Swimming Against the Tide

Institutional hedge fund allocations shrank by 5%. So why did public pension plans increase their exposure by 2%?
Do public pension plans know something that other institutional investors don’t? Or is there another reason why they seem to be defying industry trends? Whatever the explanation, public defined benefit plans increased their hedge fund allocations last year, even while corporate, foundation and endowment investors were trimming theirs, according to data uncovered by BNY Mellon’s Asset Strategy View.

As of November 2016, hedge fund assets account for 12.3% of the $1.7 trillion in assets in the BNY Mellon institutional client universe, which includes accounts owned by defined benefit plans, corporations, foundations and endowments. Seventy-one percent of these institutional investors invested in hedge funds, with an average allocation of nearly 17%. Endowments boasted the largest hedge fund exposure, with allocations averaging just shy of 23%. At the other end of the spectrum, public plans averaged only 12.6%.

A GENERAL DOWNWARD TREND—WITH ONE NOTABLE EXCEPTION

Over the year ending November 2016, hedge fund allocations have dropped virtually across the board. As of November 2016, the average allocation fell 5% from the same time the previous year, with foundations and endowments leading the slide. Endowments alone reduced exposures by over 9% —more than any other type of institution. The pullback was especially sharp among smaller endowments (<$1 billion), which cut their allocations by just over 15%. Approximately 1% of BNY Mellon institutional clients divested their hedge fund exposure entirely, resulting in a total reduction of 5.4% across the entire universe.

One type of institution bucked the trend. Public defined benefit plans actually increased their overall exposure to hedge funds, bumping up allocations an average of approximately 2% over the same time the previous year.

Endowments trimmed hedge fund allocations the most, while public plans increased their exposure.
What is to blame for shrinking hedge fund allocations?

WHY ALLOCATIONS ARE GETTING SMALLER
What is to blame for shrinking hedge fund allocations? The two most likely culprits are hedge funds’ relatively poor performance as an asset class, and secondarily, cash flow decisions.

Simply put, hedge funds had a weak year among institutional investors within Asset Strategy View. For the 12 months ending November 2016, hedge funds experienced the fifth-worst performance out of 34 sub-asset classes. Their median return for the year was 1.9%, underperformed only by private energy and non-U.S. sub-asset classes except emerging markets. As asset values declined, the size of hedge fund allocations naturally dwindled.

Cash flow decisions account for the rest of the story. Nearly $42 billion dollars exited hedge funds while only $36 billion entered, resulting in a net negative cash flow of $5.7 billion. On an asset-weighted basis, hedge funds suffered cash outflows for 9 out of the previous 12 months. Corporates were responsible for most of this red ink. Public pension funds were the only type of institution that made net positive contributions to hedge funds.
WHAT DOES THE DATA REALLY SAY ABOUT INVESTOR BEHAVIOR?
Many headlines about hedge fund allocations have been discouraging—but a deeper dive into the data reveals a more complicated reality. Not all trends point downward: different types of institutional hedge fund investors seem to be following different paths. For example, during the 12 month period ending in November 2016, foundations and endowments saw the largest reductions in their allocations, with smaller endowments leading the way. But public pension funds moved in the opposite direction, increasing their allocations over the previous year. While it is impossible to untangle all the drivers of allocation changes, the data suggests that public pension funds’ expanding allocations were mostly due to net positive cash investments in hedge funds—and not merely asset growth.

So, despite what mainstream conventional wisdom suggests, there seems to have been a real (if small) rekindling of interest in hedge funds in one segment of institutional investors. This unexpected discovery illustrates the kind of potentially valuable insights that often lie hidden deep within the data. Fortunately, we now have the right tools to mine it.