Absolute returns: a guide to hedge funds

Hedge funds as an investment vehicle are a constant source of debate. **PETER PONTIKIS** examines the latest literary effort on this subject.

As in any business after a long time it is refreshing to receive a new take on an intractable, complex and controversial subject. In our industry, it is the debate between the search for wealth via relative value versus that of absolute returns achieved through a hedge fund.

Ineichen's book contests the myths and presumptions surrounding the industry and the mania for relative value that holds so much sway among the passive and not-so passive fund global management businesses.

He suggests the so-called 'second paradigm' of investing made so famous by the giants of finance in the likes of Markowitz & Co and that has evolved into a fetish for index and index tracking—ignoring the basic principle of investor preference, i.e. to make money.

He instead posits an alternative, 'new', third paradigm that is fast emerging, where performance is not measured between various relativities (and thus open to selective goal post setting—if not moving) but between a riskless rate or benchmark. That is, the third paradigm agenda is to make money—pure and simple. In this, he feels the hedge fund (HF) industry is best placed to do this.

The book begins with a historical review of the hedge fund business and seeks to draw valuable lessons for both the HF believer and non-believer. It goes into easily accessible detail on the various style classifications of the industry, including relative value, event-driven and opportunistic business models.

Orthodox financial theory suggests that investors should focus on the long term. It also suggests that investors will generate satisfactory return if they have a long enough time horizon when they buy equities. This may or may not be true. The problem faced by absolute return HF managers is they might not live long enough to experience the long term.

As the book states, HF managers do not care if the probability of under-performing bonds over a 25-year period is low. Contrary to the bad press, absolute return managers are also interested in how they get there; that is, they are interested in end-of-period wealth as well as during-the-period variance.

While not a secret, the main reason why traditional funds do more poorly in downside markets is that they usually need to have a certain weight in equities according to their mandate, and therefore are often compared to cars without brakes. The freedom of operation is limited with traditional asset managers and the book compares this with the more flexible HF managers.

Another reason why HF managers may do better in down markets is that they often have a large portion of their personal wealth at risk in their funds. Arguably, their interests are more aligned with those of their investors.

This alignment, together with the lack of a relative measure for risk, increases the incentive to preserve wealth and avoid losses.

The guts of the book examines the HF business as a separate asset class, separate style and as just another financial services company.

It also looks at changing taxonomy of the industry, the main current trends underway, and takes a pretty clinical view of the practical and intellectual challenge of performance evaluation methodologies confronting the business—especially about the issue of benchmarks for the industry and possibility of replication.

He suggests HF managers regard themselves as 'boring'. Not offering the excitement of business and financial cycle swings, they simply want to offer financial wealth-increasing vehicles with low volatility. The irony is that the industry is still regarded as more risky than long-only equity exposure by a majority of financial professionals and regulators and even a larger majority of the general public.

His coverage of the Long Term Capital Management (LTCM) debacle is less convincing when he comments: "the coverage of which is very much anti-hedge fund industry".

While partly true, he quite rightly compares the wealth destruction of the \$US4.4 billion due to LTCM versus the \$US64 billion of Enron.

However, anyone who was trading the last volatile quarter of 1998 would remember that LTCM was not just 'a business failure'; it was a sequence of regulatory, accounting and bank procedural failures that all combined to threaten global financial markets and the 'system' per se with dislocation and depression. The fact we did not have one I think is less a reflection of the good author's critical ability, but one of luck, and shows the limits of his professed goal of representing the hedge fund business.

Regardless of the slant of Ineichen, his review is welcomed and brings much needed balance to the debate about the emerging role of hedge funds in the growing sophistication of global markets.

It is a good addition to the cluttered finance book shelf. The difference here is that the content is not merely elucidating old ground, but confronts an emerging debate (and challenge) to the conventional asset managers.

It is an experienced and persuasive interjection to the tired status quo.

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Ineichen, Alexander M., *Absolute returns: the risk and opportunities of hedge fund investing*. New Jersey. John Wiley & Sons, 2003. J