Traditional Asset Allocation in a Hedge Fund World

FIELD NOTES

BY WENDY BRODKIN AND ERIC KIRZNER

The cornerstone of every good investment program is asset allocation. The blueprint for portfolio construction, it articulates the appropriate combination of various asset classes. Asset allocation is typically derived using risk/return optimization methodology to produce an efficient frontier of alternative combinations. The optimization model uses input assumptions about expected risk, return and correlations. Typically, the assumptions are based on historical, long-term characteristics.

But does this work with hedge funds? Hedge funds have limited presence in the institutional market and no long-term reliable database exists. Not only don't they fit the mold of traditional asset allocation methodology, they challenge its ongoing appropriateness.

Hedge funds are a diverse group of investment strategies. They vary in degree of market exposure, ranging from zero (market neutral funds) to very high (some long/short funds). All have the flexibility to leverage and the ability to short-sell.

The industry is still in its infancy and is highly fragmented. There are about 4000 hedge fund managers but few standardized practices and only limited regulation. Nevertheless, the investment appeal of hedge funds is compelling. Many hedge funds are structured with the expectation of producing positive annual returns on a consistent basis in the range of 8 to 15 per cent. Equally important, hedge funds offer liquidity because they invest in public markets.

Currently, most institutional investors are not yet sure whether to or how much to invest in hedge funds. They tend to approach the decision with the traditional framework, modelling risk and return for hedge funds to optimize their allocation with stocks and bonds. This clearly doesn't work because the linear risk/return relationship and normal distributions may not hold. Other investors are simply carving out 5 to 10 per cent from their traditional portfolio. Others treat hedge funds as a third equity strategy, absolute return, to complement active and passive strategies. Regardless, hedge funds have inadvertently created misgivings about the traditional asset allocation.

WHAT'S WRONG WITH THE TRADITIONAL APPROACH?

The traditional approach may be an adequate approximation under theoretical market conditions, but it is not valid in a hedge fund world. The framework is based on two faulty assumptions tolerated for the sake of expediency. First, the asset class assumptions based on historical market indexes are assumed to resemble data for actively managed investments. This is wrong, even for traditional stocks and bonds. Active management distorts data, usually by smoothing out volatility. The distortion is even greater for hedge funds. In any case, there is no reliable long-term data for hedge funds.

Second, the asset classes are assumed to be mutually exclusive. But even traditional portfolios overlap and create unexpected return patterns. The overlap between hedge funds and traditional investments is larger because hedge funds invest in stocks and bonds. With 30 or more types of hedge fund strategies using leverage, the potential for unintended factor exposures is huge. Some assume this is identified through historical return correlations. The truth is that factor overlap is ignored completely in the asset mix decision.

The traditional method of portfolio construction simplifies some very complex variables from a top-down perspective. But the special attributes of hedge funds require a look at underlying holdings on a bottom-up basis. This asset mix should be examined for the impact of adding hedge funds in terms of factor and risk exposures, concentration ratios, even inadvertent wash trades, allowing

Wendy Brodkin is president, Goodman & Company Institutional Investments.
Eric Kirzner is professor of finance at the Rotman School of Management, University of Toronto.

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for more realistic risk and return expectations.

WHAT'S THE RISK OF IGNORING THE HOLDINGS?

When individual holdings are ignored, the outcomes from traditionally constructed asset allocations can range from disappointing to perilous. Recently, some outcomes have been worrisome even without hedge funds for a number of pension funds. The pension funds appeared well diversified from a top-down perspective but were hard-hit when stock markets worldwide declined simultaneously. Gaps between expected performance and actual results also occur in portfolios that are diversified by style or manager. For example, growth and value can generate very similar results for prolonged periods when both styles operate within the large-cap domain.

Similarly, gaps can exist between the expected investment and the actual holdings. It is not uncommon for funds to hold more than 50 per cent cash at certain points in time. As well, market neutral funds are not always market neutral. Most have half-long and half-short positions. But that doesn't mean they're 50/50 all the time, and it certainly doesn't mean the positions are paired in a manner to hedge the market effect.

Another risk of ignoring the underlying holdings is over-diversification. Under the top-down approach, each asset class looks like a simple line item. When the holdings are broken out, there may be hundreds of positions. This is also true with traditional investments like emerging market funds. With hedge funds, though, the dilution of investments may be extreme. A fund of fund industry has developed that combines multiple strategies and multiple managers for investors. There are significant benefits to investing this way but there is a danger that too many funds are combined for capacity purposes and the returns end up diluted. Consider 40 or 50 managers each in 40 or 50 markets and each market holding multiple positions in multiple industries!

A final risk is that investors overemphasize the historical results for risk, return and correlations when underlying holdings are ignored. They assume that the results are indicative of future results, which is simply not true. Only the actual holdings provide some clue about the future. Without an analysis of the holdings, there is no telling how they will interact with the rest of the portfolio. Sometimes actual holdings do not even exist and simulated results are provided as a proxy for historical results. Thus, the risk of unrealistic expectations is even higher!

Due diligence is demonstrated in traditional asset allocation decisions by using risk/return methodology. The usefulness of this approach has always been limited but now hedge funds have rendered it almost meaningless.

An alternative method for allocating to hedge funds is to combine individual holdings to construct a portfolio from the bottom up. Portfolios can then be evaluated with and without hedge funds for the differences in risk, return and exposures. Clearly, there are some serious logistical difficulties in doing this with any kind of precision but it has to be a better approximation than one based on false assumptions. At the very least, underlying holdings must be reviewed to avoid serious problems later on.

Currently, transparency is limited in the hedge fund industry. Some fund of funds will not even disclose the names of their underlying managers, much less the holdings. While it is understandable that some managers won't disclose shorts and illiquid positions, it is simply not reasonable for a manager not to disclose anything at all.

After Enron, no one in a position of fiduciary responsibility should be too shy to ask the tough questions. The hedge fund managers know this because they apply the same standard to their own investments. They also know that historical returns do not "speak for themselves." That is why due diligence is so important. It may be a challenge for managers to accept the same standards from institutional investors, but surely not an insurmountable one.

As for investors, the challenge is greater because, in the past two decades, even bad decisions produced good returns. It will be difficult to change an accepted, seasoned and apparently successful approach. Yet, that approach is simply not good enough anymore, especially when it comes to asset allocation decisions in a hedge fund world. ■