Episode 178: Hedging Your Bets in Retirement: What You Should Know

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Retirement income, financial personality, hedge funds, long-short strategies, market neutral, quantitative strategies, alpha, beta, leverage, short selling, survivorship bias, risk premia harvesting, systematic trading, accredited investors, investment returns.

SPEAKERS
Wade Pfau, Briana Corbin, Alex Murguia

Briana Corbin 00:00
The purpose of retirement style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style, and sign up to take the industry's first financial personality tool for retirement planning. most people hear hedge fund and think yachts spreadsheets and billionaires whispering in code. But what does it all really mean, and does it matter for your retirement plan? In this episode, Wade and Alex decode hedge fund strategies like long, short and market neutral, explaining how they work, who uses them and why it managed for investors trying to retire with style.

Wade Pfau 01:05
Hey everyone, welcome to retire with style. I'm Wade. I'm here with my trusty co host, Alex, and we're going to be continuing an arc on alternative investments. Specifically today we're going to get started on talking about hedge funds before we get into that, though, we do have the YouTube Live coming up. It'll be June 2 at 2pm eastern it'll be a chance to ask us questions in a live setting on YouTube. And I'm sure after that, hopefully we'll we'll get a nice backlog of questions, that we'll have a few episodes on Q and A subsequently as well. But we're looking forward to that June 2, 2pm Eastern Time, and hey us, you're going to be the one doing the the talking today. So welcome to retire with style.

Alex Murguia 01:47
All right? Wade, Hey, man, you should you shouldn't warn people that I'm going to be doing the talking, because that means everyone will either listen to this at three times speed or just go to the next episode, right? Wade, it's

Wade Pfau 01:59
an Alex clintrik Episode For those keeping track, but

Alex Murguia 02:04

yeah, everyone for that, YouTube Live, please start sending in questions, because it helps us prioritize and collate them in a manner that you know we can. We can talk about relevant topics at once, as opposed to being scattershot all over the place. But yeah, we love, we love to do the Q and A radio time. That's when we play our we try to be Dave Ramsey, shall I say? Or Rick Edelman, which? Which one do we try to be? Or Susie Orman,

Wade Pfau 02:36
maybe none of the above. Although I've never actually heard Rick Edelman's show.

Alex Murguia 02:40
I have for like a couple minutes. At a time, and I don't know it's that's not a good or bad thing. It's just one of those that never heard the when you live this for your employment, the last thing I want to do is drive home and listen to it some more,

Wade Pfau 02:57
a bit more serious than the other. Although, I don't even know,

Alex Murguia 03:00
although, if you're an advisor listening to this, please don't stop. I realized that while I was saying that, like, oh my god, I made a terrible mistake,

Wade Pfau 03:14
too on retirement stuff.

Alex Murguia 03:15
So I needed to hedge that's a great segue, a good segue into hedge funds. Yeah. And today we want to, we introduce a topic of alternatives. And the granddaddy of them all right now is hedge funds. And these are things that are in the nomenclature, right? Hedge funds. And it started with what? What is a hedge fund? You know, they need to hedge and so we'll talk about that in a bit. But I think the definition, at least in the nomenclature, of hedge funds, have grown beyond just investment vehicles that hedge, that hedge their bets, right? We'll talk about those that truly hedge, but it's one of those things I wanted to put out there in that sense, though. I mean, they're think of them as private funds, and they're actively managed investment funds that use various strategies to generate returns. Think about mutual funds that are more unshackled. Not that mutual funds need to be shackled, but there's certain regulatory requirements just to make sure that everyone's on the up and up that you know that provide these sort of shockers, like limits on positions that that these funds take, etc, etc. Those are, those are, those are not present. You know, when you have a hedge fund because of their the nature of of how they are,

Wade Pfau 04:35
right? Last week, you do need to be an accredited investor, and we try. Yeah, I was thinking

Alex Murguia 04:41
more investment strategy wise. Now, what's their goal right now? Again, saying hedge funds is akin to saying mutual funds. There's many types. There's there's not just a hedge fund is a hedge fund. There's some that are ultra conservative, frankly, and there's some that are. Ultra aggressive and everything in between, in a similar manner to mutual funds. So when folks just say, make a blanket statement like hedge funds are terrible. They're too aggressive, those folks

usually probably don't know what they're talking about. I mean, they could, they could sort of poke at the structure of them and the transparency of them and things like that. That's fine, but in terms of the investment mandate, they run the gamut. And so it's just not enough to say I have a hedge fund, or I'm thinking about hedge funds, again, that's akin to saying I'm thinking about mutual funds, I mean, and we're waiting, you know, kind of kind of response. And so a lot of these, what you'll see is they aim for absolute returns. They seek because they're they're placing bets on I have this I'm able to forecast, or I'm able to identify some sort of mispricing that others aren't. And I really don't care which direction the market is head heading, because I can make accommodations from that, because I'm no longer a mutual fund to to to use certain products that you know may hedge or may not, or may amplify, as opposed to hedge returns now, so they seek market gains regardless of the direction of which it's going, right and like I said earlier, unlike mutual funds, they have fewer regulations. They can use leverage and derivatives,

Wade Pfau 06:25
right shorting positions too. Yeah, they

Alex Murguia 06:28
take shorting positions, and I'll talk about what that is in a bit. But yeah, they take on leverage short positions, whereas mutual funds, you know, cannot, right now, because of that, that flexibility, they're able to enhance their returns. But before I get into short positions and getting into tactics, let's talk a little bit about fee structures, the admin, the admin piece of this, yeah, and on the fee side, that's something that maybe a lot of folks have heard the idea of the two and 20 fee charge. Yeah, exactly about what that is that's coming down over time, simply because they're they're more accessible. When things are more accessible, there's more competition. When there's more competition, all of a sudden people aren't as smart anymore in terms of being able to charge for their their their services, if you will. And so it's traditionally, you get a 2% management fee, and they'll take 20% of the profits, right? And so that could be very expensive, because let's say, you know, something returns 10% Well, whatever you've invested in, you're going to get charged 2% of that in the management fee. And then in addition, you're going to get another whack at it, where you take 20% of the profits. Now, some of these, when they read that 90% of any losses, yeah, well, this is what I getting at. Some of them have watermarks. And watermarks are effectively like, let's say there is a loss one year, then they can't take their fees unless they hit a watermark that effectively breaks them back to even, right? But the reality is, a lot of these funds depend their cost structure is dependent on taking profits every year and when that's not there, these folks fancy themselves as Masters of the Universe, right? When that's not there, because they had a bad year. For whatever reason, some of them will tend to close down the fund and just say we're done, and all of a sudden open up a new fund in which they're not subjected to that watermark anymore, which is another caveat in which, you know, buyer beware comes investing in hedge funds. Obviously, in any normal, I'm not saying that's everybody, but in any normal distribution of of a population, you're going to have your good folks, you're going to have your bad folks, and you're going to have your folks in between. And you know, when you look at the incentive structure, where lion's share of their of their revenues are going to come from the profits, and you notice some people don't make it, and it's going to take them probably two years, three years to recoup that until they can even charge a fee. They're human beings, and it's very easy to just shut it down and then start again six months later with a friends and family round, or something along those lines. All right, so you have to, you have to keep that in mind. That being the case, though, these are coming down.

And someone could say, well, if they're providing value and they're providing Alpha year after year, well they should charge everything up until that alpha amount, right? There's there's that. There's that argument too, as well. And you're right. You know, if you can't provide me, if you cannot perform the market every year, regardless of market movement by, I don't know, 10% a year, then you would think they would take all these cuts, because why not? And you'd be happy to pay for it. The issue is, are these things actually something you can count on year after year? And if not, then what happens? Right? But again, there. A lot of movement, where some of these are called hedge funds, but they're really, and I'll talk about it later. They're really kind of taking alpha and turning it into beta with systematic trading processes. And the people that are doing that are naturally lowering their fees because they're they're mimicking those trading strategies, and they're getting very similar results, if not better, because they're taking out a human component. And then all of a sudden, people are asking, Why am I paying you for something that could be automated, like, quote, unquote, like an index, like an active mutual fund versus an index mutual fund? When you know, year after year, they underperform, active managers underperform, and you take that over a five year period, the numbers are staggering. Why would you want to pay one and a quarter percent in a management fee when an index fund at point 1% will provide better returns, right? And so you see this race to the bottom. And you know, do you see a race to the bottom in hedge funds? I don't know. My fingers not on the pulse to that extent. Or I know the entire universe and what, what they're being charged. But there, there is, there is a downward trajectory, not, not an upward trajectory. And I'm sure, based on who, who we're talking about, void,

Wade Pfau 11:09
a race to the bottom, makes it sound negative, but it's really a good thing for the consumer that, yeah,

11:15
I mean,

Wade Pfau 11:19
without sacrifice of value. So it's good for the consumer.

Alex Murguia 11:24
There you go. Now hedge fund performance. How do they do? Are there? Are there magicians out there? I mean, look, I you know where we stand with the active and passive. And part of my argument is, sure there may be a Michael Jordan out there that's, you know, demonstrably better than anyone else. But guess what? You're not Michael Jordan, and Michael Jordan doesn't want your money. It's kind of my take on it, at least after a certain point. Why would he, you know? Why would he want that? And if he was taking your money, he charged you up until the amount that it would make him an average basketball player, if you will. And so it's tricky like that, but you do see, you know, you do see numbers. You see a lot of times tear sheets where they're saying, look how this fund performed and the like, versus the index of available hedge funds and things. Now, I have issues with that, simply because a lot of these hedge fund databases suffer from survivorship biases. A lot of these funds, unlike Morningstar, when they're looking at mutual funds, the funds that died are in the database, right? And so that's going to hurt the aggregate performance. Let's say you're looking at 10 year mutual fund performance, and let's make completely making this up. Let's say the index performed 10% and the average active fund prefer perform, I don't know, 7% that 7% return is taking into account the funds that

are no longer in that database, that died, that closed down four years into, you know, four years before the 10 years were up, right? When you're looking at some hedge fund databases, you know, last time I checked that, stuff was rampant in which they do those funds take themselves off account, they're not in that database. So you're getting this over inflated sense of performance. Some folks, you know those returns, you know some databases, they require auditing and the like, but that's not 100% and so I personally always look at these returns with a grain of salt. The other piece is sometimes when you're looking at, when you're looking at non normal trading strategy, non normally distributed trading strategies, things along those lines, when using leverage, when using things like that, it's hard to compare them against traditional measures of risk, like a Sharpe ratio and things along those lines, because you would have to accommodate for those. And when you do that kind of stuff, you really, you know, things start getting fuzzy, if you will. And in addition, like I said, What are you comparing the returns to? Right? Because if you can take the systematic trading strategies, if you could take trading strategies that folks are doing and calling it alpha, and systematically replicate it, which is effectively turning it into beta. Then really, on a risk adjusted basis, there's probably some factor that they were just exposing themselves to systematically that led to those higher returns. And if you can get that systematically, then there really was no alpha to be had, you know, maybe they identified some sort of trading strategy, but markets work and they become replicated. And where's the where's the value is what you have to ask yourself. And the last piece is how they report, and things along those lines, with regards to the use of options and the like. There's a couple of research papers, the granddaddy of them all was to hedge funds, to hedge funds, hedge I believe, by Cliff Asness. And what he looked into was creating a lag in the returns, a one month lag. And what that means is, if a fund, you know, says, I returned 10% this year, you know, from J. January to December. You know? Well, you know what let's do from February to January, where you create this month long lag. And what you found is, when you did that, the hedge funds, you know, many of the equity during hedge funds were actually their betas shot up through the roof. You know, there was this lagging component when compared to the market. And so you have to ask yourself, Is this a reporting trick? And by trick, I don't mean any malfeasance. I just mean, is this just some quirk in the reporting, you know, in terms of getting the true value of all the assets, you know, especially when you're not just 100% dealing with liquid securities and the like. And it kind of looks that way a little bit. Again, that's not saying there are not some that are outperforming like crazy. And I'm not trying to take this completely cynical view of the world, but there are all these things that you have to consider within the orbit of are these? Are the is the performance really there, right? And so the performance history is, tricky, because survivorship based bias in the data, risk adjusted returns versus just basic, you know, compared to index tracking, especially when you're dealing with publicly traded securities, and then correlation considerations, because if you lag the performance by one month, the correlations to the markets shoot up. And so what are you really doing? Because at the end of the day, you don't care that you're at a cocktail party saying, look at this great hedge fund that I have. You care about your nest egg, and you care about the actual return that's being manifested in the risk that's being reduced for that. And you want to make sure that's always there. And sometimes you see it, and sometimes you don't. And I can't, I can't in my, in my as in my humble opinion, for me as a professional, I can't say wholeheartedly, yes, hedge funds usually tend to outperform, and they diversify, you know, from the markets. I can't say that either way. It has to be on a one by one basis, you know, if you're asking me, in which I'm really looking under the hood and seeing the sources of those returns and then comparing them accordingly to the comp to the right sources to see if there was any value. Will the normal consumer do something like this? I don't think so. Wade right.

Briana Corbin 17:16
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Wade Pfau 17:40
No, well, you've got to be accredited investors for the first place.

Alex Murguia 17:44
Will the normal accredited investor consumer do this?

Wade Pfau 17:48
Okay? Probably not. Still, probably not, right? Although

Alex Murguia 17:53
I know retirement researchers are a different breed, but you know, for the most part, I don't see that. Now, there are many hedge fund strategies. Let's go over some of them. This will be a two parter. So there's long, short, which is a real term, where it came from, hedge funds, right? Long, short equity strategies, market neutral approaches, which is a little bit of a kissing cousin, if you will, quantitative hedge fund strategies. These are the, you know, the high frequency traders that that you read about all the time. Oh, that's just one different one component of that, global macro hedge funds. Those are the ones that you see a lot about in movies and things like that, where they're really moving chess pieces around and playing the three dimensional chess of the world economy, and seeing where there's an opening event driven strategies, which those can, frankly be quite conservative, and manage futures, which are largely trend following strategies, usually around commodities and things like that. All right.

Wade Pfau 18:53
Okay, so that was six different strategies that you'll be going into, although not all into this episode,

Alex Murguia 18:59
not all of it in this episode here. We're gonna try to focus on long, short, market neutral and quantitative. All right, so long, short, long, just to define that, long is really what 99% of investors do they buy a stock. Well, I'm just saying 99% I don't have an actual number behind that, but for listeners of this podcast and consumers accredited

Wade Pfau 19:24
nickname for Wade and Alex, well, yeah, exactly. Oh yeah,

Alex Murguia 19:29
that's not funny, man,

Wade Pfau 19:33
yeah, is this Yeah?

Alex Murguia 19:34
Wade is like, how tall you wade? 511, 60,

Wade Pfau 19:39
yeah, not particularly tall,

Alex Murguia 19:40
yeah, and well, thank you for that statement. Wade being that on high five. So I guess I'm the on the short and Wades along. But effectively, what it is long is when you just hold, buy and hold, you're buying it. You're long the position you're, you know, buy and hold for the long term. I. Get, I would imagine that's where that came from. Short is when you're betting against a stock. And so what happens there is, effectively, and you see this, a lot short sellers are being squeezed, or things like that, right? And so let's say, like, give you an example of going short a position is, let's say a stock is selling for $10 a share, right? And I want to buy and I think it's going to go down, right? And so what I do is I'm going to pick up 10 shares. I'm going to sorry, I'm going to borrow 10 shares. I'm not putting any money down. I'm going to borrow 10 shares. And you could do this, Schwab, fidelity, mutual fund companies, all of these people, some of these trading platforms, now they make their money off of the interest from borrowing shares. So even though you have shares of a stock at Fidelity or whatever, they can take those shares and borrow and lend them to somebody else, even though you still own them, right? That kind of thing. And so effectively, I want to go short stock XYZ. And so I'm going to do 10 shares, I tell you know, they're selling at $10 I'm going to take 10 shares. I'm short 100 bucks, right? I'm going short 10 shares of this stock because I think it's going to go down. So what I do is I borrow the 10 shares. I didn't pay money down. I'm borrowing 10 shares. I have to pay interest on it, and if it, if it goes up, at a certain point, I'm going to get I'm going to have to return those shares, and that's where they get squeezed. But for the most part, all right, I'm going short. Let's say the stock in a month loses 50% right? And so now what was, what was, what was $100 those 10 shares were 100 were worth $100.10 times 10 is 100 so now, a month later, it's gone down 50% I was right. It went down 50% what I do is, all I have to do is return the shares. I'm paid interest along the way, but as long as I return the 10 shares, guess what happens? I effectively borrowed $100 worth of stock, right? I only have to repay $50

Wade Pfau 22:17
is this? You're gonna borrow them, sell them, and then repurchase them.

Alex Murguia 22:21
I'm pretty much just paying back 50 bucks. So I keep $50 Voila, there's your there's your miracle, if you will, that being the case, if it goes up, they can be called where they say, Hey, you have to pay these back. And all of a sudden, let's say it goes up 50% now, all of a sudden, I have to pay back $150 not 100

Wade Pfau 22:43
and that's a problem because you don't own the shares, or

Alex Murguia 22:47
I don't own the shirts. Have to buy them. You can't exactly, I have to make that trip. And so effectively, that's when you get short squeeze. But what you're seeing is, why would anyone do that, and why should that be a good thing? You know, you could say it's a good thing or a bad

thing. You know, sometimes, some governments actually like to, like, prohibit short selling. But the reality is, is it's a price discovery mechanism. You know, a lot of fraud is found when people take short positions. Why is this person thinking that this stock is going to go down? And then people start looking into it more and more, really, if you love accounting, then you know shorting is in your blood, right? But that's ultimately what you're doing when you're taking a position short. So a long short position is a long short strategy is you're you're investing, right? And some of your stocks are long and some of your some of your stocks are short. And I'll get into that one in a little bit. I just wanted to find long short market neutral. I'm doing this one together because it's a little bit of a kissing cousin. So I want to introduce both of these a little bit, but

Wade Pfau 23:49
just before that one. So the idea is, like traditionally, mutual funds are just going to take long positions, and so you can only bet on buying stocks you think are going to go up with a long short world. You have the potential to bet on stocks you think are going to go up, and also bet on stocks you think are going to go down. So you you have more optionality for your investment choice.

Alex Murguia 24:10
Yeah, and there's going to be a net position, like, are they net long on the market? Like, you could have 80% of your stocks are long, 20% are short, etc. So what's your net ultimately. So there's a market direction there that I want to make clear, market neutral, you're balancing long and short positions based on what you feel are their price discrepancies that are gonna sort of coalesce a little bit more, right? And so you're trying to actually minimize overall market exposure, so it's market neutral, and you're really looking at the price differences between them, you think there's an anomaly in the price differences, and that's where you're going to make your money off. So it's a little different, but you're using both long and short strategies to be able to accomplish that, all right, so long, short, well, here I'll talk about a little bit more. So in a long short, you. Position right? You aim to capture Alpha both on long positions and on short positions. Right? You're almost like agnostic, like, Hey, I think this stock is going to go up. I'm going to buy I think this stock is going to go down, I'm going to short it. They don't necessarily those two positions. Don't necessarily have to have a relationship with each other. Nor are you concerned about the overall general marketing market direction, although, you know, the reality is, if the market tanks, every position will go down. If the market goes up, you know, it's hard for every position not to go up. And so there is a balance where there is some directional approach. And that's where you kind of are you net short, net long? You do that to kind of protect yourself, so but you are still reducing market exposure while getting equity like returns right? It does help hedge against bear markets, but hedge not immunize yourself, which a market neutral strategy tries to do, right? And again, you can imagine now the type of skill needed for this. There needs to be a significant amount of of of skill to be able to do this. Now, it's relative to the skill needed for market neutral, but you still need this right? And so think about if you have a long, short fund. This is interesting for investors seeking equity alpha, you know, regardless of downside, you know, with some downside mitigation, what I mean by that is, hey, regardless of the market, I want this money manager to make money for me. If markets are going down, I want him to pick the ones that are going to go down, you know, the most and markets are going to go up. I want the ones that are going to go up the most and markets are kind of doing their regular thing. I want him to be able to disentangle which ones are going to go up, which ones are going to go down. Okay? And so there you go. That's long, short kind of position now, and well,

Wade Pfau 26:50
on that coming too, like, like, oh, GameStop. Cita, for example, is a case of this where hedge funds were going short on gamestop because they thought the price was going to go down, and the retail investors all got together and went long and pushed the stock price up. And that causes a lot of pressure for the short sellers, because there's an the stock can go up an unlimited amount. And so the amount you need to potentially pay back can be ignored Exactly.

Alex Murguia 27:16
They're uninsured. For the upside, it can go up forever and ever. And so eventually they call, you know, and frankly, those those shares are borrowed, and so fidelity, at some point may want them back, because they don't make their covenants and things like that. And so all of a sudden they got to produce the shares from somewhere, and so they have to buy it and then return them. And so that buying pressure causes the stock to go up, which, that's what they mean by. They're getting squeezed, you know, in that sense. But you're right. That happened with GameStop, where it was a game of chicken between the retail investors and these hedge funds. And you're right. Game stock, you can make the case. Why was it going up in the manner that it did? It wasn't supposed to. And so, you know, these folks are looking at balance sheets thinking, this thing has to go down because it's pure, it's a sandcastle. And someone had different ideas. You know, all the retail investors kind of knew this, and they were like, No, you know what? We're going to continue to make it go up, because we know that we're going to squeeze you, and we're going to get another 20, 30% out of this stock just because of this logistical workflow that you're in right now that you're going to try to unwind, you know, it's, it's, effectively, it's the opposite of when somebody has to, you know, somebody has to sell, and the stock goes down and down and down because, you know, you know, you can drive that price on. It's just the same idea, but in the other direction, because they're borrowing the shares. They don't actually have them. And so if it goes up to Wade's point, it can go up indefinitely. It can go up to 1000 to 10,000 and where are they at that

Wade Pfau 28:51
point? And that's why short selling, it can be riskier than long going long, because with going long, you to lose your entire investment. But when you go short, you could lose. I mean, it's

Alex Murguia 29:02
the furthest you can go. The floor is zero if you go long, unless you're doing with leverage, the floor is zero if you go short. The floor is more than zero because in terms of your net worth, because, yeah, it could go to a million. And you may, you only, you may only have $100,000 you know, to be able to buy stocks, and to be able to buy the stocks, to then return them, etc. So is this? Now what's happening here, and the reason we're doing this is there are some strategies, albeit to a lesser extent, available now. Way to was saying this earlier, we're talking about accredited investors and things like this. But what you're seeing now with technologies is you're seeing access to things like this for the consumers, if you will. And you know, and this is not to say, do this or not, by no means is this an endorsement, you know, Wade and I have our McLean hat on. And our retirement researcher had on which those are registered and investment advisory firms, you know, so by no means are we promoting this or think this is what you should do. This is just to be an informed consumer. But there are beginning to be platforms where consumers can access this themselves, and frankly, even through advisors. You know, as long as you're a current investors, there's these platforms that are coming out for advisors that are that are providing this universe of hedge funds and, you know, illiquid securities that

advisors can begin to tap into for their clients. So you are seeing this out there in the, you know, in the, what's the phrase here in the wild? In the wild? Yeah, exactly. You are seeing this out there in the wild. And the reason I we thought this be, this would be a great arc to have, is because more and more people are getting pitched these strategies, you know? And we, like I said, we have a lot of prospects that come in with these strategies. They don't know what they are, why they're even in it, and the amount that they're in doesn't even move the needle within their portfolio, and it causes aggravation. And so we're trying to help you be informed consumers. Are just what this is, but know that you're seeing a lot of these things available, more through advisors than you ever have, and you're seeing a lot of these just in certain markets available, you know, such as daily liquid mutual funds, interval funds, if you will, and the like, right? And there are some ETFs that track long and short strategies. Like I said, they're turning alpha into beta, and so that's why you're seeing this whole price compression as well.

Wade Pfau 31:36
All right, okay, market neutral. Market

Alex Murguia 31:40
neutral. So here they're seeking absolute returns, absolute you know, the markets go up or down, doesn't matter. We're gonna we're gonna be able to do this by removing market beta. Now, again, long short equity, but they want a zero net exposure, right? Remember, long, short mutual funds, yeah, they're going short some securities, but let's say they think, but in general, we think the markets are still trending up. So we're going to be 60 long, 40 short as a percent market neutral. They're trying to offset complete market movements, and their bets are more like, listen, I think the price differences between these securities are such that, you know, historically, they're always much closer. They're too dispersed. So I'm gonna go long one and I'm gonna go short the other. You'd go long the one that you think is, you know, undervalued relative to its historical price, you know, compared to the other one. And you're going to go short the one that you think it's overvalued relative to how it compares to the other one. And so you you lock out the market, and you're just playing on those prices to to, you know, to effectively come together to its historical mean. And, you know, hence, it's market neutral like that, right? And so it's low correlation to any single market direction, because you're equally long one position short the other. And I'm saying one position, but they do this with many positions, if you will, right? And so this creates the stability during volatile markets, because you're just worried about the price movements up or down between a select set of securities, but the net exposure to the market is always kept at neutral. You're not net long, net short, that kind of thing. And so this is ideal for alpha generation in a sideways market, right? Because you know, when the markets are going up, the markets are going down, you know, you don't know, but if you can, like play on the price differences between certain securities. You know, if you're able to do so, that's where it makes sense, and that that is able to enhance risk adjusted returns without adding equity beta, if you will, because you're you're neutralizing the market from that, from that equation

Wade Pfau 34:01
bonds, but with a minimal increase in volatility of performance. Exactly.

Alex Murguia 34:07
Yeah, exactly. You want to say that again, Wade, because I heard it, but I didn't hear clearly. But for everyone, but just

Wade Pfau 34:13
you're trying to outperform bonds, otherwise you could just be in bonds, but with a minimal increase in the volatility of the performance exactly

Alex Murguia 34:21
now which strategy is, and again, you're seeing these in a similar manner, you know, for the for the investing public, than you are with longshore Now, which one of these is better, or that kind of thing. Well, in my estimation here, market neutral strategies are ideal. You know, these are all hypothetical statements I'm making, right? They would be ideal for low volatility, steady returns. Hence, Wade's bond coming. I'm not saying they're like bonds, but they're not going to give you huge market upside. They're aiming for steady returns, controlling for the market. And the source of those returns are the price differentials between securities that they think. Are not quite where they should be, right, and so they're often used by institutional investors when they want to diversify from market risk. Long, short strategies offer higher return potential because they're going to ride on the coattails of general market movements as well, you know, but it there's higher risk around that. So the too long didn't read version is, you know, market neutral strategies hedge out market risk completely by focusing on pure stock selection. Long Short strategies, they have that pure stock selection, but they're still taking based on their net exposure. They're still taking a broader market direction. All right, so in essence, you have a couple of variables here, market exposure. Long, short. Strategies are partial market neutral. They want it at zero. Which one has Alpha? Well, I would say market neutral is probably the most dependent on alpha, because it's neutralizing the market. So you're not going to write on the coattails of a general market direction. You're writing on the coattails of your ability to find price discrepancies between a group of securities and having those prices move in the direction that you think. And that's a hard ask, because you need to have the price that you the price of something that you think is overvalued to go down and you think, and you have to bet on the price of something that you think is undervalued to go up relative to each other, right? And so it's a tricky thing, whereas, in the alpha that you're hoping for in the long short is there is some of that, but there's also general net exposure that can help you, all right, leverage, well, because, because you're neutralizing the market. You know, in a market neutral, you have to use more leverage to be able to get returns that are greater than fixed income, to Wade's point as well. And so there's usually a little bit more higher leverage in the in the market neutral, because that's how you sort of amplify that, no net exposure, if you will. They both, they both short. You know, from that standpoint, volatility is going to be higher in the long or short the market neutral. Yeah, it's less it's less volatile because of, you know, the way they're able to hedge out the market completely. But is that needed? You know, when you can get maybe a similar return to bonds? I don't know, you have to ask yourself that. And so risk profile, long, short, equity, like to me, market neutral is lower risk with stable returns. But again, you have to take into consideration how those sources of risk are developed, and could you? Can you replicate that by putting in the bonds and and doing systematic things on your own? Most likely, I think you can. But that's that's where you're at when you're looking at market neutral, long, short equity strategies. Wade anything there that I may have missed

Briana Corbin 37:59
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Wade Pfau 38:24
Just a question I have with that fee structure, would that sort of two and 20 be common with market neutral as well, since there's less profit potential and that 2% fees a hurdle to get over to outperform fixed income, yeah,

Alex Murguia 38:40
yeah. I mean the good ones, they do it, but they'll do it because they, they figure they can make it, and they just lever it up more. They just generate those that that amount through, through the leverage they can take in it. But again, two and 20 has become this banner that results vary now that, you know, I, when I was great, when we were kind of putting this together, I was thinking, do we want to say two and 20? And 20 anymore? You know, in that sense, you know what you find when you look into it is based on the expected returns of the strategy and the, you know, the volatility in it, or whatever they're going to charge you, whatever percent and profit taking portion that they can above and beyond what their alpha is, you know, I mean, they're going to always take it to that level. So whether it's two and 20 or not, I don't know. I think what's more important is they're taking a fee, and they're taking a percent of their return. What that number is depends on the overall structure, but as a as a proportion to the overall return, whether it's two and 20 or like 1.75 and 15, you know, that kind of thing, I think is a similar kind of ratio relative to the overall expected total return. Does that make sense? Way? Right? Arbitrage and quantitative. Strategies

Wade Pfau 40:00
here. And that's the third broad heading. Yeah, that's the third

Alex Murguia 40:05
broad one. And arbitrage is you're taking advantage here of of these sort of price inefficiencies. Now that's different than what we were talking about in the market neutral. Market neutral is really just assessing, hey, usually these differences between these two prices isn't the same. So I'm going to lock something in and bet on that to converge, and I'm going to neutralize my overall market exposure. Here it's, you see this a lot with like, corporate events and things like that. Stocks that are dual listed, it's listed like this in one exchange, not the other. Let me quickly, you know, catch that, if you will, quantitative strategies. They're using data driven algorithm models that's like been all the rage, you know, over the last 10 years, if you will, this sort of convergence of the stats bros coming into the industry and making it all algorithmic, especially with the advent of of trading, you know, being able to high frequency trade and things along those lines. Now, with regards to this, there's quite a few strategies around that that I want to make sure, and I want to make a point that this is a little different. When I talk about arbitrage, it's a little different from the event driven strategies, because sometimes, when there's a merger, and we'll talk about this in the next one, there's an ability to kind of, you know, there's usually a spread. If a company is buying another company, and the company right now is $40 and I'm buying a company that's $20 and I'm gonna offer $25 a share for it. That company doesn't move to $25 that day. It goes to like, let's say $23 $24 and there's $1 there that you can say to yourself, hey, there's a free dollar here in return. If this deal goes through a month from now, why don't I go long the company that's $23 and go short the company that's $30 because that'll guarantee me that 1% that that that one point difference in price, right? That's different than

what we're talking about. I don't want to get into it too much right now, because that's for tomorrow. That's for another day, if you will. But arbitrage is you're exploiting price differences in these securities, and you want to do it quickly, and think of the the example of, let's say a convertible preferred strategy, where, in that strategy, think about here a convertible preferred where, let's say company XYZ, and a company XYZ issues convertible stock, right? And each preferred share can be converted into two common shares of stock, right? And the convertibles are issuing some dividends along the way, some interest payments along the way. That's why they're doing convertible as opposed to, you know, normal bonds or corporate bonds and the like, right? And so let's say the common stock is trading at $30 a share, right? The common stock is trading at early dollars a share. So that means that each preferred share should be worth at least $60 because if it's going to be converted to two shares of common stock, two times 30 equals 60, right? Plus a little extra, let's say for dividends and things like that that we were talking about earlier, right? But let's say the preferred stock is trading at $55 not at 60, right? There's usually something inherently also at issue that is doing that. So what you would do, though? So this is a clean example, but there's reasons why that. But let's just say that the preferred is trading at 55 so you short sell to the common shares. You know. You get the 30 bucks, you know, right there. You pay $55 to buy the preferred. You received $60 effectively, you have that $5 difference right there, right? Because at some point you convert the preferred shares into two common stocks, and you deliver that when you close out your position. And so that's what you that's what you get, and that's a that's a basic example, but this is what's going on when you're talking about these sort of arbitrage strategies, right? You're trying to exploit price differences within securities. And there's a speed that you have to do that in, because you have people now combing all these, they all these market prices to capture these things, right? And so that's what you get in, sort of these arbitrage strategies, right? Or what's the stock trading in Germany? You know, in the German market is trading at this, and this other market is it's trading at this. That doesn't make sense, you know, why don't we buy this one short the other, and wait for these things to converge? Right now, there's pennies to be made. I'm not saying you're going to be making $10 a trade here, but these are pennies. And so this is where. You get into this. Let's do this 1000 times, you know. And so that 1000, a million times. And so that's where you get into these sort of high frequency things. Now, again, arbitrage, they're really trying to seek risk free profits by capitalizing on these price differences in similar securities such as convertible stocks or in dual listed stocks. You have to kind of realize that's at the end of the day, that's what they're trying to do, right? That's the source of return quantitative hedge funds. They're just using mathematical, algorithmic trading models to just comb the base and exploit inefficiencies. Now I'll get to what these could be in a bit, and they're not too different from when I was talking about market neutral strategies. They're just doing this on steroids, if you will. They're trying to systematize it, as opposed to, you know, market neutral strategies, you know, for a long time, those would be the stock pickers, you know, that kind of thing here. I don't think they have that kind of ego. They're just trying to, you know, mathematically, put up models that will begin to find things and just agnostically trade on them. Right now they, I can't stress enough, these strategies rely heavily on technology and vast amounts of data to generate small, consistent gains over time. It's that joke. Wade, right? Like, if markets, you know, would you pick up a $20 on the sidewalk? Wade,

Wade Pfau 46:29
as an economist, yeah, the economist would say, if there were, it's not there were there, it would have someone had already picked it up. Yeah,

Alex Murguia 46:35
someone would have already picked that. And the reality is, is the the flip side to that is, look, it's not worth spending your whole day looking down for money, because you're gonna hurt yourself, you know, and you're gonna spend an inordinate amount of time trying to find that. But if, all of a sudden, you have this vast array of technology available for you that increases throughput by factors of 1000 that can look down for you while you're walking the side or without you actually looking down, and will scoop it up for you. Then, all of a sudden, maybe it's worth picking up that $20 right? And in essence, that's what they're doing. You know, in a funny sort of way, that's what they're doing. And they're doing this with half a pennies, and they're doing this 10,000 I'm making it up because I don't know it's all about they're doing this 10,000 times an hour. You know why? Because it adds up over time. And if you have enough leverage behind that, voila, there you go. Now, if you have enough leverage behind that, then you you go back to your long term capital management disaster that you had in I think it was 98 or something like that, right? And so that's what you have with these quantitative strategies. Now, there's a couple of them that you want to think about. There's statistical arbitrage, right? And that's where people throw the terms around pairs trading mean reversion. You know, that's they're just looking at trading two stocks and trading off of that and hoping that they'll revert to the mean. It's a little less stock picking than the market neutral strategy, because they're just looking at mathematically. They're not looking at what's the true value of this. This is what, I think the true value of this, and this is why, historically, it should begin to converge. They're just, you know, scouring the the internet's scouring the market, the market data, and say, okay, boom, we've got good two good ones here. Let's trade off of that trend following strategies. They're using momentum based strategies. I'll talk about this a little bit more when we're looking at managed futures, machine learning models. To be to be honest, this is beyond my ken. It's not like I'm up to date on machine learning models and high frequency trading strategies, but what they're doing is using algorithms to find patterns, if you will, within within the the marketplace. I mean, you know, this is where probably the world of David Simon would be. But you know, these, these freaking guys, high frequency trading and risk premia harvesting, risk premium harvesting is something that we've looked at, and that's something that, you know, I can speak with, you know, a little bit of what that is, right? And you hear this a lot, and this is one that many advisors, not many, but there's some advisors that that do this, and some advisors that I respect that are doing this. This is something that we're looking at, but we're not actively doing this ourselves right now. Now to take this and use as an example, what is risk premia harvesting, right? And that's effectively, well, if you believe in the value premium, which is over the long term, value stocks will outperform more stable stocks. Why? Because they are riskier. Now, there's a lot of research being done that if you add up, it's not really just a straight up value premium, it's value premium with a profitability component thrown in, which I tend to buy I tend to buy into. You know that that can still be accommodated for in this strategy, right? But in its basic sense. Because if you want to do a risk premia strategy, you know, with regards to, you know, using stats and things like that, well, effectively, you look at the cheapest 10% of the stocks based on, let's say, price to book, add in a profitability component to that filter, and what are the 10 most the on a percentile basis, you got the cheapest 10% now give me the most expensive 10% based on price to book, with a probability filter built into that. And I'm going to short the ones that are the most expensive, and I'm going to go long the ones that are the cheapest, and voila, I have my risk premium harvesting strategy. Now you could say the way I've explained it, you can you can say, Oh, wow, that's kind of simple, but it's not that difficult, that that pretty much is what it is, you know. And this is what I the terms I was getting to earlier. They're taking alpha, and sometimes these strategies are taking what was previously, let's say, 10 years ago, thought

of as manager alpha, and they're really creating a systemic trading strategy around that, and having beta now you can make the case that this one as opposed to others, may make sense, because if you do believe in these risk premiums, then okay, yeah, you know, you can do this, and it should be successful. My issue with that is these risk premiums happen over the long term, and they're making these bets on a yearly basis, and so they're expecting this to come to come to fruition from one year to the next. So you're going to have bad years that's just given. You're going to have bad years. You're hoping that after over 10 years, 15 years, this kind of risk premia harvesting strategy played out. Now you can make the case. Why don't you just buy a value index, if you will, and leverage it up if you want, or just don't do anything and wait. And the answer is, right, you can do that, and you won't get the risk premium harvesting hedge fund, but you know, you'll take advantage of the value premium coming through, but that's what that is. Why should it work? Well, if historically cheap companies outperform expensive companies over the long term, then just make that trade every year and hope that the long term is not that long on a year to year basis. Right? Wade thoughts,

Wade Pfau 52:20
you know, I realized I should have asked here earlier in the episode. Usually you're the one asking me, but you've used the terms alpha and beta quite a bit, and it just, oh, verified beta is like the market return and alpha would be if you're able to earn excess return above the market holding the overall market index.

Alex Murguia 52:40
Yeah, yeah, that's exactly it. Alpha is what's referred to as, what it really comes from a linear model, right? When you look at the linear model, you know, return, expected returns equal alpha plus beta, you know, which is the market, if you will, you know, and that's it, right there. And now alpha tends to be the unexplained variance. And the unexplained variance is what's attributed to the manager outperform the manager skill, yeah.

Wade Pfau 53:11
And that's a you're saying, like in an active management world, alpha belongs to the skill the manager to select the right securities and so forth. Yeah. What you're saying is now, with the technology, you're able to effectively replicate that with a pending skills. So it becomes part of the market.

Alex Murguia 53:28
Exactly what's happening with technology and with once people are better understanding these strategies, that unexplained variance is becoming very explainable, and so the Alpha began, begins to shrink. But that's where the terms alpha and beta came from. It's just the the initials in a linear equation, you know. And alpha happens to be the first one. Beta is the next one. But wait, we should create shirts. I'd say alpha is Greek for mythical manager outperformance or something like that. It's mythology, Greek mythology. But yeah. And so again, those are the the three hedge fund strategies that I wanted to talk about and just lay the groundwork. And it's not necessarily given its whole thesis. Again, the whole point of retire with style is to make folks inform consumers as they enter retirement for retirement income strategies. And so are we doing this? This is stuff that the reality is, if you're in your 40s and 50s, you've been accumulating. You may have been doing this yourself. You may be realizing you know what, I should start looking at avenues for financial advice. And if your net worth is big enough, invariably, you're going to come across an advisor beginning to pitch hedge funds, and it may

have nothing to do with a need that you have, but it may sound great. And so what we want to do is kind of not debunk them, because maybe it works for some people, but I want to help. We want to help folks become informed consumers about what this means, and just the word hedge fund isn't enough. It's what's under it. And so today we went over three types of them. You know, long, short, market neutral. What else? Wade, I'm trying quantitative, all right, and those are kind of what you have in the next episode. We'll do global, macro, event driven and manage features.

Wade Pfau 55:22
That's right. Wade, okay, yeah, I think we can take it home from there as well. We'll continue this next week with the other types of hedge funds, but again, we'll have that YouTube live on June 2 at 2pm Eastern time. So prepare your questions for that, and we'll catch you next time on retire with

Alex Murguia 55:41
style later everyone. Wade

Briana Corbin 55:43
and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you, consult your financial advisor. All investing comes with the risk, including Risk of Loss past performance does not guarantee future results. I