Outlook 2006: A Challenging Comparison

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NEW YORK (HedgeWorld.com)—Hedge funds often claim to extract alpha, or returns uncorrelated to movements in underlying markets. No doubt some individual managers do that.

But recent hedge fund performance in the aggregate appears to be closely related to markets. For instance, fund returns turned up in late 2005 when stocks rallied, and the same pattern was also observed in late 2004.

Long/short equity, the most common hedge fund strategy, typically means a long-biased portfolio. But the extent of the bias varies. The recent trend is for equity long exposure to increase, says Michael Markov of Markov Processes International LLC, Summit, N.J.

Using a version of returns-based style analysis, he found that equity hedge fund returns in 2005 through October, measured by the HFR index, behaved like a long-only portfolio with a large component of cash.

This hedge fund tracking portfolio consists of 28% U.S. value and mid-cap stocks (in the form of the appropriate Russell indexes) and 34% developed country stocks outside North America (the MSCI EAFE index). As for the rest of the return, the three-month Treasury yield accounts for it.

In November, this stock-index-plus-cash portfolio was put to the test. It returned 2.34% for the month, while the HFR equity hedge index returned 2.39%. The close correspondence backs up the argument that long/short equity returns are coming from market exposure.

That suggests you don't have to be in hedge funds to get hedge fund returns: A combination of common indexes may do the trick. Mr. Markov's point, however, is not that hedge funds don't add value to investor portfolios. Rather, he argues that the value they add is skill-based beta.

He believes hedge fund managers are good at finding market returns. For example, a couple of years ago they started moving into international equity—the MSCI EAFE index became an increasingly larger component in the tracking portfolio. That was a smart move, years ahead of the current tide of inflows into international mutual funds.

Equity hedge fund returns decline when the market declines and rise when the market rises—but less so than the market in both directions. The implication for 2006: Long/short equity returns will go in whatever direction the market goes.

Moreover, Mr. Markov points out that one can predict the average return. It can be estimated from the tracking portfolio.

He said the same approach also can be applied to other strategies, but the exposures have to be held long enough to show up in returns data. A short-term trading strategy such as statistical arbitrage does not lend itself to this method.

Not surprisingly, the analysis suggests returns from funds of hedge funds are primarily beta-driven and very similar to the index portfolio described above. To be sure there are managers with alpha skills, but there is no established method to find and identify them.

Others, in particular Robert Jaeger of EACM Advisors LLC and Clifford Asness, manager of AQR Capital Management LLC, have argued along similar lines. But they believe they can beat the average and catch that elusive alpha **Previous HedgeWorld Story**.

Mutual fund managers such as Rydex now offer products that promise to capture the skilled beta returns made by hedge funds. Comparing hedge funds to various tracking portfolios will make for an interesting exercise.