Much to learn from switch to alternatives

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The equity bear market from 2000 to 2003 was arguably the most important catalyst for the increased interest in hedge funds in recent years. From March 2000 to March 2003, the total return from the MSCI world index (in US dollar terms) was minus 45 per cent; the return from all hedge funds, as measured by the CSFB Tremont Hedge Fund index, again on a total return basis in US dollar terms, was plus 11 per cent. Moreover, those hedge fund returns were achieved with only about a quarter of the volatility of the MSCI index and with a fairly low degree of correlation with that index (roughly 50 per cent).

That experience in itself was enough to persuade many investors to raise their allocation to hedge funds. But if further support for the case was needed it was readily provided by portfolio optimisation models. Fed with those bear market risk and returns, such models, unsurprisingly, started to recommend a higher allocation to such alternative investments.

Although many "alternative" asset classes - particularly hedge funds - are now regarded as mainstream, the switch to alternative investments has been a disappointing experience for many investors.

Total dollar returns since March 2003 from the CSFB Tremont Hedge Fund index have been 55 per cent of those from the MSCI world index. The volatility of returns from hedge funds has been greater than in the bear market (about half that of the MSCI index, rather than a quarter, as seen in the earlier period) and the correlation with the MSCI index has risen - to 80 per cent. The compelling risk and return characteristics seen in the bear market have, in short, largely evaporated.

This has meant that active asset allocation - that is, the selection of the hedge fund style and manager - has been the key to successful exposure. Of the 13 different hedge fund styles identified by CSFB Tremont, those specialising in emerging markets have produced the best returns since March 2003. Anyone allocating to this class of hedge fund at that time would, by the end of February 2007, be registering a total return of 104 per cent. However, that is still less than the return from the MSCI index over that period, of 117 per cent.

Thus even the best-performing hedge fund style has not done as well as a passive exposure to the MSCI index over the same period. Even worse, if an asset allocator had correctly identified emerging markets as the best performing sector, he would have been much better off with a purely passive exposure to the MSCI Emerging Markets Free index. Since March 2003 that has returned 267 per cent, well above the returns from the typical hedge fund operating in that market, and with only modestly higher volatility.

There are additional difficulties associated with exposure to hedge funds. First, gaining access to the appropriate hedge fund style is not a straightforward matter. In March 2003 there were only a handful of emerging market hedge funds open for new business. Indeed, the hedge fund universe seems just as vulnerable as the "long only" world to the risk of attracting inflows at precisely the wrong time.

Second, the lag between capital being raised for a particular type of hedge fund and that capital being deployed in the market can often be as long as a year. In such circumstances, successfully tapping into the strength of emerging market hedge funds from March 2003 onwards would have required identification of, and investment in, an appropriate fund in March 2002. Even the most perspicacious asset allocator is likely to have found such a task challenging.

Third, survivorship bias in hedge fund data (see, for example, the letter by Rolf Banz, Financial Times March 27, "Many hedge funds fail in their first two years") may mean that aggregate hedge fund indices have an upward bias in their returns. Fourth, the inflow into hedge funds may have run ahead of the available investment opportunities. Hedge funds may be able to generate good returns from market anomalies when capital is scarce, but when capital is plentiful too much money may well be chasing too few opportunities.

What can we learn from this experience? First, for those willing to ride out short-term volatility, long only exposure may well produce superior long-run returns in comparison with investing in hedge funds. Second, exposure to hedge funds may well be more appropriate in a bear market. Third, active management of the allocation to different hedge fund styles is essential.

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