

TALES FROM THE TRENCHES

A one-time plan sponsor and money manager talks about alternatives.



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With 23 years of professional experience in the alternative investment sector as a hedge fund manager, pension fund staff analyst, and a fund-of-funds manager, the author can offer four key points for Canadian pension plan sponsors to consider regarding allocating investments to hedge funds.

Firstly, there is substantial evidence that, historically, a well diversified portfolio of hedge fund investments provides a risk-adjusted return superior to either traditional equity or bond markets. A few points on this: firstly, that the incidence of “blow ups” or fraud are much less common than people seem to think. An Internet search found only 39 occurrences since 1993. While noting the search was not exhaustive, the assertion was made that to anyone familiar with corporate news on equities in the last few years or with the default rate on junk bonds, it should be obvious that this is not a major problem by comparison.

TOO RISKY?

Secondly, many traditional pension plan sponsors view hedge funds as being ‘too risky’, without really understanding the opportunity in these strategies or the actual level of risk. The argument can be made that, with respect to fraud, blow-ups, or volatility, hedge funds, in general, are not markedly more risky than traditional equities. It is clear that the hedge investments had both a higher return and a lower volatility than the unhedged investments. Further, the hedged program offered returns with a lower correlation to traditional asset returns and therefore provided a superior diversification opportunity.

DIVERSIFICATION BENEFITS

Thirdly, a portfolio of hedge funds can be selected to

promote a low correlation with traditional portfolios of assets and, therefore, acts as good diversification. Even for mortgage arbitrage, considered by many to be the most problem-fraught hedge fund strategy, the cumulative return on the HFR Mortgage Arbitrage Index provided almost as much return with about half of the standard deviation.

ALL IN ALL, THE EVIDENCE DOES NOT SUPPORT THE CLAIM THAT HEDGE FUNDS INVESTING IS RISKY, AT LEAST AS COMPARED TO UNHEDGED INVESTMENTS IN SIMILAR INSTRUMENTS OR IN EQUITIES IN GENERAL.

Fourthly, analysis of hedge fund returns by quartile and strategy suggest that top quartile alternative managers continue to provide superior performance in many strategies. The spread between the returns on the best performing managers and the worst has not deteriorated. If alpha were disappearing, the best managers would not beat the worst—no one would make any money.

NEED FOR UNDERSTANDING

Finally, the combination of the first four points leads to the conclusion that pension plan sponsors in Canada have an obligation to understand hedge fund investments well enough to determine if investing in them is in the best interests of the beneficiaries of their plans.

All in all, the evidence does not support the claim that hedge funds investing is risky, at least as compared to unhedged investments in similar instruments or in equities in general. Additionally, while hedge funds paid off well in the past, perhaps all of the alpha is gone. ■