HEDGE FUND INDEX UNITS FACE HANDICAP

New index "funds of funds" suffer from constraints.

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In the past year or so a number of major index providers have come to market with investable hedge fund index funds. Heavyweights from the long-only world, like Standard and Poor's and MSCI, have waded in with these investment vehicles, as well as leading names in the hedge fund world like HFR and Tremont Tass. What is going on here? Is this a legitimate addition to the management of hedge fund portfolios, or is it something somewhat less noble driven by a desire to capture the higher fees available in the hedge fund business? One must view this development skeptically when the two most significant long-only index providers—which do not manage a cent in that space—offer index management products for hedge fund investment. This paper reviews the issues surrounding these product offerings to determine exactly what they are.

Modern investment management is entering its third phase. The first was at the turn of the previous century when Charles Dow created the first index in 1896. It was a period of absolute return management characterized by balanced portfolios, no attempt to earn alpha and no specialization. The second phase began with rich theoretical development of the capital asset pricing model (CAPM). Market index benchmarks became popular, culminating in the "tyranny of indexes," characterized by relative return management, weak alpha generation and the evolution of specialization.

The current third phase is now swinging back to absolute return management, robust alpha generation and an accelerated evolution of specialization. In this phase, market indexes have a minor role, at least according to the theory, but not according to providers of hedge index funds.

The tragic flaw comes right at the outset, when the assumption is made that hedge funds and their related cousins in the commodity trading (CTA) world constitute an asset class. Looking at the characteristics of what constitutes an asset class, it is apparent that hedge funds use conventional asset classes but they are essentially investment strategies. As investment strategies, they are information-bearing alpha generators that are as antithetical to the basis of a market index as one can get.

The single most important characteristic of a market index is that it effectively captures the non-information bearing content of the "market." In other words, the investor needs to know nothing to capture this return. Extending this thought to hedge funds is laden with pitfalls, since these are information-bearing strategies. The investor cannot simply passively capture this return, however defined.

Simply review what these investable hedge fund indexers must go through to create their products: the hedge fund constituents must meet predefined minimum standards for such elements as style purity, personnel stability, management competence, life of the firm, assets under management, capacity, operating controls and risk management. This type of screening process is the hallmark of active management.

In other words, these investable creations are nothing more than highly specialized funds of funds. As such, they are pale imitators of their considerably more robust brethren. Because of their construction rules, they ignore many potent diversifying styles, accept lesser performing managers and strategies, concentrate highly correlated strategies and embody more fat tail risk than most funds of funds. There is no practical way that they can manage portfolio risk.

So back to the question, "what is going on here?" Anyone marketing to institutional investors knows that hedge funds are hugely unfamiliar territory. To be successful, one has to create a product that fits with their prior experience. Index funds certainly do that. But these are not index funds, and the cautionary note *caveat emptor* most certainly applies. ▮