Australian hedge funds
Why they are worth taking a look

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Although the term 'hedge fund' has arguably meant a less than perfect experience for many northern hemisphere investors since the onset of the Global Financial Crisis (GFC), in Australia, the investor experience has been remarkably positive—not only in quantitative terms of performance and risk, but also in qualitative aspects such as accessibility, liquidity and fees. This is particularly so in the case of equity-based funds.
The research firm, Australian Fund Monitors (AFM) covers over 250 Australian absolute return and hedge funds. According to its independent data, the AFM Equity Fund Index, which tracks 208 Australian-offered funds, outperformed the S&P/ASX 200 Total Return Index over the period of January 2003 to June 2013, with a return of 11.53% per annum compared to 9.22% per annum respectively.

The universe of funds covered by the AFM Equity Fund Index covers a range of strategies, including market-neutral, long-only, income, long/short, buy/write, event-driven and 130/30.

**Beating the market—with less risk**

Importantly, equity-based funds have outperformed the market with less risk. The standard deviation for the AFM Equity Fund Index was 7.88 per annum, versus 13.41% per annum for the S&P/ASX 200 Total Return Index. In terms of the largest drawdown, the peak slump for the AFM Equity Fund Index, at -25.22%, was significantly less than for the S&P/ASX 200 Total Return Index, which came in at -47.19%.

Taking a more recent performance comparison, for the period of January 2008 to June 2013—and isolating the impact of the GFC—the performance of the AFM Equity Fund Index again exceeded that of the S&P/ASX 200 Total Return Index, with a return of 4.04% per annum compared to -0.53% per annum.

The risk comparison again favoured absolute return funds. The standard deviation for the AFM Equity Fund Index was 8.90% per annum versus 16.09% per annum for the S&P/ASX 200 Total Return Index; the largest drawdown being 23.97% compared to 44.13% respectively.

From this data, a conclusion can be made that over a long-term comparison comprising of a bull and bear market, and with the recent ‘GFC followed by recovery’ period, absolute return equity funds outperformed the market’s total return, and took on less risk doing so.
Tapping into the top skills

Performance data backs the proposition that hedge funds play a role in a diversified portfolio designed to generate and protect wealth. The diverse range of hedge funds available in Australia and worldwide may be relevant for superannuation fund members, pensioners and ordinary investors alike. The specific strategies help them meet their investment objectives by adapting to their specific risk/return profile.

One example may be the capacity of an absolute-return equity strategy to reduce volatility when combined with long-only equity strategies. Another may be the ability of a hedge fund strategy to provide exposure to stock-specific risk while remaining market neutral.

An example close to hand is our Bennelong Long-Short Equity Fund1, which has been closed to new money. It is a research-driven, market- and sector-neutral pairs trading strategy investing mainly in large cap stocks from the S&P/ASX 200 Index, with a 10-year track record and annualised net returns of more than 20%.

The fund’s portfolio manager, Richard Fish, has more than 25 years of market experience. Since inception in January 2002, the fund has earned yearly positive returns, including an 11.95% return in 2008 and 20.6% in 2011, both of which were negative years for the S&P/ASX 200.

Value, transparency and access

On the fees front, generally speaking, Australian funds are cheaper than their global counterparts. Generally, hedge funds are characterised by the notion of ‘2 plus 20’—a management fee of 2% per year and a 20% performance fee. While this is common, it is by no means the template for all hedge fund fee structures: according to AFM’s database, the average fee of funds is a management fee of 1.3% per year management fee, and a performance fee of 13%. This only improves the relative attractiveness of Australian absolute return funds compared to long only and indexed equity managed funds.

A fund showing that calibre of consistent long-term outperformance across periods of positive returns as well as periods in which markets were volatile and negative, is also a very handy addition to any investor’s arsenal.

Part of the reason why hedge funds are underused by Australian investors is because of commonly held misconceptions in relation to their cost, risk, apparent illiquidity and supposed lack of transparency. These perceptions generally come from sensationalised overseas headlines. Once investors and their advisers open their minds to the potential strengths of hedge fund strategies and how they can enhance investment outcomes, allocation to these vehicles will surely become more popular.

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1 Similarly, Kardinia Capital manages Bennelong’s second hedge fund. The Bennelong Kardinia Absolute Return Fund has delivered investors 14% per annum over seven years. This ‘variable beta’ (which means the manager has the flexibility to adjust the Fund’s exposure to the underlying market) strategy has ensured a positive return in every calendar year since inception in 2006. This obviously includes the heart of the Global Financial Crisis in 2008 when the Fund returned positive 0.30% whilst the market fell close to 40%.
When it comes to transparency, the characteristics of the Australian investment market are such that opaque hedge funds do not get supported. The channels in the Australian investment market by which money reaches fund managers are strongly intermediated; managers need to be able to articulate their value proposition (including process, performance and regulatory compliance) in an acceptable manner to both the institutional and retail value chains.

In the wholesale market, entities such as asset (or investment) consultants, professional research houses, and wholesale investors’ investment committees and trustee boards all represent ‘boxes that must be ticked’ in order for a fund manager to be awarded money. In the retail market, ‘gatekeepers’ include research houses and financial adviser dealer groups’ Approved Product Lists (APLs), which go hand in hand.

At no stage within these hierarchies are opacity nor ‘black box-style’ investment strategies rewarded—in fact, transparency is mandatory for managers to attract fund flows. This makes the Australian market different to the North American market, where there is a larger community of sophisticated investors such as limited partnerships and high net worth investors prepared to invest unadvised in funds solely on the basis of an information memorandum. The ‘retailisation’ of the Australian market effectively prioritises and rewards transparency, and is considered an essential requirement for managers.

The same is true for liquidity, which is effectively in-built as a requirement in the Australian marketplace. If you are offering a retail fund, you cannot have investors locked up for a significant length of time. There are a variety of methods managers use to manage liquidity and redemptions, but again, the market looks for—and rewards—greater liquidity. In particular, retail investors need daily liquidity.

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Hedge funds—a growing sector

In conclusion, strong performance achieved with less risk cannot go unnoticed, and absolute return funds are reaping much more interest than ever before. According to data gathered from research house Rainmaker Information, the Australian hedge fund sector now manages about AUS$37 billion of the Australian superannuation pool, compared to AUS$20 billion just prior to the GFC. Although it represents less than 3% of total assets, if we observe the growth rate rather than the total quantum of funds, we see that there is significant room for growth.

The ‘apex predator’ of the Australian funds management industry, the AUS$82 billion Future Fund (the Australian government’s quasi-sovereign wealth fund), is a big investor in what it calls ‘skill-based strategies’. It spreads across a variety of asset classes, using a combination of fund-of-funds and direct hedge fund investments. The Future Fund was established in 2006 and today it has become the biggest user of hedge funds in Australia. However, it recently lowered its alternatives allocation from 16.3% to 15.3%, according to its March 2013 quarterly fund update. Having an influential investor so committed to hedge funds cannot help but increase awareness of the sector.

So while hedge funds might not be suitable for everyone—considering their structures, strategies and risks which certainly require additional research and understanding on the part of the investor—the reality is that the best funds provide outstanding performance with significantly lower volatility than traditionally managed funds. It is unlikely that there is an investor in Australia who is not at least interested in this proposition.

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To the point:
- Although hedge funds have been a less-than-perfect experience for many northern hemisphere investors, Australian investors have had a remarkably positive experience.
- Equity-based hedge funds have outperformed the market with less risk.
- Australia’s diverse range of hedge funds may be relevant for super fund members, pensioners and ordinary investors alike.
- Various commonly held misconceptions about hedge funds are some of the reasons why these strategies are under-used by Australian investors.
- Generally speaking, Australian funds’ fees are cheaper than that of their global counterparts.
- The ‘retailisation’ of the Australian market prioritises and rewards investment management transparency.
- The best hedge funds provide outstanding performance with significantly lower volatility than traditionally managed funds.