

Frank Belvedere, F.C.I.A., CFA
Vice President, Alternative Investments Montrusco Bolton

Understanding Hedge Funds

Over the last several years, interest and awareness of the hedge fund industry has increased worldwide. Canada has not been excluded from the surge in activity with interest by both institutions and individual investors alike.

Hedge funds managers and the absolute return investment strategies which they employ have generated equity like returns, low correlation to bond and stock markets and volatility between one third and one half of equity volatility. While there are practical issues of survivor bias the performance data does give an indication of the potential benefits to investment portfolios.

I believe, however, that some crucial information is missing to complete the puzzle of what hedge funds are and what managers do. This information relates to how hedge funds generate returns and what the essential building blocks of absolute returns are. In other words, how can hedge funds generate equity like returns? We know from traditional investing that the building blocks of equity market returns are nominal earnings growth, dividends, and changes in price-earnings ratios. Nominal earnings growth can be divided into inflation, productivity increases and changes in the workforce. But what are the building blocks for absolute return strategies?

In this article, I shall attempt to shed some light on this question, which I believe must be clarified before institutional investors make meaningful allocations to these strategies. Before presenting a crude building block approach to decomposing hedge fund returns, it is essential to present the following features of hedge funds which are useful in making comparisons between them and evaluating the risk of individual funds and strategies. As for traditional long only investing, risk is embedded in the manager's portfolio construction processes, as well as in the style or strategy itself.

Leverage

There is some confusion in the industry as to what constitutes "leverage". For discussion purposes, I will define leverage to be additional investment exposure on long investments achieved through borrowing. A manager with \$1 million in assets, who borrows to buy \$1.2 million of securities, would be leveraged 20%. Knowing the level of leverage is essential, but alone it does not provide a complete picture of the particular strategy. Leverage merely indicates by what factor long positions have been magnified.

Net Exposure

I define this to be “longs” less “shorts”. A manager who is 120% long (using leverage) and 50% short, has a net directional market exposure of 70%. This assumes (simplistically) that the longs and shorts are balanced by style, cap and industry. The significance of net exposure is that it is the measure of directional market risk that resides “unhedged” in the portfolio.

Gross Exposure

I view this as the “invisible hand” at work in hedge fund portfolios. Gross exposure is the total of the long and short positions. In our example, a manager who was 120% long and 50% short would have a gross exposure of 170%. This is significant as it represents the absolute level of investment bets. Hedge funds’ gross exposure often can exceed 100% (even with no long side leverage), and this in itself is a form of leverage with a very direct impact on returns. If the combination of longs and shorts earns, say, a modest 7%, the total portfolio earns 11.9% on invested assets.

What can we say, then, about our sample manager (perhaps a long-short equity manager) who is 120% long and 50% short? First, that he or she uses modest direct leverage of long positions, that there is a fairly high (70%) directional market exposure (which will cause returns to be impacted by general market movements, though less than for a long only portfolio) and that there is a strong reliance on the manager’s security selection skills as evidenced by the 170% gross exposure (and the leverage it implies).

The preceding should be useful in characterizing the key elements of the manager’s portfolio construction process, general risk level and potential sources of return.

Sources of Return

It should be possible to identify, in advance, the potential sources of return from a particular hedge fund strategy and from the manager’s particular application of that strategy. I would suggest that there are four sources of returns from hedge fund strategies: static return, market exposure return, gross exposure return and manager alpha, which for convenience purposes is treated as a residual. This list only contains one additional source of return (i.e. gross exposure) versus a traditional long, unleveraged portfolio. However, understanding the contribution of each of these, for a particular manager and strategy, should go a long way towards forming proper expectations for manager performance.

Static Return

This is defined as the return of the portfolio without any change in price of the underlying securities. For a traditional equity portfolio it is the dividend yield and for a bond portfolio it is the coupon.

Absolute return strategies can have several sources of static return. For long equity positions, it is the dividend yield and for short equity positions, it is the short “rebate” (earnings on the proceeds of short sales). Both are reduced by borrowing costs to leverage and the need to pay dividends to the lender of borrowed stocks.

Convertible bond arbitrage has a fairly high static return which underlines its usefulness as a replacement for part of a typical bond portfolio. The static return is the sum of the bond coupon (say 5%) and the short rebate (say 4% on 50% of the underlying stock exposure), for a total of 7%. Identifying the expected static return is the first step in decomposing hedge fund returns.

Market Exposure

If a manager was 120% long and 50% short, the 70% stock market exposure should expose the fund to 70% of the market’s movements. If equity markets generate 10% long term, including 3% from dividends, then general price movements could add 4.9% annually to the hedge fund manager’s long term returns. Exposure to directional market moves is a source of returns in some but not all strategies. In equity market neutral (longs equal shorts), it would be zero (theoretically), as would also be the case for a fully hedged merger arbitrage position. The point to be noted here is that hedge funds actually “hedge” unwanted risks, usually market risk, in varying degrees.

Gross Exposure

Defined as the total of all long and short investment positions, gross exposure indicates the real level of leverage in a portfolio. As such, altering gross exposure is a powerful hedge fund management tool. It also provides insight into the manager’s ability to provide equity like returns, even as overall market exposure (to general market moves) has been reduced.

Cynically, gross exposure over 100% could be viewed as pure financial engineering with a symmetric, but magnified, chance of success or failure. In reality, managers alter gross exposure based on their views of the markets and the subset of opportunities available to them. It is thus a meaningful tool which can be used proactively to control risk and enhance return.

Manager Alpha

This should be a significant component of a hedge fund manager's returns reflecting, as for traditional long only investing, the value added by a manager's security selection skills.

By way of example, an equity market neutral (equal long and shorts) with a zero alpha would earn the risk free rate net of dividends on borrowed stock. His long and shorts would cancel out any stock market impact. Such a manager who is able to generate 10% per annum is benefiting from the additional power of two sources of alpha and, possibly, from gross exposure in excess of 100%.

It is interesting to consider that the alpha generated from traditional active management is very moderate, generally 2 % or less versus traditional equity benchmarks. I believe this is due to the constraints imposed by "relative return" mandates under which the manager is expected to add value versus the benchmark, while at the same time controlling the risk associated with the active investment decisions. The result is that portfolios reflect the benchmark and carry "deadweight", i.e. positions held exclusively to control tracking error.

Hedge fund strategies are "absolute return" mandates. As such, they are not managed against a benchmark and the manager is free to use his best ideas. Portfolio construction and security selection is guided only by the manager's stated strategy and targeted risk levels. I believe that, free of the confines of a targeted benchmark, managers in absolute return space are able to generate higher alphas.

Summary

Evaluating hedge funds requires evoking the three "Ps" (people, process, and performance). Understand the firm's history, the qualification of its personnel and the stated investment style and approach. Determine the parameters of portfolio construction: market segment, number of positions, leverage, net exposure and gross exposure. Evaluate risk control systems and how they have been applied. Decompose expected return into its component parts: static return, market return, gross exposure return, and manager alpha. Hopefully the framework suggested herein will allow fiduciaries to develop the comfort level necessary to invest in this rewarding area.