Show me the alpha

Angela Ashton | PortfolioConstruction Forum | 25 June 2014

"Show me the Alpha: Breaking down hedge fund returns to achieve portfolio objectives", by Mark Woolley, Spring 2014

Presented by the author at a recent IMCA[1] Seminar, this paper examines the oft-considered subject of hedge fund returns. Hedge funds are an area that interest me. I should declare that I sit on the Committee for the Hedge Funds Rock Awards here in Australia. But it is more a charity fundraiser than anything else.

I find hedge funds interesting because there is so much debate as to what they are supposed to do, whether they do what they say they're going to do, and the simultaneous loathing and respect they seem to engender in all types of investors.

First, interesting statistics... The global hedge fund industry is now at its largest ever with around US$2.8 to US$3 trillion under management. But, the dispersion in the size of funds is very wide, with 67% of hedge funds under $250million in assets. Some 6% of managers account for 68% of all hedge fund assets globally. In Australia, it's estimated that the size needed for a hedge fund to be sustainable is about A$100 to A$150 million (although I think it is less than that, depending on the strategy). So, there are probably a lot of hedge fund managers out there not earning their six figure bonuses.

Woolley took us through some analysis BlackRock undertook on hedge fund returns in 2013 (a short timeframe, but there are good reasons why it is better to work with short-term data sometimes[2]). They used data from all funds listed in the HFRI Fund Weighted Index (around 1,600 funds globally), did some fairly advanced regression work on the whole group and by strategy, to find whether funds provided alpha.

Overall, the 2013 return for the Index was about 9.1%. BlackRock's analysis found that about one third of that was from alpha - idiosyncratic risk sources. By strategy, the amount varied enormously. For example, equity hedge strategies provided -2% alpha (although they had the best overall return, due to a high beta component i.e. equity markets were strong in 2013). Macro managers had poor overall returns, but added about 2.7% alpha.

What was interesting was the dispersion of results. Over the whole universe, the best 10% of managers added 19.4% of alpha or more in 2013. The worst 10% of managers detracted 12.5%. Overall, the average manager alpa was 3.1%.

This level of dispersion is far greater than is the case for traditional fund managers. In other words, even a modicum of ability in choosing hedge fund managers has the potential of adding tremendous value to a portfolio.

So, how do you choose quality hedge fund managers?

This is what Mr Woolley does for living so, although he has some good insights, he also didn't give us any really hot tips that I can share here. Here were his guidelines to think about with hedge funds:

1. Know what your objectives are - There is a wide diversity amongst Institutional investors as to what they want hedge funds to do. It varies from providing high absolute returns, to providing low volatility returns, to being lowly correlated with other assets. Hedge funds can't do everything. Having a clear objective as to what you want them to achieve can help you focus your efforts to find the right manager(s) for your portfolios.

2. Strategy returns are unpredictable - e.g. While long/short funds work a treat one year, the next year will belong to credit strategies. Therefore, it is better to hold more than one type of hedge fund.

3. With hedge funds, you are investing in risks (the output is return) - You are best to diversity your risks.

4. Today's alpha can be tomorrow's beta - However, new market inefficiencies will always exist. They often come from changes in legislation, regulation, complexity, even sectors (think about the changes in print media and energy, for example). In other words, there will always be alpha opportunities, but they change over time. Any investment in hedge funds should be monitored and decisions must be made about the long-term sustainability of any strategy.

5. Undertake good due diligence (or get someone to do it on your behalf) - Operational due diligence, for example, is really only for the most boring of accountants. It is highly unlikely you want to do this. But, it is critical. If this had been done properly, noone would have invested with Madoff.

6. Look for red flags - e.g. Hedge fund managers not holding, say, 90% of their own personal wealth within the hedge fund they manage and want sell to you.

7. Style drift can also be an issue - Managers must evolve with alpha opportunities, but style drift can be fatal.

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ENDNOTES

1. Investment Management Consultants Association. See more at www.imca.org.au.
2. Survivorship bias in hedge funds is well known – this can start to skew results in public data after a few years.