INTERVIEW WITH PROFESSOR AMIN RAJAN

FINalternatives

What is your view on liquid alternatives, especially given this year's disconnect between hedge fund fees and the average performance they delivered?
Prof. Rajan: Like all other strategies, liquid alternatives have their place under the sun. They offer two benefits that retail investors value, such as ready liquidity and credible diversification. Yes, there has been a disconnect between fees and performance of late. If it persists, further fee compression will be inevitable. Hedge funds no longer aim to deliver "shoot the lights out" returns. Their key appeal in today's volatile environment is the downside protection they offer.

Will the U.S. lawsuit regarding Intel's inclusion of hedge funds in its retirement plans reignite the debate over pension allocations to alternative assets?
I do not think so. The reports of the death of hedge funds have been exaggerated over the past ten years, yet AUM continues to defy gravity. This is for two reasons:

The first is the relentless thirst for uncorrelated absolute returns, or positive investment outcomes irrespective of market conditions. Along with high net worth investors, endowments were the first to go into hedge funds in the first big wave in the 1990s. Sovereign wealth funds, insurance companies and pension funds followed suit in the last decade. From a standing start at the time of the 2000-02 bear market, for example, pension plans worldwide have 5% allocations, adding up to over $1.8 trillion today. In the beginning, mouth-watering returns drove the growth. Now, it is the search for low-volatility, risk-adjusted returns. The perception is that hedge funds are well-placed in this context.

The second reason behind headlong growth is the rapid convergence between mainstream and hedge fund strategies that first started in 2004. Hedge fund managers seeking stable revenue streams have been emulating their long-only cousins. Likewise, long-only managers facing outflows from their equity products and mounting threats from indexed funds have been adopting hedge fund tools to deliver uncorrelated returns. Shorting, leverage, unconstrained mandates etc. were rare in the long-only space ten years ago, but this is no longer so. As correlations within and across asset classes have spiked, it has become critical for managers to employ high-conviction, contrarian techniques to stand out from the pack.
Since 2008, most defined-benefit plans worldwide have experienced mounting deficits as a result of a double squeeze: low returns on the asset side and low discount rates on the liability side. Worse still, the extreme equity market volatility have also injected unusual fluctuations in the balance sheets of plan sponsors directly, and their share prices indirectly. Therefore, moderate-return, low-volatility investment options have gained ascendancy.

Old school diversification, based predominately on an equity-bond mix and relative return benchmarks, is being replaced by a new form that seeks to manage risks more than returns, and volatility more than correlation. Its core aim is capital conservation, with an absolute return benchmark. Furthermore, the version gaining traction now is akin to the old balanced mandates, but with five key differences: it deploys a broader palate of assets; it engages in tactical tilts to capitalize on periodic price dislocations; it targets an absolute return benchmark; it adopts an absolute–risk focus; and it separates out alpha and beta. This eclectic approach has turned the spotlight on alternatives in general and hedge funds in particular.

Hence, the current wave of investment in hedge funds is different from the last one in one important respect: the first was primarily driven by high net worth individuals seeking outsized returns from stand-alone strategies within broad risk parameters. In contrast, the current wave is largely driven by pension plans seeking modest returns from a blended solution within narrow risk parameters.

Is illiquidity, both in traded markets and in alternatives, being properly taken into account? Are investors being adequately compensated for it?
The answer to the first part of the question is yes, it is being taken into account. As for proper compensation, the answer is no. When these investors are turned into forced sellers, there may not be a buyer of their assets. This is best illustrated by the Volcker Rule that has reduced liquidity in the bond markets. One data point says it all: it now takes seven times as long for investors to liquidate their bond portfolios as in 2008.

The exit lanes for trades are now crowded, as evidenced by bizarre price swings, like the flash crash in U.S. Treasuries in October 2014. It begs big questions:

First, what will happen if investors rush to sell government bonds or emerging market debt when the Fed starts its rate-tightening cycle?

Second, what if a further drop in the oil price starts a stampede in the $1.3 trillion high yield market –16% of which is U.S. energy investments?

Third, given the circumstances, will investors forced to meet margin calls also be forced to liquidate their equity positions, creating a snowball effect?

These are difficult questions, and it is thus very hard to price liquidity in today's environment. The problem becomes more difficult with illiquid alternatives, such as private equity and real estate. Lack of liquidity in 2008, for instance, caused a near 40% percent fall in the value of real estate investments. It has taken seven years to recoup that loss.

Private debt, both asset-backed and cash-flow based, is all the rage at the moment. Are the risks in this asset class worth the higher yield they can generate?
Yes, historically, private debt has delivered a 13% return with a net default rate of just below 2%. It will remain in ascendancy for two reasons. First, as equities have turned ultra-volatile since the financial crisis, investors have been switching to surrogate assets that have bond-like features with equity-like returns. Second, and more importantly, as banks continue to repair their balance sheet, their ability to lend to mid-market companies has become limited. In Europe alone, demand for private debt will exceed $6 trillion over the rest of this decade.

Is there a negative correlation between hedge fund transparency and the ability of managers to find mispriced opportunities/ generate alpha?
Yes. Historically, hedge funds have delivered stellar returns by exploiting price anomalies. With increased transparency around their trades, such anomalies get arbitraged away quickly. Increased transparency comes at a price.

This year's performance has again turned the spotlight onto fees. Over the longer term, is the traditional hedge fund fee structure doomed?

The current structure is geared towards a world of double-digit returns. Without them, fee compression will be the norm.

Is China still the growth nexus for hedge funds in light of the drastic regulatory interventions over the summer?
These interventions were a major setback, although I think only temporarily. The demand for hedge funds by Chinese investors will continue to grow apace. We are entering a world of low returns, but that does not necessarily mean low volatility. On the contrary, hedge funds will retain their place in the investor universe.

You wrote in 2012 about a potential evolution into product alpha and solutions alpha. Is this split happening?
Yes, definitely. Ageing demographics is driving it. Under it, investors are drawing a distinction between product alpha that is time-dependent and solution alpha that is need-dependent. One is about beating the markets; the other about clients' identified needs. Before the crisis, high returns were the end-all and be-all for investors, in the belief that such an approach could accommodate a variety of goals. Since the crisis, retail investors are using a different benchmark that targets various needs, such as retirement, liquidity, etc. Looking ahead, I think regular income and capital protection will matter more than returns.