The Current State of the Hedge Fund Industry

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If you have been reading headlines from the financial press lately, you probably think the hedge fund industry is on the verge of collapse! The following are a smattering of recent headlines.

> ***"New Jersey slashes hedge fund allocation amid poor returns"[1]***
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> ***"New York City Pension to Cut $9 Billion Hedge Fund Bet in Half"[2]***
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> ***"AIG to cut hedge fund bets after 'Greatly Disappointing' Results"[3]***
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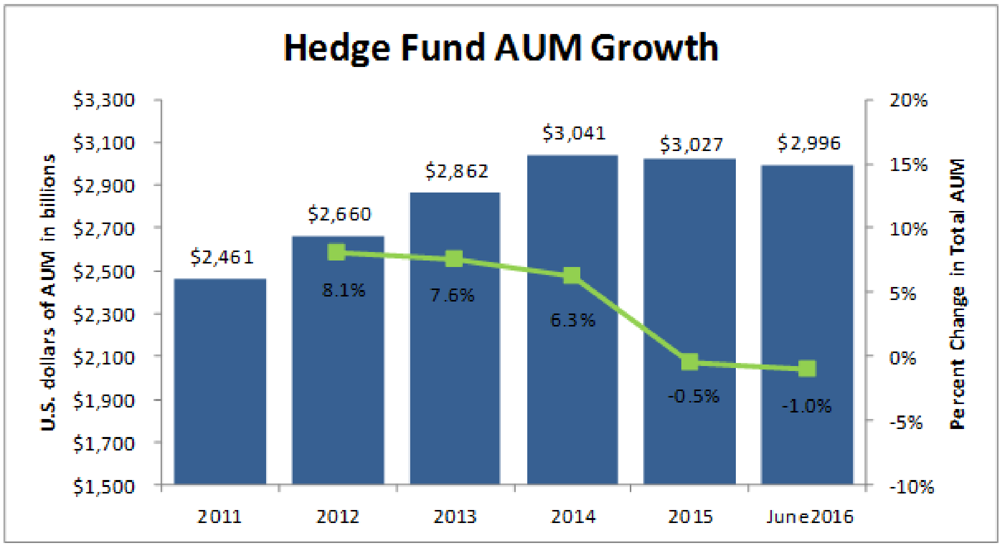
> ***"Investors yanked $25.2 billion from hedge funds in July alone"[4]***

So is the hedge fund industry in as much trouble as many media outlets would have you believe? The two most common topics in the financial press surround disappointing performance and redemptions. Given the sharp market declines in January and February and the subsequent rebound in the following months, hedge funds have generally struggled to react effectively to the rapidly changing market climate. In the wake of muted and disappointing returns versus long-only indices so far in 2016, there have been a few high profile redemptions by large state pension plans and insurance companies that have been well documented in the media. However, such redemptions have represented a small percentage of hedge fund investors and assets.



Source: Evestment

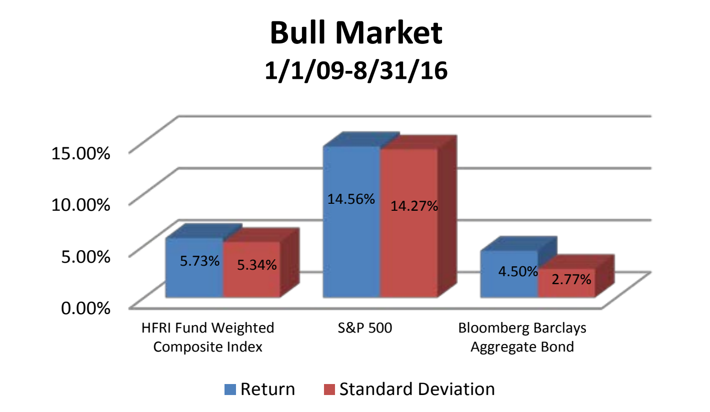
[1]Herbst_Bayliss, Svea. "New Jersey slashes hedge fund allocation amid poor returns" Reuters.com. Reuters, August 3, 2016
[2]Braun, Martin. "NYC Pension Votes to Scrap $1.5 Billion Hedge Fund Portfolio" Bloomberg.com. Bloomberg, April 14, 2016
[3]Basak Sonali and Katz, Lily. "AIG to Cut Hedge Fund Bets After 'Greatly Disappointing' Results Bloomberg.com. Bloomberg, January 26, 2016
[4]LaRoche, Julia. "Investors yanked $25.2 billion from hedge funds in July alone" Yahoo!Finance. Yahoo!, August 24, 2016

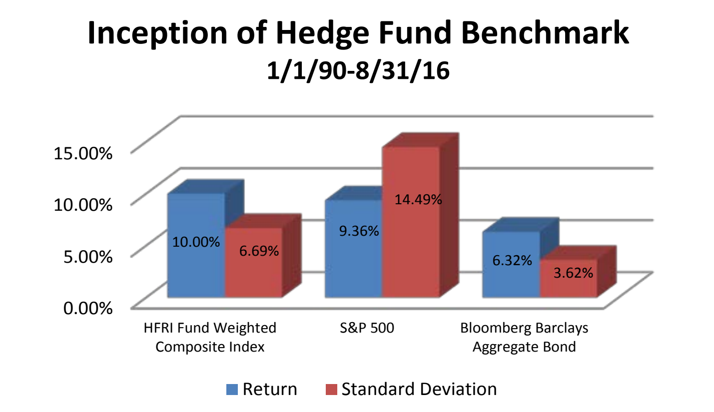
DiMeo Schneider & Associates, L.L.C.

According to Evestment's July 2016 Hedge Fund Industry Asset Flow Report, hedge funds have had net redemptions of $56 billion year to date. While $56 billion is an eye-popping figure, Hedge Funds began 2016 with over $3 trillion in assets, so redemptions represent less than 2% of industry assets. ***We believe a reduction in capital is a healthy thing for those who remain in hedge funds as it relieves overcrowding, which is a key reason many hedge funds have disappointed investors.***

As we head into the 8th year of a bull market, hedge funds have been criticized for failing to keep pace with the broader stock market. However, hedge fund investments should never be expected to match broad bull market returns. Hedge funds will typically have a net market exposure ranging from zero to sixty percent, which creates a significant headwind when the market is in an upward trend. Additionally, an unprecedented level of central bank intervention has provided liquidity to worldwide capital markets, which has amplified asset prices. While the current bull market has seen moments of heightened volatility, it has not yet seen a level of sustained volatility that has historically accompanied hedge fund outperformance.

As seen in the chart below, hedge fund performance has exceeded the performance of the S&P 500 with less volatility over the longer time horizon. As would be anticipated, hedge funds have not kept pace with the S&P 500 during the most recent bull market.





Over the next decade, we believe many investors will be challenged to meet their investment objectives in an environment that we believe offers historically low future return prospects. The U.S. equity market is near historically high valuation levels. Fixed income securities' valuations are stretched with negative or near negative interest rates across the globe. ***There are both heightened risks and pockets of opportunities where we believe hedge funds are uniquely and beneficially positioned compared to long-only mandates.***

We believe an allocation to a portfolio of skilled hedge funds is warranted in most diversified portfolios for the following reasons:

1) To reduce aggregate portfolio risk and improve overall risk-adjusted returns
2) To reduce aggregate portfolio correlation to broader markets
3) To generate alpha (or returns not tied to overall market direction)
4) To preserve capital in broad market downturns
5) To complement traditional asset classes within a diversified portfolio

The dispersion of returns among top and bottom hedge fund managers is much wider than with traditional long-only managers. Therefore, manager selection has been and will continue to be a critical driver of success or failure within any hedge fund investment program. Additionally, weightings to strategies should be made carefully to ensure that any single trading style does not hamper returns.

We see an improved environment for hedge funds on the horizon, where (eventual) rising interest rates will become a relative tailwind for hedge fund performance. We believe hedge funds will benefit for three reasons:

1) We expect greater dispersions in stock returns as higher interest rates reward companies with good balance sheets that are operated effectively and punish highly levered or poorly operated companies. The ability to be both long and short in such an environment will create opportunities.
2) We expect an increase in distressed fixed income securities as higher interest rates challenge the more levered companies. We believe hedge funds are uniquely positioned to take advantage of opportunities such an environment creates.
3) Financing of portfolios would move from net carry negative to net carry positive as managers can earn higher interest income from holding short rebates and unencumbered cash.

We continue to believe there is alpha to be earned by investing in hedge fund strategies; however, that alpha is scarcer than in previous time periods. It is as critical as ever right now to access hedge fund strategies on the most cost-effective basis possible. Therefore, investors with the requisite size should bypass the extra layer of fees of the fund of fund structure if they can.

As we look ahead to an improved hedge fund investing environment, we invite you to contact the professionals at DiMeo Schneider & Associates, L.L.C. for further assistance or questions.

About the Author:

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Craig leads the hedge fund due diligence efforts for the firm. He also leads the firm's customized portfolio construction work on behalf of firm clients. Craig is the chairman of the DiMeo Schneider's Hedge Fund Committee. Craig is also a voting member of the firm's Private Equity and Discretionary Committee. Most recently, Craig was a Senior Alternative Investment Analyst at Segall Bryant & Hamill, where he sat on that firm's Hedge Fund Investment Committee while leading investment and operational due diligence for the fund of hedge funds offerings. Craig has also worked in finance and audit roles at Citadel Investment Group, Credit Agricole Alternative Investment Services and Northern Trust. Craig began his career as an auditor with Arthur Andersen and holds a MBA from the University of Illinois as well as a BS in Finance from Illinois State University. He is a Certified Public Accountant and a CFA® Charterholder.