The Absolute Return Letter
April 2007

The Emperor's New Clothes

As is always the case when a topic in finance gains momentum, academics join the bandwagon, usually with the purpose of intellectualising the debate but always with the result of increasing the complexity of the discussion.

For many years, academics and industry professionals have been debating the source of hedge funds returns. The latter have always argued that hedge funds produce absolute returns largely uncorrelated to equity market returns. Academics, on the other hand, claim that the main source of returns is, and has always been, beta (also known as market risk). In recent years, some have even suggested that hedge fund returns consist not only of alpha and beta, but also of "alternative" or "portable" beta.

Old wine in new bottles

On this last point we cannot resist the temptation to quote Harry Kat, Professor at the Cass Business School in London. In an article called *'Alternative Beta: Old Wine in New Bottles'* he concludes:

"Basically […] it is a word game. Alternative betas are largely traditional betas called differently. Alpha-beta thinking is a fancy form of asset class thinking and factor model based hedge fund replicating portfolios are a lot more traditional than many suspect. Alternative Beta? I wouldn't lose sleep over it. You know most of it all already."

A marketing gimmick

We wouldn't hesitate to go one step further than Professor Kat. Let's call it by its real name, a marketing gimmick, because that is what it is. In recent months, the media have been busy reporting on the seemingly endless stream of new low cost hedge fund replication strategies (sometimes called cloning strategies). It appears that leading financial institutions are keen to dissect hedge fund strategies and repackage them as low cost imitations which fit into more conventional investments and fee structures.

Merrill Lynch has launched the first such product, a replication product with the aim of mimicking the HFRI Composite Index, a basket of about 1800 hedge funds. Goldman Sachs, JP Morgan and State Street are all expected to launch similar products in the near future and a number of other financial services firms are currently testing multi-factor models with the aim of replicating specific hedge fund strategies. From where we sit, it is difficult to see exactly what investors gain from this investment strategy. However, one thing is certain. This latest product initiative is about as far away from the original idea of hedge fund investing as can be.

Always a step behind

The multi-factor based replication funds are funds with return characteristics that resemble those of hedge funds. Despite the lower fees (probably their only attraction), these strategies are mostly based on linear regression and have lost all the dynamics of a good hedge fund manager. To put it simply, the replication funds will always be a step behind the hedge funds whose returns they seek to replicate. You *cannot* clone a hedge fund until you know what and where it has been trading. And by the time the replication funds figure it out, the hedge funds have moved on.

In principal we have no problem investing in these structures as long as it is clear to all parties that this has nothing to do with hedge funds. Some readers might pause here and think we are perhaps slightly paranoid and maybe even afraid of competition. Not at all, because replication funds could not be further away from what we are doing. Let's quickly remind ourselves what a hedge fund is.

What is a hedge fund?

The hedge fund industry, despite being over 50 years old, really took off in the 1980s. In those days, the industry catered almost exclusively to high net worth individuals and the focus was as much on high returns as it was on uncorrelated returns. Hedge funds were mostly global macro funds (now just one of over twenty different hedge fund strategies) and they were usually managed by aggressive – and smart - traders who created alpha by exploring opportunities in their core area of expertise, using both shorting and leverage extensively.

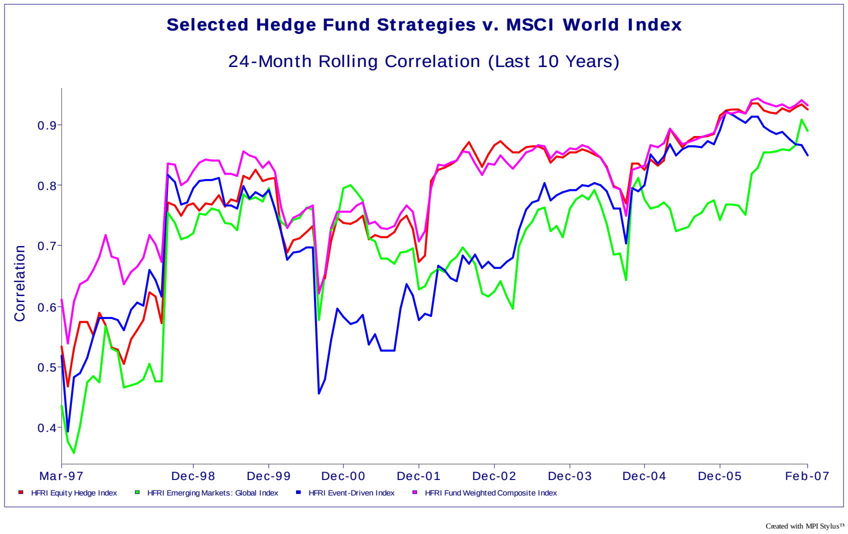
Today most large banks have recruited hedge fund managers who sit next to traditional portfolio managers. The institutionalisation that this has led to is one of the main reasons why leverage and volatility have never been lower, along with returns. Only correlations have gone up. Why is that?

No volatility, no Alpha

Well, when volatility comes down, so does the ability to extract alpha from the market. This has forced many hedge fund managers to behave increasingly like long-only managers. At the same time, more and more traditional portfolio managers have adopted hedge fund managers' mindsets by increasingly looking to protect their returns and deliver absolute returns. In this context, it should not be surprising that hedge fund returns are more highly correlated with global equity markets than they have ever been before (see chart 1 overleaf).

In its infancy a hedge fund was a 'hedged' fund, nothing more, nothing less. Today there are many hedge fund strategies which neither use leverage nor go short. The name 'hedge fund' was always a misnomer, as there are no perfectly 'hedged' strategies – at least not that we know of. In light of this we usually refer to these strategies as 'alternative strategies'. Today the only common denominator in the hedge fund industry is the fee model - 2/20 - and even that may be about to change.

Chart 1:



Source: Hedge Fund Research, Inc.

The average equity long/short fund today has very little to do with a hedged investment. The correlation between equity long/short and equities has doubled over the last 10 years and is now in excess of 90% (see chart 1 above). Other strategies have experienced a similar trend. Unfortunately, 70% or perhaps even 80% of the hedge fund universe has experienced this rise in correlations with global equity markets. In other words, what we are saying is that 70-80% of all hedge funds offer investors limited or no hedge against their traditional portfolio.

Selling Beta as Alpha

It is this part of the hedge fund universe which we think is prone to cloning by the investment banks. In 2005 Bridgewater wrote a report entitled *'Hedge Funds Selling Beta as Alpha'* where they demonstrated very simple replication strategies for convertible arbitrage, fixed income arbitrage, emerging market strategies, distressed securities, risk arbitrage and managed futures. Basically these strategies are loaded with systematic risk (beta) to the point where it is difficult to justify paying the fees charged.

Andrew Lo and Jasmin Hasanhodzic from MIT made similar findings when they followed more than 1600 hedge funds during the period 1986-2005. They found that they could recreate 70-90% of the hedge fund returns by investing in the traditional markets. Harry Kat mirrors this result in his research claiming that 70-80% of hedge fund managers are not producing alpha.

Not on our agenda

We have no doubt that Merrill Lynch, Goldman Sachs and others will enjoy some significant success with these new replication products. However, we can assure you that a product trying to replicate thousands of hedge fund strategies is never going to be on our agenda. Again, we will turn our attention to Harry Kat who happens to sum up our views pretty well:

"So if a hedge fund index can be replicated accurately it is probably because the index in question contains only a few truly alternative ingredients. As a result, the index's correlation with traditional asset classes will be high and the diversification benefit that it brings correspondingly low. From an investment perspective, indices that cannot be replicated accurately are more interesting, as they are likely to contain more alternative elements and therefore could make better diversifiers. However, since they cannot be replicated there is no way to invest in them."

So where are the opportunities?

So where do you find investment opportunities which cannot be replicated and therefore are more attractive from a diversification point of view? To begin with, you need to focus on the 20-30% of the hedge fund universe where managers have proven again and again that they can identify alpha by pursuing niche investment strategies.

These strategies are often characterised by high barriers to entry, enabling the manager to protect his returns from competition for much longer periods of time. Frequently, managers in this segment of the market invest into 'positive alpha pools' which we define as investment transactions where both the buyer and the seller can enjoy a positive outcome – in other words a win-win. This may occur because of differing regulatory treatment of the investment or as a result of a transaction between a financial and a non-financial party.

Investing in mainstream hedge fund strategies is not going to go away but the juice is to be found elsewhere.

Jan Vilhelmsen

Absolute Return Partners

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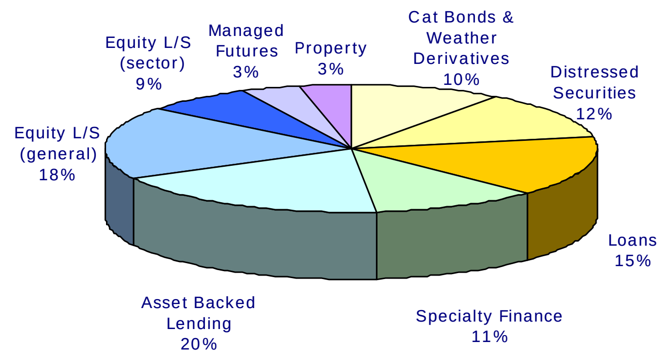
The **Multi-Strategy Portfolio**
as at 28th February, 2007:



The **Millennium Wave Portfolio**
as at 28th February, 2007: