

THE TIPPING POINT

2007 was the year the investment industry went alpha-centric.



BY CHRISTOPHER HOLT

Like many twenty-something MBA students in the mid-1990s, I once had the impression that technology and innovation

were synonymous—that the Internet, for example, had unleashed a “paradigm shift” that would not be matched in my lifetime. As a result, I filled my academic schedule with courses on strategy and e-business, and steered well clear of “old-economy” finance classes, the traditional bread and butter of business school curricula.

At around that time, one of my classmates urged me to consider a course by a young finance professor who had quickly gained a reputation for thinking out of the box. The professor had been researching the embryonic field of hedge funds—an obscure pursuit that I felt illustrated little more than the fact that the field of finance had begun to eat its young. I politely declined, explaining that innovation was all about technology, not finance. I did not know it at the time but this decision was one of the most bone-headed of my life. That business school was the Fuqua School of Business at Duke University and that professor was David Hsieh, one of the academic pioneers in the hedge fund industry.

TIP OF THE ICEBERG

The ensuing years have proved beyond a doubt that “paradigm-shifting” innovation is alive and well in the investment industry. Hedge funds, it turned out, were only the tip of a much larger iceberg that also included other forms of alpha/beta separation (portable alpha, alternative beta, 130/30, ETFs) and even the growth of the derivatives industry. Last fall, I found myself in the somewhat ironic position of introducing David Hsieh to conference audiences not once, but twice. The professor from the field I derided for its conformity was living proof that investment and innovation had now become synonymous.

EVANGELICAL THINKING

Hsieh wasn’t the only financial evangelist I met up with last year as I travelled around the world reporting on industry conferences, researching for my website and occasionally entering the fray as a chair or panel moderator. Hsieh’s colleagues, Bill Fung and Narayan Naik, the outspoken Professor Harry Kat, understated Swissmen Lars Jaeger and Alexander Ineichen, the enterprising industry pioneer Thomas Schneeweis, the frank and plain-spoken Larry Siegel and the always colourful Angelo Calvello each contributed to the new dialogue in their own unique way.

But like all evangelists for a new way of thinking, they were each initially met with the same sense of skepticism—a skepticism that eventually gave way to acceptance as both the long-only industry and the hedge fund industry came to realize that in the end, it wasn’t about long-only vs. hedge funds, hedge funds vs. “hedge fund replication,” or even hedge funds vs. 130/30. In the end, it was all about alpha. For the first time, it seemed that institutional investors and hedge fund managers had reached common ground.¹

The world’s first conference dedicated to “alternative beta and hedge fund replication” was held in London in February 2007. Interest in this topic surprised even the organizers and the event was a virtual sellout. Not all attendees, however, were there to cheer the rise of so-called “hedge fund replication” (a process whereby hedge fund returns are approximated using passive investing techniques). In fact, the idea that hedge fund managers could somehow be replaced with what some considered to be dart-throwing monkeys was met with resistance, and even some offence, by many quarters of the hedge fund community.

Fast forward to a hotel on the shores of Lake Geneva in late September (or to the hallowed halls of Manhattan’s Princeton Club a month later), and you

Christopher Holt is founder and editor of AllAboutAlpha.com.

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would find that hedge fund managers had not only accepted the notion that their returns contained various “alternative betas,” but that many of these managers had actually launched their own hedge fund replication offerings. In fact, many funds of hedge funds now borrow from the lexicon of the hedge fund replicators to illustrate how they aim to add value. In fact, some of these new techniques are now making their way into the world of traditional risk management.²

The issue of 130/30 funds has been no less contentious. These funds appeared on the global investment agenda only a couple of years ago and 2007 marked the coming out for the hybrid hedge fund long-only products. The question on everyone’s minds during 2007 was, “who is better suited to providing these products: hedge fund managers or traditional investment managers?”

WHO'S THE BEST?

As usual, bloggers were the first to weigh in. Several prominent current and former hedge fund managers deriding 130/30 funds as hedge funds in disguise, requiring skills that only a hedge fund manager could provide (e.g. short-selling and managing leverage). Ergo, they argued, hedge fund managers were best qualified to manage these funds. Yet traditional long-only managers soon began to open up a sizable lead with many of the world’s largest quantitative managers launching 130/30 funds. These firms argued that only they had the risk management and fiduciary experience to provide such funds to an increasingly cautious institutional marketplace.

Hedge fund managers shot back that 130/30 was nothing more than an exchange-traded fund (ETF) (the “100”) and a de-leveraged market neutral fund (the “30/30”). When this debate was sparked at a conference in Boston featuring the unstoppable Harry Markowitz, I asked him whether this was, in fact, an appropriate way to view these funds. With the enthusiasm of a man a quarter of his age, he referred me to a recent paper he had written on the role of mean-variance optimization in 130/30 portfolio construction. In it, he showed that the hedge fund managers may actually have to revisit this view.

Even within the hedge fund and long-only industries, there was discord last year over who was better able to execute these strategies: fundamental managers or quantitative managers. In this contest, quantitative managers clearly won the face-off, but as 2007 came to a close, fundamental managers were making a comeback.

Portable alpha, the topic that started it all several years ago took a backseat to the newer variants on the alpha/beta theme (e.g. 130/30). Over the course of the year, it became increasingly clear that “portable alpha,” like the term hedge fund itself, had become so over-used that it had lost much of its meaning. There were hedge funds that called themselves portable alpha, consultants’ methodologies called portable alpha, and hedge fund/ETF portfolios called portable alpha. During the course of 2007, the original meaning of portable alpha (isolating active management and overlaying it onto a different benchmark) seemed to give way to a more all-encompassing notion that one might simply call alpha-centric investing.

ENABLING A NEW PARADIGM

In a very real sense, alpha-centric investing, like e-business, has ceased to be a separate and distinct strategy. Instead it has become a ubiquitous and integral part of modern portfolio management. Like the Internet, portable alpha, alternative beta, and 130/30 are technologies that will *enable*, but will almost certainly not *define* this new paradigm of investing. The year 2007 marked the point at which these technologies ceased to be curiosities and were internalized by the global asset management community. They had begun to cross the chasm between what the technology industry calls early adopters and the rest of us.

Maybe those business school courses on innovation and technology will come in handy after all... ■

ENDNOTES

1. Lett, Tristram and Holt, Christopher “Two Solitudes: Replication and short extension bridge the pension and hedge fund gap” *Canadian Investment Review*, Fall 2007.
2. Lett, Tristram, “Benchmark Hedging: Liberating Your Risk Budget,” Working Paper, forthcoming.