Through the Alpha Smoke Screens: A Guide to Hedge Fund Return Sources

Introduction

Why this book was written

In the past 10 years capital inflows to hedge funds have exploded, generating a 10-fold increase in assets in as many years. Hedge funds, traditionally an investment for a select group of high net worth individuals, have become democratized. At the same time, in the popular imagination the very term "hedge fund" often carries a whiff of scandal due to the huge losses of some high profile funds such as Long Term Capital Management (LTCM). Because hedge funds have produced both extraordinary returns and spectacular losses, they continue to be the subject of heated debate.

Some researchers and investors see hedge funds as a new paradigm in asset management[1] and therefore a necessary element in their portfolio allocation. Yet the popular business press often portrays them as a scam, the likely cause of the next investment bubble[2] or even a threat to the very architecture of the global capital markets.

What accounts for these wildly differing views? Most investors, business writers and even many investment managers outside the hedge fund arena simply do not understand how hedge funds make money. Only through a clear understanding of hedge fund return sources and risk characteristics can portfolio managers and investors make informed decisions about how hedge funds fit into their portfolios. The purpose of this book is to explain hedge funds and their return sources as simply and clearly as this complex subject permits. By providing a clear understanding of how hedge funds make money, the aim is also to dispel many common myths and misperceptions about hedge funds and provide the reader with a clearer picture of what hedge funds really are.

Academics and investors alike have started to unravel the "mystique" of hedge fund returns and to question prevailing myths. A new paradigm is beginning to emerge, which will eventually allow a wider investor audience to understand the real characteristics of hedge funds, how they earn returns, and the important role they play in the complex architecture of modern capitalism.

This book not only describes what hedge funds are, and how they take risks and earn returns; it also takes a strong view on the nature of those returns. The intention is to demonstrate that hedge funds generate returns primarily by assuming certain risks, thus earning risk premiums that can be readily analyzed and understood by investors. If true, this means that hedge fund managers are in fact earning most of their returns in the same fashion as other investors, albeit at a higher level of complexity, across a wider spectrum of risk factors and with a greater degree of freedom from regulatory constraints.[3] This contention flies in the face of the mystique the industry has sometimes used to market itself, namely its claim to generate returns mostly from exploiting market inefficiencies. But because investors are rightly suspicious of a "free lunch" in the markets in which hedge funds trade, making clear the true nature of hedge fund returns is crucial to their wider acceptance as legitimate investments.

Because hedge fund returns derive from the underlying financial markets in which they

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operate, the book will also discuss the role of hedge funds in the overall world of capital markets. Understanding the role and return sources of hedge funds also opens a door to a deeper understanding of financial markets.

Finally, the case will be argued as to why the understanding of hedge fund return sources is vital in the hedge fund investment process. Analysis will include the implications of this understanding for the definition of a proper allocation structure across hedge fund strategy sectors, the selection of individual hedge fund managers and the process of post-investment monitoring and risk management in a portfolio of hedge fund managers.

The challenges of understanding hedge funds

Many investors still regard hedge funds as an investment class that generates returns by mysterious means and judge successful managers exclusively on the basis of their stellar past returns. But the hedge fund battlefield is now littered with the bodies of secretive funds such as LTCM, Quantum, Tiger, Niederhoffer and Beacon Hill, all of which ultimately failed spectacularly. These very public failures occurred just as hedge funds expanded to a broader investor base, including a higher number of institutional investors bearing fiduciary responsibilities. Thus, there is growing demand both for increased transparency from hedge fund managers and improved knowledge among financial professionals who allocate assets to them, and these demands have started to change the face of the hedge fund industry itself.

The challenges of understanding hedge funds are diverse, including complexity, heterogeneity, lack of transparency, rapid change and persistent myths. Hedge funds carry a high degree of technical complexity such as spread strategies, leverage, short selling, and investments in a variety of different asset classes and instruments. They are much more complex and heterogeneous than traditional asset classes (equities and bonds). Unfortunately, a more detailed understanding of hedge funds has in the past been hampered by many hedge fund managers' unwillingness to disclose details of their strategies. To make matters worse, these strategies are changing even as investment professionals struggle to understand them. But despite the complexity concerning the specifics of a hedge fund strategy, the investor has to pose a simple question: "Why do hedge funds earn returns?" A convincing answer to this question is vital for proper investment and portfolio management decisions and is mandatory in order to avoid investment disasters such as LTCM.

Who can benefit from this book?

Anyone who has a basic understanding of financial markets and wishes to become more knowledgeable about hedge funds can benefit from this book. It is targeted at all financial professionals who work with, or allocate assets to, hedge funds. This includes an increasing number of private and institutional investors, fund of funds managers (allocators), hedge fund managers themselves, brokers, administrators and custodians.

The book should also be helpful to other types of professionals involved in addressing the challenges of hedge funds, including traditional asset managers, financial analysts, consultants, regulatory agencies, legal authorities, advisers, financial journalists and, last but not least, students. Because of the wide range of strategies examined, even hedge fund experts will benefit from the topics presented. With this broad audience in mind, the use of mathematical formulae is avoided and any technical terms are defined. To understand the

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concepts of this book, the reader needs only a basic understanding of equity, fixed income, foreign exchange and commodity markets (including plain vanilla derivatives such as options and futures) and the core principles of modern portfolio theory.

How the book is different

One indication of the increasing popularity of hedge funds among investors is the growing number of books about hedge funds. This book is not another general discussion of all aspects of hedge funds. Instead it focuses on the key issue of return sources and the relationship of returns to systematic risk. Against the background of definitions and readable explanations of individual hedge fund strategies, readers will need to understand the return source discussion, to which two chapters are dedicated. (More advanced readers may want to glance through the first five chapters as a prelude to moving on directly to the second part of this book.) Focusing on return sources allows this book to go into greater detail about the nature, risks and return profiles of individual hedge fund strategies.

Most of the myths and misunderstandings that persist around hedge funds derive from a lack of understanding of their return sources, so a key aim here has been to dispel myths that have led many people to regard hedge funds as something less than a legitimate asset class. Risk management is also discussed (although it is examined in more detail in the author's earlier books[4]). Combined with an understanding of the various hedge fund strategies, active risk management can eliminate many of the problems people associate with hedge funds.

Despite a growing number of reference books and articles, hedge funds remain a mysterious form of investment to many people. This confusion comes partly from the difficulty of comprehensively defining hedge funds and partly from the secrecy in which they have traditionally operated. But the main culprit in the fog of misunderstanding around hedge funds is the dearth of clear information on return sources and systematic risk factors.

Conventional finance theory does not allow for a "free lunch." So it is understandable that investors who believe in efficient markets are suspicious of claims that hedge funds solely exploit market inefficiencies to obtain abnormal profits. The picture will become clearer as it is demonstrated that most hedge fund strategies in fact earn much of their returns by assuming (systematic) risks that can be readily analyzed and understood by investors. This book will further demonstrate that investor confusion regarding the source of hedge fund returns stems partly from an inability of conventional risk measures and theories to properly measure the diverse risks of hedge funds and the correspondingly diverse sources of return. Many investors believe that investing in hedge funds is all about "the search for alpha," but this book demonstrates that this search has to start with "understanding betas" – ie, assessing the various systematic risk factors of each strategy.

How the book is structured

This book is divided into four parts: background; return sources; practical applications; and the challenges ahead.

Part I provides the general background on hedge funds needed to allow readers to understand the later discussion of return sources. Chapters 2 and 3 provide an overview of hedge funds and their recent development, including a discussion of some myths and misperceptions about the hedge fund industry. Chapter 4 covers the empirical risk and return properties of

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individual hedge fund strategies, while Chapter 5 describes these strategies, ranging from long/short equity strategies, via the different relative value ("arbitrage") strategies, through to event-driven and opportunistic trading approaches, and finally managed futures strategies.

Armed with this background, Part II focuses on return sources. Chapter 6 discusses the market efficiency paradigm and different capital asset pricing models, and links those to hedge fund return sources and what is called the "hedge fund return enigma." The chapter further explains the economic reasons for hedge fund returns and distinguishes between the two broad classes of return sources – risk premia and manager skill. Chapter 7 discusses some selective quantitative results of modeling return sources.

Part III focuses on practical applications of the reader's new understanding of return sources. Chapter 8 applies the knowledge gained in a practical guide to sector allocation, manager selection (due diligence) and post-investment risk management. This chapter also discusses the pitfalls of sector and manager allocation, including chasing past returns, return tweaking, omission of important risk types and the liquidity trap. Chapter 9 explains the construction of proper hedge fund benchmarks and indices – a topic of increasing interest to the hedge fund investing community.

Part IV reviews the book's conclusions and looks to the future.

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[1] See, for example, the introduction to A. Ineichen, *Absolute Returns: The Risk and Opportunities of Hedge Fund Investing* (New York: John Wiley & Sons, 2002).

[2] As several newspaper comments suggest: see, for example, "The Hedge Fund Bubble," *Financial Times*, July 9, 2001; "The $500 Billion Hedge Fund Folly," *Forbes*, August 6, 2001. A more recent "anti-hedge fund campaign" was launched by *Forbes* magazine in the spring of 2004 with the headline article "The Sleaziest Show on Earth: How Hedge Funds are Robbing Investors," *Forbes*, May 24, 2004.

[3] From this perspective it is actually doubtful whether hedge funds constitute a new "asset class" as many protagonists of the industry proclaim.

[4] L. Jaeger (ed.), *The New Generation of Risk Management for Hedge Funds and Private Equity Investments* (New York: Institutional Investor Books, 2003) and L. Jaeger, *Managing Risk in Alternative Investment Strategies: Successful Investing in Hedge Funds and Managed Futures* (London: Financial Times/Prentice Hall, 2002).

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