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HEDGE FUNDS: MYTH AND REALITY

"Absolute return" is somewhat of a misnomer for these sophisticated tools.

For much of its life, the hedge fund industry has been awash in myths. In many ways, much of the industry has not resisted the temptation to mythologize itself, in part due to stringencies of regulation, but often for reasons that have been self-serving: the opportunity for hedge fund managers to claim trading wizardry without the ready rebuttal of facts and understanding, to demand fees far in excess of those charged in more mundane and accessible investment vehicles, and to capitalize upon the difficulty in analyzing hedge funds relative to peer groups, market benchmarks, or economic factors. However, with recent research, the growth and institutionalization of the industry, and the large-scale involvement of investors requiring a more precise understanding of sources of return, many of the myths surrounding hedge funds have begun to dissolve.

First and foremost among these myths is the idea that hedge funds are "absolute return" investments. The central idea here is that because hedge funds can potentially make long or short investments in any tradable asset, no benchmark is applicable; the practical reality is that managers do hold the same types of assets over time—whether because of transaction costs, specialization in expertise, persistence through time in investment views, or the unwillingness to hold cash when the manager lacks a good idea. Therefore, almost all hedge fund managers have beta exposure to the sources of return for that strategy. This beta exposure may overlap with that of traditional portfolios—directional equity exposure, directional interest rate exposure, directional credit exposure—or it may not. In the case of non-traditional beta, for example, a fund collects income merely by being short volatility, either by writing contractually explicit options or by taking on similar exposure by indirect means. In either case, performance measurement and portfolio construction by investors should explicitly recognize such exposures.

A corollary to the notion that there is substantial beta in hedge fund returns is the idea that we must have a better notion of alpha being delivered by the manager. The historical view is that alpha is abundant and purely the result of manager skill. With a more expansive idea of the factors that go in to determining returns—not just the traditional cash or equity index benchmark—we come to recognize that the amount of alpha out there is less than has been generally assumed. This does not mean that alpha does not exist—it certainly does—but merely that we can and should use the tools of investment analysis to measure it more accurately, rather than accept uncritically simplified and inaccurate characterizations.

Similarly, with a deeper understanding of the sources of return for various hedge fund strategies we are presented with the realization that not all hedge funds are appropriate for inclusion in traditional investment portfolios. The merits of adding hedge funds to a traditional portfolio are a function of the investment objectives and constraints, as well as the factor exposures that hedge funds bring to the portfolio. Some hedge fund strategies can be best thought of as "return enhancers" relative to the exposures of traditional portfolios—namely, vehicles that add alpha without altering the core factor exposures of the portfolio. An example of this would be hedged equity, which while adding alpha still retains substantial equity exposure; another example would be distressed securities, which again add alpha but retain substantial credit exposure of the kind found in the typical high-yield bucket. Other hedge fund strategies are best thought of as "risk diversifiers"—strategies that add alpha and reduce overall portfolio risk by delivering exposure to factors that generally do not dominate the exposures of a traditional portfolio. Equity market neutral managers and commodity trading advisors, whose assets traded and trading strategies typically result in overall risk reduction for traditional portfolios, exemplify this class of hedge fund strategies.

Ultimately, chief among the virtues of hedge fund strategies is that they allow the investor to implement investment views more efficiently than through traditional long-only asset allocation. ■