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MPI Cautions Institutional Investors Not to Rush for the 'Hexit' Without Quantifying Portfolio Efficiency Benefits

NEW YORK, June 20, 2016 /PRNewswire/ – Institutional investors should undertake a quantitative analysis of their hedge fund investments' long-term contribution to overall portfolio efficiency, rather than basing their asset allocation strategies on a short-term comparison with equity benchmarks.

This is the conclusion of a new research study – 'Hexit: Is Now the Time to Pull Out of Hedge Funds?' – based on analysis conducted by MPI (Markov Processes International, Inc.), specialists in the analysis of systematic factors influencing investment performance, which provides analytics and reporting solutions to the financial services industry.

In response to the steady flow of announcements from large institutional investors scaling back or exiting their hedge fund investments – often citing under-performance against equities – MPI analyzed the contribution of hedge funds to broad-based portfolios over three time horizons.

By running established performance proxies through MPI's asset allocation tool, the analysis found hedge funds, in general, still provide valuable diversification benefits and improve portfolio efficiency, even during periods of extended equity bull markets (2003-2016). Even though hedge fund allocations may not provide the same efficiency benefits over stock-and-bond portfolios in the current 2009-2016 bull run, they remain an effective performance stabilizer through turbulent periods.

"There has been a lot of attention paid to hedge fund fee structures and under-performance versus equity benchmarks, but we wanted to establish whether hedge funds were delivering on their core role within investment portfolios," said Michael Markov, co-founder and chairman at MPI. "Hedge funds are not designed - and should not be expected - to outperform equity markets during protracted equity market rallies. Despite the focus on performance alone by many in the industry, hedge funds aim at volatility reduction, improving diversification within a portfolio and typically deliver superior long-term risk-adjusted return."

Using an asset allocation framework, the MPI research team demonstrated that investment in hedge funds would have improved the portfolio efficiency of cash, bonds and equity portfolios, for any risk tolerance level, for the periods January 2003-June 2009 and January 2003-April 2016.

Nevertheless, MPI's research also suggests that small allocations to hedge funds may not be appropriate for institutional investors in prevailing market conditions. "When analyzing efficient allocations, we found that the optimal hedge fund allocation hits the 25% maximum constraint very quickly in the two cases that include the crisis period. This indicates that a small (i.e. 1%) hedge fund allocation may be harder to justify, echoing results of our previous analysis of CalPERS decision to exit hedge funds," said Daniel Li, co-author of the research paper.

As such, MPI asserts institutional investors should conduct a thorough quantitative analysis of their particular hedge fund investments' contribution to their own strategy, using appropriate performance benchmarks and proxies. "In light of the challenges of implementing a hedge fund investment strategy effectively, we will examine the impact of fund selection on overall portfolio efficiency in a follow-up research paper," said Markov.

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About MPI
MPI (Markov Processes International, Inc.) is a global provider of investment research, analytics and technology. Its solutions are used by leading organizations throughout the financial services industry, including: alternative research groups, hedge funds, hedge fund of funds, family offices, institutional investors, consultants, private banks, asset managers, investment advisors and private wealth professionals. For more information, visit http://www.markovprocesses.com. Follow us on Twitter @MarkovMPI.

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