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The long & short of it

HEDGE FUND INVESTING IN INDIA IS ALL SET TO SEE AN INCREASED INTEREST FROM INVESTORS AND ASSET MANAGERS ALIKE

Hedge funds are an asset class in India whose time has come. Over the next few years, the Indian market is likely to see a sharp pick up in new product launches from across asset managers, offering an assortment of different strategies in this sector.

Set in motion by the Alternate Investment Fund (AIF) category III guidelines by Sebi in the year 2012, asset managers have responded by launching an array of investment strategy offerings such as absolute-return, event-driven, quant-based and finally, the classical fundamental long-short equity products. Not surprising then sophisticated domestic investors (such as High Net-worth Individuals, Family Offices and Corporate) have actively taken to investing in these funds (note, while category I and II are for venture capital funds, infrastructure funds, real estate, and private equity funds, category III fund regulations by Sebi are chiefly for hedge funds). Investors seek to add a hedge fund to a conventional long-only equity portfolio since it can help to reduce risks, enhance portfolio stability and generate uncorrelated return to the traditional portfolio.

While hedge funds are a nascent asset class in India, globally this asset class already manages over $3 trillion-3.5 trillion of assets as compared to a total global asset management industry size of US$68 trillion (*See: Sizing up the market*). And within this hedge fund universe, the largest shares of assets (roughly 40%) are invested in long-short strategies.

A commonly held view of hedge funds is that they are risky, speculative, leveraged investment vehicles, an image supported by the financial media stories on esoteric global macro bets of star hedge fund managers such as George Soros or debacles of certain hedge funds such as Long Term Capital Management (LTCM). While some hedge funds are indeed aggressive, the vast majority typically target a risk profile

Sizing up the market

Globally, hedge funds are a force to reckon with

	AUM		Fees	
	$Trillion	%	$Billion	% fee
Alternative	10	15	104	42
Active specialities	13	19	54	21
Solutions/LD/ Balanced	9	13	21	8
Active core	24	35	58	23
Passive	12	18	14	6

Source: Boston Consulting Group

Alfred Jones' original goal was to eliminate market direction risks by buying undervalued stocks and shortselling overvalued ones

that is lower than one would associate with traditional long-only equity investments. By definition, a "hedge fund" ought to be required to "hedge" or in other words have the capability to sell short in order to protect the downside of the portfolio. Just like the product offerings of traditional mutual funds can span from liquid funds to small-cap equity funds, the hedge fund universe, too, encompasses a broad range of strategies spanning the entire risk-return spectrum.

The origin of the hedge fund industry is credited to Alfred Winslow Jones, a sociologist and an editor of *Fortune* magazine, who launched the first recognized hedge fund in 1949. His strategy was focused on stock picking coupled with hedging by shortselling and use of leverage. His original goal was to eliminate market direction risks by buying undervalued stocks and shortselling overvalued ones – in investing parlance, he was seeking to eliminate beta and enhance alpha. This investing innovation is now known as the classic long-short equities model. But as the hedge fund industry grew, its make-up also evolved. It is now common to see several flavours of investment focus for hedge funds such as arbitrage funds, global macro, event driven etc.

To understand how a hedge fund is different from a traditional investment portfolio, let us narrow the discussion to understanding its largest category, the classic long-short equity hedge fund, as conceived by its innovator.

As the name suggests, the goal of a long-short equity fund is to profit from both rising as well as declining securities. A conventional long only fund can at best express a negative view on a stock or a sector by not owning it, whereas the canvas for a "stock-picking" oriented long-short fund is larger, with the ability to find and short declining securities as well, hence expanding the opportunity to generate alpha. We today live in a world of massive technological change. Some argue that we are at the cusp of one of the biggest and the most disruptive technology transitions of all time and that this accelerated pace of technology changes makes it imperative that several businesses will face declines. Thus, the ability to identify and short such businesses is a meaningful differentiator

Far from fair weather

Picking the right alternative investment fund leads to super outperformance

Return Data	Period 1	Period 2	Period 3	Period 4	Period 5	Total Return
Fund Return	-1.5%	30.0%	21.2%	-1.9%	2.0%	55.3%
Nifty	-24.0%	75.8%	18.0%	-24.5%	16.5%	38.6%

for a long-short equity fund as compared to a conventional long-only fund.

Furthermore, conventional long only funds are usually fully invested at all times; and while they benefit from a rising market, they are also likely to be hurt by a falling market. Long-short funds, on the other hand, have the flexibility to reduce exposure (by either reducing the long positions or increasing shorts or both) to overheated/overvalued/declining markets, while increasing exposures in oversold/undervalued/ rising markets. The result is that long-short funds, therefore, have the ability to participate in rising markets and protect capital in declining ones (or even better, earn return even in declining markets due to their flexibility to short). Thus, this asymmetric return profile (participating in rising markets and protecting downside during downturns) helps to lower volatility in performance, lowers risks and increases the odds of beating the indices, or even long-only funds, over a full cycle.

But are sharp declines in stock markets frequent enough to be taken advantage of? According to Ned Davis Research, the US market (which has the longest recorded history for stock market return), from the year 1900 to 2013 has recorded 123 corrections (defined as a decline of over 10% but less than 20%) or a correction occurring every year and 32 bear markets (defined as decline of over 20% or more) or a bear market occurring every three and a half years. The volatility of the Indian market is likely to be no different.

While some hedge funds are indeed aggressive, the vast majority target a risk profile that is lower than one would associate with traditional long-only equity investments

Some experts today argue that global equity markets are close to an inflexion point. The US, the largest equity market in the world, is witnessing the longest bull market in its history. However, the reversal of Quantitative Easing (QE), rising interest rates globally, tariff wars, currency wars, asset bubbles, debt bubbles, EM shocks have the potential to lead to a sharp meltdown of equities globally. While forecasting such events is a futile exercise, the flexibility to protect capital or even take advantage of any such declines which may occur, can be an advantage for a long-short fund.

Again, it is often conventionally argued that since stocks and markets go up over the long term, it is wise to just stay invested at all times and not bother about protecting capital in the short term. However, consider the actual performance of a hedge fund *(See: Far from fair weather)*.

As can be seen, the fund has underperformed in two out of the five periods and still generated significant excess return over a longer time-frame. A closer look will show that the excess return is largely thanks to the downside protection in the two sharp declining periods. Also, notice that not only is the volatility of performance lower, but the risk of capital decline has also been lower.

The key point being made here is the simple arithmetic of declines: if you lose 50% from your starting capital in a year, then it requires 100% return after the decline to reach back to your starting capital level. In effect, for the purpose of compounding your wealth, it is more damaging to lose money than make it. Losing less in down years and compounding from a higher level of capital base make it possible to earn higher equity type return while taking lower risks.

Having discussed the merits, it is equally important to take cognizance of the risks involved in investing in hedge funds. The greater flexibility in investing also implies greater discretion for the fund manager and a higher reliance on the manager's skill. Further, a stringent risk management process becomes even more imperative, especially whilst using a short portfolio. Not surprising then, this asset class is regulated to ensure only sophisticated investors such as High Networth Individuals are allowed to invest in it. To conclude, hedge fund investing in India is all set to see an increased interest from investors and asset managers alike.