HEDGE FUNDS

Still a major player, despite some investors' suspicions

Alternative investments, for all their growth and increased acceptance into the mainstream, still have their doubters. Worries about transparency and the conservative attitude of more traditional investors and managers have, however, helped these asset types to evolve into more sophisticated instruments

In recent years the explosive growth in alternative assets such as hedge funds, private equity and commodities has been accompanied by a debate as to how much should be allocated to these assets. This discussion has intensified as institutions have gained experience in the sector to include a more thorough analysis of the exposures obtained by investing in "alternatives", particularly in reference to their existing portfolios.

The growth in alternative assets represents a sea-change in the attitude to traditional investments. The equity bull market from 1982 to 2000 and the bond bull market from 1990 to 2003 afforded investors easy gains. However, the three-year equity bear market with falls of 50 per cent in markets such as the S&P made it clear that equities were not a one-way bet; and low bond yields offer little return with a higher probability of capital losses.

History suggests a lacklustre outlook for equities. Equity bull markets have tended to last around 20 years followed by a bear market of 10 to 15 years largely due to secular influences (see figure one). Demographics is the current major secular influence, with an ageing population in most major developed economies, declining fertility rates and increased life expectancy. The demand for equities is likely to be lower as a greater number of investors moving into retirement seek wealth preservation rather than wealth creation.

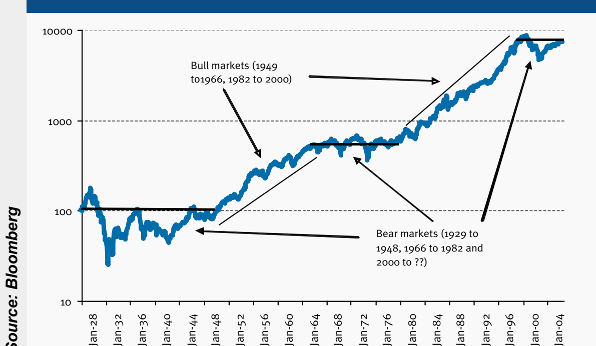
During a bull market in equities and bonds, investors pay less attention to how the return is being generated. However, in flat or falling markets investors start to look more closely at the source of return.

ALPHA AND BETA

Finance uses alpha and beta to describe two basic components of return from an investment. Beta is defined as the investment return generated from accepting market risk. Alpha is defined as the excess return due to manager skill. For example if a fund manager mimics a benchmark index (such as the FTSE 100) then the return is all due to the market movement and is referred to as beta. If the fund manager outperforms the benchmark then the difference between the benchmark and the portfolio return is due to manager skill and referred to as alpha. Beta can be easily and cheaply attained by investing in futures or index tracking products. Experience shows that alpha (excess return) is more elusive.

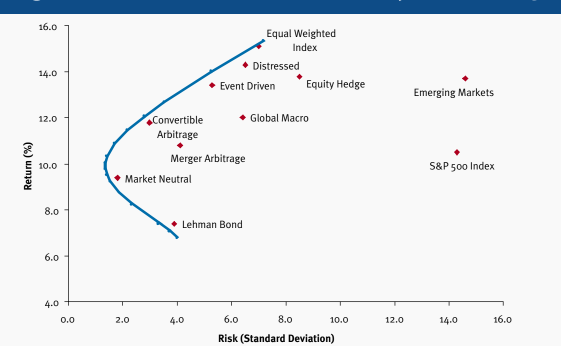
Events such as the 2000 bear market alerted investors to the fact that mutual funds with a long-only investment process were generating almost all of the return from the market (beta). Mercer statistics indicate that the alpha from large capital mutual funds is only around 1.5 per cent (over 10 years to 2004). Figures from Morningstar indicate that only 40 per cent of large capital mutual funds outperformed the Vanguard 500 index over the last five years. The failure of many traditional managers to generate alpha led to increased popularity of the idea of "portable alpha". Portable alpha refers to the process where the investor separates the

Figure One: S&P 500 performance 1928 to 2006



Source: Bloomberg

Figure Two: Returns and risk (Jan '90 to Dec '05)



Source: CISDM

return decision into beta and alpha. That is, how much market exposure they desire and then how much additional alpha they can gain from another source.

Many saw hedge funds as a source of "portable alpha" as they had outperformed traditional assets and were often referred to as "absolute return" strategies. Figure Two shows the performance of the major hedge fund strategies and the main traditional indices. Not only have hedge funds produced a better return, it is also done at much lower risk.

However, investing in hedge funds has presented new challenges to investors, the biggest being that they are typically unregulated investment vehicles with much lower levels of transparency and high initial investment levels (usually above $100,000). Despite the better consistent performance of hedge funds they have also been viewed with suspicion. There have been some well publicised cases of losses such as LTCM and more recently Amaranth. However, these represent a small portion of hedge funds.

As a result, fund of hedge funds with specialist due diligence and diversified portfolios became a popular way of providing access to hedge funds for private investors and institutions. Structured products have also become popular by offering features such as capital guarantees to protect investors from losses (although this comes at a cost) and lower entry amounts into hedge funds.

Figure Three: Correlations of hedge fund styles to S&P 500

	Market Falling	Market Stable	Market Rising	Type of Correlation
Convertible Arbitrage	0.49	0.30	0.07	
Distressed Debt	0.64	0.23	-0.18	
Emerging Markets	0.75	0.32	0.32	
Equity Hedge	0.60	0.46	0.15	Unfavourable
Event Driven	0.79	0.54	-0.12	
Fixed Income Arbitrage	0.68	0.47	-0.13	
Equity Market Neutral	0.03	0.05	-0.06	Stable
Macro	0.29	0.18	0.21	
Short bias	-0.48	-0.59	-0.34	Favourable

Source: EDHEC

As investors became more familiar with hedge funds they started to look more closely at the source of return. The growth in the industry has also spawned more academic research into the area. It has become evident that while hedge fund returns have been better than traditional investments they are not the panacea that solves the issue of return without exposure to equity and bond markets. Hedge funds often have a high correlation to equity and bond markets. In that sense they are not absolute return funds or a proxy for portable alpha. Figure Three shows different hedge fund strategies correlation to the S&P 500 index.

The hedge fund style with the most favourable correlation is equity market neutral. This strategy also offers the best risk adjusted return. This is probably the closest strategy to provide a pure alpha. As suggested by one commentator (Laurence Siegel of the Ford Foundation) "A high-quality market neutral long-short fund driven by skillful insights is the highest expression of the art of active management, and it represents what hedged investments ought to be".

Asset allocation has evolved from allocating between traditional assets based on the investor's risk return profile to one that includes alternative assets such as hedge funds. However, while hedge funds risk adjusted returns have been superior they have also relied to some extent on the overall market return. With the potential for lacklustre equity and bond markets, the asset allocation decision has needed to become more sophisticated as investors look more closely at the source of return and embrace ideas such as "portable alpha". It is the concept of obtaining exposure to this "alpha" component which is a significant differentiator to the returns of the equity markets, rather than piling on more "beta" exposure, that perhaps offers the true alternative investment solution that institutions are looking for in order to really enhance their existing portfolios.

Armajaro Asset Management LLP (authorised and regulated by the Financial Services Authority) was formed in July 2002 as an alternative asset management company. The original members are Neill Brennan, Richard Gower, Anthony Ward and Armajaro Holdings Limited. The Asset Management Partnership has over $400m in assets under management. It also has an Equities division, which manages the Coolum Fund and a Commodities division, which manages the Armajaro Commodities Fund.