The future of hedge fund investing

There is ever increasing controversy surrounding hedge funds. **PAUL ALI** and **MARTIN GOLD** pose the question of whether these funds have a future.

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The Australian hedge fund sector is still in its nascency, with 65 hedge funds in operation (including funds of hedge funds) and an estimated $1.1 billion in assets under management (as at 30 June 2002).

The sector is expected to experience strong growth in the short term, due to the increased marketing of hedge fund products to retail investors and allocations to hedge funds by the large Australian superannuation funds, including the Federal Government's superannuation schemes.

The hedge funds sector in Australia is idiosyncratic, displaying few of the characteristics commonly associated with hedge funds in the more mature hedge fund markets such as the United States and the United Kingdom.

Overseas hedge funds are generally discrete funds that target high net worth and institutional investors, are structured as closed-end funds, lock up their clients' investments for periods of one to three years and impose strict conditions upon redemptions.

In contrast, the majority of Australian hedge funds are structured as funds of hedge funds with relatively low minimum investment requirements, are open-end funds and place few restrictions upon redemptions. Moreover, the initial minimum investment for many Australian hedge funds has declined steadily since their launch.

Also, the vast majority of Australian hedge funds are indistinguishable from conventional managed funds. Local hedge funds are subject to the same licensing and disclosure requirements as conventional managed funds (unlike overseas hedge funds which are deliberately structured to take advantage of the licensing safe-harbours and reduced disclosure obligations provided for the securities laws of their home markets).

Almost all Australian hedge funds share the same legal domicile with their investment manager: Australia. Again, this is in contrast to overseas hedge funds where the hedge fund is jurisdictionally bifurcated from the hedge fund manager.

The first part of this article examines recent innovations in hedge fund products and offers insights into the future of the local hedge funds sector. The second part of this article reviews the performance characteristics of hedge funds.

Innovations in hedge fund products

The evolution of products offering indirect exposure to the hedge funds sector has broadened the distribution of hedge funds and also reflects the increasing institutionalisation of hedge funds and the supply-driven nature of the hedge funds sector globally.

The most common 'first generation' products are feeder funds and funds of hedge funds incorporating portable alpha strategies, that combine the 'alpha' generated by discrete hedge funds or hedge fund strategies with the returns from conventional index-tracking funds.[1]

More recently, a second generation of derivative and securitisation products has emerged, which offers economic pay-offs linked to individual hedge funds, pools of hedge funds or hedge fund indices. These new products offer indirect exposure to hedge funds that is overtly transparent and, in the case of listed products, provides investors with increased marketability and liquidity for their investments.

Hedge fund-linked securities

Hedge fund-linked securities are debt securities with an embedded pay-off linked to the performance of an underlying pool of hedge funds. These securities offer investors enhanced liquidity, continuous pricing and relatively low minimum investment thresholds. Where listed, hedge-fund-linked securities can be bought and sold on an exchange by investors in the same manner as any other listed security.

The securities are issued with fixed maturity dates and are backed by a portfolio of hedge funds. On maturity, investors receive the difference between the net asset value of the portfolio on the initial valuation date and the maturity date. In addition, investors can, during the term of the securities, redeem their securities on fixed redemption dates, for a cash amount reflecting the prevailing net asset value of the underlying portfolio.

However, since the value of the securities is linked to the net asset value of the underlying hedge funds, it is possible that they may expire worthless on maturity, due to sharp or continued draw downs in those hedge funds. To overcome investor concerns about the risks inherent in hedge fund investing, it is becoming more common for hedge-fund-linked securities to carry a capital guarantee; however, this generally applies only to investors who remain for the full investment term.

The Collateralised Fund of Hedge Funds Obligation (CFO) is a new alternative to the conventional pooled fund structure employed by funds of hedge funds.[2]

The first CFO was launched in May 2002 and this new asset class is attracting strong interest from institutional investors in the United States and Europe.

CFOs are similar to the hedge-fund-linked securities discussed above, in that both structures involve the creation of tradeable instruments backed by a pool of hedge funds (see Figure 1). However, the latter product serves the dual purposes of overcoming the problems of limited liquidity commonly associated with hedge fund investments and broadening the investor base of hedge funds to include retail investors.

Hedge fund indexing strategies

Research into the performance of conventional, actively managed funds has established that such funds do not, over the long term, generate excess returns relative to their benchmark indices.[3]

A similar trend has also been observed in respect of funds of hedge funds. Together, this provides a strong rationale for the development of passive hedge fund strategies involving the tracking of hedge fund indices.[4]

The growth in the global hedge funds sector has been accompanied by the development of hedge fund performance indices. In the second half of 2002, Morgan Stanley Capital International and Standard & Poor's launched their hedge fund indices, joining established hedge fund index compilers such as CSFB/Tremont and Hedge Fund Research Inc.

Hedge fund index derivatives can offer a practical alternative to investors who are considering funds of hedge funds. Hedge fund index derivatives may provide greater diversification than a typical fund of hedge funds, by tracking an index which offers exposure to a diversified pool of hedge funds selected according to fund size or other objective criteria (see Table 1).

As with mainstream indices, there exists a fundamental mismatch between the purpose of an index (which is to provide an arbitrary measure) and an investment strategy.[5] Hedge fund indexing strategies therefore require careful consideration of the suitability of the underlying investments.

Assessing the performance of hedge funds

Hedge funds have historically offered investors significantly different investment characteristics to those of conventional funds. However, investors should be cognisant of the fact that the returns of hedge funds are derived from the same

FIGURE 1 **GENERIC CFO**

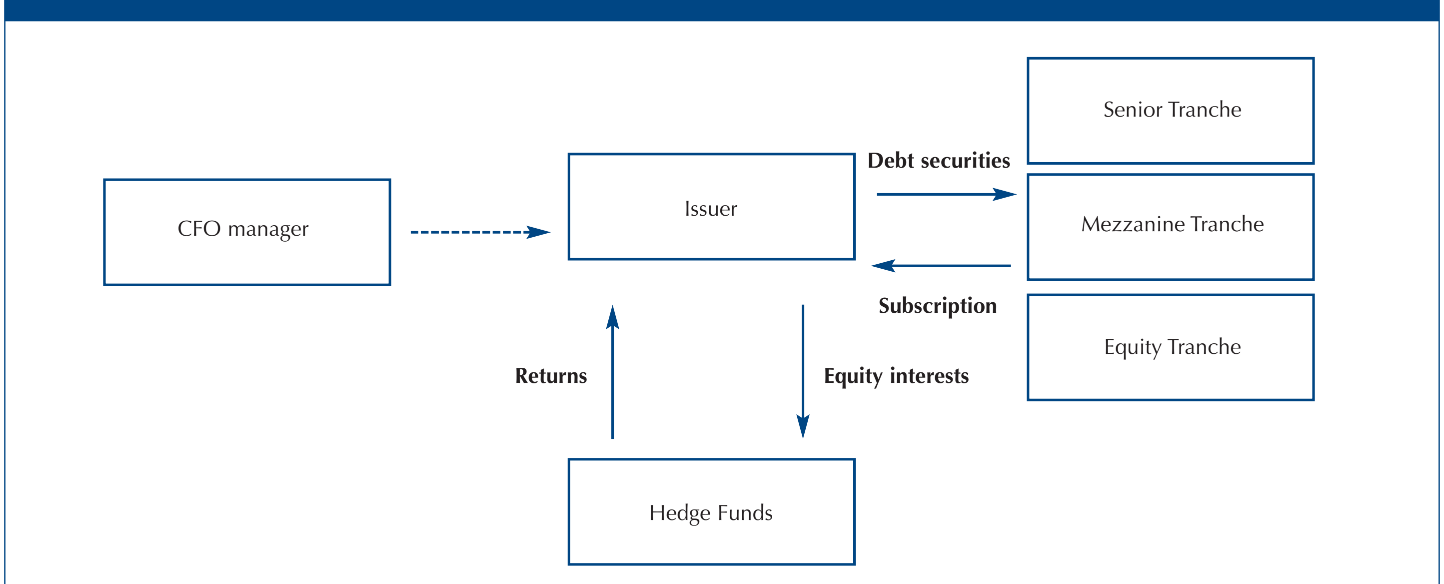

TABLE 1 COMPARING HEDGE FUND INDICES

Index	CSFB/Tremont	Hedge Fund Research	MSCI	S&P
Index methodology				
Weighting scheme	Asset-weighted	Equal-weighted	Equal-weighted and Asset-weighted indices	Equal-weighted
Fund selection	Quarterly	Quarterly	Quarterly	Ad hoc
Index rebalance	Quarterly	Monthly	Monthly	Annual
Currency	US$	US$	US$	US$
Inclusion criteria				
Minimum size	US$10 million	No	US15 million	Yes
Minimum trading period	12 months (possible waiver for funds with >US$500m under management)	No	No	Yes
US and non-US funds	Yes	Yes	Yes	Yes
Funds of hedge funds	No	No (separate fund of hedge funds index)	Yes	No
Closed funds	Yes	Yes	Yes	No
Other information				
Number of indices	10	33	>150	3
Number of funds tracked	2,600	>2,000	>1,000	40
Constituent disclosure	Fund names only	No	Yes	Fund names and strategy only
Commencement	Jan. 1994	Jan. 1990	Sept. 1999 (indices launched 9 July 2002)	Oct. 1998 (indices launched on 7 Aug. 2002)

underlying assets—shares and bonds—as conventional funds. Hedge funds derive their returns predominantly from the United States fixed income and equity markets (see Table 2).

Although the returns from hedge funds may not be closely correlated to traditional managers and markets, this does not mean they are insulated from market volatility. For example, a fund holding a long position in SFE Share Price Index (SPI) futures contracts without any leverage will have a correlation co-efficient of +1 while a fund holding a short position (sold SPI futures contract) will have a correlation co-efficient of –1. If the fund alternates between long and short positions intra-month, these positions will tend to offset each other, but the fund will continue to be exposed to general market volatility.

TABLE 2 POPULAR HEDGE FUND STRATEGIES IN TERMS OF ASSETS UNDER MANAGEMENT

Strategy name	% of total hedge fund assets
Long/short	42.6
Event-driven	19.4
Global macro	9.3
Convertible arbitrage	8.6
Equity market-neutral	6.8
Fixed income arbitrage	5.7
Emerging markets	3.4
Other	4.2

Source: Tremont Advisors, June 2002

The major attraction of hedge funds for investors is the claim that hedge funds can deliver above-market or ‘absolute’ returns that are not strongly correlated to the returns of conventional asset classes or investments such as shares and bonds. Hedge funds generally seek to beat money market returns while also delivering an ‘equity upside’ from the capital markets—the best of both worlds.

The ability of hedge funds to outperform risk-free money market assets is readily verifiable but comparing the performance of hedge funds with the major equity indices reveals mixed results. Hedge funds should be considered for inclusion in diversified portfolios only if they can provide diversification benefits without dragging down the overall returns for the portfolio.

A comparison of the performance of the hedge funds sector, represented by the returns of the composite hedge fund indices published by CSFB/Tremont and HFR since their inception, with the returns from US and Australian money market proxies (the yield on the US 90-day Treasury Bill and UBS Warburg Bank Bills Index respectively) reveals a marked change in the performance characteristics of hedge funds (see Table 3).

Hedge funds have struggled to outperform the money market proxies, suggesting that, on average, investors would have been better off investing in the money market. For Australian investors, the returns from bank bills have consistently outstripped hedge fund returns over this period without incurring any risk.

It remains to be seen whether the recent trend of convergence between hedge fund and money market returns continues or whether there is a