

# Hedge Funds: Do Expectations Align With Strategies?

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## Snapshot

- › Hedge funds have lagged the S&P 500 Index for much of the last decade.
- › Some investors see that result as a major problem. We see it as a focus on the wrong benchmark.
- › SEI's approach to constructing multi-manager hedge fund strategies is differentiated by our ability to measure and monitor alpha generation, determine fertile areas for alpha, monitor and replace managers when necessary, and negotiate preferential terms.

The popular financial press has been overflowing with stories about the fall from grace of hedge funds—the former “masters of the universe”—over the past 10 years. These stories usually focus on the fact that hedge fund investors have lagged far behind the S&P 500 Index, while at the same time continuing to pay notoriously high fees. The key flaw in this argument is that the S&P 500 Index represents the broad equity market and is not an appropriate benchmark for most hedge fund strategies.

As their name suggests, hedge funds take significant hedging or short positions, and most carry substantially less market risk than equity indices. Ultimately, the success of these investment strategies can be judged by answering this question: do hedge funds generate significant positive alpha (or excess return) above and beyond their market exposure, and how much are investors paying for this alpha?

## Our Approach

Because hedge fund returns are usually a mix of alpha and beta (benchmark exposure), it is crucial to measure and track the alpha component. Simply identifying the appropriate benchmark is a challenge for strategies that invest across asset classes, geographies and sectors. Measurement is further complicated because benchmark exposure varies over time.

With this in mind, SEI has developed a number of tools to measure and track manager alpha against a range of benchmarks. Armed with these tools and an experienced team, SEI's approach is differentiated by the following investment philosophy:

- › **Do not be complacent:** When a manager's alpha deteriorates, we ask if this is a temporary or permanent phenomenon. Perhaps the manager's style is temporarily out of favour and this may represent an opportunity to add. On the other hand, it may be a permanent change, resulting from loss of focus or strategy drift. In this case, we do not hesitate to cut a manager; no exceptions for reputation or (former) “masters of the universe”.
- › **Fish in the right ponds:** We look for alpha where it is more likely to be found. Think of managers focusing on less well-covered smaller-capitalisation companies, international markets, niche strategies, or those taking advantage of new types of data.
- › **Pay for alpha, not beta:** We are willing to pay higher fees for strategies where most of the return is derived from alpha, such as non-directional strategies. For more directional strategies, we recommend investors should insist on only paying a performance fee over a market benchmark.
- › **Be opportunistic (be early, or be late):** We find that it is possible to structure attractive investment terms with smaller or newer managers that are highly motivated to offer better terms (be early). Conversely, if a quality manager is going through a difficult period that we believe is transitory, this is a good opportunity to add to the investment, especially on preferential terms (be late).

## Our Portfolios

The results we deliver to our investors are all that matters at the end of the day. While 2018 was a difficult year for just about every asset class, our defensive offering—the SEI Opportunity Fund—posted a positive return. Our more aggressive offering—the SEI Special Situations Fund—incurred only a fraction of the market downside, and more than recovered those losses during the first quarter of 2019. It is well ahead of HFRI's fund-of-funds indices over one, three and five years, and both funds' risk-adjusted returns (Sharpe ratios) exceed that of the S&P 500 Index over the past three years.

### Annualised Performance as of March 31, 2019

	2019	YTD	1Y Return	3Y Return	5Y Return	Since Inception <sup>4</sup>	Volatility <sup>2</sup>	Sharpe Ratio <sup>3</sup>
<b>SEI Funds<sup>1</sup></b>								
Special Situations Fund:	7.10%	7.10%	3.10%	6.60%	2.70%	4.00%	4.60%	1.2
Opportunity Fund:	3.00%	3.00%	2.40%	4.30%	1.30%	2.50%	2.40%	1.3
<b>Market Indexes</b>								
S&P 500 TR:	13.60%	13.60%	9.50%	13.50%	10.90%	13.30%	10.70%	1.1
MSCI World TR:	12.50%	12.50%	4.00%	10.70%	6.80%	9.00%	10.10%	0.9
MSCI Emerging Markets:	9.60%	9.60%	-9.60%	8.10%	1.20%	1.60%	13.00%	0.5
Dollar Index:	1.20%	1.20%	8.10%	0.90%	4.00%	2.50%	5.80%	0
Bloomberg Barclays Global Agg:	2.20%	2.20%	-0.40%	1.50%	1.00%	2.00%	4.70%	0.1
Bloomberg Barclays US Agg:	2.90%	2.90%	4.50%	2.00%	2.70%	3.40%	3.00%	0.3
Bloomberg Commodity:	6.30%	6.30%	-5.30%	2.20%	-8.90%	-4.20%	9.90%	0.1
<b>Hedge Fund Indexes</b>								
HFRI Composite Fund of HF:	3.80%	3.80%	-0.60%	3.20%	1.70%	2.10%	3.20%	0.6
HFRI Div. Fund of HF:	4.50%	4.50%	1.00%	3.70%	2.20%	2.80%	3.40%	0.7
HFRI Global HF Index:	2.60%	2.60%	-3.30%	1.90%	-0.30%	0.80%	3.70%	0.2

<sup>1</sup>Returns for SEI Special Situations Fund Ltd and SEI Offshore Opportunity Fund II Ltd include December estimates. Returns are gross of management fees and net of expenses of approximately 0.60% annually. Actual performance for investors will be presented in the monthly statements produced by the administrator and is also available upon request. Clients implemented via collective investment trusts incur product-level fees, including trustee and administrative fees, which will affect performance.

<sup>2</sup>Volatility is annualised 3-year standard deviation through 31/03/2019.

<sup>3</sup>Assumes risk-free rate of 1.2% 31/03/2016-31/03/2019.

<sup>4</sup>October 2003 is used as date of Inception for SEI Offshore Opportunity Fund II Ltd. October 2009 is used as date of Inception for SEI Special Situations Fund Ltd. Performance for periods of less than one year is cumulative. Performance data quoted is past performance. Past performance is not a reliable indicator of future results. The principal value and investment return of an investment will fluctuate so that shares, when redeemed, may be worth more or less than their original value. Current performance may be higher or lower. For performance data current to the most recent month end, please call your client service representative.

Sources: Bloomberg Barclays LP, SEI. All returns shown in USD.

## SEI's View

Our analysis has shown that the critics are correct in one respect: alpha generated by most hedge fund strategies has fallen since 2008. We recognise that the hedge fund industry has become more crowded and competitive in recent years, and it has become more difficult to remain differentiated and generate alpha.

SEI's approach has not stood still. We have adapted and evolved in an effort to continue finding managers and strategies that can deliver attractive returns for our clients.

## Index Definition

**S&P 500 Index:** The S&P 500 Index is a market-capitalisation-weighted index that consists of 500 publicly traded large U.S. companies that are considered representative of the broad U.S. stock market.

## Important Information

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