Hedge Fund Barometers, Introduced

By Jim Liew

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The hedge fund industry has evolved from a cagey, secretive, cottage-industry to a much more transparent, institutional-grade industry. Gone are the days when mere "access" to hedge funds was considered a competitive advantage. Rather, we are now seeing our industry actively pursuing intuitional investors and even creating products tailored for them. One example is the proliferation of managed account platforms, where hedge funds allow access to position-level data to the platform providers. Few hedge funds would have provided position-level data a decade ago, but after a torrent of scandals, the fiduciaries have demanded greater transparency and our industry seemingly desires to accommodate. Some platform providers have gone so far as to provide intra-day performance to intuitional investors (e.g. AlphaMetrix). The ability to monitor "real-time" performance attribution is now possible and gives way to many institutional investors donning their "Chief Risk Officer" hats to oversee a portfolio of investments at the position-level. It is nothing short of remarkable how much our industry has changed in such a short time span.

Presently, our industry seems poised to make another leap forward. Many investment committees are engaging in a heated discussion regarding "exotic beta" behind closed doors. This signals the first wave of products and innovations that will come down the pipeline very soon. The next wave will be products that measure the behavior of different hedge fund strategies by taking a "representative" sample of a discretionary strategy. If the majority of returns are driven by the opportunity set, and the cross-sectional variation of managers' return is limited, then the "representative" fund approach should work well. Consider this piece of ad hoc evidence: The positive correlation of large global systematic trend-followers with one another within the managed futures space. The trend is your friend, but it's also everyone else friend too, no? After all, why did so many distressed managers have a banner year in the same year? It appears many of them caught an overly ripe investment opportunity set, rather than exhibiting manager skill. These are just a few of the observations that call into question the key drivers of hedge fund returns. Is it skill or mere exposure to the right investment opportunity? In support of the latter is the research of Fama-French, which concludes that net of fees over a long period of time, very few active mutual fund managers can beat their benchmarks. If active mutual fund manager are failing to beat their benchmarks net of fees, by analogy, would not hedge fund managers also be struggling in this most impossible endeavor?

What then, are the implications for our industry, if hedge fund returns are not driven by manager skill? For one, the old guards of hedge fund indices are going to come under serious attack as newer, and more informative, indices, or what we term hedge fund “barometers”, begin to materialize. Gone will be the days where hedge fund sector performance will be based on a group of hedge fund managers who presumably possess skill. Once you put together a portfolio of similar hedge fund managers, you will pull out the main driver of the strategy. Since no hedge funds possess unique skill, you don’t need to pull together a bunch of managers; all you possibly need is one. And what are the benefits of such a barometer? Since barometers are constructed at the position-level, position-level transparency and real-time performance will be easily available to satisfy the fiduciary’s ever growing needs. Currently, the most popular hedge fund indices are not constructed at the position-level since they are aggregating NAVs of underlying managers, so position-level transparency cannot be attained by these incumbent indices (e.g. Dow Jones CS, HFRI, Barclay’s, etc.).

Thoughtful construction of hedge fund barometers can only benefit our industry because it will 1) have educational value, 2) ultimately win market share and 3) provoke an introspective and long-overdue debate on the issue of manager skill net of fees. The incumbents that oppose it will predictably hunker down to protect their turf. Institutional investors will, first and foremost, replace those managers who cannot consistently beat these well-constructed barometers. Barometers will exist based on quantitative recipes (when possible) and taking a “representative” discretionary manager approach. Both products will allow for position-level analysis at the intra-day frequency and ultimately become investable products. The sales pitch will be simple: cheaper exposure to hedge fund strategies for fiduciaries who need more transparency and real-time risk management.

As institutions increasingly demand to be closer to the investment process, and given that they already have position-level transparency on managed account platforms, they will inevitably seek the ability to confirm the investment process stated in the prospectus. Namely, they will want to be able to monitor changes within the portfolio holdings intra-day. And eventually institutions will seize upon the opportunity to have complete autonomy over the investment process in the form of their own internal multi-strategy hedge funds (the smaller institutions may create shared-internal multi-strategy hedge funds). The barometers serve, therefore, as the bridge for institutions in building out their own internal hedge funds.

In the past, hedge fund performance was monitored by having actual investments within the fund. If one wanted to find new hedge fund, one would have to almost exclusively rely on a network of friends. Performance information was shared within this intimate network of friends and data would be typically stored in local Excel files or in email inboxes. Many times, simple quantitative analysis (i.e. inclusion/incremental-analysis) could not be properly performed, given the scarcity and the difficulty in acquiring the necessary data. The need for hedge fund performance data created a nice business model for those data vendors who began storing and selling hedge fund information. Soon, it became necessary to analyze the monthly return streams and quantitative analysis was a key component of the proposed recommendation packages. Fund of funds began to distinguish themselves by marketing the most advanced risk-management and quantitative analysis. We also experienced a nice growth in quantitative tools such as more advanced screening processes, more quant tools that employed regression based analysis, new findings in distributional analysis, (i.e. Omega Ratio), etc. Throughout this period, our community learned more about how seemingly uncorrelated hedge funds strategies could become correlated in extreme market periods as we now had monthly data to test such hypothesis. Readily available monthly data was the beginning of the institutionalization of hedge funds since rigorous empirical studies could now be performed.

A direct consequence of readily available monthly data was the observation that aggregate hedge funds or fund of funds could be “replicated” by providing a mixture of a little equity, little credit, little short-volatility, etc. with exposures. The race to “replicate” took off quickly. There were two schools of thought with regard to Replication: 1) Attempt to replicate the distributional characteristics of hedge fund returns and 2) Decompose returns into liquid tradable factors. Unfortunately, both schools did not succeed because the product was too simple and priced at such low fees that it wasn’t interesting to create or sell.

As technology advanced, we experienced many interesting developments in risk-management too. Companies began providing commercial products that would help analyze risks at the position-level of hedge fund investments. Similar analysis had been readily available on trading desk for their risk managers at prime-brokers. We witnessed the proliferation of such risk reports and saw them become widely available and accepted across the institutional investment community. Risk reports became a staple for whenever an allocation decision had to be made. Unfortunately, these risk reports, which were often generated after many long simulations, were seldom actionable especially intra-day.

So, now we come to our present circumstances. We are operating in an environment were larger hedge funds are getting larger and institutions have become wary of the smaller start-up funds. Risk management is typically done on the position-level, daily, and managed accounts allow intuitional investors (possible) access to real-time positions-level information. We add to this mix the hedge fund barometers that will allow institutional investors to measure the (intra-day) performance of “exotic beta” strategies (both of those that can be quantified and those that are based on discretion). Some of the more interesting research remains to be performed by analyzing the intra-day behavior of these new barometers.

Ideally, these barometers would reside on some managed account platform with position-level transparency so that the institutional investor will be able to re-allocate quickly to possibly better investment opportunities with the added confidence and understanding of the risk/rewards trade-offs. We may start to see investment allocation decisions made much more rapidly. A few years ago, allocation changes were done quarterly or monthly, but in the very near future, we foresee allocations changing daily and even possibly intra-day with the help of the development of investable hedge fund barometers. Institutional investors could park their allocation to an event driven discretionary barometer and wait until they find a manager who has shown to consistently beat this barometer net of fees. If the barometer is priced very competitively, they will have an advantage since most hedge funds still charge 1-2% management and 20% incentive fees. Those fees may very well be too high if our thesis holds true and barometers will have a significant impact on the overall fees charged by hedge funds.

It should be an exciting time as the debate intensifies but in the end, only time will tell whether hedge fund barometers will be critical in the evolution of the hedge fund industry.

Just my humble commentary on the future of hedge fund investing,

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