Alternatives

Public funds seeing hedge fund returns back in the black

'Perfect storm' translates into strong performance across most strategies

By CHRISTINE WILLIAMSON

Hedge fund portfolio returns of large U.S. public pension funds staged a dramatic comeback in the year ended June 30, reversing a two-year downward slide.

Each of the 20 hedge fund portfolios of 17 U.S. state pension plans analyzed by *Pensions & Investments* produced positive returns in the fiscal year ended June 30, a sharp contrast to the year earlier, when 90% of the portfolios were in the red.

"There was a perfect storm in the fiscal year ended June 30 in which most hedge fund strategies bounced back," said Eric R. Nierenberg, chief strategy officer and director of hedge funds and low-volatility strategies for the $67 billion Massachusetts Pension Reserves Investment Management Board, Boston.

The higher-return trajectory of these large state hedge fund portfolios is evidenced by the 8.3% median return of *P&I*'s universe for the year ended June 30, up 1,120 basis points from a median return of -2.9% a year earlier. The median return of the hedge fund benchmarks was 6.3% as of June 30, 2017, compared to -3.4% the previous year.

The mean return of the universe in the 12 months ended June 30 was 8.9%, up from the -3.3% mean return as of the same date in 2016. The mean hedge fund benchmark return was 7.5% as of June 30, 2017, and -1.9% the prior year.

A year-to-year comparison found returns of 70% of the hedge fund portfolios in the 2017 *P&I* universe topped their plan-designated benchmarks in

SEE **RETURNS** ON PAGE 30

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SEE RETURNS ON PAGE 30

Returns

CONTINUED FROM PAGE 5

the 12 months; only 40% of portfolio returns topped their benchmarks in the year-earlier period.

Further comparison showed the one-year returns of 11 hedge fund portfolios as of June 30 topped the 7.9% return of the HFRI Fund Weighted Composite index for the same period and 16 were above the 6.5% return of the HFRI Fund of Funds Composite index.

"Pension funds should be happy for the most part with the performance of their hedge funds for the year ended June 30. The 8.9% average return of this group of hedge fund portfolios is well above the actuarial return of most pension funds and outperformed the average benchmark return by 140 basis points," noted Donald A. Steinbrugge, managing member of Agecroft Partners LLC, a Richmond, Va.-based consulting and third-party marketing firm specializing in hedge funds.

P&I's analysis shifted to June 30 returns from Sept. 30 for its annual dive into hedge fund performance to align with the fiscal-year end of most U.S. state pension funds. All performance figures are net of fees. Assets are as of June 30.

Five hedge fund portfolios turned in double-digit returns. The $2.8 billion alpha overlay hedge fund portfolio of the $41.5 billion Public School and Education Employee Retirement Systems of Missouri, Jefferson City, topped *P&I's* chart with a 20.5% return.

The $1 billion equity-oriented hedge fund portfolio of the $76 billion New Jersey Retirement System, Trenton, which is managed by the state's Division of Investment, produced the second-best return — 18.5% — in the year ended June 30.

New Jersey's $1.8 billion credit-oriented hedge fund pool was fifth in the performance ranking with a 10.1% return. The credit-focused hedge fund portfolio was the only one among the five highest-returning portfolios to trail its benchmark, which produced a 13.2% return for the year ended June 30.

The $142 billion Teacher Retirement System of the State of Texas, Austin, was third in the performance ranking with the 11.7% return of its $5.8 billion directional hedge fund portfolio.

Rounding out the list of top-performing hedge fund portfolios, at the No. 4 spot, was the $2.6 billion hedge fund portfolio of the $26.8 billion Texas Municipal Retirement System, Austin, which returned 10.3% for the 12 months.

Wide range

The one-year returns of public pension plan hedge fund portfolios ranged widely from the 20.5% return of Missouri Public School/Education Employees' alpha overlay portfolio to the 1.7% return of the $3.1 billion hedge fund portfolio of the $48.8 billion Teachers' Retirement System of the State of Illinois, Springfield.

The chart-topping alpha overlay hedge fund portfolio of Missouri Public School/Education Employees fund was the second-best-performing strategy in *P&I*'s June 30, 2016, ranking, with a return of 0.6%.

SINGIN' IN THE RAIN: Eric R. Nierenberg saw the investment landscape as a 'perfect storm' that was good for managers.

The key to the portfolio's success in the most recent fiscal year was "a combination of good portfolio construction and broad-based, strong performance across managers," and relatively modest leverage, said John Tuck, director of private equity and alternatives, in an email.

Mr. Tuck stressed that strategy selection and weighting within the portfolio proved "very beneficial" and noted every manager in the pool met or exceeded expectations resulting in a portfolio that "exhibited a low relative beta, good protection in down periods and significant outperformance, both in terms of alpha and excess return."

The sixth-ranked Missouri educational fund's more defensively oriented hedged asset program continued to "benefit from a unique approach to portfolio construction that has generated attractive absolute and risk-adjusted returns," Mr. Tuck said.

In the year-earlier ranking, school fund's hedged assets portfolio ranked seventh with a -1.4% return.

Evolution in hedge funds

Hedge fund investment by U.S. public pension plan has undergone an evolution over the past decade that has fueled the solid performance of hedge fund portfolios this year.

Agecroft's Mr. Steinbrugge said the strong performance of many U.S. public pension plan hedge fund portfolios as of June 30 is evidence that investment staff did a good job on manager selection.

"Ten years ago, pension funds viewed hedge funds as a separate asset class and bucketed strategies together," Mr. Steinbrugge said, noting many larger, more sophisticated pension funds now are "looking for best-of-breed hedge fund managers for their equity and fixed-income assets classes. Adding hedge funds to these broader portfolios adds diversification and reduces the volatility of the overall portfolio."

Another aspect of the evolution in hedge fund investment is custom portfolios, such as directional, non-directional, absolute return, portable alpha and crisis risk offset portfolios, said Stephen L. Nesbitt, CEO of alternative investment consultant Cliffwater LLC, Marina del Rey, Calif.

"It's hard to compare funds in a list like this because it's not clear exactly what the objectives of each investor are and the beta content of each portfolio," Mr. Nesbitt said. "Some investors are much more aggressive, trying to beat a benchmark like the Standard & Poor's 500 index by taking on a lot of beta."

Benchmarking hedge fund portfolios is not an easy task, sources stressed, noting tracking error can be high because few investor hedge fund portfolios track closely to established indexes such as the HFRI indexes produced by Hedge Fund

Returns

CONTINUED FROM PAGE 6

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"Pension funds should be happy for the most part with the performance of their hedge funds for the year ended June 30. The 8.9% average return of this group of hedge fund portfolios is well above the actuarial return of most pension funds and outperformed the average benchmark return by 60 basis points," said Donald A. Steinbrugge, managing member of Agecroft Partners LLC, a Richmond, Va.-based consulting and third-party marketing firm specializing in hedge funds.

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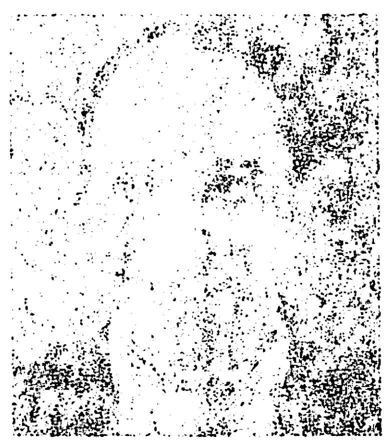

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