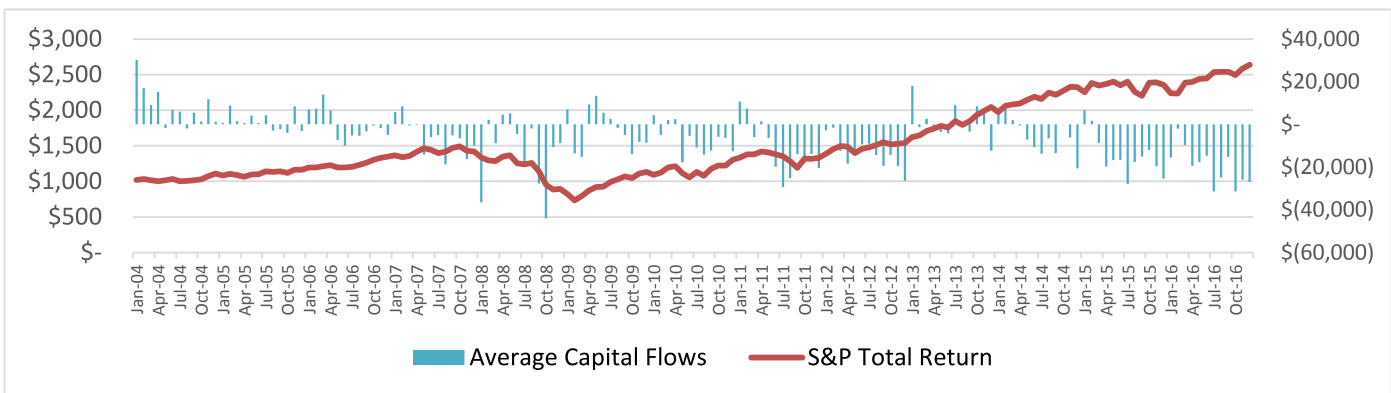
The Case for Investing in Smaller Long/Short Equity Hedge Funds via a Fund of Hedge Funds

Introduction

Historically, high stock market volatility has caused many investors to make poor investment decisions such as buying high or selling low. Investors often sell on the way down and do not buy again until a recovery is well under way. Fear of losses often costs investors more in dollar terms than if they had just stayed the course. For many investors, staying the course is often easier said than done. In the past, investment advisors pointed to bonds as a way to help lower overall portfolio volatility and keep investors from pulling out of the stock market at the wrong times. However, with today's low interest rates, the risk/reward profile of bonds may be skewed to the downside.

S&P 500 Stock Index Returns vs. Equity Mutual Fund Net Investment Flows, 2004-2016



Net mutual fund flow data six month trading average, data from ICI.

Hypothetical $10,000 Equity Portfolio Based on the S&P 500 Remaining Invested vs. Market Timing, 1997-2016

	Ending Portfolio Value	1997-2016 Compound Annual Return
Remaining Invested the Entire Period	$43,954	7.68%
Missing the Best Performing Month	$39,623	7.13%
Missing the Two Best Months	$36,094	6.63%
Missing the Three Best Months	$32,941	6.14%
Missing the Four Best Months	$30,242	5.69%
Missing the Five Best Months	$27,796	5.24%
Missing the Six Best Months	$25,558	4.80%

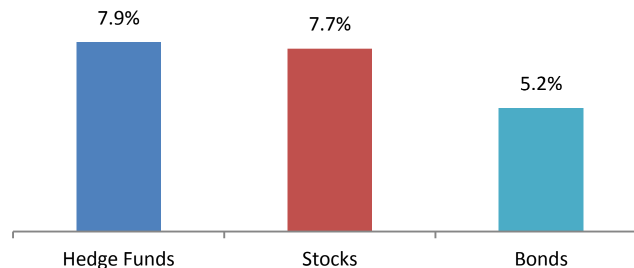
Source: S&P 500 Stock Index. Past performance is no guarantee of future results. The S&P 500 Index is a widely recognized unmanaged index. Index returns do not reflect the deduction of expenses. Returns assume reinvestment of all distributions and do not reflect the deduction of taxes and fees. Individuals cannot invest directly in an index.

The Case for Investing in Smaller Long/Short Equity Hedge Funds via a Fund of Hedge Funds

Why Long/Short Equity Hedge Funds Make Sense

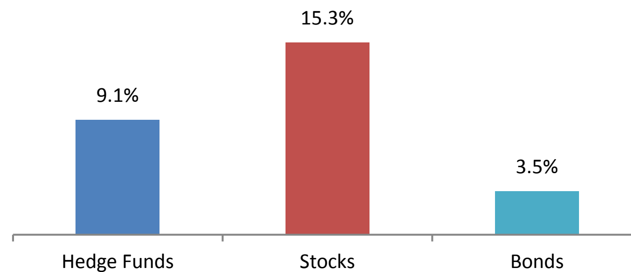
Long/short equity hedge funds invest in stocks, just like their long-only counterparts. However, they also have several additional tools at their disposal such as the ability to profit from stocks going down by taking short positions, the ability to enhance returns via leverage, the ability to use derivatives, and the ability to hold large cash positions during periods of uncertainty. Historically, long/short equity hedge funds have provided “equity-like” returns but have done so with less volatility. Over the 20-year period from January of 1997 to December of 2016, long/short equity hedge funds delivered 7.9% net annualized returns with a 9.1% annualized standard deviation versus 7.7% and 15.3%, respectively for the S&P 500 stock index.

Annualized Returns, Jan 1997 – Dec 2016



Source: HFRI Equity Hedge; S&P 500 Stock Index; Barclays US Aggregate

Annualized Volatility, Jan 1997 – Dec 2016

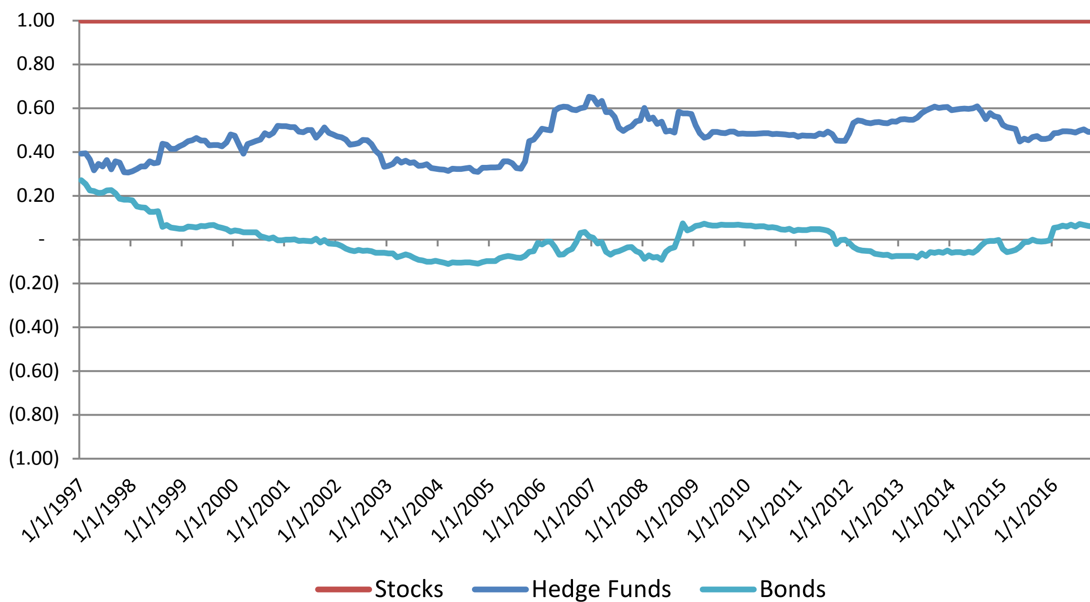


Source: HFRI Equity Hedge; S&P 500 Stock Index; Barclays US Aggregate

Past performance is no guarantee of future results. Hedge funds can be risky and are not suitable for every investor. Tools such as shorting and leverage can potentially increase losses and volatility. Shorting involves unlimited loss potential.

The Case for Investing in Smaller Long/Short Equity Hedge Funds via a Fund of Hedge Funds

Long/short equity returns have historically demonstrated a low sensitivity to equity market returns measured by beta. Beta measures the tendency of an investment's returns to market movements. A beta of one means an investment's returns would move with the market. A beta of less than one means an investment is less likely to move with the market and is, therefore, less volatile than the market. Low sensitivity to equities suggests that long/short equity hedge funds diversify and can improve the risk/return profile of a traditional long-only stock/bond asset allocation.



Source: HFRI Equity Hedge; S&P 500 Stock Index; Barclays US Aggregate

Past performance is no guarantee of future results.

Re-allocating part of traditional equity exposure to long/short equity hedge funds can potentially dampen overall portfolio volatility without sacrificing returns. In the example below, 20% has been taken away from equity exposure in a traditional 60% stock/40% bond portfolio and re-allocated to long/short equity. The impact resulted in a modest increase in returns while lowering volatility.

Hypothetical Stock/Bond Portfolio Returns, 1997-2016

	60% Stocks / 40% Bonds	**40% Stocks / 20% Hedge Funds / 40% Bonds**
Cumulative Performance	286.7%	288.7%
Annualized Performance	7.0%	7.0%
Volatility	9.3%	7.7%

Source: Stocks: S&P 500 Index; Bonds: Barclays US Aggregate Bond Index; Hedge Funds: HFRI Equity Hedge Index
Past performance is no guarantee of future results. The S&P 500 Index is a widely recognized unmanaged index. Index returns do not reflect the deduction of expenses. Returns assume reinvestment of all distributions and do not reflect the deduction of taxes and fees. Individuals cannot invest directly in an index.

Cross Shore believes that long/short equity hedge funds have a competitive edge versus traditional long-only equity mutual funds because they are less constrained. Long/short equity hedge funds can take both long and short positions, can hold significant cash positions, and can use non-equity instruments such as options, convertible bonds, and debt. In addition, long/short equity hedge funds are not tied to an index and their risk management objective is to minimize loss rather than to minimize deviation from a benchmark index.

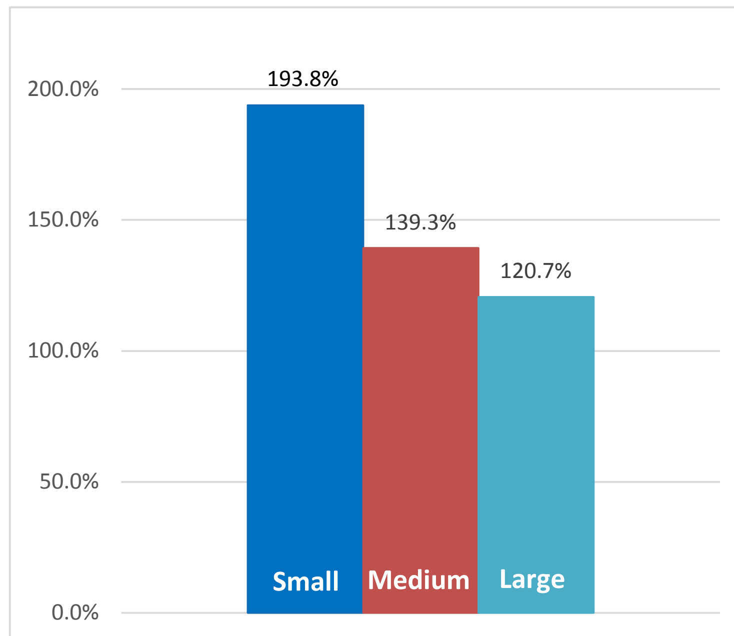
The Case for Investing in Smaller Long/Short Equity Hedge Funds via a Fund of Hedge Funds

CROSS SHORE
CAPITAL MANAGEMENT, LLC

Why Smaller Hedge Funds

Smaller hedge funds, which in many cases includes newer hedge funds, have historically outperformed their larger counterparts. There are several factors that could contribute to this dispersion. For example, smaller managers can potentially be more nimble and adjust portfolio exposures more quickly during periods of extreme market volatility. In addition, smaller managers generally have a larger opportunity set as they can take positions in micro, small and mid-cap companies that will have a meaningful impact on their portfolios. Smaller managers can also provide access to capacity constrained opportunities such as highly specialized sectors and regions.

Small, Medium, and Large Hedge Funds
Cumulative Performance 2003-2016



Source: eVestment

Definitions: Small < $250 mm, Medium $250-999mm, Large > $1bn

There is also the question of incentives. Hedge funds typically fall into two camps: investors and asset gatherers. Investors keep their assets at a level that they think is optimal for maximizing returns. Many will reach a point where they stop accepting new investments in order to ensure they don’t breach that threshold. In some cases, hedge funds will return money to investors after a particularly good performance period in order to get back to that optimal level. On the other hand, there are asset gatherers. The goal of these hedge funds is to grow their asset bases as large as possible, regardless of the potential impact on returns.

Why Invest in Hedge Funds via a Fund of Hedge Funds

Hedge fund investing via a fund of hedge funds is comparable conceptually to stock or bond investing via a mutual fund. For example, if an investor would like to invest in stocks but does not have the capital to build a diversified portfolio of stocks nor the time or expertise to research individual stocks, he or she can invest in an equity mutual fund instead. The same concept applies to funds of hedge funds: if an investor would like to invest in hedge funds but does not have the capital to build a diversified portfolio of hedge funds nor the time or expertise to research individual hedge funds, he or she can invest in a fund of hedge funds instead.

Hedge funds are difficult for most individual investors to access. Minimum initial investment minimums can be very high, typically ranging from $1-10 million. It is also challenging to identify best-in-class hedge funds for someone who is not well-versed in the industry, especially newer and smaller hedge funds. It is worth noting that individual hedge fund performance can be volatile so it is generally best practice to diversify across a number of different hedge funds rather than putting all of your eggs in one basket. However, building a well-diversified portfolio of hedge funds requires significant capital, potentially in the millions of dollars.

Fund of hedge funds managers specialize in evaluating hedge funds and constructing portfolios of hedge funds. They examine both qualitative and quantitative factors when analyzing hedge funds and building portfolios of hedge funds. For example, on the qualitative side, things like intellectual capital, depth, and pedigree of the investment team would be evaluated. In addition, the creativity and originality of investment idea sourcing, research process, idea implementation/portfolio construction, and risk management would also be evaluated. On the quantitative side, risk-adjusted performance and correlations to various benchmarks as well as other hedge funds is examined and evaluated.

Fund of hedge funds managers also evaluate the operational infrastructure of hedge funds and evaluate the depth and strength of a fund's back office team, their policies and procedures, and the quality of their third party service providers.

Conclusion

Long/short equity hedge funds can be a valuable component of your asset allocation. Historically, investors could lower the overall volatility of their portfolios, without giving up returns, by reallocating a portion of their traditional long-only equity exposure to long/short equity. This lower overall portfolio volatility can potentially keep investors fully invested in the market during drawdowns so they do not miss the benefits of being fully invested when the rebound ultimately comes. Generally, smaller managers have demonstrated an edge over their larger counterparts. Investing in a basket of different hedge funds via a fund of hedge funds allows investors to diversify their hedge fund exposure without committing substantially more capital to the asset class and also allows investors to lean on the fund of hedge fund manager's expertise when it comes to manager evaluation and portfolio construction.

The Case for Investing in Smaller Long/Short Equity Hedge Funds via a Fund of Hedge Funds

Hedge funds are not appropriate for all investors. Hedge Funds can use leverage and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. Hedge funds can result in increased volatility of the fund's performance and increased risk of loss. An investor could lose all or a substantial amount of their investment.

This publication is for informational purposes only and is not intended as an offer to purchase Cross Shore Discovery Fund, Cross Shore QP Partners, LP, or Cross Shore Overseas Fund, Ltd. While reasonable care has been taken to ensure that the information herein is factually correct, Cross Shore Capital Management, LLC makes no representation as to its accuracy or completeness. The information herein is subject to change without notice.

Cross Shore Capital Management, LLC "Cross Shore" is an SEC-registered[1] investment adviser located in New York. Cross Shore may only transact business in those states in which it is notice filed or qualifies for a corresponding exemption from such requirements. For information about the registration status of Wavelength, please view the SEC Commission's website at www.adviserinfo.sec.gov. A copy of Cross Shore's current written disclosure statement discussing Cross Shore's business operations, services and fees is available from Cross Shore upon written request.

Investing involves the risk of loss, principal loss is possible. Past performance does not guarantee future results. All data provided by Cross Shore Capital Management, LLC including any reference to specific securities or sectors is provided for informational purposes and should not be construed as investment advice. It does not constitute an offer, solicitation or recommendation to purchase any security.

[1] SEC registration does not indicate a certain level of skill or training.

All indices referenced are included to show the general trend of the underlying asset classes they represent and are not audited by Cross Shore. The HFRI Equity Hedge Index, an equally weighted performance index, consists of investment managers who maintain positions both long and short in primarily equity and equity derivative securities. For more information on the HFRI indexes please visit www.hedgefundresearch.com. The S&P 500 Index is a widely recognized unmanaged index of equity. The Index returns assume reinvestment of all distributions and does not reflect the deduction of taxes and fees. The Barclays US Aggregate Bond Index is a broad based index used to represent investment grade bonds being traded in the US. Individuals cannot invest directly in an index.

For Additional information on Cross Shore Capital Management, LLC and it's offerings, please contact Kevin Hurd, Director of Marketing & Investor Relations, at (516) 684-4046 or khurd@xshorecap.com.