



Robert A. Jaeger

Vice-Chairman and Chief Investment Officer, Evaluation Associates Capital Markets

Diversification and Alpha

What to expect.

Institutions that are interested in hedge funds are looking for at least two things: (1) Diversification away from conventional equity market risk (2) A source of return that has an economic rationale and is not totally dependent on “manager skill.”

Institutional investors need to have realistic expectations in both areas. In terms of diversification, low correlation with equity is not enough by itself. What institutions really need is low downside correlation, that is, investments that will perform well when the standard asset classes are not performing well. However, various hedge fund strategies have very different downside correlation characteristics such as:

- 1. Very low correlation.** Relative value strategies (where the manager is long and short at the same time) and genuinely opportunistic strategies (where the manager can be long or short or neutral) have the lowest correlation with the standard markets.
- 2. High positive correlation.** Some equity hedge fund managers are consistently net long and, hence, have a high correlation with equities.
- 3. Intermediate positive correlation.** Both risk arbitrage and distressed debt strategies have residual equity risk. Weak equity markets have a negative impact on the pricing, timing, and cancellation risk of merger/acquisition transactions, and affect the pricing of low quality credits.
- 4. High negative correlation.** Short sellers are consistently net short, and hence have a high negative correlation with equities.

In addition to the above characteristics, many hedge fund strategies (other than short selling) come under pressure during periods of major financial stress. So the institution that wants to achieve low overall correlation must draw from the full menu of hedge fund strategies, including short selling, in order to construct an intelligently diversified portfolio.

As for the source of return, many hedge fund strategies are totally dependent on manager skill. For exam-

ple, equity hedge funds, including market neutral funds, depend entirely on stock selection and related skills. “Global asset allocation funds” (macro funds, futures traders, etc.) take long, short, or neutral positions in a wide variety of markets, and thus may be viewed as practising “market timing” in multiple markets. Unlike long-oriented equity investing, which takes advantage of the fact that equity prices tend to go up over the long haul, these hedge fund strategies do not have a “wind at their back.”

But some strategies do have an economic rationale: they provide liquidity to more traditional investors and markets. Often, the typical equity investor doesn't like to hold stocks that become involved in mergers and acquisitions. The equity investor already has a large gain and may achieve a slight, incremental gain if the transaction is consummated on schedule. However, the investor runs the risk of losses if the transaction is repriced, delayed, or cancelled. The risk arbitrageur assumes the risks that the equity investor prefers to avoid. Similarly, the distressed debt investor buys debt that traditional fixed income investors may be forced to sell in order to maintain portfolio yield or comply with investment guidelines. The convertible hedger provides liquidity to an “orphan” asset class that is neither pure equity nor pure debt.

But the sort of liquidity that hedge funds provide is “everyday liquidity,” not “heroic liquidity.” Heroic liquidity requires deep pockets, a long investment horizon, and a willingness to “step up to the plate” during times of pronounced dislocation. But the typical hedge fund is operating on leverage, has a shorter investment horizon, and is trying to generate consistent returns. So hedge funds cannot deliver heroic liquidity, though they can deliver tremendous amounts of everyday liquidity. ■

