Comparing Apples and Oranges is Fruitless

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Every month, we see the headlines comparing hedge fund index returns to that of the S&P500 among most, if not all, financial media and alternative investment publications. The comparison implicitly suggests the S&P 500 as the "proxy" to outperform for hedge funds as a whole. The exercise is rather naïve and fruitless, and for numerous reasons.

The hedge fund universe is heterogeneous. Comparing and rating returns among some of the hedge fund's universe subcomponents has little or no constructive significance, let alone comparing the whole to a US equity index. While it makes no sense to compare returns of fixed income arbitrage hedge fund strategies with merger arbitrage or systematic global macro strategies, how would one justify comparing the whole to the S&P 500?

As we explore and assess the heterogeneous hedge fund universe much further, we quickly realize that the intended performance objectives, as stated in the fund's disclosure and marketing documents, are even more diverse in nature.

Some of them include non-index related objectives such as "X% return with half the volatility", "X% return above the risk-free rate while minimizing drawdowns", "maximizing upside returns and minimizing downside potential", "X% annual income return plus X% annual capital gains, on average over a market cycle", "maximizing the harvest of risk premia and carry while minimizing relevant drawdowns", "absolute return", "maximize risk-adjusted returns and low correlation to traditional asset classes", "targeted returns between X% and Y% while keeping volatility between A% and B%", "equity-like returns with fixed income-like volatility", "double/triple NAV every N years", "maximize (or targeted) returns with a maximum X% downside on a monthly and/or yearly basis", "equity-like returns with some downside protection", some illiquid strategies state a "N-year net annual return of X%", some quant-centric strategies only state a specific volatility target with no performance objective while others have no stated performance objectives.

Some funds do state index-related returns such as "net returns outperforming the relevant index with half the volatility", "net returns outperforming the relevant index with half the downside, or plainly "outperforming the index".

Performance objective explicitly stated by hedge fund managers do derive from their approach and philosophy, let alone asset class, geography, sub-sector and strategy classification. These performance objectives ulyimately dictate the criteria for portfolio inclusion, exclusion, investment horizon, tolerance to losses at the position and portfolio levels, hedging parameters, as well as portfolio net and gross exposure calibrations.

Understanding the diversity of hedge styles and sub-styles, their relevant and wide spectrum of performance objectives and derived approach and philosophies only further alienates the justification of the S&P500 index as a relevant proxy.

The Alternative Investment Management Association (AIMA) recently published "Apples and Apples: How to better understand hedge fund performance". It is an educational guide to address and counter the marketplace confusion relating to hedge fund performance. The guide says comparing hedge fund performance to the S&P 500 can be an "apples and oranges" comparison. The guide also proposes the following five steps to improve understanding of hedge fund performance:

1. Look at risk-adjusted returns: annualized 5, 10, and 20-year returns and risk-adjusted returns for hedge funds as a whole outperform the S&P 500 on a risk-adjusted basis.

2. Look at long term data: short term data can create confusion and usefulness increases with longer term data points because hedge funds tend to better preserve capital during drawdowns vis-à-vis long-only investments.

3. Look at the returns by strategy: the aggregated hedge fund indices are extremely diverse and are often irrelevant to investor's portfolio real exposures.

4. Compare with the most relevant asset class: such as equity long short versus the S&P 500 and the fixed income strategies versus bond indices.

5. Be aware of differences between hedge fund indices: average versus asset-weighted and using open versus closed funds or investable versus non-investable indices.

The hedge fund community itself also bears part of the responsibility for the recurring headlines comparing its monthly and year-to-date returns to the S&P 500. Some of the blame stems from the fact that the bulk of hedge fund managers have a long-only asset management background where the performance objective was to outperform a reference index. Many of these managers have retained a "relative return" philosophy and mindset in the deployment of their hedge fund strategy. They have basically transposed their existing Alpha-seeking process into a long-short portfolio context labelled as "hedge fund".

However, there is another segment of the hedge fund community that did not emerge from a relative return or Alpha-seeking background. These are the Absolute Return managers that previously deployed their strategy on the Bank's proprietary trading desks. Their returns were not measured in terms of percentage or relative return basis. Their returns were measured on an absolute monetary basis, given a pre-determined and limited risk allowance. These managers basically continue to deploy their absolute return strategies but as entrepreneurs rather than proprietary traders. They continue to benefit from a bank's balance sheet through a prime brokerage agreement rather than through an allocated risk budget.

The above two groups represent the bulk of the hedge fund managers' population. The first, being those who are operating within a relative return or Alpha-seeking mindset. The second represents those operating within an absolute return framework.

The AIMA's education guide to address and counter the marketplace confusion relating to hedge fund performance may be appropriate to the first group. Essentially, these managers are typically seeking to harvest some form of Alpha within a pre-define asset class; and this, within a deliberate risk mitigation framework to control unwanted risks and relevant drawdowns. The manager's ability, talent and persistence to derive high-quality returns within a risk mitigation framework can be assessed and confirmed through numerous and existing quantitative tools.

However, the guide may not entirely apply to the second group who is seeking to generate absolute returns. Essentially, they are seeking to harvest upward and downward directional price movement opportunities from a pre-define array of tradable financial instruments.

Very few, if any, acceptable quantitative tools are available to effectively evaluate and confirm a manager's ability and persistence to generate high-quality absolute returns. And this is what my next article shall explore.

