Kepler | Trust Intelligence

Investing in hedge funds with investment companies

How investment trusts can provide access to the dynamic and diversifying asset class of hedge funds...

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BH MACRO LIMITED

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It might come as some surprise that the inaugural hedge fund was launched in 1949 by a journalist, not a Wall Street hotshot. That said, Alfred Winslow Jones' fund flew largely under the radar until 1966 when Fortune magazine published an article on its ex-writer entitled "The Jones nobody keeps up with".

The article hailed Jones as "one of the wonders of Wall Street", having achieved almost double the ten-year returns of the best-performing equity fund. It also coined the phrase 'hedge fund' to describe Jones' long/short equity strategy to 'hedge' against market movements. This revelation sparked a wave of interest, with 200 hedge funds springing up in the next two years alone.

Over half a century later, the Financial Times reports there are now 30,000 hedge funds managing over $5 trillion in assets for investors seeking positive returns in both rising and falling markets. Traditionally the domain of institutional investors and high-net-worth individuals, hedge funds have become accessible to retail investors via investment companies and UCITS, providing a dynamic and diversifying asset class which we explore in more detail below.

What are hedge funds?

Hedge funds pool money from investors to be invested by professional managers with the aim of delivering superior risk-adjusted returns.

These funds aim to protect against losses and reduce volatility, or 'hedge their bets', by making counterbalancing trades against original positions. For instance, a fund may take long positions on stocks its managers perceive to be 'undervalued' and short positions on stocks its managers think are 'overvalued' with the aim of generating returns in both rising and falling markets. Whilst equity funds typically have beta due to their sensitivity to broader equity market movements, hedge funds typically aim to have low (or no) beta.

Hedge fund managers have the flexibility to employ a variety of investment strategies (including higher risk strategies which are not permitted in many other forms of collective investment vehicle such as short selling and leverage), which may help them to enhance returns and manage risk.

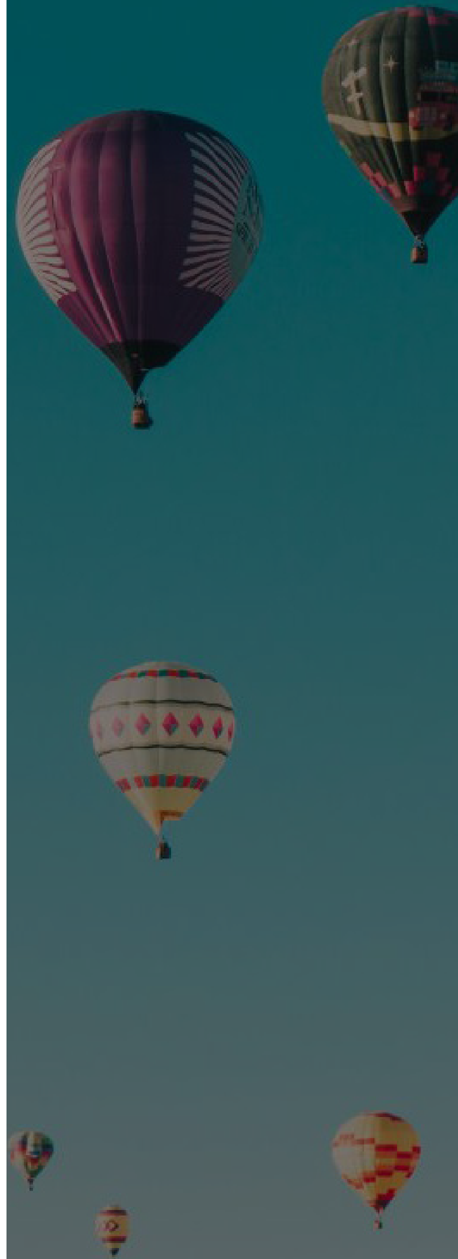
The main categories of hedge funds are as follows:

- **Long/short equity funds:** whilst most investors are familiar with 'long' positions (wherethe share price is expected to rise), short strategies are based on an expected fall in share price (i.e. selling borrowed shares deemed to be overpriced in the expectation of buying them back at lower prices, gaining the difference). Long/short funds aim to capitalise on both types of stock-specific gains whilst reducing overall market risk (as long and short positions benefit from rising and falling markets respectively).

- **Global macro funds:** these aim to profit from market movements caused by political and economic events. Managers take short or long positions in a variety of assets (including equities, bonds, currencies and commodities) around events such as the likely direction of interest rates or the outcome of elections.

- **Relative value funds:** these look to exploit price anomalies between related assets such as equities, bonds, commodities and currencies. These can occur in equity markets during corporate events such as takeovers or in bond markets where assumptions on interest rates and inflation vary.

- **Activist funds:** these build a significant stake to influence companies to instigate operational or financial changes to improve shareholder value, such as a restructuring or sale of assets.



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- **Event-driven funds:** these look to capitalise on temporary pricing opportunities arising from corporate events such as restructurings, mergers and acquisitions and bankruptcy. This could include buying distressed senior debt and shorting equities if the company has yet to file for bankruptcy (on the assumption that the share price will fall thereafter).

- **Fixed-income arbitrage funds:** these exploit expected temporary pricing inefficiencies in bonds or other fixed-income assets in a similar way to long/short equity funds. This is a market-neutral strategy that potentially includes arbitrage on yield curves and/or on credit spreads.

- **Quantitative funds:** these use mathematical models and algorithms to make trading decisions, drawing on the modelling and research of large data sets and often involving high-frequency trading.

- **Multi-strategy funds:** these use a blend of the above strategies to offer more flexibility, often with a focus on capital preservation.

Why invest in hedge funds?

Hedge funds may add diversification to an investment portfolio as they offer potential alpha generation uncorrelated to core equity and fixed-income assets and seek to provide some protection against downside risk in falling markets. We look at the individual factors in more detail below:

Portfolio diversification

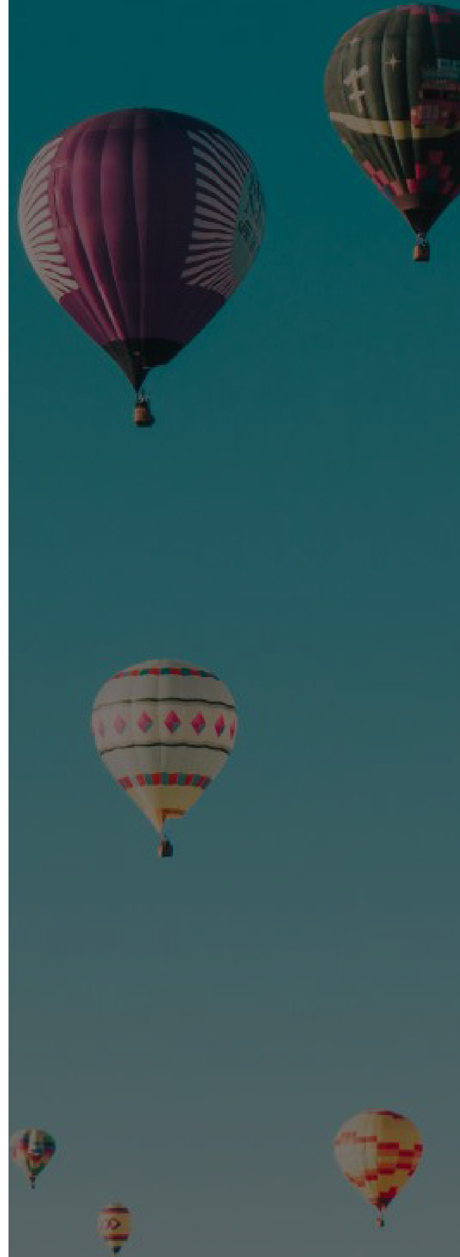
Famously tipped by Nobel Prize-winning economist Harry Markowitz, the pioneer of modern portfolio theory, as “the only free lunch in finance”, diversification helps investors manage risk and smooth returns by spreading their portfolio across different assets.

One of the classic allocation models is a 60% equities/40% bonds portfolio which seeks to balance upside potential with downside risk. Thanks to a largely negative correlation between equities and bonds, this portfolio has, over the medium to long run, historically yielded stable returns with bond markets generally offsetting downturns in equity markets, although this negative correlation is not guaranteed in the short run and some years have seen falls in both.

For example, correlation between equities and bonds turned positive in 2022 as rising interest rates triggered a risk-off exodus from equities, and bond markets suffered their worst performance in more than a century. By the end of the year, both the S&P 500 and FTSE World Government Bond indices had fallen by almost 20% (source: FE Analytics, total returns in US dollars).

As this illustrates, bonds do not always provide a hedge against equity falls and vice-versa, and therefore investors may be looking for a further source of diversification to mainstream bonds and equities.

Hedge funds are potentially one such option, offering a dynamic source of diversification across different asset classes with the aim of generating returns in both rising and falling markets. This approach differs from mainstream equity and bond funds due to the broader investment universe (including commodities and currencies which are typically less correlated with equity and bond markets) alongside the use of long/short equity, market-neutral and arbitrage strategies.



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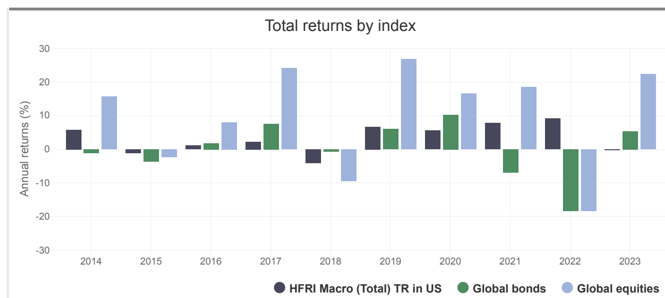
As shown in the chart below, the HFRI Macro Hedge Fund I-index has delivered positive total returns in all but three of the last ten years. Whilst outperformed by global equities (represented by the Morgan Stanley Capital International All Country World Index) and sometimes also by global government bonds (represented by the FTSE World Government Bond Index) in 'good' years for those investments, its characteristic as a diversifying asset class is best illustrated looking at performance in the poorer performing years for equities or bonds. For example, in 2022, the macro hedge fund index achieved a positive return of almost 10%, in contrast to the near 20% decrease in both global government bond and equity markets.

Fig.1: The Macro Hedge Fund Index Has Consistently Delivered Postitive Returns Over The Last Decade



Source: FE Analytics, total returns in US dollars. Based on FTSE World Government Bond and MSCI ACWI indices.
Past performance is not a reliable indicator of future results.

Whilst the hedge fund index didn't produce a positive result in 2015 and 2018, in each of those years it delivered a superior return to the combined negative return from global bonds and equities. Clearly, past performance is not a faultless predictor of future performance, but this analysis helps to show how hedge funds may provide a useful source of diversification and protection against losses beyond a traditional equity and bond portfolio.

Potential for attractive risk-adjusted returns

Hedge funds seek to generate positive returns on a risk-adjusted basis, in contrast to traditional equity and bond funds that typically aim to outperform a benchmark. Whereas traditional funds tend to follow a buy-and-hold approach with returns often highly correlated to the wider market, hedge funds use sophisticated investment strategies involving leverage and short selling to potentially capitalise on market inefficiencies with the aim of achieving positive returns in both rising and falling markets. In recent years, equity and bond markets have experienced heightened volatility driven by geopolitical risks such as the conflicts in Ukraine and the Middle East, as well as macroeconomic challenges including high inflation and fears of economic recession. Greater volatility generally creates the opportunity for hedge funds to generate superior alpha irrespective of the direction of markets.

The Sharpe ratio is a statistical measure of risk-adjusted returns, comparing the return of an investment against its risk, calculated as its excess return (above the risk-free rate) divided by volatility (i.e. the standard deviation of the excess returns, a standard measure of risk). A higher Sharpe ratio indicates a better risk-adjusted performance relative to the risk taken.

The chart below demonstrates how the addition of hedge funds to a traditional 60/40 equity and bond portfolio would have improved risk-adjusted returns over the last 20 years. Whilst the addition of further bonds reduces the Sharpe ratio (and risk-adjusted returns), diversifying into a macro hedge fund significantly increases risk-adjusted returns across all levels compared to a standard 60/40 portfolio. The Sharpe ratio peaks for a portfolio with 80% in hedge funds and 20% in equities and bonds (scaled from 60/40).

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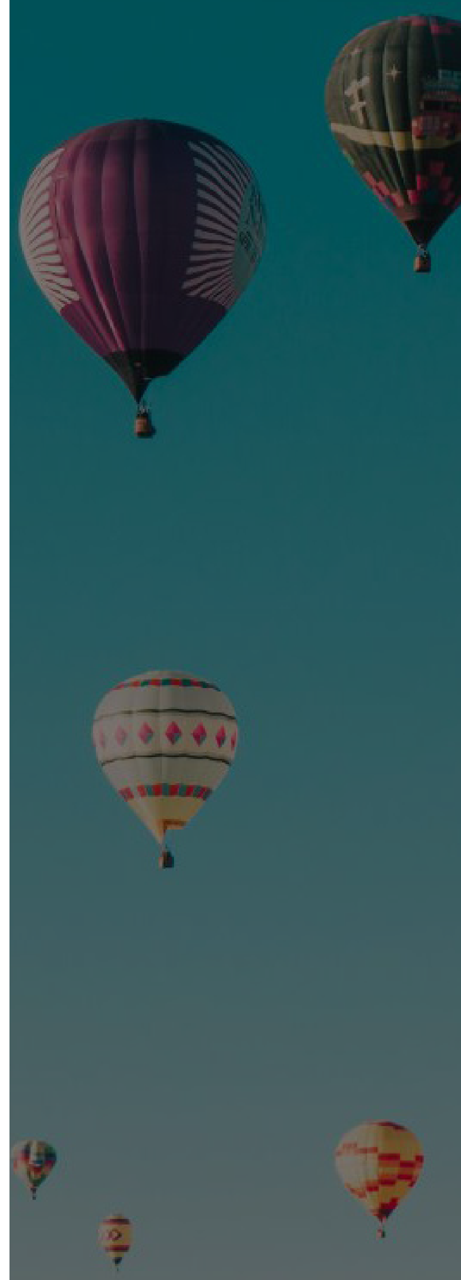
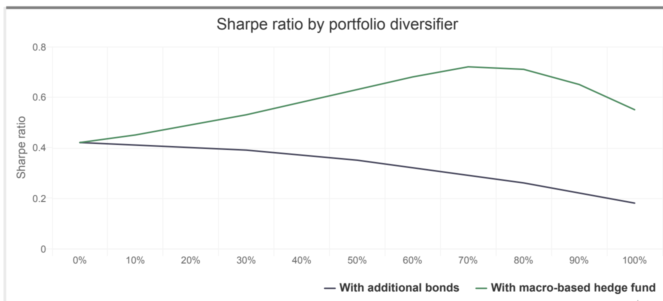


Fig.2: Diversifying Into A Hedge Fund Could Improve Risk-Adjusted Returns For A 60/40 Portfolio



Source: FE Analytics. 60/40 portfolio based on NAV (USD) returns for the MSCI World Index (equities) and Bloomberg Global Aggregate (bonds) for the 20-year period ending 31/07/2024. Diversifiers added in 10% increments (reducing the 60/40 portfolio by 10% each time) based on the Bloomberg Global Aggregate (for additional bonds) and HFRI Macro (for macro-based hedge fund) indices.
Past performance is not a reliable indicator of future results.

Putting this into context, the traditional 60/40 portfolio generated annualised returns of 6.3% in the 20 years to 31/07/2024, with an annualised volatility of 12%, but adding a 20% exposure to a macro hedge fund index over the same period would have delivered a slightly lower annualised return of 5.9% but with a 20% reduction in annualised volatility.

By seeking out uncorrelated opportunities, hedge funds aim to reduce the impact of market volatility and economic cycles that underpin returns from conventional assets, as well as to capitalise on elevated geopolitical and macroeconomic uncertainty.

Access to specialist traders

Depending on the strategy, hedge funds can allow investors to leverage the expertise of specialist traders to exploit market inefficiencies and opportunities. Traders tend to have an in-depth understanding of specific markets, asset classes and trading techniques, but seek to gain a competitive edge through trade construction, predicting price movements or executing highly-targeted trades which can have asymmetric payoffs (a smaller maximum potential loss relative to the larger potential returns achievable).

Risk management is usually very much integrated into the investment process and provides a rigorous framework to maximise potential returns whilst seeking to protect capital. Traders will typically work to bespoke risk mandates (including the use of stop-losses to protect against downside exposure), alongside designated risk managers.

After an era of ultra-low interest rates followed by monetary tightening in many developed economies, macroeconomic fundamentals such as economic growth, inflation and monetary policy have started to diverge. This change could increase the level of opportunity for macro traders to generate superior and idiosyncratic returns with a low correlation to mainstream asset classes.

How difficult is it to invest in hedge funds?

Marketing of hedge funds is heavily regulated and, as a result, it can be difficult for retail investors to meet the strict eligibility criteria required to invest.

Under SEC rules, hedge funds can typically only be marketed in the US to “accredited investors” who are also “qualified purchasers”, being institutional investors (such as pension funds and insurance companies) and certain very high-net-worth individuals. There are similarly stringent criteria in the UK to qualify as “eligible counterparties” (typically legal entities) or (individual) “professional investors”.

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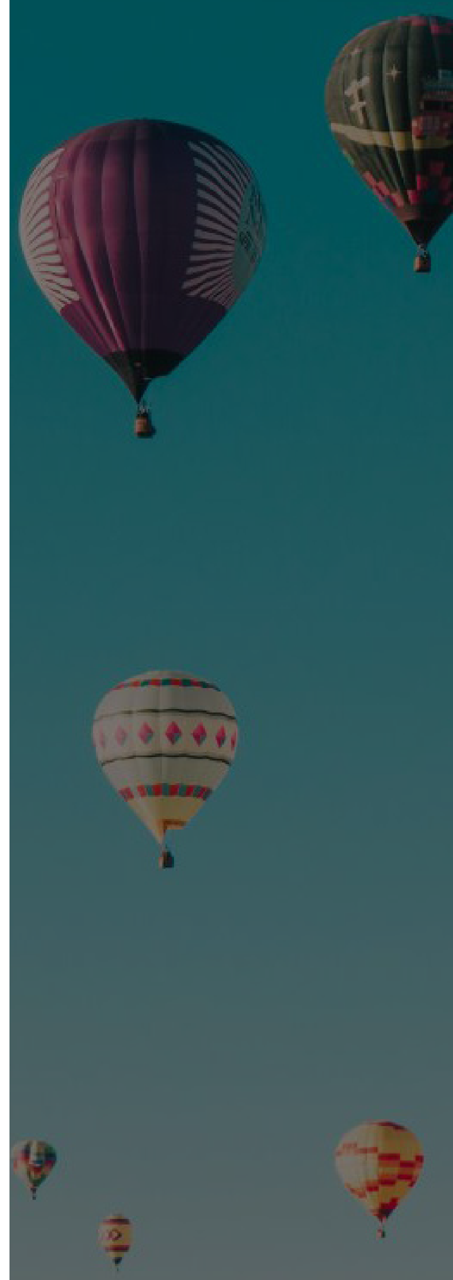

Eligible professional investors will also be required to meet minimum investment thresholds (which can be upwards of £1 million) and to complete onboarding procedures. In addition, lock-up periods imposed by the hedge funds themselves can impose liquidity constraints, such as restricting withdrawals to monthly or quarterly intervals. Due to the above criteria, it is challenging for retail investors to invest directly in hedge funds.

Investing in hedge funds using investment companies

Investment companies (also commonly referred to as investment trusts) can be a convenient vehicle to gain exposure to hedge funds because of their closed-end nature. These vehicles are open to ordinary investors who do not need to commit large sums and can buy and sell shares in the company at any point on the London Stock Exchange.

There are currently five investment companies in the AIC Hedge Funds category (of which one is in the process of being wound up). Alternative Liquidity Fund and Third Point Investors offer access to a portfolio of investments including venture capital and Gabelli Merger Plus+ focusses primarily on arbitrage from mergers and corporate reorganisations. The remaining active company, BH Macro is the only pure, diversified hedge fund in this category.

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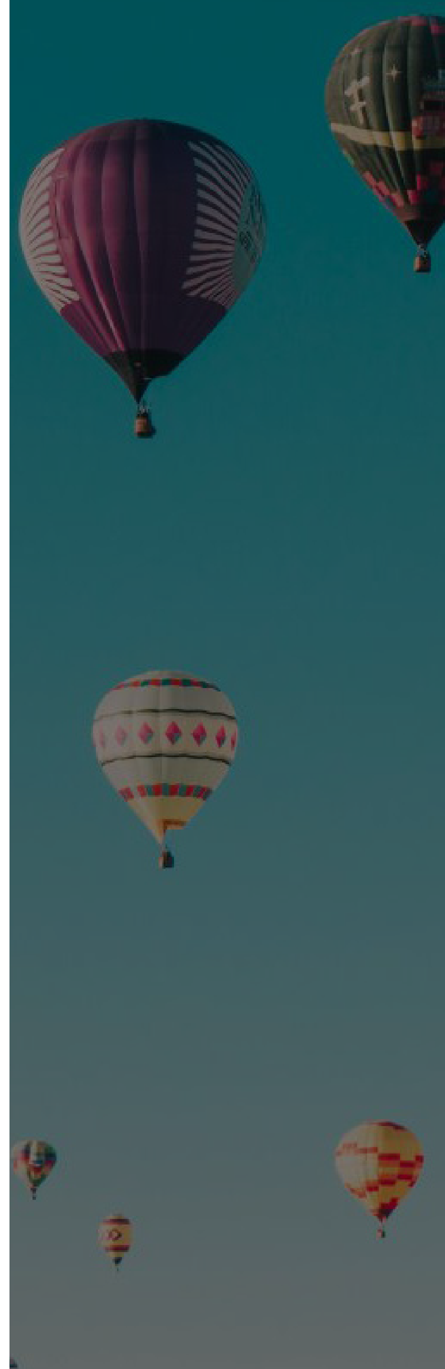

Case Study:
BH Macro

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BH MACRO LIMITED

Name: BH Macro Limited ("BH Macro")

Launched: 2007

Manager: Brevan Howard Capital Management LP ('BHCMLP')

Ongoing charges (financial year ending 31 Dec 2023): 2.16% (GBP shares), 2.14% (USD shares)

Dividend policy: Dividends have not been paid historically

Benchmark: BH Macro does not measure performance against a given benchmark

BH Macro (ticker "BHMG" (GBP shares) and "BHMU" (USD shares)) is the only investment company listed on the London Stock Exchange that offers investors exposure to a diversified macro hedge fund and provides a differentiated offering to the long-only, equity-focussed mainstream investment companies.

BH Macro provides a liquid access point to a top-tier global macro hedge fund strategy.

Whilst it is designed for professional and institutional investors, the closed-ended, publicly traded vehicle format allows retail investors to potentially gain exposure to an asset class that is traditionally reserved for sophisticated or institutional investors.

BH Macro is a direct feeder into Brevan Howard Master Fund Limited ("Master Fund"), which is managed by BHCMLP, a leading global hedge fund manager with $34 billion of assets under management and over 1,100 staff across eight main trading hubs located around the world (as of 31/07/2024).

BH Macro seeks to produce compelling, asymmetric returns, independent of the market environment and with low correlation to risk assets.

Data shows that the returns delivered by BH Macro have historically had a low structural correlation to equities and bonds.

What is BH Macro's investment objective?

BH Macro's investment objective is to deliver consistent, long-term capital appreciation via its investment in the Master Fund. The Master Fund pursues a multi-trader model that employs a combination of macro-directional and macro-relative value strategies.

BH Macro has achieved an annualised NAV return of 8.3% since its launch in 2007, with volatility of 8% (around half that of global equities) and an impressive Sharpe ratio of 0.9 (as of 30/08/2024).

What kind of assets does BH Macro invest in?

BH Macro invests exclusively in the Master Fund. The Brevan Howard Master Fund has exposure to a variety of asset classes, with a primary focus on global fixed income and foreign exchange but also peripheral exposure to other asset classes, such as equity, credit commodities and digital assets.

Who runs the Brevan Howard Master Fund?

The Master Fund is managed by BHCMLP. Brevan Howard has over 150 portfolio managers and traders, around 20 economists and strategists, more than 30 risk officers, and a 200-plus-strong trading support team (as of 01/08/2024).

Are investments driven by a particular style?

Through its investment in the Master Fund, BH Macro seeks to produce compelling, asymmetric returns independent of the market environment, with a low structural correlation to equities and bonds.

The investment style is based around three main pillars:

- Global macro research forms the backbone of the investment process and promotes independent and contrarian thought.
- Brevan Howard seeks to structure convex (i.e. asymmetric) trades where the upside potential significantly outweighs the downside.
- Brevan Howard's 30-plus-strong risk team is integrated into the investment process with each trader having a bespoke risk mandate and working with a designated risk manager to protect capital as well as maximising potential returns.

BH Macro provides diversified capital allocations across Brevan Howard's trading teams, meaning that performance is not dependent on any individual trader, asset class, market view or trading style.

To what extent are absolute returns important?

Through its investment in the Master Fund, BH Macro seeks to generate positive returns across the market cycle, including equity market downturns. Looking at the S&P 500 index's 20 months of worst performance since 2007, BH Macro delivered a positive GBP share price return in all but five of these months (and, in these negative months, still outperformed the S&P 500 index in both share price and NAV returns).

What is BH Macro's dividend policy?

BH Macro has not historically paid dividends.

What are BH Macro's ongoing charges?

The ongoing charges for the year ended 31 December 2023 were 2.16% for GBP shares and 2.14% for USD shares (calculated using the AIC Ongoing Charges methodology).

Does BH Macro have a management fee and/or a performance fee?

BH Macro pays an annual management fee of 1.5% of the NAV of each class of its shares. BH Macro's investment in the Master Fund is not subject to management fees but is also subject to an operational services fee of 0.5% per annum of the Master Fund NAV attributable to BH Macro.

BH Macro also pays an annual performance fee equal to, broadly, 20% of any increase in the NAV of each class of its shares during the relevant annual calculation period, subject to a high watermark.

Does BH Macro use gearing?

BH Macro does not typically employ gearing, although the Brevan Howard Master Fund's traders will often structure trades through options which therefore include an element of leverage. These trades are designed to offer geared upside but, in contrast to traditional gearing, should not exacerbate the downside to any great extent.

With the approval of its board of directors, BH Macro is able to borrow up to 20% of its NAV, including to satisfy working capital requirements or share buybacks.

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