

WHERE'S THE RISK?

Pension plans should understand the risks and rewards before adding a hedge fund allocation.



HARINDRA DE SILVA

President, Analytic Investors, Inc.

IT IS HARD TO DENY THE ATTRACTIVENESS OF THESE STRATEGIES IN TERMS OF THE RISK AND REWARD OPPORTUNITY THEY PRESENT TO INVESTORS

Poor returns from equity markets, realistic expectations for the equity-risk premium, and low interest rates have plan sponsors clamoring for a solution to meet their actuarial return requirements. A common solution to bridging this funding gap has been to increase the allocation to alternative strategies such as hedge funds, which offer the promise of high absolute returns virtually regardless of the market environment.

As with all strategies, there is a significant risk that some investors will be disappointed with the returns from their alternative allocations. Before making an allocation, investors would be well-served to fully understand the risk-and-return profile of each strategy. As with conventional strategies, the returns to any hedge fund strategy can be allocated to systematic factors (beta risk) or manager skill (alpha). In analyzing hedge funds it is important to treat them not as an asset class but rather a particular type of strategy, where the majority of the return is supposed to stem from active decisions by the investment manager to take both long and short positions. If a manager has skill, there is no doubt that by having the ability to go long and short they can increase the efficiency of the strategy, resulting in a higher information ratio.

Analysis of the returns from hedge funds, looking at the returns to each type of strategy as represented by the HFR Hedge Fund indices, suggests that the risk-reward ratio is indeed higher for these strategies: the typical strategy has an information ratio in excess of 2, in contrast to the typical 0.3 to 0.4 risk-reward ratio expected from investing in equities. As with most indices of active manager performance, the accuracy of these index returns has been the subject of debate. Even adjusted for these biases, it is hard to deny the attractiveness of these strategies.

The returns from these strategies do not, however, represent pure "skill" or alpha on the part of the manager—there is significant "beta risk". Statistical analysis of hedge fund returns suggests that the returns of some strategies are systematically related to risk factors such as the equity market return, the return of high yield bonds, or the twists in the yield curve. For the average fund, these returns account for 45% of the variation in returns, but for some strategies this can rise to as much as 70%. All these factors represent "beta" risk that investors already have in their portfolio, and can often purchase for considerably less than the typical fees associated with hedge funds.

However, hedge funds do have a significant advantage over institutional investors in the way they can allocate their "beta" risk. Specifically, the relaxation of the "long-only" constraint enabling them to take both long and short positions, and the ability to use leverage allows hedge funds to combine these risks in a more efficient manner, providing a portion of their superior returns. The balance of the return stems from security selection.

Should investors prefer funds with returns coming from security selection, as opposed to more efficient portfolio construction? On average, the returns to security selection cannot be positive, so as an industry it is impossible for all investors to benefit from the alpha inherent in some hedge fund strategies. Pension funds can, however, all benefit from using a better combination of systematic risk in their portfolios—suggesting that those investors who focus on those hedge fund strategies that have high systematic exposure have a lower risk of being disappointed in terms of future returns. Alternatively, those sponsors who do not mind the "maverick risk" of doing something different should just remove the "long-only" constraint in their next asset allocation study and realize some of the efficiency gains from long-short investing directly. ■