How absolute are hedge funds returns?

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6 January 2011

The term “absolute returns” has been battered and ridiculed as well as misused by business and politics alike. Clarification is in order. The basic idea behind the term is to compound capital positively over the long-term. The term stands for an investment philosophy that stands in stark contrast to the relative returns doctrine and financial orthodoxy. And that’s a good thing.

Active risk management is the key to the kingdom

The term “absolute returns” stands for an *investment philosophy* that is quite the opposite from the relative return investment philosophy of benchmarking and indexation.[1] At the most simplistic level, absolute returns means making money when things go well and not giving it all back when things do not; or, put differently, compounding capital positively over the long-term. This definition refers to absolute return strategies executed for example by hedge funds as well as capital guaranteed structured products or strategies, where the maximum loss is limited through risk management tools and techniques.

The term “asymmetric returns” describes the *implementation* of the absolute return investment philosophy.[2] The idea of *asymmetric returns* takes into account the preference for positive returns over negative returns, prominently publicised by Kahneman and Tversky (1979). The “asymmetric” in *asymmetric returns*, therefore, suggests a preference for many and large *positive* returns, while trying to avoid *negative* returns, especially large ones. The key "insight" is that large losses are not good for one's financial and mental health, as they kill the rate at which capital compounds. A loss of 50% requires a return of 100% just to breakeven.

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1 See for example Ineichen (2003)

2 The term “asymmetric returns” in relation to “absolute returns” was first used in Ineichen (2002).

The “absolute return” moniker has been abused

Table 1 shows an attempt to distinguish between relative and absolute returns. Note that if a long-only fund is re-branded to include the “absolute returns” moniker, it does not mean that it is indeed an absolute returns vehicle. A TAA (tactical asset allocation) program that is fully invested at all times also doesn’t fit the premise of an absolute return vehicle. Buyers beware. A lot of mischief has been done with this term.

Table 1: Difference between relative return and absolute return model

	Relative-return models		Absolute-return model
	(Indexing)	(Benchmarking)	
Return objective	**Relative returns**		**Absolute returns**
General idea is to	*Replicate benchmark*	*Beat benchmark*	*Exploit investment opportunity*
Risk management	**Tracking risk**		**Total risk**
General idea is to	*Replicate benchmark*	*Beat benchmark*	*Preserve capital*

Source: Ineichen (2001)

The return objective of a relative return manager is determined by a benchmark. An index fund aims to replicate a benchmark at low cost while a benchmarked manager tries to beat the benchmark. In both cases the return objective is defined relative to a benchmark, hence the term “relative returns”. A relative return manager losing 50% of his investors funds (with their own money, relative return managers subscribe to the absolute returns philosophy too) with the benchmark falling 52% did actually quite well. Many investors started to question this relative return investment philosophy when equity markets did indeed fall by 50%; a thing that actually happened twice in the last decade. Hedge funds do not aim to beat a market index. The goal is to achieve absolute returns by exploiting investment opportunities while staying alive.

Benjamin Graham was once quoted saying: “The essence of investment management is the management of risks, not the management of returns.” Investors cannot “manage returns”, there is no such thing as “return management”. Risk, however, can be managed. The difference between the two models in Table 1, in terms of how risk is defined and managed, is therefore very important. Defining risk as tracking risk means that the risk-neutral position of the manager is the benchmark and risk is perceived as deviations from the benchmark. For instance, a benchmarked equity long-only manager moving from equities into cash (yielding the risk-free rate[3]) is increasing risk as the probability of underperforming the

[3] An argument can be made that there is no such thing as a risk-free rate.

benchmark increases. In the absolute-return space, the risk-neutral position is cash. A move from an equity long position into cash means reducing risk as the probability of losing money decreases. The same transaction, moving from equities into cash, can mean both increasing as well as decreasing risk, depending on how risk is defined.

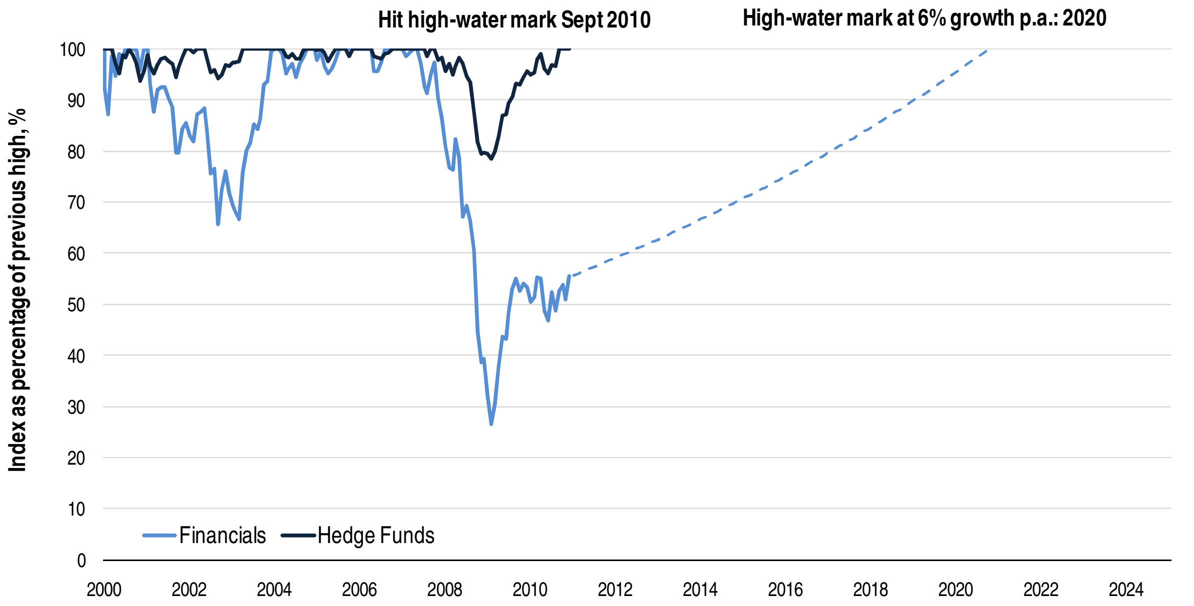
Put simply, under the absolute-return approach, there is an investment process for the upside (return-seeking by taking risk) and for the downside (some sort of contingency plan if something unexpectedly goes wrong or circumstances change, etc). Absolute-return investing, therefore, means thinking not only about the entry into a risky position, but also about the exit. Protecting the investor's capital is part of the value proposition. An absolute return strategy, therefore, can be viewed as the opposite of a long-only buy-and-hold strategy.

Note that "investor protection" is not the same as protecting the investor's money. Regulation, transparency and a market benchmark protect the investor. However, with the relative return approach, the investor's principal is not entrusted to a fiduciary who tries to preserve it in difficult times but whose mandate implicitly or explicitly dictates that the principal is exposed to the full extent of market volatility – the volatility of the market benchmark. This exposure has been considered acceptable, at least up until 2000, because the wealth protection function was held by the end investor and because of some strong-held beliefs with respect to return expectations, diversification benefits and investment processes during the long bull market. The last decade has—and this is putting it mildly—softened many beliefs that had established themselves in investor's minds during history's greatest equity bull run in the two decades prior to the last.

Absolute returns investors want to compound their capital positively. This means "risk" is simply the opposite, i.e., the prospect of compounding capital negatively. In other words, it is not tracking risk or volatility that matters, it is losses—or, more precisely, the avoidance or minimisation of losses—that should be the focus of the risk management process. It is sustainable and/or large losses that kill the rate at which capital compounds.

Chart 1 shows two indices as a percentage of its previous all-time-high. This format allows visualising the extent of the losses as well as the period it takes to recover the losses. The unhedged investment style (relative returns doctrine) represented through the light line in Chart 1 has compounded at 1.0% per year from January 2000 to December 2010 while the hedged investment style (absolute returns investment philosophy), the dark line, compounded at 6.5% per year. This is a big difference. If all goes well and everything compounds at 6% the unhedged investment style will reach high water mark during 2020 and would have been under water for 13 years, not unlike the Japanese stock market which is currently in its 22nd year under water.

Chart 1: Financials versus hedge funds (Jan 2000 – Dec 2010 with assumed 6% CAGR)



Source: Ineichen Research & Management, Bloomberg

Financials: S&P 500 Global 1200 Financials; Hedge funds: HFRI Fund Weighted Composite Index. The dotted line shows an estimated path for recovery assuming 6% compound annual growth rate (CAGR).

Derek Bok, former dean of Harvard University, was once quoted saying “If you think education is expensive, try ignorance.” Looking at Chart 1 we could rephrase and argue “If you think hedge funds are risky, try stocks.”

Conclusions

The term “absolute returns” as well as the term “hedge funds” were not only cause for disappointment during the financial crisis but also have been ridiculed as being ill chosen terms or a misnomer. After all, the returns in 2008 were not “absolute” and the funds were not perfectly “hedged”. We beg to differ. The term “absolute returns” is a good term when associated with a proper active risk management process. (A risk management process should not be confused with a risk measurement process.) The term stands for an investment philosophy that aims to compound capital over the long-term while surviving financial accidents and controlling for losses—especially large ones—on the way.

Literature

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