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# THE QUEST FOR INSTITUTIONAL QUALITY

## *The challenge of managing hedge fund risk.*

Your portfolio is a soup—a blend of asset classes and managers. Should hedge funds be included in the recipe? And what are the risks? Ultimately, the answer depends on how an allocation to hedge funds impacts overall portfolio expected return and risk. This is a more challenging criterion than it first appears because of variations in hedge fund quality and the complexity of hedge fund strategies.

How, then, can we assess the characteristics and quality of individual hedge funds, potential ingredients for the soup? Style classification is often used as a guide to understanding volatility and correlations of active managers, but this approach may be misleading as there are no generally accepted standards that apply to hedge funds. Further, the length of history available on hedge funds may be insufficient to validate style or to help forecast performance.

Academic research on hedge funds has shown statistically significant correlations between hedge fund styles and evidence of multi-factor systematic exposures. If it is true that much of the return of a typical hedge fund is derived from a predictable average exposure to market factors, then perhaps many hedge funds could be described as cleverly repackaged beta, and not in fact “pure alpha.” This is not what investors should be paying for.

## DEFINING INSTITUTIONAL QUALITY

Regardless of style classification or data constraints, investors must separate systematic exposures (beta) and active exposures (alpha) to understand the normal portfolios of hedge funds. Further, investors must believe that the hedge fund managers under consideration have the ability to produce a positive alpha, a process that requires skill and diligence on the part of investors. These minimum conditions define “Institutional Quality” hedge funds. Institutional quality means there is clarity on the systematic exposures present in the strategy, and an investor can be confident that the hedge fund has the ability to produce a pure alpha.

But having quality ingredients is not enough; we must know how to blend them in the proper proportions. Intuitive rules can be demonstrated for investors with constant risk aversion or constant risk budgets. While there is no single right answer as to how hedge funds fit in an institutional portfolio, two approaches for incorporating hedge funds are recommended: 1) hedge funds as an “active overlay” at the total portfolio level and 2) hedge funds as “portable alpha” within a traditional asset class.

## THE RIGHT MIX

The most common practice is to set the allocation to hedge funds as part of the strategic asset allocation process, often in the alternatives or so-called absolute return asset classes. While simple to execute, this method mixes alpha and beta exposures in a framework that was designed for only systematic exposures. Instead, the two recommended methods properly distinguish alpha from beta, which is consistent with modern portfolio theory and with the theory of active management.

## HAVING QUALITY INGREDIENTS IS NOT ENOUGH; WE MUST KNOW HOW TO BLEND THEM IN THE PROPER PROPORTIONS.

The alpha overlay approach integrates the expected alpha and active risk of the hedge fund with the investor’s chosen asset allocation policy. This highlights the benefits of skillful selection of hedge funds on overall portfolio performance. The second approach incorporates “equitized” hedge funds in a traditional asset class. Manager structure optimization techniques enable the investor to incorporate hedge funds in the traditional asset class while controlling risk budgets. Simply put, these are the strategies for investing in hedge funds that can manage hedge fund risk and potentially improve the performance of institutional investors’ portfolios. ■