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’40 Act Daily Liquidity Hedge Funds: Considerations for Institutional Investors

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This paper provides a framework for analyzing the profile of the daily liquidity ‘40 Act mutual fund structure for investing in hedge fund strategies relative to the traditional private placement structure.

With the mounting hype surrounding the growth of the ’40 Act[1] hedge fund industry, many institutional hedge fund investors are evaluating whether to utilize a ’40 Act structure for their hedge fund investments or to stay with the traditional private placement structure.[2] To assist the institutional investor in making this decision, this paper assesses the risk and return profile of the ’40 Act structure that has daily liquidity, also known as the mutual fund structure, relative to the traditional private placement structure. The paper also discusses the relevance of other features of the ’40 Act mutual fund structure for institutional hedge fund investors to consider.

The analysis finds that the daily liquidity of the ’40 Act mutual fund structure could result in those funds having higher tail risk than private hedge fund structures. In addition, the investment constraints necessary because of the daily liquidity requirement of this fund structure could result in inherent structural disadvantages, likely to result in lower expected fund returns. Ultimately, this leaves the institutional investor to decide whether the greater liquidity and potentially lower fees of the ’40 Act mutual fund structure outweigh the lower expected return and increased tail risk inherent in this structure.

The ’40 Act structure

The main ‘40 Act structures that fund managers can use are open-ended, closed-ended, and ETFs.[3] When these structures employ hedge fund strategies, the resulting product has been commonly referred to as a “hedged mutual fund,” “alternative mutual fund,” “liquid alternative,” “retail liquid alternative,” “registered alternative,” “registered hedge fund,” “retail alternative,” and “’40 Act alternative” depending on the speaker and the audience. Most in the hedge fund industry simply refer to this product as a “’40 Act fund” or a “RIC” (regulated investment company), with the fact that the strategy is related to hedge funds simply being assumed.

The ’40 Act structure evaluated in this paper is the open-ended, daily liquidity variety most commonly known as the mutual fund. This paper refers to the structure as the “’40 Act mutual fund structure” and the product as a “mutual hedge fund.” Neither closed-end structures, which typically have liquidity terms more closely resembling those of the traditional hedge fund private placement structure, nor ETFs are evaluated here although both are, in fact, worthy subjects for future analysis.

While daily liquidity is in theory a good thing, there are several effects of this requirement that result in increased risk for investors in mutual hedge funds. A significant left tail risk emerges due to the creation of a “bank run” dynamic.

Risks created by the ’40 Act mutual fund structure

The daily liquidity of mutual hedge funds can create “bank run” risks because of the asset-liability mismatch problem created. Although open-ended mutual hedge funds have stated daily liquidity, current rules actually allow these funds to have less than the ability to liquidate all underlying investments in a day. First, rules require that only at least 85% of a mutual fund’s assets be “liquid.”[4] Second, the rules define “liquid” as being able to liquidate a position “in the ordinary course of business within seven days.”[5] This mismatch between stated “daily” liquidity provisions and the liquidity actually available to investors may create bank run risk. As with all commingled fund investments, investing with other investors can create bank run risk because investors are incented to redeem first and ask questions later in challenging market environments. When investors fear that they will not be able to get their money out when they want it, they will be incented to redeem early and quickly.

Although “bank run” risk exists in all mutual fund structures because the investors in them have daily liquidity, the risk is heightened with mutual hedge funds due to the relative novelty of the strategy to the retail investor. It is not clear how retail investors will react if and when their mutual hedge funds underperform. While traditional long-only mutual funds have been around for decades and their performance is well-understood, the reaction of retail investors in mutual hedge funds to adverse news is not yet known or understood. As noted in a recent Office of Financial Research (OFR) report, mutual hedge funds “can introduce more complex trading strategies and embedded leverage than traditional retail mutual funds do. During a market shock, when the risks become more apparent, investors who failed to appreciate the risks of these investments could engage in heavy redemptions of those products, exacerbating the shock.”[6] Therefore, institutional investors who invest in ’40 Act hedge funds, and in particular mutual hedge funds, are making an assumption about whether retail investors understand their investment.

Moreover, these “bank runs” can be caused by reasons other than performance. As noted in the OFR report, “concerns about the liquidity of one fund can quickly spread to similar or related funds, or the sponsor of a fund complex.”[7] In other words, prudent underwriting by the investor and prudent management by the manager do not eliminate bank run risk. A failure of one mutual hedge fund could initiate a re-

underwriting by all mutual hedge fund investors who may have assumed their investments were safe. Runs can start even if investors think that other investors will be surprised by this occurrence. The results could be dire if this were to occur during a market downturn.

The use of derivatives by mutual hedge fund managers can leave these funds particularly vulnerable to large redemptions during times of market stress. Current rules require mutual hedge fund managers to cover all borrowings with three times as many assets.[8] However, mutual hedge fund managers are able to use derivatives to effectively lever above the amount covered by the 300% coverage rule. Limits on effective leverage achieved by the use of derivatives of the mutual hedge fund manager are subject to less onerous and less defined rules.[9] Managers only have to cover the expected daily mark-to-market of their derivative positions. During market pullbacks, the expected loss on these positions could exceed the liquidity that the manager maintains as cover. This could start a cascade of irreversible losses as managers liquidate what they can to meet margin calls. In fact, the mere hint of the possibility of accelerated losses can ultimately start a "bank run." As a result, investors should avoid assuming that mutual hedge funds are less risky because of their leverage constraint, because the use of derivatives can mask true leverage levels and total risk.

Structural shortcomings that result in less attractive return profiles

The daily liquidity requirement of mutual hedge funds may force managers to invest in lower-returning liquid assets or, worse, hold cash which, in turn, creates a drag on returns. As previously noted, runs on funds can happen for reasons outside of a manager's control. Therefore, in addition to holding larger cash buffers, managers may be incented to invest conservatively in order to avoid posting losses that could create runs on their funds. The daily liquidity requirement both increases left tail risk and also restricts a manager from more aggressively seeking return. However, hedge fund investors should want their managers to embrace taking idiosyncratic risk, which at times will create mark-to-market losses. Institutional investors can afford to keep taking those risks because they can diversify them across a portfolio of hedge funds. However, some retail investors may not be as diversified or have the same long-term investment horizon. The result is a potentially less diversifiable return profile for hedge fund investors using the '40 Act mutual fund structure to invest.

The '40 Act mutual fund structure puts hedge fund investors at a structural disadvantage in generating attractive returns relative to the traditional private hedge fund structure.

Hedge fund strategies that can be implemented in the mutual hedge fund format are limited and cannot alone form a well-constructed hedge fund portfolio. Generally, the best hedge fund portfolios are aggregations of idiosyncratic risks and sources of alpha, not only across managers but also across strategies. Investors who only invest in mutual hedge funds are typically restricted to long-short equity, equity market neutral, global macro, and CTA-type strategies, as these are the most liquid. However, this limited strategy selection can leave investors without key hedge fund strategies such as

long-short credit, distressed debt, event-driven, and fixed-income relative value. Institutional investors would be remiss to set up portfolios that exclude these core strategies.

Institutions investing in hedge funds through the traditional private partnership structure can benefit from their longer-term investment horizon…

Daily inflows and outflows cause mutual hedge funds to repeatedly incur trading costs because of the daily liquidity. This is a deadweight loss for the rest of the investors in the fund. These additional costs may not be beneficial to institutional investors with longer-term investment horizons.

The growth of mutual hedge funds can actually help the returns of investors who choose to stay with the traditional private placement structure for hedge fund investing. It is common that when managers implementing similar strategies dispose of assets through fire sales, those who are invested in the same strategies and hold similar assets will take mark-to-market hits. However, while some may have to sell at fire sale prices and thus lock in their losses, those who are not only able to hold onto these assets, but also to add to them at lower prices, will stand to benefit when prices correct. Hedge funds frequently trade around retail cash flows. It is a tried and true strategy that when retail investors sell, institutional investors buy. Traditional private hedge funds serving the institutional investors who have the ability and the willingness to hold assets typically longer than retail investors, stand to benefit from capturing potentially heavily discounted value. This opportunity is more attractive today than it has been in recent history because the Volcker Rule has limited investment banks from being this liquidity provider.[10]

Other considerations for institutional hedge fund investors

...and they are able to achieve transparency and oversight comparable if not superior to that achieved in the '40 Act mutual fund structure.

Institutional investors can use their longer-term investment horizon to earn excess returns. This article so far has pointed out that the daily liquidity feature of mutual hedge funds may create *more* rather than *less* risk for institutional investors. However, taking a step back, it is not clear why an institutional investor would want to pass on having this return premium in their hedge fund portfolio in the first place. Of course, the institutional investor should have plenty of liquidity in their total portfolio to meet any cash needs. And, hedge fund portfolios should generally be more liquid than longer -term investments like private equity and real estate. However, it may make more sense for institutional investors to use their hedge fund portfolios as a source of *intermediate*, rather than *immediate*, liquidity. Given that institutional investors must plan for both current and future spending needs, it is prudent to earn *intermediate-term* risk premia, capturing higher returns than more liquid investments, while allowing for cash management to meet present needs.

Transparency and independent oversight are not unique to the '40 Act mutual fund structure. Institutional investors can receive transparency and independent oversight

of their hedge fund investments in their traditional private placement hedge fund investments. Some institutional investors are already receiving all of their positions on a monthly basis with a less than 30-day lag, which is far superior to the required 60-day lagged, quarterly transparency of mutual hedge funds. Moreover, institutional investors have been successful in setting up private hedge fund investments with oversight from an independent board of directors.

Conclusion

This paper formulates a framework for institutional investors who are evaluating whether to use the ’40 Act mutual fund structure for their hedge fund investments or to continue to invest in hedge funds utilizing the traditional private placement structure. The structure of mutual hedge funds comes with increased tail risks, lower return expectations, and limited strategy selection. Institutional investors must, therefore, weigh whether these risks, costs, and limitations are justified by potentially lower fees. Finally, transparency and independent oversight can be achieved in the traditional private placement hedge fund structure that is comparable or superior to that achieved by the ‘40 Act mutual fund structure.

Ultimately, institutional investors must weigh whether increased tail risks, lower return expectations, and limited strategy selection justify the potentially lower fees of mutual hedge funds.

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[1]Investment Company Act of 1940 (“‘40 Act”). 15 U.S.C. § 80b-1 - 80b-21.

[2]The private placement structure encompasses both the LLP and the LLC structures.

[3]To be clear, exchange traded funds (“ETF”) are in fact a type of closed-end fund. Also, note that the ‘40 Act additionally covers Business Development Companies (“BDC”).

[4] U.S. Securities and Exchange Commission. 57 FR 9828 (Mar. 20, 1992). Rules and Regulations.

[5] Ibid.

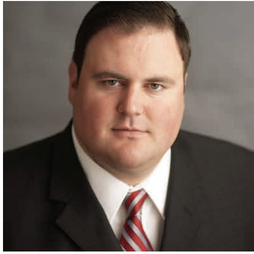
[6] U.S. Department of Treasury, Office of Financial Research. Sept. 2013. Asset Management and Financial Stability. Retrieved from http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

[7] Ibid.

[8] U.S. Securities and Exchange Commission. Registered Investment Company Use of Senior Securities—Select Bibliography. Feb. 2013. Retrieved from http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

[9] Ibid.

[10] “The Volcker Rule.” Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) § 619; 12 U.S.C. § 1851.



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Andrew is an Associate Director working in Portfolio Management, focusing on portfolio construction. He is actively involved in the strategy and asset allocation for the firm's flagship Moderate Multi-Strategy portfolios and previously served as the chairperson of the Portfolio Solutions Group where he assisted in the portfolio construction of custom account mandates. Andrew began his career at PAAMCO focusing on investments within corporate and consumer credit with an emphasis on structured opportunities as well as fixed income strategies. Prior to attending business school, Andrew worked at IndyMac Bank, which was later merged into OneWest Bank, where his experience included balance sheet credit risk analysis, bulk trading, and whole loan portfolio pricing.

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