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Capturing Hedge Fund Portfolio Diversification

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Advisors considering hedge funds for their clients face a challenge. Hedge funds as an asset class have proven benefits for portfolio risk management and performance, but share many of the basic requirements of traditional investing (see "Can Hedge Funds Perform for Your Client Portfolios?" *Senior Consultant,* January 2003). Like traditional investment styles, hedge fund managers use highly diverse investment strategies, see rapid rotation between winners and losers, and show wide dispersion of performance for winning and losing strategies. As a result, principles of diversification and risk management are critical components of a hedge fund diversification strategy. But hedge fund attributes make it difficult to build a liquid and flexible portfolio that can adjust to market conditions. For many investors, hedge fund of funds are the best means to overcome these barriers.

HEDGE FUNDS SHARE A COMMON GOAL: PRODUCE POSITIVE "ABSOLUTE RETURNS," REGARDLESS OF MARKET DIRECTION

Many Styles and Strategies

Hedge funds share a common goal: Produce positive "absolute returns," regardless of market direction. They attempt to do so by identifying inefficiencies or pockets of return in the investment markets and frequently use some of the most sophisticated derivative strategies to do so while producing a meaningful return. Within that simple definition, however, hedge fund managers have divided themselves into a large number of sub-specialties. The CSFB/Tremont Hedge Fund index divides more than more than 2,000 current and past investment funds into nine sub-specialties (see Table 1).

Regardless of the definitions used, the portfolio characteristics vary significantly for each of these strategies. For example, Long/Short equity funds have modest correlation to the S&P 500 at 0.60 but remain a directional bet with a positive market bias. Equity Market Neutral focuses on equity market bets that are less directional and reduces the correlation to the S&P to 0.40. Both show nine year returns in the 11% range, but Equity Market Neutral has performed far better on a risk/return basis with a Sharpe ration above 2.0, while Long/Short funds have a Sharpe of 0.62. By this measure alone, Equity Market Neutral funds generate nearly six times the risk-adjusted return of the S&P 500. It is reasonable to attribute Equity Market Neutral's recent out-performance on the risk-adjusted scale to its "defensive" posture compared to Long/Short Funds and the S&P during the downturn in the last three years. Across styles and strategies, some hedge funds use leverage to enhance their return profile.

Hedge fund investors should also be aware of Event-Driven, Global Macro and Convertible Arbitrage Funds, each of which exploit a unique niche in the global securities markets. Event-Driven managers focus on distressed securities and merger arbitrage in companies undergoing significant change, such as a merger, restructuring or bankruptcy. Global Macro managers focus on long and short opportunities in the global markets and may select equities, currencies or derivatives markets using top-down analysis of global trends. Convertible Arbitrage managers look for returns by seeking out price discrepancies between a company's convertibles securities, equity and options.

Sub-Index Performance Diverges Widely and Rotates Quickly

Like traditionally constructed portfolios, hedge fund portfolio performance is highly sensitive to the investment strategy selected. Over a nine-year period, the top performing and bottom performing CSFB Tremont investment styles diverged by as little as 19.9% and as much as 61.5% on an annual basis. Of course, individual hedge funds show even broader dispersion around these indices.

Just as importantly, individual investment styles moved in and out of leadership quickly. Comparing the top three hedge fund investment styles each year to the prior year's performers shows repeat appearances in the top three investment styles just 21% of the time. An advisor who picks last year's top three performing strategies will have little chance of outperforming in the coming year. (See Table 2 for a detailed sector performance matrix.)

Table 1.
CSFB/Tremont Hedge Fund Index Sub-Specialties

CSFB Investment Strategy	% of Index Assets	S&P Classification*
Long/Short Equity	34%	Directional/Tactical
Event Driven	24%	Event Driven
Global Macro	13%	Directional/Tactical
Equity Market Neutral	8%	Arbitrage
Convertible Arbitrage	7%	Arbitrage
Fixed Income Arbitrage	6%	Arbitrage
Managed Futures	3%	Directional/Tactical
Emerging Markets	3%	Directional/Tactical
Dedicated Short Bias	2%	Directional/Tactical

*Alignment between CSFB and S&P classifications is approximate

Table 2.
CSFB/Tremont Hedge Fund Index - Sub-Strategy Performance Matrix

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Top Performer	Short Bias 14.91%	Global Macro 30.67%	Emerging Markets 34.5%	Global Macro 37.11%	Managed Futures 20.64%	Long/ Short 47.23%	Convertible Arbitrage 25.64%	Global Macro 18.38%	Managed Futures 18.33%
#2	Emerging Markets 12.51%	Long/ Short 23.03%	Global Macro 25.58%	Emerging Markets 26.59%	Long/ Short 17.18%	Emerging Markets 44.82%	Short Bias 15.76%	Convertible Arbitrage 14.58%	Short Bias 18.14%
#3	Managed Futures 11.95%	Event Driven 18.34%	Event Driven 23.06%	Long/ Short 21.46%	Market Neutral 13.31%	Event Driven 22.26%	Market Neutral 14.99%	Event Driven 11.50%	Global Macro 14.66%
#4	Event Driven 0.75%	Convertible Arbitrage 16.57%	Convertible Arbitrage 17.87%	Event Driven 19.96%	Short Bias 0.42%	Convertible Arbitrage 16.04%	Global Macro 11.67%	Market Neutral 9.31%	Market Neutral 7.42%
#5	Fixed Income 0.31%	Fixed Income 12.50%	Long/ Short 17.12%	Market Neutral 14.83%	Global Macro -3.64%	Market Neutral 15.33%	Event Driven 7.26%	Fixed Income 8.04%	Emerging Markets 7.36%
#6	Market Neutral -2.00%	Market Neutral 11.04%	Market Neutral 16.60%	Convertible Arbitrage 14.48%	Convertible Arbitrage -4.41%	Fixed Income 12.11%	Fixed Income 6.29%	Emerging Markets 5.84%	Fixed Income 5.75%
#7	Global Macro -5.72%	Short Bias -6.00%	Fixed Income 15.93%	Fixed Income 9.34%	Event Driven -4.87%	Global Macro 5.81%	Managed Futures 4.24%	Managed Futures 1.90%	Convertible Arbitrage 4.05%
#8	Convertible Arbitrage -8.07%	Managed Futures -7.10%	Managed Futures 11.97%	Managed Futures 3.12%	Fixed Income -8.16%	Managed Futures -4.69%	Long/ Short 2.08%	Short Bias -3.58%	Event Driven 0.16%
Bottom Performer	Long/ Short -8.10%	Emerging Markets -16.91%	Short Bias -7.35%	Short Bias -5.48%	Emerging Markets -37.66%	Short Bias -14.22%	Emerging Markets -5.52%	Long/ Short -3.65%	Long/ Short -1.60%
CSFB/ Tremont Index	**-4.36%**	**21.69%**	**22.22%**	**25.94%**	**-0.36%**	**23.43%**	**4.85%**	**4.42%**	**3.04%**

Data Source: HedgeIndex.com, February 2003

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Single Manager Funds Introduce Extra Risks

Like traditional investments, hedge funds demonstrate a broad array of investment strategies with equally divergent performance and risk attributes. More importantly, sector performance does not carry over from year to year, as style performance rotates quickly. Allocating to single manager hedge funds has other significant issues.

- Single manager hedge funds typically are not diversified investments; they may be highly concentrated in just a few trades or securities.
- Many hedge funds share limited information on their investment strategy and are largely unregulated, increasing risk that a manager will fail to perform as expected.
- Access to hedge funds is an insider's game, performing due diligence on a large number of hedge fund managers and seeking out top performers requires experience, skill and contacts within the industry.
- Hedge funds have high minimums and building a diversified portfolio of single manager funds requires millions in capital.
- Reallocating a portfolio can be extremely difficult because of redemption rules.

Understanding Hedge Fund of Funds

The most powerful solution for overcoming these limitations and investment risks are hedge fund of funds. The best funds perform a significant service to advisors and investors because they address many of the diversification, expertise and access issues described above.

- Hedge fund of funds allocate across several investment styles and managers, seeking to meet or exceed the underlying index. From an investment consultant's point of view, this increases the chances that an investor will see performance with modest tracking error to the benchmark.
- Simultaneously, a hedge fund of funds should significantly decrease individual manager risk and investment style risk, as the fund can be allocated across many managers and styles.
- A single allocation to a fund of funds includes: allocation to many underlying hedge funds, access to the manager's due diligence expertise and on-going reallocation of the portfolio to meet market conditions.

Hedge fund fees differ from traditional managed assets. Advisors need to watch for excessive fees. According to one recent analysis, the most common structure for a hedge fund of funds was a management fee of 1% on assets, plus a performance-based fee of 15% of performance over a benchmark. The second most common structure called for a management fee of 1%, and a performance-based fee of 10%. The most common benchmarks were the risk-free rate of return, the S&P 500 and 0%.

As tempting as it may be to seek the next hot trader in a single manager fund of funds, hedge fund of funds deliver a sensible investment solution for adding an absolute return sleeve to a broader investment portfolio. Advisors get the fund of funds manager's expertise for a modest fee and gain access to funds that would otherwise be unavailable to most investors. Above all, advisors can achieve greater portfolio diversification and risk reduction for their clients, while still maintaining a meaningful return profile. ■

About the Author

Matthew Sola is principal of Solworks, a strategic marketing firm serving both the traditional and absolute return industries. Questions and comments are welcome via e-mail (m_sola@yahoo.com) or via phone (973-538-9588).

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