DON'T PAY FOR BETA

Seek out alpha and avoid settling for at-par market returns.

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With the lackluster performance of equity markets from 2000 to 2002 and the resulting deficit position of many pension plans, the interest in pure alpha strategies has increased significantly. Many hedge funds have been sold as pure-alpha solutions: we often hear that they have equity-like returns with bond-like risk and little or no correlation with markets. However, it is beneficial to look behind the risk and return numbers.

ALPHA WITH SOME BETA

An analysis of the returns of hedge fund strategies shows that most are not market neutral, that is, they are not pure alpha strategies. Over the 1994-2000 period, the aggregate hedge fund index had a market exposure (beta) of 0.37. Thus, on average, a significant portion of hedge fund managers' returns came from market exposure. Some strategies, such as emerging market hedge funds, had a much higher beta of 0.74.

BETA UNDERESTIMATED

Academics have known for a long time that less liquid assets have understated risk estimates (beta, variances, correlation). Such underestimation occurs in real estate, small cap equities, private equities, emerging markets and distressed securities, as well as in any hedge fund strategy that invests in those assets.

For hedge funds that deal in less liquid assets, both their low risk characteristics and their diversification benefits are exaggerated. Fortunately, statistical techniques can be used to adjust the apparent risk characteristics and arrive at more accurate ones. Using these techniques, the measured beta of 0.37 for the aggregate hedge fund index becomes an adjusted beta of 0.84! These are clearly not all pure-alpha strategies. The adjusted betas of global macro, long/short, and emerging market hedge fund strategies are close to or above 1. Dedicated short bias strategies have an adjusted beta below –1, meaning that they must produce a high alpha to compensate for the fact that markets tend to go up in the long run. Among the various hedge funds, those with the lowest betas are equity market neutral strategies, with an adjusted beta of 0.2, and managed futures, with -0.19. These strategies are also the least affected by the underestimation issue. They are therefore the closest things to pure-alpha strategies.

IMPACT FOR FUNDS OF FUNDS

The benefits of funds of funds (FoFs) include convenience, access to closed funds, diversification and alpha through better hedge fund selection. However, studies indicate that on average, FoFs may not be able to pick the better managers, just as long-only managers have a tough time picking the better stocks. Of course, some FoF managers are more successful than others.

To build a diversified portfolio of hedge funds, FoF managers must be aware that many hedge funds do not deliver pure alpha: a significant part of the return comes from their beta. FoF managers also must be familiar with the underestimation of beta and make the appropriate adjustments.

IMPACT ON FEES

Beta is cheap: there are a few excellent index managers who can deliver market returns inexpensively. Alpha from skill is expensive, and many hedge fund fees reflect this, typically involving higher base fees plus a performance fee. You should be sure that you are paying higher fees for skill and alpha, not for beta.

Some FoFs may succeed in neutralizing the beta at the FoF level. However, they may still pay high fees for beta, as the FoF manager pays performance fees to each hedge fund manager separately, including on each manager's respective beta. One solution would be for the FoF manager to negotiate with each hedge fund manager a performance fee schedule that excludes beta, taking into account the beta underestimation issue discussed above. ▮