



Hedge Funds, What is a Plan Sponsor to Do?

The low interest rate environment has made finding investments appropriate for pensions, foundations and the like very difficult. They are searching for strong investment returns but need to diversify away from the stock market - one of the few areas of growth in recent years. So, after several years of withdrawals, investors are returning to hedge funds in hopes of achieving this diversification as well as favorable investment results.

Interestingly this surge of new assets is coming despite relatively lackluster investment performance. According to Hedge Fund Research, the average fund returned 20% in 2009 and 10.3% in 2010 compared with the Russell 3000 Index returns of 25.5% and 14.8% in those years, respectively (not bad in absolute terms but bad on a risk adjusted basis). This trend is continuing in 2011 with hedge fund returns trailing major stock indices by several percentage points. Presumably the hope is that the hedge funds will perform well if the stock market takes a tumble.

After years of asset declines in hedge funds, money began flowing back into them in late 2009. Recently, total hedge fund assets exceeded \$2 trillion and they are likely to surpass the asset levels achieved in early 2008. The biggest hedge funds saw the first and strongest wave of asset contributions with inflows initially going mainly to the \$5 billion plus firms as new clients (and sometimes former clients) made the jump after an improvement in the market environment and fund performance. No doubt the thinking was that these large firms were more stable and had weathered the financial crisis better than their smaller counterparts. In addition, investors are often concerned about being the big fish in a small firm's hedge fund pond so may stay away until critical mass is achieved.



Now smaller hedge fund firms are beginning to see growth in their assets. According to a recent Wall Street Journal article, the largest managers, defined as those with assets greater than \$5 billion, received 80% of the capital allocated to hedge funds in 2010 but in the first quarter of 2011 this dropped to just over 50%. Those managers with less than \$250 million of assets under management received 7% of in-flows in the first quarter of 2011 while they manage less than 4% of the industry's assets indicating a definite shift in investor attitude.

This move may signal more confidence about the market environment or the realization that smaller funds are often more nimble and better able to act on their investment ideas. As is the case in other market segments (small cap equity for example) it is often easier for hedge funds to make trades quickly and efficiently when they are dealing with a smaller asset size. Therefore, smaller funds may have a greater likelihood of achieving stellar investment performance.

One thing that's clear is hedge funds, large or small, will have to begin producing strong, consistent results in order to maintain their new higher asset levels and justify their high fees. The good news is that many fund managers were humbled by the financial crisis and have a renewed focus on their core investment beliefs which should serve them, and their clients, well in the long run.



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