



Hedge funds may be not so 'alternative'

>By Philip Coggan

>Published: May 8 2005 17:48 | Last updated: May 8 2005 17:48

>>

Hedge funds often trumpet their ability to deliver alpha risk-adjusted outperformance. But a vital part of their appeal to investors is that they can provide a diversified return when traditional asset classes such as equities and bonds are only expected to perform modestly. This raises the question of how hedge funds get their returns.

There are three benign possibilities. The first is that the managers are more clever than those elsewhere. The second is that they gain an advantage by using techniques (specifically shorting) that are not options for traditional fund managers. The third is that they can exploit anomalies in parts of the market (distressed debt, for example) ignored by other investors.

A fourth possibility is that the returns achieved by hedge funds are not really "alternative" at all. Hedge fund returns could be dependent on the strength of the overall market. In that case, they would not really be a source of diversified returns.

A recent paper*, sponsored by International Asset Management, a hedge fund group, examines this issue in respect of "market neutral" hedge funds. If these live up to their billing, they ought to provide a source of return that is dependent purely on the fund manager's skills.

Andrew Patton, the author, used data from 194 live and 23 dead hedge funds in the sector to test market neutrality against a number of measures. The most obvious was "mean neutrality", whether returns were closely correlated with that of the index (in this case, the S&P 500). Another option was "variance neutrality", whether the riskiness of the fund increased at the same time as the riskiness of the market.

A third test was based on "value at risk", a measure of the probability of the maximum loss in a portfolio over a set period. Is the VAR of a fund affected by the VAR of a market portfolio? A fourth test was based on a fund's exposure to extreme events such as the market crash of 1987.

A fifth, strict, test, was "complete neutrality", which required that the distribution of a fund's returns were completely independent of the market return.

Having analysed the data, Mr Patton found that about a quarter of all funds described as "market neutral" had some correlation with market returns. Investors buying into such funds are not really diversifying their equity portfolios. The author tested the robustness of his conclusions by analysing the data relative to other benchmarks or by excluding the initial, or most recent, months of hedge fund performance.

Although this result might seem disappointing, it is significant that market neutral funds were less exposed to the S&P 500 than the other types of funds Mr Patton analysed. As one might expect,

about 88 per cent of traditional long-only portfolios have
>a correlation with the S&P 500. More surprising, perhaps, is the finding
>that two-thirds of “event driven” hedge funds have a market correlation of some kind.

Many investors will get exposure to the hedge funds sector via a “fund of funds” route. Mr Patton found that about half of funds of funds had a significant correlation with the benchmark. A similar proportion of “equity hedge” funds also had such a correlation.

The analysis shows how difficult it is to get away from the influence of the stock market. Arguably, however, it does point the way forward for investors; find the funds that do not have a correlation with the index.

The odds in the market neutral sector are three-to-one in favour.

Here there may be a clue in how long the fund has been running. Mr Patton finds there is a significant relationship between the age of the fund and the correlation coefficient.
>This suggests “style drift” may occur in funds, with managers who originally claimed to be market neutral getting steadily closer to the benchmark.

It is possible that survivorship bias may be a factor. After all, bull markets tend to last longer than bear phases. The long-term performance of a hedge fund should accordingly get a lift from having a market correlation. If investors are swayed by overall returns, rather than risk-adjusted measures, that will make a difference to a fund’s survival chances. In other words, clients may want to diversify from the market in theory but not always in practice.

>
>*Are Market-Neutral Hedge funds Really Market-Neutral? by Andrew Patton, London School of Economics

>
>
>

Find this article at:

http://news.ft.com/cms/s/aa6c001a-be5d-11d9-9473-00000e2511c8,ft_acl=,s01=1.html

