Hedge Funds versus Hedged Mutual Funds: An Examination of Equity Long/Short Funds

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Article Summary and Key Findings

INTRODUCTION


Despite this publicity, there have been few substantive studies of these products. In the absence of more rigorous analysis, one hears a range of opinions about liquid alternative mutual funds. These include, in particular, the view that liquid alternative mutual funds will systematically underperform comparable hedge funds either because of regulatory restrictions (e.g. on leverage) or because investment talent will be lured to the more generous economics of the private placement hedge fund industry. Whether this actually is the case is very much an unanswered question. Put another way, are these liquid alternative mutual funds substitutes for hedge funds? This article addresses this question for one sub-investment style within liquid alternatives.

The article is directed toward a professional investor community. It appears in The Journal of Alternative Investments, Winter 2014. It is available on their website at: http://www.ijournals.com/toc/jai/current. It is the first in a series of articles addressing whether liquid alternative mutual funds are reasonable substitutes for private placement hedge funds. This first article focuses on equity long/short mutual funds and how they compare to private placement hedge funds. Subsequent articles in this series will look at other liquid alternative investment strategies including multi-alternative mutual funds, market neutral mutual funds, and managed futures mutual funds.
The article describes the process of identifying an appropriate universe of equity long/short mutual funds to analyze and compare to equity long/short hedge funds. This began with a review of all mutual funds categorized by Morningstar as one of four “alternative” styles in January 2013 (242 mutual funds in total). The prospectus and annual report of each of these mutual funds was reviewed to identify those most comparable to equity long/short hedge funds. For the purpose of this analysis, those liquid alternative mutual funds managed by a single investment team (single manager versus fund of funds), who invest in a diversified portfolio of US or developed market equities (i.e. diversified versus sector or regionally focused investment style), and who employ a directional long/short investment style (i.e. not market neutral) were included in this study. Of the funds in Morningstar’s alternative investment universe, 47 active funds (as of January 2013) and 8 closed funds were found to meet the criteria above and included in the analysis.

KEY FINDINGS

The article first profiles the funds included in the analysis (e.g. by start date, size, and sponsorship). It then analyzes these funds and compares them to equity long/short hedge funds across two metrics: equity exposure and performance. Key findings include:

**Key Finding #1: Equity Long/Short Mutual Funds and a Sample of Equity Long/Short Hedge Funds Held Similar Actual Equity Exposures as of the Period of Analysis.**

Analysis of comparative actual equity exposures (i.e. gross long, gross short, total gross, and net exposure as of the end of 2012) of the equity long/short mutual funds and a sample of equity long/short hedge funds indicate similar average gross long equity exposure but somewhat smaller average gross short equity exposure among the mutual funds. This latter difference was influenced by a number of equity long/short mutual funds (i.e. 13) having no direct short equity exposure as of the period of the analysis. Re-analyzing the data without these specific mutual funds resulted in no difference in any of the average equity exposure measures between equity long/short mutual funds and the sample of equity long/short hedge funds. The results of this analysis do not support the view that regulatory constraints related to position sizing (i.e. leverage) faced by equity long/short mutual funds will necessarily present an impediment to their performing similarly to their private placement hedge fund counterparts.

**Key Finding #2: Quantitative Analyses of Equity Long/Short Mutual Funds and Leading Equity Hedge Fund Indexes Showed No Substantial Factor Exposure Differences.**

Quantitative analyses measuring equity exposure and factor sensitivity (both single factor and multi-factor) over various time periods were performed and found no substantial differences between an index of equity long short mutual funds (including “dead” funds) and indexes of leading equity long/short hedge funds. Private placement hedge fund indexes demonstrated
some greater variability in equity beta (versus the S&P 500) over time. However, individual equity long/short mutual funds showed similar time varying beta. Here again, differences between mutual funds and hedge funds seem to reflect particular investment preferences of individual fund managers rather than systematic constraints.

**Key Finding #3: Return/Risk Analyses of Equity Long/Short Mutual Funds and Leading Indexes of Equity Long/Short Hedge Funds Showed No Substantial Performance Differences.**

Comparative return/risk analyses for the index of equity long/short mutual funds and leading hedge fund indexes were performed for the period January 1, 2008 through June 30, 2013. No substantial performance differences were found for the full time period, though private placement hedge funds did demonstrate some greater performance variability in earlier years of the analyses.

**Key Finding #4: Segmenting Equity Long/Short Mutual Funds by Sponsoring Firm (i.e. Diversified Investment Firm versus Specialized Investment Firm) Did Result in Observed Performance Differences.**

Equity long/short mutual funds were grouped into two segments (i.e. those managed by diversified investment firms and those managed by specialized investment firms). The comparative performance of each segment, along with the performance of the hedge fund indexes, was then reanalyzed. The results indicate that equity long/short mutual funds managed by diversified investment firms outperformed those mutual funds managed by specialized investment firms and the HFRI Equity Hedge Fund Index on both an absolute and risk adjusted basis. This finding runs somewhat counter to the view that it is the independent, unconstrained character of the hedge fund industry that contributes to its perceived success.

**CONCLUSION**

The analyses described in the article indicate that equity long/short mutual funds offer equity exposures similar to private placement equity long/short hedge funds and perform quite similarly to them in both absolute and risk adjusted terms. While the liquid alternative market is developing very rapidly, with many recent entrants, it appears that, to date at least, equity long/short mutual funds do offer reasonable substitutes for private placement hedge funds. Whether this holds for other categories of liquid alternative mutual funds will be the subject of future articles.
About the Author
David F. McCarthy has been active in hedge fund investing for over 25 years. He is the Principal of D.F. McCarthy LLC, a consulting and advisory firm. In 2002, he co-founded Martello Investment Management, LP, a specialist fund of funds and advisory firm concentrating on absolute return hedge fund strategies. Previously, Mr. McCarthy was an Investment Manager for Global Asset Management (GAM) where he managed GAM’s trading funds of funds. He has been an investment officer with the Atlantic Philanthropies, a partner in Rayner and Stonington, a deputy manager of the International Financial Advisory Service of Brown Brothers Harriman & Co., and a consultant with McKinsey & Co. Mr. McCarthy is a faculty member of Fordham University in New York and University College Cork in Ireland. He holds a Ph.D. from University College Dublin, an MBA from Stanford University, and a BA from the University of New Hampshire.