WILL HIGHER CASH RETURNS HURT HEDGE FUND MANAGERS?

by Sloan Smith, MBA, CAIA, CPWA®

In 2022, the Federal Reserve increased short-term interest rates at a historically fast pace in order to hinder inflation. This had a massively negative effect on equities and fixed income, where both were down 18% and 13%, respectively.

However, these decisions by the Federal Reserve created an interesting dynamic, not only in the greater fixed income market but in cash, treasury bills, and money market funds.

As of August 2023, Treasury bills and money market funds were providing an annual yield of approximately 5%, a return profile that has not been seen in these asset classes since the 2008 global financial crisis. For close to fifteen years, low interest rates were the norm and alternative strategies such as hedge funds were able to charge significant management and incentive/performance fees without any substantial issues. But the market environment has changed.

Investors are questioning whether a hedge fund should implement a hurdle rate that is close to a money market or treasury bill return before collecting performance fees. In addition, investors are questioning the validity of some hedge fund strategies, especially if they are unable to generate a return premium to Treasury bills or money market funds. The hedge fund landscape is heavily scrutinized and it will be important for the asset class to show its ability to create better fee alignment with its investors while generating a risk and return profile that is more favorable than cash equivalents.

Key areas to monitor:

Management and Performance Fees
Historically, hedge funds have followed the typical "2 and 20" model, a 2% management fee and a performance or incentive fee of 20%, wherein they collect 20% of the fund's profits if they generate positive over a particular period. However, we have seen the hedge fund space experience some downward pressure when it comes to fees. As of the end of 2022, the average hedge fund fee was 1.4% and the performance fee was approximately 17.3%. Hedge funds are under a lot of pressure to justify their larger fees, especially due to the increased return profile of cash equivalents.

Therefore, it is important that hedge funds provide favorable fee terms for their investors where their differentiated return profile relative to equities and fixed income adds value to a greater portfolio. If there is contrary behavior found in this space, then it might make sense to reevaluate your allocations in this asset class.

Hurdle Rate
Treasury bills, money market funds, and other cash equivalents are yielding close to 5% as of August 2023. In the hedge fund space this should be a discussion point when it comes to potentially implementing a hurdle rate, or the minimum acceptable rate of return needed. Most hedge funds receive most of their compensation through the incentive fee.

In many cases, fees should not be collected unless the hedge fund manager can exceed the 5% cash return threshold. There may be exceptions to this rule, particularly with high quality, hard to access managers that have consistently generated a return profile more favorable than cash. However, this should be discussed heavily while performing future due diligence on hedge funds strategies.

Redemption Activity
If hedge fund managers are unwilling to make changes to their investment terms so they are more investor-friendly or are unable to clearly outline how they can deliver a return over cash equivalent, then it is important to monitor redemption activity. Money market, Treasury bills, and fixed income have become more favorable due to higher current yields.

It might make sense for more investors to redeem capital from hedge funds and allocate more to the fixed income, where they may find greater return potential with more liquidity and, potentially, less risk. If hedge funds managers are unable to evolve and manage this new dynamic, then outflows should be expected.

Track Record During a Higher Rate Environment
Hedge funds have historically proven their worth during a higher interest rate environment when volatility is more elevated and there is greater return dispersion in various assets classes such as equities, fixed income, commodities, etc. In hedge fund due diligence, the fee and potential hurdle rate component are important.

But it can be advantageous to look at more tenured strategies that found success in generating robust return in a higher rate environment. Their success during these time frames could provide comfort in knowing that they have a proven ability to find success in this type of market environment.

Overall, the hedge fund industry is going through a makeover, where they need to show their value over less risky asset classes. This dynamic should lead to stronger conversations that create more alignment with investors and, hopefully, a more enhanced risk/return profile. The bar has been raised for hedge funds, which will ultimately lead to winners and losers in the space. Investors must pay attention to these key trends so that they can remain comfortable with their hedge fund allocations.

They should feel that their underlying managers are truly creating a diversified risk/return profile that is more favorable than simply holding cash or purchasing a money market fund or Treasury bill.

Sloan Smith, CAIA, MBA, CWPA®, is a Principal and Director at Innovest Portfolio Solutions LLC, a Denver based investment consulting firm.

www.innovestinc.com/sloan-smith