

Is it really alpha?

Hedge funds often characterise their mission as the pursuit of pure alpha. A growing body of research, however, argues that a significant proportion of observed hedge fund returns are really alternative beta. David Rowe considers the implications for the hedge fund industry and for investors

Few things generate a more emotional response than questioning the essential validity of someone's chosen vocation. When I was taking an MBA in finance in the late 1960s, the capital asset pricing model (CAPM) was a hotly debated topic. Much of the heat in that debate was generated by the theory's implication that security analysis had little to offer investors unless it was informed by non-public (that is, inside) information. As an occasional look at CNBC or any other financial news network will reveal, security analysts had less to fear from CAPM than one might have thought at the time.

More recently, there has been considerable debate about the possibility of replicating hedge fund returns by fixed or mechanically rebalanced portfolios of tradable instruments. On the surface, this seems like a remarkable possibility. Hedge funds often characterise their mission as the pursuit of pure alpha or, reduced to its simplest terms, as the search for market anomalies comparable to a six-cent nickel or a nine-cent dime. Such anomalies offer the possibility of returns with little of the risk produced by exposure to systemic variables, such as interest rates, exchange rates or equity prices. The rub, of course, is that the very act of profiting from such anomalies causes them to be competed away. This raises the question of whether hedge funds can maintain their historically high returns in the face of a massive inflow of capital.

The traditional image of a hedge fund prowling

around the landscape for market inconsistencies to be exploited has many attractions. Since these inconsistencies will presumably arise in different areas at different times, the pattern of profits from exploiting them should have no durable correlation with systemic market variables. If this image reflects reality, then hedge funds offer an ideal tool for diversification. Obviously, the success of hedge funds in generating healthy returns in a low interest rate environment has attracted money from many high-net-worth individuals. More recently, however, it is the diversification argument that has made them a respectable outlet for traditionally conservative investors such as pension funds and charitable endowments.

Over the past few years, academic research has begun to raise doubts about the popular view of how hedge funds operate. Andrew Lo¹ is widely known for his work on the potential for replicating hedge fund returns with an appropriate fixed or mechanically rebalanced portfolio of publicly traded instruments.² The general conclusion from the research of Lo and others is that a proportion of hedge fund returns is attributable to manager expertise. In many strategy categories, however, a majority of returns represent premiums that compensate investors for bearing some form of systemic risk. In other words, these returns represent various forms of alternative beta rather than pure alpha.

Discussion of this topic will continue to be clouded by emotion and self-interest. Hedge fund managers relish the idea that their returns arise from superior skill and insight. Anything that questions that presumption is bound to be rejected out of hand by many in the industry. As with security analysts since the 1960s, however, I am sure that hedge fund managers will do just fine. The potential to replicate a significant portion of hedge fund returns does not invalidate the approach. By making the sources of the returns more transparent, separating what is alternative beta from pure alpha may well encourage the continued growth of investments into these vehicles. Understanding the types of systemic risk involved would support more reliable analysis of the impact of hedge fund investments on portfolio diversification. Generation of alternative beta is also likely to be a more scalable form of investment than the search for pure alpha.

Of course, the big question is whether dispelling some of the mystery behind hedge fund returns will eventually make the long-standing 'two-and-20' fee structure a thing of the past. My suspicion is that it will do so at some point, but not until investable hedge fund clones become a proven alternative to hedge funds themselves. In the meantime, the possibility of thinner management fees will continue to generate more heat than light around discussions of hedge fund replication. ■

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¹ Andrew Lo is a professor of finance at the Massachusetts Institute of Technology and the 2001 winner of the IAFE Financial Engineer of the Year Award

² For example, see J Hasanbodzic and A Lo, Can hedge-fund returns be replicated?: the linear case, *Journal of Investment Management* 5(2), spring 2007, pages 5–45, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=924565