How to benefit from hedge fund strategies at a fraction of typical costs

BRYAN BORZYKOWSKI
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It wasn't long ago that high-net-worth investors were mad for hedge funds, thinking that these alternative assets would bring big gains with lower volatility. It was an asset class that only the wealthiest could get into – they were, and many still are, for accredited investors only – and owning one made for great bragging rights, too.

"It was novel," says Adam Patti, chief executive of IndexIQ, a New York-based firm that makes alternative-asset ETFs. "You'd be at a cocktail party and say I invested in this fund and your friend would say, 'Can I get into that?'"

That exclusivity and, at least in the 1990s, the outsized returns came at a cost: Most hedge funds set their fees at 2 and 20 – they'd charge a flat rate of 2 per cent on one's total asset value and 20 per cent on any profits earned.

People were happy to pay up, especially two decades ago, when equities were rising and a lack of competition among hedge funds made it fairly easy to beat benchmarks, but investors, still mostly high-net-worth, are starting to say no to high fees.

Falling fees

In 2016, the average annual management fee charged by hedge funds fell to 1.39 per cent of the value of a customer's assets, according to Eurekahedge, a hedge fund database provider. That's down from 1.44 per cent in 2015 and 1.68 per cent a decade ago.

Several high-profile U.S. hedge funds, such as Caxton Associates, Och-Ziff Capital Management and Tudor Investment, also cut their fees last year, although they're still pricey. Tudor, for instance, was charging a 2.75-per-cent fee on assets and a 27-per-cent fee on profits. Its fee is now 2.25 per cent and 25 per cent.

Still, it's significant that fees are falling at all, but it's not surprising, Mr. Patti says. Hedge funds aren't as popular as they used to be, with assets under management contracting by $21.8-billion (U.S.) in 2016, the first time that's happened since 2008.

Hedge fund performance has also weakened the last several years. Historically, hedge funds have provided a 3-per-cent to 6-per-cent return over the risk-free rate, Mr. Patti says. Now, that the risk-free rate – the rate of return one can get, in theory, by taking on no risk – is nearly zero, those numbers look less impressive, he says.

The Barclay hedge fund index, which tracks the performance of more than 3,000 hedge funds, did return 6 per cent in 2016, but only 0.04 per cent in 2015 and 2.88 per cent the year before that. It's up just 2.45 per cent year-to-date, while the S&P 500 has returned 4.9 per cent over the same period.

As well, the fee debate that's raging in the mutual fund industry – cheap ETFs have made people question the value of paying a 2 per cent MER on funds – has started to seep into the hedge fund industry.

"We're finally starting to see competition in the fee area with mutual funds," says Eric Kirzner, a finance professor at the Rotman School of Management. "The same thing is happening in the hedge fund industry. Given the less than stellar performance, they're trying to find ways to compete."

Hedge funds for less

While some high-net-worth investors will still want to access to best in breed hedge fund managers, and are willing to pay for that access, others want to pay less for those strategies, and, through exchange-traded funds and certain mutual funds, they can.

For several years now, Vancouver's Nicola Wealth has integrated hedge fund strategies into some of their mutual funds. Its balanced portfolio has a 5-per-cent allocation to these strategies, which includes long-short, global macro, arbitrage and more.

It implements some of these strategies itself, but it also engages with hedge fund companies, such as La Jolla, California's Altegris and Toronto's Polar Asset Management Partners.

Some of the funds it employs charge 2 and 20, which Nicola Wealth has to pay, says Ben Jang, the company's alternative strategies manager. While he does think many hedge fund managers are overpaid, some of these strategies are difficult to replicate, so the fee can be worth it.

Fortunately, investors aren't on the hook for those costs. Nicola Wealth charges between 0.5 per cent and 1.25 per cent on a client's assets depending on how much they invest with the firm.

"We're materially lower than hedge funds," Mr. Jang says. "But we still feel like this is a good opportunity for clients."

Investors can also buy a growing suite of ETFs that track hedge fund strategies. Toronto's Purpose Investments, for instance, sells a number of hedged ETFs, such as its Purpose Multi-Strategy Market Neutral Fund, which implements long-short equity, momentum and other tactics.

Mr. Patti's IQ Hedge Multi-Strategy Tracker ETF, which has $1.1-billion in assets under management, combines six hedge fund strategies into one product.

Both the Purpose and IQ ETFs, with MERs of 0.80 per cent and 0.75 per cent, respectively, are more expensive than an S&P 500 ETF, which costs around 0.2 per cent, but they're still much cheaper than owning a traditional hedge fund.

It can make sense for high net-worth investors to own hedge fund products, Prof. Kirzner says – it's not unreasonable to have between 20 per cent and 30 per cent of one's assets in the strategies, he says – but nowadays they can do so for a reasonable price.

And fees will continue to fall, Mr. Patti says. With increasing pressure on fees, and cheaper hedge fund-like options coming to market, 2 and 20 may not be around for long.

"If you're an adviser and can get a similar performance for cheaper, then you'll do that," he says. "Fees are on a downward trend."