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(Mis)Using Indices

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Absolute return (AR) strategies rely on such a myriad of investment instruments, markets and implementation strategies that it is challenging to try to pigeonhole them into a common set of characteristics. Their commonality is purely statistical since they tend to have a higher incidence of positive returns compared to their traditional, relative return cousins. These returns tend to exhibit less volatility and their correlation is often close to zero.

In order to create a successful index to benchmark AR strategies, it is important to ask whether or not they constitute an asset class. It is safe to say that they don't, because they lack essential asset class characteristics: common structure, common institutional arrangements and common return drivers. Consequently, it is impossible to create an index that can accurately capture the non-information-bearing content of these strategies. And yet there is no shortage of providers willing to create them.

The range of AR strategies includes hedge funds, managed futures funds and funds of funds. Only recently have these strategies come to the attention of institutional and retail investors. This is due to American rules that prohibited their marketing and distribution as well as little-understood management techniques that were considered too risky. This caused such strategies to evolve in the loosely regulated offshore market. Because of this, the highly regulated institutional standards of performance, calculation and reporting are often lacking.

A well-constructed benchmark index must be unambiguous, with well-defined construction and maintenance methodologies; appropriate in its constituents and weighting schemes; replicable so that investors can recreate it with little cost; measurable with accurate and frequent pricing; and accountable, with its rules governed by a group of independent and diverse interested parties.

Although providers are trying to do their best, they have a very difficult task. Their first and greatest failing is the inability to capitalization-weight their indices, making them inefficient in the Capital Asset

Pricing Model (CAPM) sense. Consequently, including them in CAPM analytics will provide questionable results. As well, since providers rely on managers to voluntarily tender their returns based upon the managers' own calculations, results may be inappropriately calculated or, if they are poor, not reported at all. The difference between a chart of an index with high quality data and a chart of lesser quality is most evident whenever stresses hit the market—relative performances diverge markedly. These indices also suffer from survivor bias at both the high- and low-performing ends of the spectrum.

As a result, what these indices represent is, at best, a peer group comparison of performance the size of which expands and contracts with the success of the constituent managers. It is impossible to create an AR index in which absolute returns become relative returns. This means that all performance is alpha with no adjustment for market risk. It only represents information.

In May of 1896 Charles Dow introduced the 12-stock, price-weighted, Dow Jones Industrial Average (DJIA), the first stock index. Before the DJIA, there was no answer to the question, "How is the market doing?" All risk was stock-specific, all returns pure alpha. The situation then was very similar to today's need to create indices for AR strategies.

When AR strategies are disaggregated into groups sharing common characteristics, there is a better opportunity to create more meaningful benchmarks because there are common return drivers. However, because of the non-linearity of the return streams, new techniques need to be developed to model the return drivers. Interesting work is underway in this area but, for the moment, *caveat emptor* must precede any use of indices to judge AR strategies. ■

