DID MORNINGSTAR JUST MAKE THE CASE FOR HEDGE FUND REPLICATION?

Morningstar recently published two comprehensive reports that should be required reading for anyone interested in the liquid alternatives space. The 2021 Global Liquid Alternatives Landscape tackles the difficult experience of most investors in the space due to numerous product "challenges"; aptly, it's subtitled, *A new generation of strategies aims to deliver where pioneers failed*. A second report, Mind the Gap 2021, is focused on the damage caused by performance chasing across the mutual fund landscape and has some jaw-dropping statistics specifically on liquid alts.

These conclusions are incredibly important. Morningstar builds the case that, for the vast majority of investors, allocators should seek to avoid performance chasing and invest only in products built to minimize known landmines – high fees, hidden leverage, style bias, complexity, asset-liability mismatches, etc. By logical extension, they essentially make the case for the "index-like" revolution in liquid alts. Based on a decade of our own analysis, we strongly believe that only one strategy has demonstrated the potential to deliver on this: factor-based hedge fund replication.

In this note, we will provide additional context on what went wrong in liquid alts and chart a better path forward.

What Went Wrong in Liquid Alts (Part 1): The Hot Dot Culture

Morningstar shows that liquid alts products overall returned 4% per annum over the past decade. That's not what clients saw. Astonishingly, due to performance chasing, they actually lost money.

An interesting question is, why was the hot dot culture so deeply entrenched in the liquid alts world? The reasons for this are complicated and structural but can be summarized as follows:

- During the 2010s, with relentless competition from virtually costless index-based and robo portfolios, advisors faced pressure to differentiate and demonstrate value-add. This created a base demand for liquid alternatives.

- Advisors determined the portfolio impact and allocation size based on actual hedge fund indices, not sparse data from the nascent liquid alts space.
- Exceptional returns in traditional assets, plus mediocre average returns in liquid alts[1] (and consistently lower than those of the hedge fund indices used in models), meant that advisors, in order to justify the allocation, were compelled to seek out funds that were "top quartile" or even "top decile."
- "Product mill" asset managers encouraged this by launching dozens of products and aggressively promoting the hot dots.[2]

The end result was that most advisors disproportionately invested in large, brand name funds with unsustainable performance. At the time of investment, this worked fine: it's a far more compelling story to tell clients that you've not only found a strategy that improves risk and return, but also the very best fund in the space.

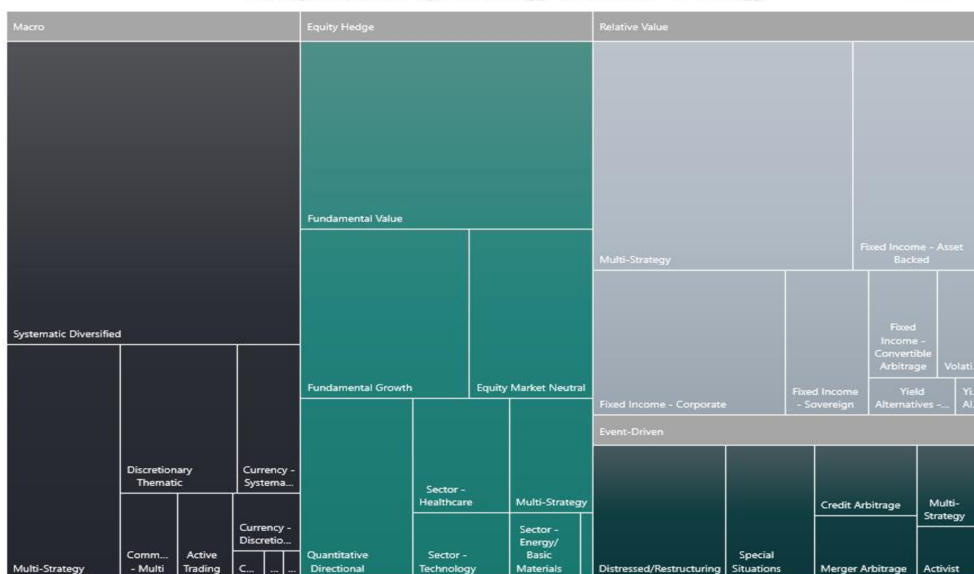
To experienced hedge fund allocators, performance chasing simply does not work as an investment strategy: top performers empirically are no more likely to outperform (called a lack of persistence). But Morningstar shows something much worse: it cost over 4% a year. The answer lies in the risky nature of single manager hedge funds.

What Went Wrong in Liquid Alts (Part Two): Overallocation

When hedge funds underperform, it's often by 20%, not 2%. This can happen overnight and without warning, or through grinding losses over years. The same holds true in liquid alts.

The simple explanation is that the single manager funds have a great deal of idiosyncratic risk. The chart below is a window into the complexity of the hedge fund world and shows strategies and sub-strategies, scaled by assets.[3]

[1] Wilshire Associates estimates the liquid alternatives industry return as closer to 2% per annum, or less than half that of a hedge fund index, like the HFRI Fund Weighted Composite. The primary reason is systematic performance drag: expected returns of hedge fund strategies before fees are much lower within the tight constraints of regulated investment vehicles. Therefore, even though fees in liquid alternative funds are lower on average, fee savings have been insufficient to offset this.
[2] In the 2021 Global Liquid Alternatives Landscape, Morningstar has a remarkable chart that shows that the twenty largest players in the space offer, on average, 40 products.
[3] Hedge Fund Research data. DBi analysis.



Within each major strategy bucket, sub-strategies go through years of out- and under-performance, and within those boxes the spread between top and bottom funds might be 30% a year. Half the funds from five years ago are gone today. Therefore, from a model/asset allocation perspective,

Hedge fund strategies can provide meaningful diversification benefits,
but single funds generally do not.

For battle-hardened hedge fund investors, the only viable solution is broad diversification across dozens of single managers. In retail portfolios, though, advisors are subject to an important practical constraint: for operational and client reporting purposes, portfolios typically invest in only one fund per strategy bucket, as shown in the following simple graphic:

Illustration: Institutional vs Retail Allocation to a Hedge Fund Strategy

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Given the nature of single manager risk, allocating 5% to a single fund is a ticking time bomb. Inevitable drawdowns are difficult to explain to clients, especially given high expectations set at the time of investment. Brand names and fund size provide scant protection. A bad experience can cast a pallor over decisions on the other 95%. Valuable advisor time and resources are consumed conducting triage, making the difficult decision to redeem and identifying a replacement fund.

The Path Forward

How can we improve outcomes going forward? First, we need to be clear about the practical goals of investing in liquid alts. We believe there are five main objectives:

1. Diversification: Allocate to a hedge fund *strategy* that can improve returns-risk over time.
2. Client Education: Have a clear and compelling story to tell clients to justify the initial allocation.
3. One Fund. Invest in a single fund vehicle for client reporting and operational efficiency.
4. Fee/Expense Efficiency. Keep fees and expenses low for regulatory reasons and client management.
5. Stability. Maintain the same allocation for five or ten years to focus resources on other parts of the business.

These criteria argue for index-like products, not the single manager funds than dominate the industry.[4] In Mind the Gap 2021, Morningstar argues that allocators should, "Focus on holding a small number of widely diversified funds." The point is to align and integrate the asset allocation process with manager selection.

One option is multi-manager funds – mutual funds that hire a diversified pool of hedge fund managers as sub-advisors. However, after a wave of launches in the 2013-14 period, most delivered disappointing returns and are too costly (2%+ expense ratio) for fee sensitive portfolios. Three quarters of the funds we studied back in 2013 have been closed.

That leaves hedge fund replication. The strategies, which were first introduced broadly around 2007, work by copying the core exposures of a diversified portfolio or index of hedge funds. There's little performance chasing risk because the target hedge fund portfolios are sufficiently diversified and stable. A well-designed replication product is built to avoid virtually all the "challenges" highlighted by Morningstar. Fees are half or less than those of multi-manager products. The index-like nature of the products means that advisors, in theory, can allocate today and hold it for a decade.

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[4] Wilshire estimates that 85% of liquid alts AUMS are in single manager products, which arguably means 85% of products offer no predictable diversification benefits in the retail portfolios described above.

Replication has another, and (to some) surprising, potential benefit: outperformance. In Europe, the four replication products in UCITS form (we manage one for SEI) have consistently been among the top ten performing multi-strategy funds over the past five years.[5] How can this be? Simplistically, replication successfully replicates actual hedge funds, and actual hedge funds tend to outperform liquid alts (it's harder to manage hedge fund strategies with constraints). Benchmarked to liquid alts categories, the strategies become "benchmark-plus." Morningstar's data also appears to show 100-200 bps of outperformance of these "passive" strategies.[6]

Granted, Morningstar did not conclude either study with an endorsement of replication per se; that would be commercially unrealistic for a firm that primarily is in the business of rating and ranking funds. But they should be commended for the clarity and rigor of this analysis, which is a huge step forward given Morningstar's prominence as a thought leader. More broadly, our expectation is not that most advisors pick either single managers or replication, but rather to use both to complement each other. For instance, a 50% core allocation to a strategy replication might be supplemented with one to three smaller investments in single manager satellites. This would go a long way toward addressing some of the thorniest structural problems in the liquid alts space.

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[5] Kepler database of multi-manager UCITS funds. The four replication-based products are the SEI Liquid Alternative (which we sub-advise), Goldman Sachs Absolute Return Tracker, NN Alternative Beta and Credit Suisse Liquid Alternative Beta funds.

[6] Exhibit 9, Mind the Gap 2021. Average annual return over the decade through 2020 of passive alternative funds was 5.77% per annum vs. 4.08% for the category overall.

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