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UConn's Endowment Is Abandoning Hedge Funds for New Kind of ETF

- Many hedge funds "don't justify the fees," says UConn's Ford
- $634 million endowment using buffer ETFs to help mitigate risk

By Emily Graffeo

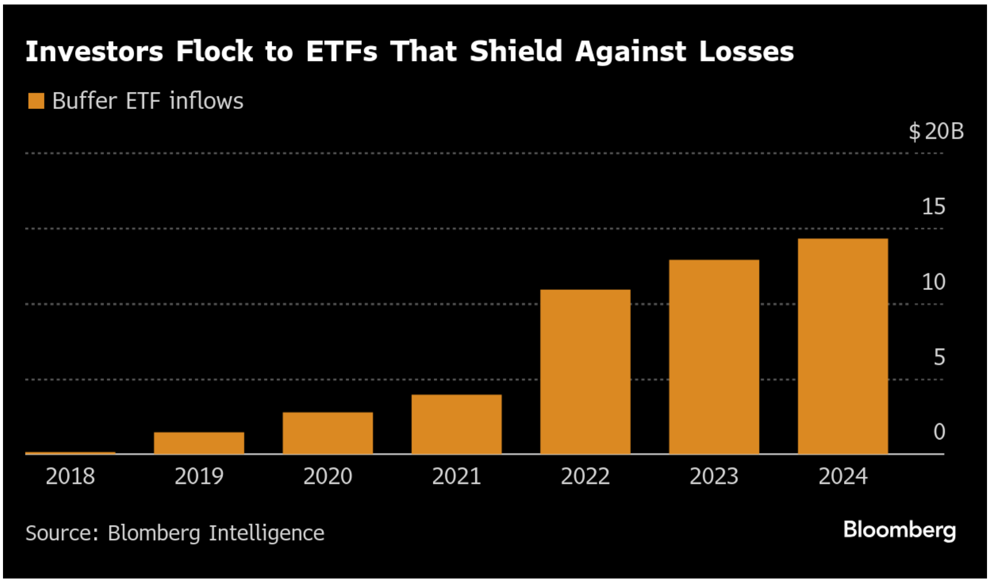
(Bloomberg) -- The University of Connecticut's endowment is turning away from hedge funds and embracing a cheaper way to mitigate risk in its $634 million investment portfolio.

The UConn Foundation sold almost all of its hedge fund exposure during the most recent fiscal year and bought so-called buffer ETFs, said David Ford, chairman of the investment committee. The increasingly popular exchange-traded funds, which use options to protect against losses while capping upside gains, have amassed more than $58 billion in assets, almost all within the past three years.

Market watchers say it's a sign of growing institutional adoption of the nascent fund strategy, one that could help the ETF industry, largely known as a beacon for retail investors, make further headway with sophisticated money mangers overseeing trillions of dollars.

To Ford, hedge funds have become a "victim of their own success," with many growing so large that returns have suffered, particularly compared to the years after the late David Swensen of Yale University revolutionized endowment investing by incorporating alternative strategies into asset allocations. Ford says buffer ETFs are a cheaper and easier way to lessen portfolio volatility relative to using a hedge fund or structuring a bespoke trade, and come with the benefit of improved liquidity.

"This takes the complexity out of hedging, or most of the complexity," Ford said. "Instead of having to go to an institutional desk and say, we want to design the following options trade, it's already prepackaged and trading."



Top hedge funds have often historically charged clients 2% of assets managed and 20% of profits. UConn has purchased buffer ETFs overseen by Innovator Capital Management, where the average fee for the products is 0.8%, according to data compiled by Bloomberg. The largest buffer funds track the returns of major stock indexes like the S&P 500, capping gains over a one- or two-year span, while also promising to shield against losses if the index slumps.

The "first way to improve our returns is to cut down on the amount of fees that we're paying," Ford said.

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Assets in buffer ETFs have surged since Innovator launched its first such fund in 2018. Other money managers including BlackRock Inc., Fidelity Investments and Allianz SE have since debuted their own offerings. Yet skeptics have argued that the funds may not be able to produce the same level of returns should the Federal Reserve continue to lower interest rates.

UConn is keeping exposure to two long-only equity managers, Ford said, as he continues to see the potential for outsized returns from stock picking.

"They're the ones who are going to pick the best single names and we'll take over responsibility for hedging," he said. "What we found is that a lot of hedge funds have less upside and they can be good at dampening volatility, but we're paying enormous fees to get lower return."

UConn's endowment returned 12.1% in the most recent fiscal year ended June 30, compared to a 13.5% gain for the Innovator US Equity Power Buffer ETF, the manager's largest such product.

"Hedge funds 25 or 30 years ago, they could do something, they could deliver something that was unique because there weren't a ton of them," Ford said. "Today you've got a number of funds that are more dependent on data and or leverage than they are on actually finding uncorrelated opportunities."

To contact the reporter on this story:
Emily Graffeo in New York at egraffeo2@bloomberg.net

To contact the editors responsible for this story:
Sid Verma at sverma100@bloomberg.net
Boris Korby