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Can Hedge Funds Perform for Your Client Portfolios?

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Advisors have a right to be skeptical. New products and asset classes leap onto the stage touting recent performance, and then recede. It's often hard to tell a fad from a legitimate investing trend. Nevertheless, the last three years have been punishing for independent advisers who use traditional asset allocation techniques as the core of their investment approach. At best, clients are frustrated with three successive years of decline in global equity markets. Today, clients have freshly minted respect for market risk in their portfolios, and advisors are bound to deliver an investment proposition that better manages risk as well as performance.

Amidst the investing carnage, hedge funds again provided a safe haven in 2002. The CSFB/Tremont Hedge Fund Index eked out a 3.04% gain in 2002, compared to 23.37% losses for the S&P 500 and a drop of 31.53% for the NASDAQ. Hedge funds, a minor asset class just 10 years ago, now control more than $500 billion in assets (slightly more than the managed accounts industry). Assets have climbed at a 36% compounded rate in the last three years.

Whether you talk of CALPERS, Harvard University or General Motors, The Doris Duke Foundation or the Ziff family, hedge funds have become a major allocation destination among many of the most sophisticated investors. Their shift in assets is based on detailed analysis of the hedge fund universe, including its long-term prospects for portfolio risk management, and perhaps more importantly, the ability to construct optimized portfolios across both traditional and alternative asset classes.

A 2001 survey by Rydex Investors shows 21% of independent advisers are using hedge funds in their practices, up sharply from 5% the prior year. That leaves 79% who have stayed outside the fold and suggests that hedge funds are not yet easy to build into an advisory practice (Table 1.) Despite strong investor demand, advisors are moving cautiously.

One essential definition of a hedge fund investment strategy is that it seeks positive returns regardless of the direction of securities markets. The charter for a hedge fund manager is to seek opportunities to turn market beta into alpha, or uncorrelated returns – a manager's value-added. By de-emphasizing market beta and benchmarks while simultaneously seeking out pockets of inefficiency in traditional markets, hedge fund managers add value. There are a wide variety of investment strategies that meet this criterion. The CSFB/Tremont Hedge Fund Index tracks nine absolute return sub-strategies from Long/Short Equity to Convertible Arbitrage.

Performance numbers tell a powerful story, but represent only a small part of the picture. In aggregate, hedge funds deliver a unique investment proposition for advisors building client portfolios. Solid performance, low correlation to traditional asset classes, significantly lower volatility and a much improved risk/return profile make hedge funds a sensible allocation solution for diversified high net worth investors.
Over the past nine years, in up markets and down, hedge funds have delivered 400% of the risk-adjusted return of the S&P 500 as measured by the Sharpe ratio; volatility has been 40% lower than the S&P, and hedge

Table 1.

	Performance		Risk Statitics		
	One Year	Since Inception (12/1993)	Standard Deviation[1]	Correlation to S&P[2]	Sharpe[3]
S&P 500	(23.37%)	7.31%	16.45%	1.00	0.17
MSCI World $	(19.54%)	5.01%	14.81%	0.94	0.04
CSFB/Tremont Hedge Fund Index	3.04%	10.64%	8.86%	0.49	0.70

[1]**Standard deviation** is a measure of risk, indicating the amount of volatility a security or index is likely to experience from period to period. A higher standard deviation indicates high volatility, and therefore higher risk.

[2]**Correlation** indicates the extent to which two securities' prices move together. A correlation of 1.0 means perfect correlation, a correlation near 0.0 indicates little coincidental price movement.

[3]The Sharpe Ratio is a measure of risk/return. A higher Sharpe ratio indicates a higher level of return per unit of risk. A low Sharpe ratio indicates little return per unit of risk.

funds have just a 0.49 correlation to the S&P 500. Some strategies, such as Convertible Arbitrage, have average nine year returns above 10% with correlations as low as 0.14.

Emergence of a New Asset Class

The data suggest that hedge funds are more trend than fad. By numbers alone, 400% out-performance over a period of nine years is a profound endorsement of the value of the asset class, and suggests far more than a moment in the sun. But does this mean that investors can expect hedge funds to outperform equities? A number of scenarios are possible. A flat or down equity market would continue to make hedge funds attractive on a pure performance basis. In a rising equity market traditional equities will again outperform. In either scenario, expect hedge funds to continue to outperform on a risk-adjusted basis and to offer considerable advantage in portfolio risk-management and optimization as part of an overall allocation strategy.

With clients newly sensitized to the benefits of portfolio risk management, hedge funds will play an important part in building your business.

A Challenge to the Hedge Fund Industry

With a solid track record of delivering quality performance to both high net worth and institutional investors hedge funds are here to stay. They have moved from an esoteric product structure to a major asset class. But to make a quantum leap to the next level with investment advisors, the hedge fund industry has a number of barriers to cross. Most importantly, the hedge fund industry needs to approach the high-end of the advisory business with investment solutions that recognize the power of advisors to reach a significant cohort of wealthy households. In addition to well structured product, success in the advisory channel will come down to building the support and infrastructure that will allow advisors to place funds with clients, not as a passing fad, but as a core holding in their investment portfolios. ■

About the Author

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