

A NEW BET: HEDGE FUNDS VS. S&P 500 OVER THE NEXT DECADE

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Ben Carlson and Nir Kaissar joined me on our “Behind the Markets” podcast last week. Ben is the Director of Institutional Asset Management at Ritholtz Wealth Management, writes a blog called “A Wealth of Common Sense” and just released a great new book, *Organizational Alpha*, that details best practices, questions and processes for institutions and their portfolio managers.

Nir Kaissar, columnist for Bloomberg Gadfly, is the founder and portfolio manager of Unison Advisors. Kaissar’s work focuses on quantitative approaches to multi-asset portfolios, such as [valuation](#)- and [momentum](#)-based methodologies. He introduced one of the first multi-asset investment managers in 2005 and mentioned to me that he has one of longest and (to his credit) one of the better track records in the multi-asset model business.

[Hedge Funds](#) vs. Market Bet

Coincidentally, I had booked these gentlemen for the show weeks ahead of time. But on March 17, Kaissar wrote on Twitter: “Who wants to bet me that hedge funds will beat the [S&P 500](#) over the next 10-years?”

His bet is modeled after Warren Buffett, who bet Protégé Partners \$1 million dollars that the S&P 500 would beat a group of [fund of fund](#) hedge funds.¹ That bet is coming to a close in the next 12 months, and by most accounts, Buffett seems likely to win his bet handily.

Kaissar’s bet is for more modest and friendly stakes: the loser has to buy a beer a decade out. Ben Carlson took him on by taking the Buffett side.

Kaissar believes today’s market valuations—and he points to the [cyclically adjusted price-to-earnings ratio \(CAPE\)](#) as one of the points that could be a drag on future returns. He and I discussed the pitfalls of the CAPE; Kaissar still has subdued expectations for U.S. market returns, and he sees strong correlations between valuations and forward-looking returns.

Carlson, on the other hand, admits that this bet might be tougher than Buffett’s. But he thinks the hedge fund universe has many challenges. Apart from the \$3 trillion invested in them and 11,000 funds all competing over limited [alpha](#) opportunities, he believes hedge funds are a “cash-plus” asset structure. What he means by that is that hedge funds would typically and historically have shorted assets and invested the proceeds in cash assets that earned a return—usually 4%–5% throughout history. Now, with short-term rates near zero, hedge funds get less earnings on those “short” proceeds. A rising-rate environment thus may help hedge funds a little, but Carlson isn’t expecting rates to rise much.

The gauge for tracking the performance of hedge funds over the next decade in this Carlson vs. Kaissar wager is going to be the [HFRI index](#). The HFRI index is a composite of hedge funds; this includes the typical asset management and performance fees for hedge funds—so Kaissar has to see the funds overcoming probably a close to 300-[basis-point \(bps\)](#) expense hurdle rate just to break even with the S&P 500. As it is currently framed, I have to say I am on Carlson’s side of Kaissar’s bet.

A Tougher Challenge

But a follow on: One no longer needs to use high-cost hedge funds to get a simple hedged strategy for U.S. equities. As both Carlson and Kaissar discussed on the podcast, there are new [liquid](#) alternative strategies that attempt to systematize [hedging](#) programs with a rules-based factor process. WisdomTree, in fact, has such a [long/short, dynamically hedged equity strategy](#).

While I would side with Carlson and choose the S&P 500 over the HFRI index (hint to Kaissar if he wants more action on their original terms), I would offer the same terms to Carlson, with the choice of a different benchmark: the S&P 500 versus the [WisdomTree Dynamic Long/Short U.S. Equity Index](#).

Here there are no underlying hedge fund fees, so it's just strategy index vs. strategy index. Over the next decade, will it prove advantageous to have been long-only in [market cap-weighted](#) indexes with no hedge or in a factor-tilted long portfolio with a dynamic hedge of market risk? In my fully biased opinion, the WisdomTree Dynamic Long/Short U.S. Equity Index benchmark would make it more difficult for Carlson to prevail.

The podcast touched on many areas outside this bet as well, so don't let this keep you from listening to other interesting areas, including topics such as:

- Why Carlson wrote *Organizational Alpha*, and the pitfalls of many institutional investing groups
- More discussion on alternative strategies and the challenges for institutional managers in picking winners
- The challenges of group decision-making processes and how to overcome them
- How Kaissar looks at asset allocations across stocks, bonds and cash and where the opportunities are today. If you cannot tell already from his subdued view of U.S. equity markets (above), they are outside the U.S. markets, particularly in emerging market equities.

Enjoy the full podcast here, and thanks to both Nir Kaissar and Ben Carlson for joining us on the broadcast!

¹On that bet, see Roger Lowenstein, "Why Buffett's Million-Dollar Bet Against Hedge Funds Was a Slam Dunk," Fortune, 5/11/16.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Momentum Factor : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Hedge fund : A hedge fund resembles a pooled investment vehicle administered by a professional management firm. It is often structured as a limited partnership or limited liability company. Hedge funds invest in a diverse range of markets and use a wide variety of investment styles and financial instruments.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Fund of funds : Funds that, instead of investing in individual securities, invest their assets in mixes of other fund.

Cyclically Adjusted Price to Earnings (CAPE) Ratio : a valuation measure of the S&P 500 Index that is adjusted for inflation and takes into account cyclical fluctuations in market earnings relative to longer term averages.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

HFRI index : Captures the breadth of hedge fund performance trends across various strategies and region.

Basis point : 1/100th of 1 percent.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.