull market, the financial crisis and its subsequent recovery. As can be seen, the S&P 500 outperformed the Equity Hedge Index by 14.8%. The tradeoff, however, was the fact that the S&P 500 maximum drawdown exceeded that of the HFRI by 1.7 times.

The next line examines the same metrics, but this time the analysis pertains only to the financial crisis. Here, equity hedge outperformed the S&P 500 by 18.33% -- largely by containing its drawdown.

The third and fourth lines (highlighted) are the reason equity hedge as an asset class is being questioned.

Line three covers the time frame from the onset of the financial crisis through July 2012. As can be seen, the S&P 500 dramatically outperformed equity hedge, albeit with a greater maximum drawdown. Perhaps most damning, however, is line four. This line analyses the time frame from the depths of the financial crisis to-date. *The S&P 500 outperformed by nearly 100% (absolute return), while having a lower maximum drawdown.* It is this time frame, and its associated characteristics, that has raised the question as to the viability of equity hedge going forward.

Line five presents the entire lifetime of the HFRI index – over which the index has outperformed both in terms of returns and maximum drawdowns. In this context, equity hedge has proven to be a superior long-term strategy for generating returns at a constrained level of risk. At least that holds true regarding past performance.

Conclusion

All of this begs the second question, asked at the beginning of this paper: Is equity hedge's underperformance a temporary phenomenon or has the asset class permanently lost its luster?

We tend to believe that the phenomenon is temporary, although the duration of future underperformance is difficult to peg. First, the Federal Reserve has indicated that ZIRP will persist at least until 2014. Having cited ZIRP as one of the core reasons for underperformance, we find it unlikely that equity hedge performance will significantly improve until interest rates normalize.

Even with the eventual normalization of interest rates, HFT, algorithmic trading, and management fees will continue as headwinds for the asset class. In our view, those that will survive and prosper in the future will have a certain set of characteristics:

- Lower Fees – while the asset class itself may not be dead, the ability (or sensibility) of managers to charge 2/20 in this space may very well be. With the limited prospects for generating material alpha, equity hedge managers will need to re-price their services -- ostensibly to look more like their Segregated Managed Account (SMA) or mutual fund siblings.
- The End of Style Boxes – equity hedge managers will need flexibility to move between market capitalization boundaries and security types (stocks, bonds, preferreds, commodities, etc.). In a marketplace where the price discovery mechanisms are distorted, the mobility to exploit various mis-pricings across asset classes can be a genuine alpha generator. Further, in an environment characterized by unusually prevalent tail-risks and tail-opportunities, a manager with the flexibility to manage the tails will likely generate more alpha than those that lack that flexibility.
- Increased Transparency – in the early days of hedge funds, the opaque black-box was the standard. In an effort to protect their "secret sauce" managers provided little (or lagged) transparency. That may have been accepted in a world where alpha was easy to access, but hardly justifiable after a period of 100% underperformance relative to the stock market. The future of this asset class may rest on transporting the platform from the opaque limited

partnership to the SMA or 1940 Act mutual fund chassis. This transformation has already begun, with 1940 Act hedged mutual funds coming online at a rapid pace.

- Increased Liquidity – like transparency, good historical investment performance allowed equity hedge managers to impose lock-ups, gates, redemption penalties and limited redemption dates. Limited liquidity was largely an unnecessary benefit to the equity hedge manager – as most (if not all) of their holdings are in highly liquid, publically traded securities that settle in T + 3. We believe that the next generation of equity hedge will offer liquidity terms much more favorable to the investor than those that prevail today.

Lower fees, asset mobility, increased transparency, and increased liquidity are the characteristics we believe will define equity hedge in the future. It is our belief that future fund flows into this asset class will increasingly be directed toward Segregated Managed Accounts and, to a lesser extent, 1940 Act mutual funds. Both of these chassis provide the elements investors now justifiably demand, and significantly reduce the likelihood of fraud.