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PERSPECTIVES

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Is the Hedge Fund Heyday Behind Us?

Following a sustained period of tremendous market momentum and questions about the value of active management, many investors are wondering whether hedge funds have passed their prime.

BY KRISTA MATTHEWS

WITH HEDGE FUND PERFORMANCE lagging global equities by nearly 800 bps on an annualized basis over the five-year period ending June 30, 2015,[1] some investors find themselves asking hard questions about their investments. This underperformance, combined with ongoing coverage of hedge fund closures and persistent headwinds facing active management, has left many shining a harsh light on hedge fund returns and fees, while also asking whether opportunities for alpha still exist.

So, is it time to abandon hedge funds?

Same Question, Different Market Cycle

Questions about hedge funds during certain market cycles are not new. Jon Hansen, a Managing Director who manages hedge fund programs for some of Cambridge Associates' discretionary clients, cautions investors not to equate short-term performance to industry demise. "There was a *Fortune* article, 'Hard Times Come to the Hedge Funds,' that outlined how managers got 'clobbered' on their shorts, 'murdered' on their longs, and had concerns as the 'SEC is moving in,'" he recounts. "That article was written in 1970. Imagine the long-term portfolio returns that investors would have missed out on if they had been convinced then that the asset class was doomed."

Jerry Kraus, a Managing Director who specializes in hedge fund portfolio construction at Cambridge Associates, points out that investors were also asking similar questions in 2007 and 1999. In sustained bull markets when correlations are high and credit is relatively cheap, hedge fund managers have fewer inefficiencies to exploit. This makes it harder for them to match the outsized returns of long-only equities—and it means that long-only performance trounces hedge fund performance during that time. Prior to the 2008 financial crisis, the MSCI All Country World Index outperformed the Hedge Fund Research Fund-of-Fund Composite Index by more than 600 bps in the five-year period ending June 30, 2007. In 1999, the dispersion was even greater—more than 700 bps.

[1] As measured by HFRI Fund-of-Funds Composite Index versus MSCI All Country World Index (ACWI). The HFRI Fund-of-Fund Composite Index is a benchmark designed to reflect fund-of-fund industry performance by constructing an equally weighted composite of constituent funds as reported by fund-of-fund managers in the Hedge Fund Research database. The MSCI ACWI captures large- and mid-cap representation across 23 developed markets and 23 emerging markets countries. Broad-based indexes and composites are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index or composite.

There is, however, one major difference between the current bull market and these prior markets—investors' exposure. "Clients have lived through this before and can understand the concept that hedge funds will underperform in a bull market," says Kraus. "But in 1999, hedge funds represented about 5% of our clients' allocation. Today that allocation is more than 20%, on average. That makes the pinch feel a whole lot tighter."

The Hedge Fund Payoff

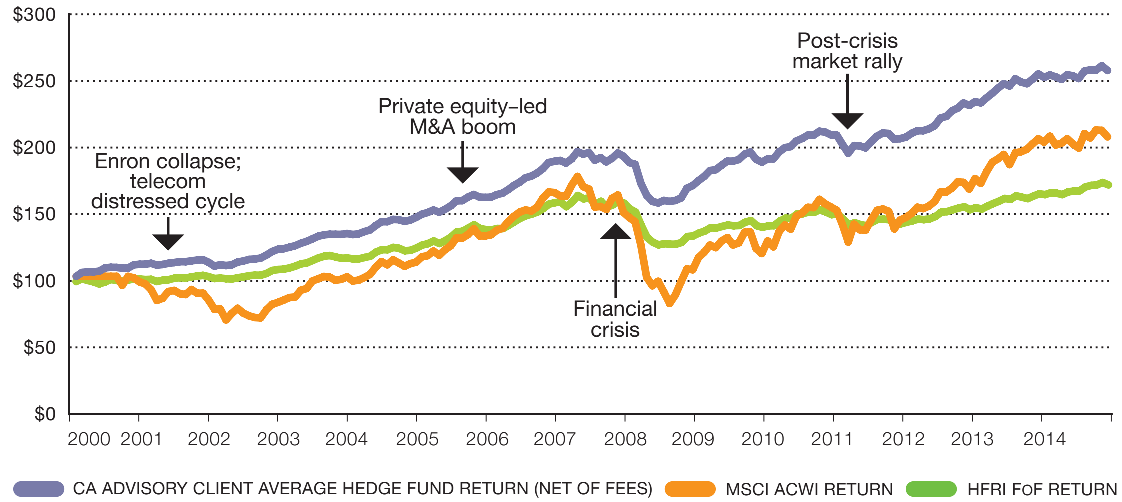
Looking across these market cycles, hedge funds have been a critical component of long-term alpha generation and downside protection for investors during the last 15 years, says Hansen.

During a time frame that included the Enron collapse, the private equity/merger boom, the 2008 financial crisis, and the most recent economic recovery, the cumulative wealth of the mean CA advisory client hedge fund portfolio exceeded that of an unmanaged MSCI All Country World Index by more than 20%, net of both Cambridge Associates and investment manager fees.[2]

The value that hedge funds have offered extends beyond just the absolute returns. When part of a

Cumulative Performance of CA Hedge Fund Advisory Clients

July 1, 2000 – June 30, 2015



Sources: CA's hedge fund advisory client universe, Hedge Fund Research, Inc., and MSCI Inc. MSCI data provided "as is" without any express or implied warranties. The cumulative wealth chart includes hypothetical examples of how an investment of $100 would have grown over time. Hypothetical performance results have many inherent limitations. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical results do not involve financial risk, and no hypothetical record can completely account for the impact of financial risk in actual investing. There are numerous other factors related to the markets in general or to the implementation of any specific investment program that cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual results. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown.

[2] Composite includes 347 full advisory hedge fund program returns for Cambridge Associates clients who receive(d) hedge fund performance reports as of June 30, 2015. Clients are added to the sample over time based on their advisory contract start date and are included for those periods during which they are advisory clients. "Cambridge Associates" comprises five investment consulting affiliates established for the purposes of providing investment management, advisory, and related services around the globe. Annualized mean returns are calculated based on a monthly equal-weighted client composite return. In some instances, fees were deducted based on a model fee calculation using the highest fee schedule appropriate for the client type and service provided. In these cases, the model fee deducted was equal to or greater than actual fees paid by that client. Returns shown are net of manager and CA fees. Past performance does not guarantee future returns. Returns may include investments made prior to becoming clients of CA, and performance may be attributable to factors other than CA's advice because of the non-discretionary nature of advisory consulting.

strategic asset allocation, hedge fund exposure has reduced the variability of portfolio returns in a meaningful way, providing superior risk-adjusted returns relative to long-only equities. Examining the 15-year time period in five-year segments reveals that the returns for the MSCI All Country World Index were different across all three periods. Meanwhile, the return for CA's mean advisory client hedge fund portfolio remained relatively consistent. "While many may lament recent hedge fund performance relative to global equity markets, it's important not to underestimate the value of more predictable returns and lower volatility during both up and down markets," Hansen says.

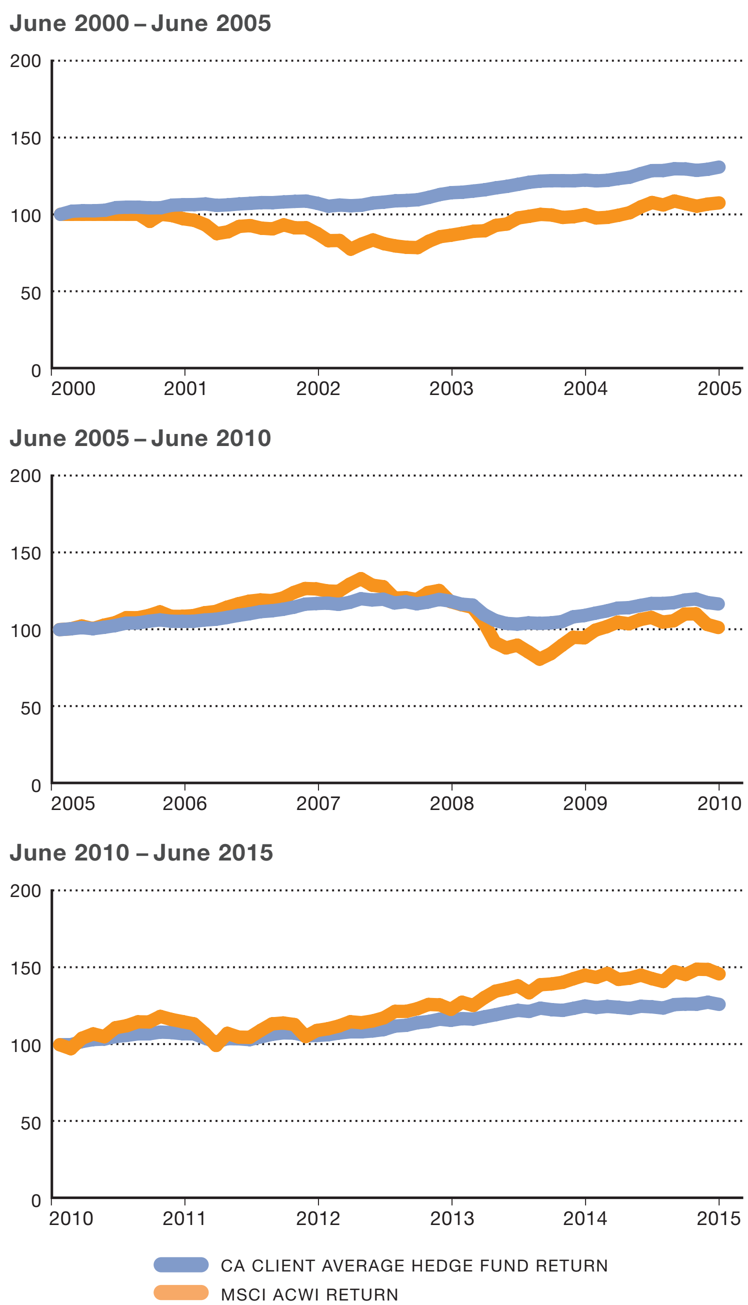
Kraus concurs. "In periods after equity markets have performed strongly, it's worthwhile to have balance in the portfolio," he says. "For most objectives, the balance provided by having hedge funds in the portfolio is likely to prove beneficial."

At the same time, Kraus cautions investors to ensure the hedge funds they employ take the *appropriate* risk, rather than a *minimal* amount of risk. "With any investment situation, risk is related to return. That doesn't change if you are investing with a passive investment, like an equity index fund, or an active one, such as a hedge fund. If you are trying to earn a certain level of return, you need to ensure that the type and the level of risk are suitable for your objectives and the market environment."

Like the ubiquitous disclosures read, however, past performance is not indicative of future results. As the market has become flooded with hedge fund assets, many investors are questioning whether bigger is actually better. Indeed, hedge fund assets have more than doubled since 2008, growing to roughly $3 trillion in assets under management in 2015. This leaves managers competing for a limited opportunity set, leading to a steady shrinking of alpha generation from these investments. And many investors are tiring of paying outsized fees that do not come with outsized returns.

But beware of throwing the baby out with the bath water, cautions Kraus. "It's certainly true that, in aggregate, hedge funds have matured in their investment lifecycle. That can make it increasingly more difficult to find the innovative, nimble, differentiated managers today," he notes. "But that doesn't mean it's not worth the effort to find them."

Cumulative Performance of CA Hedge Fund Advisory Clients: Five-Year Periods 2000–2015



Please see sources and notes on page 3.

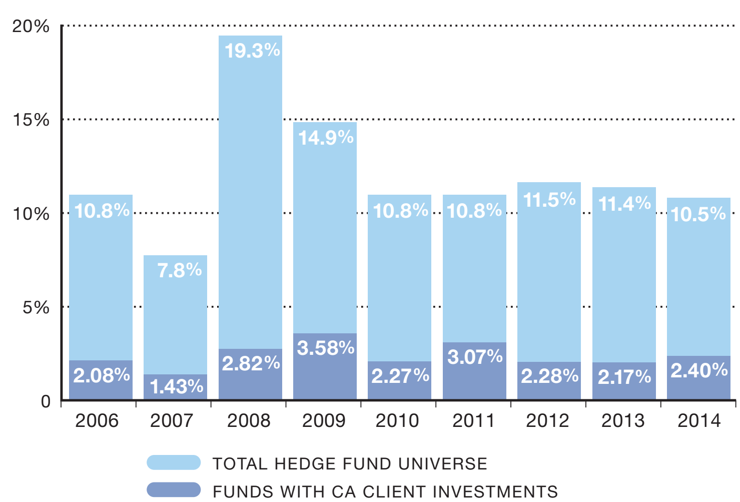
> *Investors would be hard pressed to find other investments that offer the same portfolio protection while also delivering the absolute returns and alpha that hedge funds are likely to offer when a market downturn hits.*

Hansen supports this argument with additional analysis. During the same 15-year period in which the cumulative wealth of CA's mean advisory client hedge fund program outpaced global equities, it also outperformed the HFRI Fund-of-Funds Composite Index, a broad measure of hedge fund performance, by 50%. "Dispersion among hedge fund manager returns routinely shows the top tier outpacing the bottom tier by several hundred basis points," Hansen explains. "These results underscore the importance of identifying managers that can make a compelling case for outperformance."

Finding the Winners

How, then, do investors make sure they're finding the top-tier investments? In the report *Hedge Funds: Value Proposition, Fees, and Future*, Hansen and other Cambridge Associates colleagues highlight the importance of deep due diligence that delves into a fund's investment philosophy, terms, and business operations. The paper argues that these elements make up a fund's value proposition and together help increase the likelihood of consistently attractive risk-adjusted returns.

Comparing Hedge Fund Annual Liquidation Rates



Universe of Funds with CA Client Investments represents products in which CA advisory and discretionary clients have invested since 2006. Investments made by CA's advisory clients were not necessarily recommendations made by the firm. Annual liquidation rates reflect the number of product liquidations during each calendar year divided by the number of products at the start of the year. Since 2006, CA advisory and discretionary clients have invested in 838 total hedge fund products. 174 of these products have liquidated.

Sources: Cambridge Associates calculations based on client data and Hedge Fund Research Inc.'s figures.

At a fundamental level, Hansen explains, the most successful hedge fund managers exhibit three basic characteristics:

Consistent Security Selection Skill: Understanding the repeatability of a manager's process for sourcing ideas is important. Virtually anybody can get lucky once. To truly be considered for long-term investment, a manager should prove that its process is driven by differentiated skill regardless of the strategy pursued.

Portfolio Management Expertise: How managers use their own research to capitalize on their best ideas while managing risk can separate exceptional managers from merely good ones.

Proficient Operations: When evaluating their own business practices, managers should apply the same lens they use to analyze investment opportunities to ensure they are operationally stable. They should also be good business partners—investors should trust managers to treat them fairly during both prosperous and challenging times.

Of course, fees are also an important and often-scrutinized component of hedge fund due diligence as well. Hansen suggests that, in addition to focusing on a manager's returns net of fees, it's also critical to examine the components of the fee schedule. For example, he says, management fees, meant to allow the manager to run the business, should not be a primary source of profit.

"We continue to focus on how managers run their organizations. We analyze what's expensed through to the LPs and whether those expenses are within reason," Hansen says. "Managers also are more willing to engage us in dialogue over their terms and organizational structures. As a result, there's greater partnership between LPs and the GPs."

Beyond the fairness of the fees, LPs still feel apprehensive about whether they are paying too much. In that sense, Kraus suggests that investors shouldn't evaluate hedge funds differently than any other active manager.

"When pursuing any form of active management, investors should ask themselves three key questions. First, can managers outperform the market index? Second, can I identify managers likely to outperform the index? And third, what's unique about the manner through which they generate returns and what proportion of the unique return will be consumed by fees?," explains Kraus.

Know the Role

Still, some investors continue to question whether hedge funds are worth the effort, and Hansen and Kraus remind them to consider their options. As more investors use hedge funds for diversification benefits and lower yields have compressed the margin of safety offered by bonds, the uptick in hedge fund allocations has largely come at the expense of bond allocations. Dialing hedge funds back now could leave portfolios vulnerable when markets shift.

"If investors were to significantly scale back their hedge fund allocations, they would be hard pressed to find other investments that offer the same portfolio protection while also delivering the absolute returns and alpha that hedge funds are likely to offer when a market downturn hits," Hansen says.

Kraus puts it a different way. "With hedge funds, we expect that the majority of returns are from non-traditional sources. So if an equity-focused fund generates a beta of one-third, we can assume that two-thirds of the return comes from something other than the equity markets. As an investor, you need to consider whether you can identify another investment that offers a more cost-effective alternative that helps you generate an equal amount of return from non-equity sources," he says. "Chances are, you can't."

Looking Ahead

Recent low stock dispersion and zero interest rates have certainly created a challenging environment for hedge fund managers. But when the market cycle inevitably ends, according to Hansen, there's no

Facts About Hedge Funds

MERIT? OR **MYTH?**

BY BEN BUTTRICK


Joe Marenda

AS INVESTMENT VEHICLES designed to diversify portfolios and achieve the purest form of alpha, hedge funds' success or failure relies heavily on the skills of the investment manager. But what factors indicate greater odds of success? Joe Marenda, a Managing Director who specializes in building hedge fund portfolios, dug into Cambridge Associates' hedge fund manager database to find out.

Marenda analyzed a number of factors including manager age, fees, asset size, and strategies to evaluate some "rules of thumb" about hedge fund performance. So, which aspects of conventional wisdom hold water and which have some leaks?

Highly experienced hedge fund managers have greater success.

MERIT

MYTH

Surprisingly, evidence suggests that shorter-tenured hedge fund managers may actually perform better on average. Marenda looked at manager experience post-college and found the dividing line of meaningful performance differentials at 23 years of experience (or about age 45). In fact, in open mandate managers, younger managers generated a meaningful 62% greater wealth over a 12-year period.

better vehicle than hedge funds to capitalize on increasing market inefficiencies.

“The hedge fund structure has value because it is flexible,” Hansen explains. “It enables managers to allocate capital in ways that traditional active managers can’t and achieve returns that aren’t correlated with the market.”

Kraus agrees but warns of the hidden traps of that flexibility. “The range of investments qualifying as hedge funds is so broad that it often leads to disappointment. With investments that span from market-neutral or pure alpha to credit-focused funds, returns will—and should—vary tremendously in an absolute sense. Investors need to ensure that their risk preferences match their return expectations,” he says.

And while hedge funds might continue to offer good opportunities for investors looking to generate alpha and protect their assets, they are not the only options investors should consider. “Hedge funds have performed remarkably well for investors over the long term, and they are likely to remain a meaningful part of their allocations for the foreseeable future. But there is nothing magical about them,” Hansen cautions. “As investors, we should be constantly looking for complements to serve this role in the portfolio, challenging ourselves to make the best investment decisions that maximize alpha generation at the appropriate cost.”

Read more about hedge fund fees and terms in CA’s research paper, Hedge Funds: Value Proposition, Fees, and Future*, available online at www.cambridgeassociates.com.*

Hedge fund fees *cannot be controlled*.

MERIT

MYTH

Most hedge funds have multiple share classes, and fees can be lower for those with longer lockup periods. Long-term investors that can afford the illiquidity can have a significant advantage in cumulative wealth when opting for the longer-lockup vehicle. For example, a 1% decrease in management fee for a three-year lockup versus quarterly liquidity can result in a 14% higher level of cumulative wealth over ten years.

Smaller funds may perform better in the long run.

MERIT

MYTH

Evidence does suggest this is true, but the difference is less dramatic than other attributes. Over the 12-year period examined, smaller managers (defined as those in the bottom three quartiles of size) delivered 12% more in cumulative wealth. Larger funds really began to lag during the global financial crisis in 2008–09 and in the ensuing equity recovery through mid-2011. Performance was roughly comparable during other periods (2002–08 and 2011–14), suggesting that smaller funds may benefit from their nimbleness during periods of market duress and the immediate aftermath.

Certain hedge fund strategies have shown *persistence* in outperformance of other hedge fund strategies.

MERIT

MYTH

As with broader asset classes, this analysis showed that no hedge fund strategy consistently outperformed other strategies over time. A hedge fund program should have a mix of different strategies for proper diversification.

Hedge funds with *higher fees* typically generate better returns.

MERIT

MYTH

This may seem counterintuitive, but hedge funds with higher management fees (>1.5%) bested funds with lower fees (≤1.5%) by 1.15x net of fees based on cumulative return over a ten-year period.

Hedge funds that are *closed to new investors* generate better returns.

MERIT

MYTH

Closed hedge funds appear to perform better over time, but gaining access to these closed managers can be challenging. Being able to access closed versus open US long/short managers over the 12-year period improved the cumulative return by 1.13x.

These conclusions are based on analysis of hedge funds tracked in the Cambridge Associates manager database between April 1, 2002, and March 31, 2014.

Cambridge Conversations

David Druley

President and Head of Global Investments

BY KRISTA MATTHEWS

In this multi-part series, CA Perspectives *speaks with a member of the firm's leadership to discover what's new and learn more about what to expect going forward. In this installment, we speak with President and Head of Global Investments, David Druley. In this newly configured role, David oversees the collective efforts of CA's dedicated practice areas and research team.*

Tell us about your background before you joined Cambridge Associates.

Early in my career, I started an investment firm that built deep value equity portfolios for private clients. After that, I went back to the University of Texas to pursue my MBA. While in school, I worked at the Texas Teacher Retirement System, a public pension of over $130 billion. I focused on alternative assets, spending most of my time helping to build the system's hedge fund research capabilities. After graduating about 13 years ago, I joined Cambridge Associates.

How has your career evolved at Cambridge Associates?

When I started my career, like most of us who started here 10 or 15 years ago, I worked with different types of clients: families, nonprofits, corporations, and pensions. A significant amount of my work was outside the United States. So I've really had a global perspective from day one. As I started working with more pensions, I realized there was an increasing demand from plan sponsors for fiduciary partners who could help them navigate the increasingly complex investment landscape and regulatory environment. I saw an opportunity to take Cambridge Associates' investment acumen and marry that with a risk management framework specifically for pensions. In doing that, we believed we could generate higher returns at appropriate levels of risk in a way that was differentiated from what other firms were doing in the pension market.

Out of that we informally created the pension practice in 2009, and I became its de facto leader. That really was a beta test for the formation of our formal practice areas, including nonprofits, private clients, and pensions, in 2014. In a way, in my new role as Head of Global Investments, I've gone full circle. I'm back to focusing on making sure we have the right resources, frameworks, and investment professionals in place to generate the best returns at the appropriate risk levels—focused on all of our clients.

As an investor yourself, how do you find and implement best ideas in your clients' portfolios?

First and foremost, finding great ideas is the key starting point. That requires three things. The first is a broad network of existing and newly forming managers. The second is the time to put into evaluating all the available ideas. And the third is experience.

Our investment directors and research team partner closely to find the best opportunities. With more than 250 investment directors at Cambridge Associates, I believe we have one of the broadest, most highly experienced networks available. Complementing that, we have about 100 colleagues spending all of their time researching managers around the globe. It takes elbow grease to kiss all the frogs to find the princes, if you will. And there's no substitute for experience. Our investment directors who construct portfolios and conduct manager research average more than 17 years of industry experience. We merge all of those components—the network, the elbow grease, and the experience—to form a high-performing team focused on generating alpha for our clients.

Once we identify good opportunities, our investment teams evaluate how the ideas will fit with our clients' unique goals. For example, given the total assets and the potential size of each particular investment of government-sponsored plans, they have an opportunity set different from most endowments, families, or corporate clients. This requires us to tailor our implementation decisions, and in some cases our strategy decisions, specifically to each institution.

What are the benefits of having Global Investment Services and Global Investment Research under single leadership?

Alpha is a zero-sum game. For every winner, there is a loser. And in this business, we're competing on value add.

The way that is done has changed over time. When I started an investment business 25 years ago, information was precious. It was very hard to get your hands on data. I remember having annual reports overnighted so we could get them quicker. You could really get an edge by dedicating resources to gathering information.

Today, information is abundant. Now how you synthesize the information and allocate resources to vet the information is really what makes a difference. Understanding the biases inherent in all of us and structuring teams and processes in a way that best removes these decision-making biases is crucial. Having Global Investment Services and Global Investment Research together creates a more efficient information sharing structure. It also helps ensure that colleagues across these teams are working closely together and developing deeper relationships. When people build trust, they can comfortably challenge each other's thinking. This creates an environment that encourages debate, which is crucial for making the best investment decisions for our clients. All of this should help us to generate strong returns for our clients.

In many ways, moving to single leadership of these two core teams is very similar to the evolution of our practice areas that I mentioned earlier. Global Investment Services and Global Investment Research already have a deep and successful partnership. We are really just formalizing and maximizing what has been an incredibly synergistic relationship between these teams for many years.

How do you expect the partnership between Global Investment Services and Global Investment Research to deepen under your leadership?

We'll continue to do what we've done for decades. That is, search for great ideas early, and invest in those attractive managers or strategies. It's our foundation of success, and how we've always partnered with our clients.

As the firm grows and our client base expands, an even stronger dialogue between the two groups will only continue to benefit clients. We'll have a more immediate feedback loop on what types of strategies or managers our clients need to best

"We are hired to be very good partners and to generate excellent returns so our clients can pursue their goals. If we do that, we should all be proud of what we're doing here."

structure their portfolios, allowing us to identify investment opportunities and address client needs even earlier. Then we can more quickly and directly allocate resources focused on delivering excellent outcome for our clients. Resource allocation is one of the most critical factors impacting an investment firm's success. It will be one of the most important things I'll focus on as we move forward.

I'm excited to work closely with Noel O'Neill, who heads Global Investment Research, to maximize the synergies between these teams. Noel has been an investor, working with clients, for more than 20 years. He brings to the research effort a real understanding of what's needed to implement portfolios, and how we need to adapt and evolve portfolios to successfully generate returns. This helps foster that feedback loop, helping our dedicated research team understand what's needed on the "front lines," if you will, and helping investors to quickly get the best ideas into their clients' portfolios.

What are you most excited about as you take on this new role at the firm?

As a firm, we will continue to build on Cambridge Associates' strong foundation of working with investors to create portfolios that meet their specific goals and risk tolerance, and implement strategies and managers that can make a significant impact on portfolio results. The better we do for our clients, the deeper an impact these investors will have on their philanthropic endeavors, on their success in meeting their pensioners' obligations, or on their ability to achieve their personal goals.

For me personally, I view this as an opportunity to take what I've learned actually building and implementing portfolios and help apply that with my colleagues across all of the practices. Think of it this way: when I was the head of the pension practice, I served largely as a "player-coach." I served as an outsourced CIO for my pension clients and I coached the pension practice at large. Now as President, I'm just moving up my level of coaching to more of a "general manager" level. Every basis point of value add can have a significant impact on the institutions we work with, and I'm excited to help continue to find ways to add significant alpha across our entire client base.

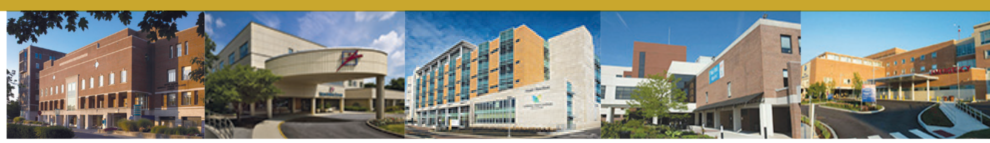
Which aspects of your career are you most proud of?

I've been so proud to work with all types of institutions and families throughout my career to implement their portfolios and help them achieve their financial goals, be it living well in their retirement or meeting their philanthropic goals. At Cambridge, I'm most proud of building a great team within the pension practice. Our team has done a terrific job of working with institutions that have significantly different return goals and risk tolerances. At the end of the day, we are hired to be very good partners to our clients and to generate excellent returns for them so they can pursue their goals. And if we do that, we should all be proud of what we're doing here.

As president of the firm, how will you measure the firm's success?

We'll be successful if our clients consider us an excellent partner who takes into consideration their unique needs and goals, implements portfolios calibrated just for them, and generates significant value add when we do it. It really just comes down to generating excellent returns for our clients and being good partners for and stewards of their capital. That's how I've always defined my own success, and that's what I expect from our firm. ■

Main Line Health



Main Line Health, an early adopter of the outsourced chief investment officer (OCIO) model, is an integrated network of hospitals and health centers in suburban Philadelphia. The award-winning, 30-year-old health system includes four hospitals—Lankenau Medical Center, Bryn Mawr Hospital, Paoli Hospital, and Riddle Hospital—as well as a rehabilitative facility, Bryn Mawr Rehabilitation Hospital.

BY PAMELA GALBATO

IN AN INTERVIEW with *CA Perspectives*, Mike Buongiorno, Executive Vice President and Chief Financial Officer, and Peter Havens, board member, offer their views on shifting their pension plan's assets to a discretionary service model. They share their experience with the OCIO model at the Investment Committee and CFO and staff levels, discussing the benefits they have recognized since the model's inception in 2012.

What is your role at Main Line Health?

BUONGIORNO: I have been the Executive Vice President, Chief Financial Officer, and Treasurer of Main Line Health for about 19 years, and I have been working at Main Line Health for 22 years. Between 2003 and 2005, I was also the interim CEO.

HAVENS: I sit on the board of Main Line Health and chair the Retirement and Income Planning Committee. I have sat on the Lankenau Medical Center Foundation board since 1998, where I am currently the Investment Committee Head. Additionally, I have been the chair of the Lankenau Institute for Medical Research since 2000.

What sparked your initial interest in the organization?

BUONGIORNO: Quite honestly, it was the organization's unique market position and my past health care experience. I knew it was a great organization, and I thought that I could lend my talents and public accounting background to make it more efficient and focused on patient safety and quality.

HAVENS: My family has a long history with Lankenau, and my interest in all of Main Line Health revolves around the exquisite care that it delivers. My great-grandfather was the second president of Lankenau following John D. Lankenau, who was the founder of the hospital. My father was a physician and an intern. My grandmother started the women's auxiliary, and my mother was a volunteer at Lankenau. We have great teaching hospitals and do world-class research; this has been an ideal place to express my passion for healthcare.

What makes your organization unique?

BUONGIORNO: Our organization is focused on continuously improving the patient experience.

Mike Buongiorno

As CFO, my responsibility is to make the required resources available so we can provide excellent medical facilities, state-of-the-art technology to diagnose medical conditions, and an exceptional patient experience. We will not have a bottom line without a safe, efficient, and high-quality patient experience, which we are able to provide through our collective efforts. At Main Line Health, we understand that a smile means a lot. It's the little things that reinforce compassion and respect that make our organization unique. At the end of the day, it's all about the patient, which is a mantra the entire organization, including the board, endorses.

HAVENS: At the board level, we focus on the patient experience and safety, which is our organization's primary objective. We have a patient safety committee that reports at every meeting. The care we deliver to our patients is world class. Those values are embedded throughout the whole system.

What are you most proud of at the institution?

HAVENS: We recently received the System Magnet designation from the American Nurses Credentialing Center. Only 22 health systems in the United States have achieved this honor.

Our focus is on patient safety and quality, not just in the hospitals but in our board meetings. Ten years ago, only later in the meeting agenda would we talk about quality. Now, we discuss patient safety and quality issues before we talk about any financial reports. This highlights our priorities and sets the tone for meetings.

BUONGIORNO: Main Line Health is walking the walk, not just talking the talk. Outside organizations recognize the quality of the care we deliver to our patients. Our system's nurses have distinguished themselves as top-tier care providers in the country. We have received numerous awards for the quality of the science that we practice, and our doctors are highly recognized in various specialties. We take very good care of patients who enter one of our hospitals. We have received many awards that recognize our commitment. And, it is ultimately reflected in our business margins. A number of our peers are going out of business. We are not only surviving, we are thriving and looking forward to the next 100 years.

What precipitated your interest in the outsourced investment office model?

BUONGIORNO: A nondiscretionary investment model was limiting our ability to make quick, informed, and clear decisions. Many of our committee members are investment professionals. We found that lengthy deliberations about recommended changes to the portfolio were hindering our decision making.

Despite this, deciding on a discretionary service model was not easy. Eventually, we agreed that a discretionary model was the right choice. Ultimately, we decided it is best for the committee to focus on results and strategy without being distracted by implementation steps. This will help us maximize our effectiveness.

How has this model benefited your institution?

BUONGIORNO: At the staff level, it has been a tremendous help. Through the outsourced model, we have delegated responsibility, which has resulted in quick implementation and changes. It has elevated the conversation to focus on performance, strategy, and how we look at the pension's liabilities and investment policy. It has allowed us to consider pension liabilities as part of investment management to mitigate long-term risk. It's been a wonderful change, and I can't imagine how we did it before.

HAVENS: At the committee level, it has expedited deliberations. We have more focus, and meetings are more efficient and effective. I am a believer in respecting people's time. Switching to the OCIO

“We now spend less time worrying about implementation and day-to-day issues and more time on strategy and long-term forecasts.”

model has allowed us to better use everyone’s time. We are able to meet our fiduciary duties as they should be met, and it has stimulated a higher level of conversation.

Did you face any challenges as you implemented the change to a fully delegated outsourced model?

BUONGIORNO: Our staff handled the transition very smoothly. It happened over a period of two or three months, and it was seamless.

Peter Havens

HAVENS: It was more of a philosophical and psychological process for the committee. The challenge was getting all committee members on board with the new direction. People were used to one model, and the new model altered their form of involvement and responsibility. While the adjustment took longer for some, we were eventually able to transition very smoothly.

How has the portfolio evolved since moving to an OCIO model?

BUONGIORNO: We are more active in the alternative asset space, and we are utilizing more active management in general. We are letting old private equity commitments run out and are making new, more informed investments in that space. Additionally, we are focusing more on our pension liabilities. At every meeting, we discuss our funded status versus where we were in the prior quarter and what we need to do to get to 100% or more.

What advice do you have or others considering OCIO?

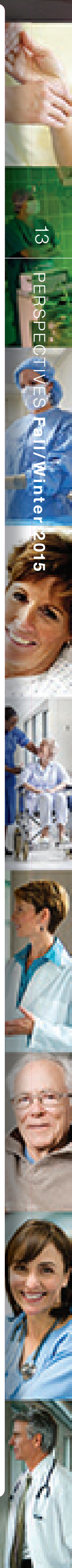
BUONGIORNO: Consider where you spend your time today and how you could more efficiently spend that time. Think about leveraging the skills of an OCIO to help you optimize your investment policy and results. We now spend less time worrying about implementation and day-to-day issues and more time on strategy and long-term forecasts. This decision has made our lives easier from an efficiency perspective, a research perspective, and a time perspective.

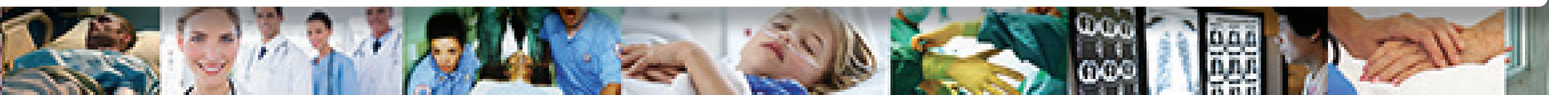
HAVENS: In recognition of people’s valuable time, going the OCIO track has been an excellent decision for us. If you have successful, busy committee members, you want to keep them engaged, take advantage of their strengths, and make the best use of their time. Focusing their energies into the appropriate areas helps keep them interested in showing up, exercising their fiduciary capabilities, and giving good advice. The OCIO model helps harness committee members’ diverse experience, intelligence, and efforts towards a particular goal, such as increasing returns, in an effective and efficient fashion.

What would you say to committee members who are apprehensive and feel they are “handing over the reins”?

HAVENS: There is no question that some have that apprehension. Committee members might perceive this as a loss of responsibility. But I argue that it is not possible to give up their responsibilities as fiduciaries. It is their responsibility to decide which discretionary provider is hired and to monitor that provider’s performance. If they are dissatisfied or feel that changes need to be made, they are responsible for making them. Ultimately, committee members are maintaining responsibility by hiring who they perceive is the best option to help them fulfill their duty. ■

Read more about CA’s approach to pension investing in Pension Risk Management*, available on CA’s website.*





You Can't Spend Pre-Tax Returns

Do hedge funds make sense for taxable investors?

BY JOHN BRODY

HEDGE FUNDS CAN PROVIDE considerable benefits to a diversified portfolio. Depending on the specific strategy, hedge funds can protect on the downside, reduce volatility for given levels of expected return, deliver excess return relative to a given market, and open up a broader set of investment opportunities and managers.

So, what's the catch? In a word, taxes.

With hedge funds, many strategies yield short-term capital gains, non-qualified dividend income, and other ordinary income, depending on implementation. Consequently, the tax efficiency of a given fund generally declines as those sources of gain and income increase. And even the best pre-tax returns matter little if they are eroded by the tax liabilities they generate. "You don't get to spend pre-tax returns," Chris Houston, Cambridge Associates' Director of Tax Strategy, says.

Taxable investors, then, should carefully consider the tax implications of potential hedge fund investments when constructing their portfolios. That means factoring in the tax consequences of specific hedge fund strategies and managers and weighing those consequences against the potential benefits of including those hedge funds.

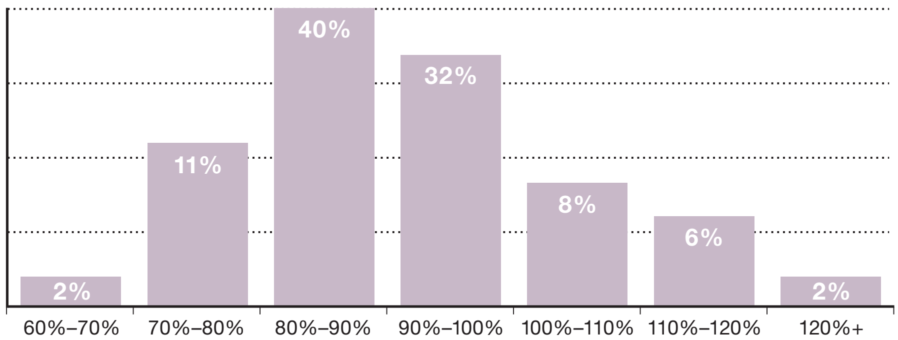
In a world of more than 10,000 hedge funds, rigorous analysis is required to understand which choices might be right for each investor. "As with returns, historical tax efficiency is no guarantee of future tax efficiency," says Houston. "But it provides valuable insight, especially when paired with a strong understanding of a manager's investment process, market history, and other factors in tax efficiency."

An analysis of Cambridge Associates' growing set of hedge fund tax data reveals that tax efficiency of hedge funds can vary considerably by strategy. "We tend to expect higher tax efficiency from activist hedge fund strategies and other strategies with long holding periods because they tend to derive much of their return from long-term capital gains," says Jeanne Mowrey, a Managing Director who leads Cambridge Associates' efforts to quantify hedge fund tax efficiency. "Meanwhile, global macro and

Hans Vaule, Jeanne Mowrey, and Chris Houston

Distribution of Tax Efficiency of Long/Short Hedge Funds

For funds with at least a 5-year track record



Source: Cambridge Associates' Investment Manager Database.

event-driven hedge fund strategies may have lower tax efficiency due to a tendency toward short-term capital gains and ordinary income."

That isn't to say that managers with the same strategy always offer similar levels of tax efficiency. Among credit opportunity hedge funds in Cambridge Associates' database, tax efficiency over the five-year period from 2009 to 2013 ranges from less than 60% to almost 90%. Why the spread? "Several factors impacted credit hedge funds' tax efficiency," says Hans Vaule, a Managing Director who helped create Cambridge Associates' tax efficiency database. "For example, the degree to which a fund's credit holdings were discounted and whether returns tied to market discount were taxed as capital gain or ordinary income under the relevant rules both have important tax implications."

Among long/short equity hedge funds, Cambridge Associates finds an even broader range of tax efficiency, from less than 60% to more than 100% over the same five-year period. Where a fund's tax efficiency is greater than 100% for a given period, the fund has actually produced a net tax benefit for investors, on top of its pre-tax return.

"This can occur if the fund realizes losses while letting gains go unrealized or if the fund realizes short-term losses but long-term gains," explains Mowrey.

Of course, overall market performance can also have a meaningful impact on tax efficiency. "Looking at tax efficiency percentages for different multi-year periods, it was striking how much it mattered whether or not the time period included 2009," explains Vaule. "The opportunity, so to speak, for many managers to realize large losses that year created a huge boost for their tax efficiency figures."

While the tax efficiency of hedge fund strategies and managers can vary, taxable investors should make portfolio decisions based on sound analysis rather than misconceptions about the appropriateness of these investments for taxable investors. "There are many hedge funds with tax efficiency levels that are comparable to other asset classes and strategies more traditionally favored for taxable portfolios, including actively managed long-only equity funds," says Mowrey.

Houston concurs. "Some taxable investors are willing to hold certain asset classes, like taxable investment-grade fixed income, with tax efficiency that can be worse than most hedge funds. Yet somehow they are more wary of the hedge funds when thinking about taxes."

And even hedge fund strategies with lower tax efficiency can be useful in a taxable portfolio without creating an undue tax burden. For starters, those lower tax-efficiency hedge funds typically would not constitute an especially large portion of the taxable portfolio. "In many taxable portfolios, it is possible to increase the tax efficiency in other asset classes and strategies to offset the impact of hedge funds that are very useful in the portfolio but do have lower tax efficiency," explains Vaule. "One prime opportunity is to use loss-harvesting strategies for a substantial portion of the portfolio's long equity allocation."

Ultimately, when contemplating hedge funds for taxable portfolios, investors should analyze the funds' role in the portfolio and their after-tax returns in the same way they assess other asset classes and strategies. "Even though some hedge funds do have low tax efficiency, it should not equate to a wholesale exclusion of hedge funds from taxable portfolios," advises Mowrey. "We will continue recommending hedge funds when, on an after-tax basis, they help achieve a portfolio's overall objectives." ■

We're Expanding

Cambridge Associates is pleased to announce the opening of our San Francisco office. In addition to our location in Menlo Park, this new West Coast office provides even more access for clients and managers in the Bay area and beyond. We are excited about our ongoing growth and committed to dedicating the resources necessary to serve our clients well. If you plan to visit us in one of these locations, please check with your meeting host for appropriate contact information.

Join Us in Rio

CA's 13th Annual Global Investment Workshop will take place May 15–18, 2016, in Rio de Janeiro, Brazil. Here we will explore the evolving opportunities and risks in emerging markets today. Experts from Cambridge Associates will provide their insights on Brazil's economic landscape, and top economic and business leaders from the region will deliver keynote presentations. Additionally, select investment firms will debate the fundamental case and timing considerations for investments in Brazil. Invitations with information on how to register for the Workshop will be sent out in February. Please contact Emily Kruglik, **ekruglik@cambridgeassociates.com**, with any questions.

NEWSLETTER PUBLICATION

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