Where Are the Diversifiers?

Stockholm (HedgeNordic) – The heterogeneous nature of hedge funds and other alternatives may complicate the capital allocation process for large institutional investors such as Finnish pensions insurer Veritas. Rather than viewing the universe as a homogenous group and blindly allocating a fixed amount to the space, the €3.9-billion pension fund classifies hedge funds, alternatives and even traditional investments based on their roles in a portfolio.

"We thought carefully last year about the role of alternatives and especially hedge funds from a portfolio construction perspective," says Kari Vatanen, who joined Veritas as its CIO in March of last year after 13 years at rival pension fund Varma. "We started to move our portfolio during last year into different functional buckets," elaborates Vatanen. These buckets include carry-seeking, diversifying and hedging asset classes or strategies. Hedge funds and alternatives may fit in any of these three buckets.

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"We define one bucket as carry-seeking, which include asset classes and strategies with a positive expected return in the longer run," explains Vatanen, who is part of this year's Jury Board for the Nordic Hedge Award. "The disadvantage of these carry-seeking asset classes is that they tend to be highly tail-correlated with each other during crisis events as the one experienced last year due to the Covid pandemic," he continues. This higher return-generating bucket "includes all risky assets and strategies that are highly correlated in difficult market environments." The other two buckets include diversifying and hedging asset classes and strategies.

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Whereas the hedging bucket includes strategies that naturally offset the carry-seeking strategies in both good and bad market environments, "the diversifying package includes asset classes that are not highly tail-correlated compared to other asset classes," according to Vatanen. "We do not expect diversifying asset classes to deliver high returns in the future, we expect zero or slightly positive returns over time, but we want them to prove that they really diversify," he emphasizes. "The question, however, is where to find diversifiers?"

Where to Find Diversifiers?

"Looking back in history, high-quality government bonds have served as good diversifiers," Vatanen tells HedgeNordic. "And U.S. treasuries were good diversifiers during the first quarter of last year," he points out. "But now, with interest rates close to zero or even in negative territory, it is probable that we will not see a big diversification effect from high-quality bonds," argues the CIO of Veritas. "It is difficult to find diversifying asset classes and strategies in this environment," he continues. "At their best, hedge funds and some other strategies might offer some diversification benefits, but that is a big question mark."

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"When it comes to the role of alternatives and hedge funds in a portfolio, it is most important to define how they behave in different market environments," explains Vatanen. "Some alternatives and hedge funds can offer additional carry, additional sources of return, meaning that they belong to the carry-seeking bucket," he continues. "But the expectation is that their return should be high enough, and we know that they are carry-seeking and are not offering any diversification during a crisis."

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"Then for our diversifying bucket, we look for hedge funds that really need to prove their diversification characteristics during a crisis," says Vatanen. "We do not expect them to have a high expected return in the future, but we do expect them to prove that they have the right characteristics, that they are diversifying," he elaborates. "That is the key in our thinking."

Role Assessment

Many investors have opted to yank money out of the hedge fund industry in recent years due to a combination of underwhelming performance and high fees. Vatanen has a different take on the industry's journey over the past ten years or so. "Quite many hedge funds, especially at the index level and also in our portfolio, have suffered in the last ten years on two fronts," says Vatanen. "First, they have experienced positive tail-correlation, which means that they are not diversifying and we cannot classify them as having diversifying features during crises."

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"At the same time, the average return of the average hedge fund has not been higher than that of a traditional 60/40 portfolio in the last decade," continues Vatanen. If hedge funds were to suffer only on one of these two fronts, the issue on the role of hedge funds in a portfolio might have been settled. "The role of hedge funds in a portfolio is questionable if they cannot give diversification and if they cannot give extra carry, extra return," argues Vatanen. "For our purposes and for our portfolio, it is important for hedge funds to prove that they are either carry- seeking or diversifying."

2020 Performance and Cleaning

Alternative investments, which include hedge funds, alternative risk premia strategies, were a disappointment for Veritas last year. “We reduced our hedge fund allocation last year because hedge funds were disappointing during the pandemic-triggered market volatility,” says Vatanen. “You have to remember that I started in March, so everything was collapsing during my first month and hedge funds did not provide any ballast either,” he continues. “They did not give any help during that market environment, and also the recovery has been much slower compared to the traditional asset classes such as equities and bonds.”

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“There are some funds that managed to do the right things,” emphasizes Vatanen. “It is not a question of strategies, it is more a question about active management and about how managers had been positioned for the events that happened,” he continues. “At index and strategy level, there have been problems across all strategy types.”

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As a result, the investment team at Veritas headed by Vatanen “made some cleaning in our hedge fund portfolio and alternatives portfolio.” Vatanen also believes that “there is no need to reduce the allocation anymore, we might even increase that in the future, but what is more important is that we want to tilt portfolio in the right direction.” According to Vatanen, “the main message is that we are planning to be more active in selection, we are not creating broad index-type hedge fund portfolio. We will adjust and tilt the portfolio based on what we believe is best at the total portfolio level in a given market environment.”

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