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A NEW APPROACH TO HEDGE FUNDS

Industry attitudes towards alpha and beta must change.

The current approach to investing in hedge funds has evolved using the traditional framework for asset allocation and related governance standards which were state-of-the-art 20 years ago but have proved less than effective over time. This traditional approach attempts to unbundle alpha and beta and implicitly assumes that equity market beta is a necessary component of investment policy. This approach is one of the reasons for the funding crisis in the pension industry; it is also to blame for the languid industry response to hedge funds.

To date, the initial investment in hedge funds is typically 5% of the total investment portfolio. Hedge funds are either included arbitrarily in the asset allocation review or in the policy implementation phase, typically as an overlay to index strategies. In both cases, nothing has really changed: the typical institutional portfolio is still invested according to the standard 60/40 formula, or something very close. The traditional approach is flawed—not just for the hedge funds but for all investment decisions—because it is predicated on faulty assumptions which oversimplify the uncertainty inherent in investing. For example:

- Stock markets always go up so market timing is wrong and "buy and hold" is right;
- Short-term losses will not affect the long term and are not relevant to institutional investors;
- Equity market beta must be part of a diversified investment policy;
- The investment policy must be diversified between traditional equity markets and bonds;
- Investors will be compensated for equity market risk;
- Risk cannot be reduced without giving up returns;
- Risk-adjusted returns and Sharpe ratios are effective in assessing the risk/return trade-off;
- Alpha exists separately from beta, and is synonymous with manager skill, and;
- Alpha and beta must be separated in investment decision-making as first the investment policy (beta) and then its implementation (alpha).

This framework is clearly biased against hedge funds, which treat alpha and beta holistically and demonstrate alpha by managing beta. Additionally, they identify and manage sources of downside risk rather than simply benchmark risk relative to equity beta; they also identify and manage sources of returns including spreads between different market segments (e.g., growth and value). Most importantly, risk and return are managed over the short term with the focus on consistency.

Prevailing governance standards have yet to recognize consistency of short-term absolute returns as desirable and necessary, despite the fact that the financial health of institutional funds depends on this. "Good" governance is based on industry practices, not best practices, and the time horizon for change is long because the litmus test continues to be "if it's not broken, don't fix it." The proposed non-traditional approach to investing in hedge funds must start with new governance standards which build on criteria-based decision-making and abandon the faulty beliefs underlying investment policy today.

The starting point for asset allocation in the non-traditional approach should be the minimum risk portfolio, typically some type of fixed income that hedges the liability exposure. Too often this is no more than a perfunctory stepping stone on the way to the 60/40 investment policy. Beyond the liability hedge allocation, hedge funds should completely replace the traditional equity exposure. There may be a strong reason to include the more volatile equity beta and, in that case, a portable beta strategy could overlay a portion of the hedge funds.

This asset allocation captures the holistic interaction of alpha and beta inherent in hedge funds in order to achieve performance consistency and realistic risk/return objectives. There is now an abundance of institutional-quality funds of hedge funds which address transparency and other implementation issues, and provide strong client servicing. Therefore, the only impediment to moving towards this non-traditional approach is the outdated belief system that has reinforced generally accepted—but ineffective—industry practices. ■