Hedge Funds: Bubble or New Paradigm?

The Asset Management Industry is Leaning Towards Absolute Return Objectives and Risk Management

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Abstract

To some, hedge fund investing is a bubble, to others absolute return strategies is a New Paradigm in asset management. Reality is probably somewhere in between. On one hand expectations of high positive absolute returns from hedge funds when equity markets fall are probably too exaggerated. On the other hand, the focus on positive absolute returns and defining risk in a value-at-risk context might be in the process of replacing the relative return approach.

Bubble or New Paradigm in Asset Management?

Bubble Theory

Some market observers view the increasing allocation to hedge funds as a bubble. More and more authors, experts and analysts expect the hedge fund bubble to burst any time soon.[2]

A bubble exists when investment horizons expand, expectations skyrocket, and everyone does the same thing at the same time. In other words, bubbles occur when the consensus view with respect to expected returns increases and investors cuddle in the comfort of the consensus view and de-emphasise sound research, due diligence and logical economic reasoning. The South Sea Bubble, Tulip Mania and the Internet Bubble were good examples of this pattern. In all cases, expectations slowly diverged from fundamentals. The bubble bursts when expectations converge with reality.

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[2] See for example 'Hedge Funds – The latest bubble?' *The Economist*, 1 September 2001; 'SEC's Paul Roye Issues a Warning About a Hedge Fund 'Craze', Bloomberg News, 23 July 2001; 'The $500 Billion Hedge Fund Folly,' *Forbes*, 8 June 2001; 'The Hedge Fund Bubble,' *Financial Times*, 9 July 2001; 'Hedge Funds May Become the Next Investment Bubble,' Bloomberg News, 30 May 2001. Not all articles are equal in terms of substance (assuming we are in a position to judge).

New wine in old wineskins?

One of the main arguments for institutional investors investing in hedge funds is portfolio diversification. This, in essence, means reducing the expected volatility of portfolio returns without compromising expected returns. Adding asset classes with expected returns that have low correlation with traditional asset classes increases the efficiency of the portfolio.[3] To some this might be like new wine in old wineskins. A few decades ago, investing in emerging markets was marketed as a new asset class with low correlation to assets in the developed world. Experiences in the 1990s have aligned the hype with reality. The obvious question is whether investing in hedge funds will suffer a similar fate. It is possible that diversification benefits are currently overestimated. Only a small segment of the hedge fund universe has low correlation with equities. It is debatable whether the industry as a whole can decouple completely from trends in equity markets or the whole economy.

Short-termism – a Red Herring?

Every evolving industry goes through times of rapid change and innovation. Increased specialisation seems to be one of the constant variables in the field of

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[3] Note that hedge funds are also viewed as asset managers employing an alternative investment strategy within a traditional asset class (as opposed to be an asset class of there own). For example: a long/short portfolio is a different way of trading equities than a long-only portfolio.

investment management. In the early stages of the asset management industry, a single manager managed a balanced portfolio. Then equities and bonds were separated. Then equities were split into value and growth, or active and passive, or domestic and international, or developed and non-developed markets. The increased acceptance and current institutionalisation of hedge funds could be viewed as a further specialisation of the asset management industry between skill-based and market-based strategies.[4] However, we do not believe that all of the recent developments are positive. Any investment that is fashionable has a tendency to attract short-term investors. Short-term investors have a tendency to buy last year's winners and have a less disciplined and rigorous investment process. This could have a negative impact on the industry if there is a sudden and unexpected mismatch between expectations and reality.

Currently, a gap is potentially opening between expectations and reality. Given the strong inflow of assets to hedge funds, some market observers are asking whether the inflows into hedge funds are decoupling from realistic expectations, ie whether there is a pattern of a bubble in progress. In other words, is the hedge fund boom a bubble?

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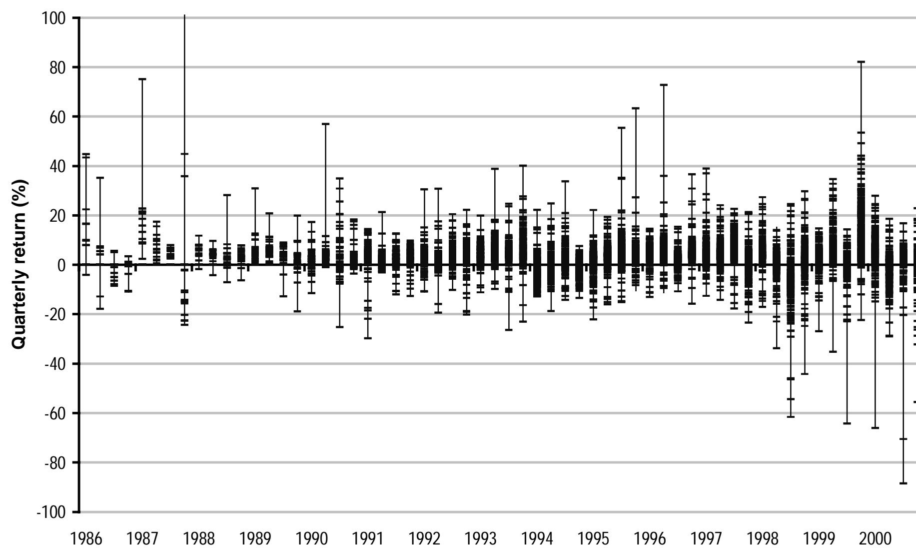
[4] The performance of skill-based strategies is attributable to the manager's skill. The performance of market-based strategies is attributable to the return of the market.

If it is a bubble, it probably would not be comparable with the bursting of the internet bubble, where losses were in the region of 80-100%. The first step could be an increase in dispersion of hedge fund returns. This is probably already happening.

Chart 1: Dispersion of Fund of Funds Returns (1986-2000, Quarterly Returns)



Source: Quellos

Chart 1 shows an increase in dispersion among fund of funds managers in recent quarters. This is, to some extent, a function of the increase in the number of funds of funds (or hedge funds for that matter). The increase of the number of hedge funds and funds of funds, however, is part of the problem. The increase in supply and demand is resulting in an absolute reduction of quality, especially among lower quartile funds or funds of funds. Consequently, the dispersion between top and low quartile hedge funds or funds of funds widens.

In addition, the hedge fund industry as a whole has a long equity bias. The absolute returns of the 1990s are unlikely to be matched in the 2000s when equity markets compound at 0-5% in the 2000s instead of 10-15% as in the 1990s. In addition, volatility has been relatively high over the past five years. Lower volatility would mean fewer exploitable inefficiencies and fewer opportunities. Lower hedge fund performance in the 2000s, therefore, could potentially also realign expectations with reality. This realignment could happen gradually or instantaneously. A number of catalysts could be found for an instantaneous correction, ie a crash. These catalysts might include market dislocation, regulatory change, corporate governance breakdown or any other extreme event. However, these events are, by definition, not foreseeable. We, therefore, regard a gradual realignment of expectations with reality as the more likely scenario than a bubble bursting à la internet.

Private equity has recently experienced such a realignment of expectations. Since the internet bubble has burst, exit strategies have become much more difficult. Many late 1990s vintages have single-digit IRRs to date. The vintages of 1999 and 2000 (peak of the TMT frenzy for venture capital funds could turn out to become what 1998 was for hedge funds. High demand led to a dispersion of performance. We believe that today the consensus view is that private equity only yields high risk-adjusted returns if one invests with the first or second quartile managers. Just being long the asset class is not enough.

This could happen to the hedge funds industry. Not a collapse as in internet shares but a realignment of expectations with reality. In the long-term, such an adjustment is desirable. An adjustment could strengthen the business case for fund of funds managers. If the alpha in the hedge fund universe can only be unlocked through market participants with a competitive advantage, but not by simply being long or through random selection, then the case for funds of funds is strengthened.

What is a New Paradigm?

The opposite view of the current trend of hedge fund investing being a fad ending in the bubble bursting is the view that absolute return strategies involving risk management techniques is a new paradigm in asset management.

Paradigm shifts happen when there are anomalies – disparate odd results that cannot be explained away by inadequate methodology alone. When sufficient anomalies occur, any street-smart individual, one could postulate, must begin to consider that the paradigm under which they are doing their work is no longer of use or is actually dysfunctional. Thomas Kuhn (1962) defines a paradigm shift as:

> "[Individuals who break through by inventing a new paradigm are] almost always…either very young or very new to the field whose paradigm they change…These are the men who, being little committed

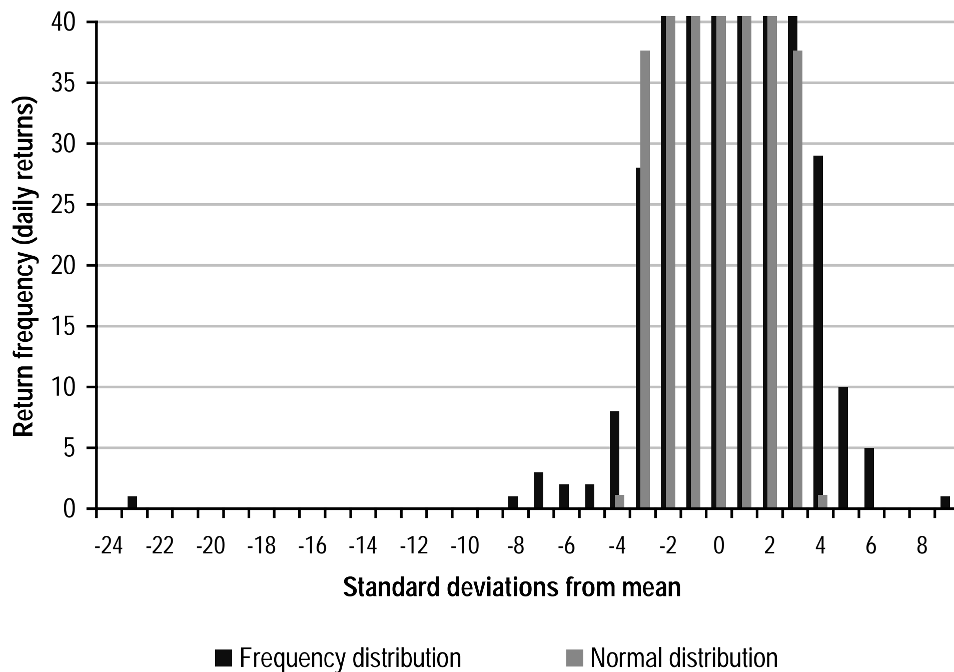
> by prior practice to the traditional rules of normal science, are particularly likely to see that those rules no longer define a playable game and to conceive another set that can replace them."

Although Thomas Kuhn's quote fits with the young, energetic, unconventional median hedge fund manager, declaring hedge funds as new paradigm might be stretched. However, the investment management industry is a continuum and subject to change. Two changes in recent years are particularly worth pointing out. First, the perception of risk has changed. Market participants have begun to examine and analyse the downside tail of the return distribution more closely. This is a departure from being satisfied with mere statistical variance of returns as a measure for risk. Second, portfolio management is mutating into risk management. Long-held methodologies and investment styles are gradually being replaced with more scientific approaches and tools to manage money, assets and risk.

Perception of Risk

Since 1987, the far left-hand side of the return distribution has been getting more attention. The October 1987 crash was probably the main catalyst for investors to start observing and modelling the far left-hand side of the return distribution more carefully. Chart 2 shows the distribution of returns of the S&P 500 index on a daily return basis.

Chart 2: Frequency Distribution Based on Daily Returns



Source: Datastream, UBS Warburg calculations
Based on daily log returns from January 1969 to 20 July 2001
Note that *y*-axis has been capped to make outliers visible.

Since 1969 there have been three occasions when the daily S&P 500 returns were larger than seven standard deviations from the mean. Note that there are outliers on both sides of the mean.

Outliers have a great influence on the risk of the venture, in this case investing in equities. These outliers, by definition, are not foreseeable. Any argument to the contrary must derive from a model with an R2 of 1.00 (Bernstein 1999). However, there is no such thing. Decision making with respect to the future will always involve uncertainty regardless of the approach used (fundamental economics, technical analysis, market psychology, astrology, etc). What we

know for sure about equity markets and their volatility is uncertainty itself. There will always be uncertainty.[5]

The above statement is not as fatuous as it may sound. It raises the question of what a money manager should focus on in the long term: expected return or risk. Looking at the world from the view of a risk manager it is obvious: risk. A risk manager would argue that one cannot manage expected return, but one can manage risk. Return is the byproduct of taking risk. Banks today do not manage portfolios, they manage risk. Their long-term investment strategy is to define the risk they want to be exposed to and manage that exposure accordingly. This implies that banks have an absolute-return focus as opposed to a relative-return focus. Potentially, asset management could be in the process of moving in the direction of banks and hedge funds, ie defining risk in absolute terms rather than relative terms. One could also argue that the asset management industry is moving back to an absolute return orientation and that the passion with market benchmarks was only a brief blip in the industry's evolution, driven perhaps by an increasing involvement of consultants and trustees.

Is the Asset Manager's Business Model Changing?

Contrast business models A and B in Table 1.

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[5] Or as John Maynard Keynes has put it: "It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain."

Table 1: Two Different Business Models in Asset Management

	Business Model A (market-based)	Business Model B (skill-based)
Return objective	Relative to benchmark	Absolute, positive return
This means:	***Capture asset class premium***	***Add value***
Risk management	Tracking risk	Value at risk
This means:	***Capture asset class premium***	***Avoid destroying value***

Source: UBS Warburg

The main difference between hedge funds and traditional long-only manager is the absolute return objective. Hedge funds, like banks, define their return objective in absolute terms, ie, not relative to a market or peer-group benchmark. In addition, risk is understood as the probability of absolute losses, ie, destruction of value. A long-only manager, also referred to as a relative-return manger, defines success and failure relative to a benchmark. A point can be made that this approach stems from a time where capturing the asset class premium (exposure to beta) was scarce. Given the huge diversity of indexed funds and derivatives this is not the case any more – at least not in information-efficient markets such as large cap equity markets in the developed economies.

One could argue that anything that survived the wars, turbulence, crises and market volatility of the 1990s has a high probability of sustainability. What might disappear is the term 'hedge fund.' The term 'hedge fund' is, to some extent, a misnomer. Not all hedge funds are 'hedged.' However, the first hedge fund managers did not want their professional destiny and wealth to be

dependent on chance, ie market risk.[6] That is the reason why the first hedge funds hedged market risk in the first place. Their goal was to hedge their exposure to chance and volatility and to ensure that performance was attributable to skill (stock picking).

In addition, the term hedge fund is also, to some extent, contaminated. The term 'hedge fund' suffers from a similar fate as 'derivatives' due to a mixture of myth, misrepresentation, negative press and high-profile casualties in the 1990s. The reputation of derivatives has improved because parts of the writing guild have found a new product to demonise: hedge funds.

Hedge funds are already in the process of being institutionalised. The traditional asset management industry has already started to offer what can best be described as absolute return strategies. The main characteristic of absolute return strategies is that the benchmark is cash. The more successful ventures have proven to be highly profitable for the launching asset management firm. In other words, the separation between skill-based and market-based strategies in the asset management industry has already begun.

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[6] This is based on the assumption that market timing is about as difficult long-term weather forecasting. Both, weather as well as an economic system, are complex and their future, therefore, is best described through a probability distribution.

Skill-based strategies are active while market-based strategies are passive approaches to money management. We believe that institutional investing in skill-based strategies will continue to gain momentum due to two trends. First, the focus on absolute returns and the fact that failure is defined as destroying value causes some strategies utilised by hedge funds to perform significantly better than traditional strategies in falling capital markets. With investors accepting the fact that returns are not normally distributed (ie have fat tails) and the fact that negative utility from falling markets is higher than positive utility from rising markets, we expect an increasing number of institutional as well as private investors to acknowledge the benefits from investing in skill-based strategies.

Second, trying to beat an informationally efficient market, in what Charles Ellis (1998) calls 'The Loser's Game', might prove too mundane a strategy in the competitive environment of institutional asset management. A move away from traditional views and strategies should enlarge the scope for alternative views and strategies. This could result in a departure from simple capital markets indices to more tailored benchmarks that take into account idiosyncratic asset and liability characteristics. This could flatten any hurdles in the path of investing in what today are referred to as 'hedge funds.'

A market benchmark changes the incentives of the manager to become diametrically opposed to those of the investor. We believe that the majority of investors see the disadvantages of limiting alpha generation by constraining a manager with a benchmark. Introducing a benchmark caused a lemming-like effect with indexation and what some refer to as closet-indexation. Closet-indexation or ‘hugging’ the benchmark means that most positions in an active portfolio are held to track the benchmark – often referred to as dead weight. Dead weight in a portfolio results from securities owned into which the manager has no insight. The proportion of the portfolio that is held to control residual volatility (volatility relative to the benchmark) is the proportion that will add no value.

Hedge funds carry less dead weight and therefore manage invested capital more efficiently. In a hedge fund, in general, only positions about which the manager has conviction will be held or sold short. Portfolio volatility and higher-moment and residual risks are controlled with risk management instruments or other hedging techniques, most of which require less capital than holding dead weight positions in the cash market. Consequently, a higher proportion of the hedge fund manager’s capital is invested in positions about which the manager has convictions. Hedge fund managers, therefore, should be able to provide higher alphas, since relative outperformance against a benchmark is not the primary objective.

Absolute-return strategies are unlikely to replace relative-return strategies. One can view benchmarking as protection against unskilled managers. A relative-return manager might be more suitable than an absolute-return manager if an investor has little time, inclination or ability to distinguish skill from luck from a portfolio manager. Benchmarking means that the manager cannot make investments that go horribly wrong – either by lack of skill or by bad luck. The dispersion of returns is small with relative return managers (and a function of the tracking error constraint given by the sponsor) and high with absolute return managers. By defining a market benchmark and a tracking error band, the plan sponsor gives the manager a risk budget in which he is expected to operate.

Indexation and its modified variants (smart indexation, enhanced indexation, etc.) have many followers. One of the main advantages of indexation is its lower cost and subsequently superior performance. Fees are generally lower with passive investments. If 80% of an active manager's positions are dead weight, then the portfolio is essentially 80% passive and 20% active. This means that a 50bp fee of funds under management is actually 250bp of the active portion. Hedge funds typically charge higher fees than long-only managers. However, the difference is not as extreme once the dead weight is taken into consideration. In other words, indexation (index funds, total return swaps) are the most cost-efficient form of getting exposure to a market. The ex-ante alpha is zero. Investing in hedge funds is, in theory, about getting (and paying for) alpha without getting beta (market exposure) that can be obtained

elsewhere more cost efficiently. In other words, long-only asset management with a benchmark is a hybrid of the two extreme forms of asset management.

Some take these arguments a step further. David Swensen (2000) argues:

> "If markets present no mispricings for active managers to exploit, good results stem from luck, not skill. Over time, managers in efficient markets gravitate toward closet indexing, structuring portfolios with only modest deviations from the market, ensuring both mediocrity and survival.
>
> In contrast, active managers in less efficient markets exhibit greater variability in returns. In fact, many private markets lack benchmarks for managers to hug, eliminating the problem of closet indexing. Inefficiencies in pricing allow managers with great skill to achieve great success, while unskilled managers post commensurately poor results."

On the most general level, investing in hedge funds is about alpha, investing in long-only funds is mixing alpha and beta (with a limit on tracking error), and pure indexation[7] is all about beta.

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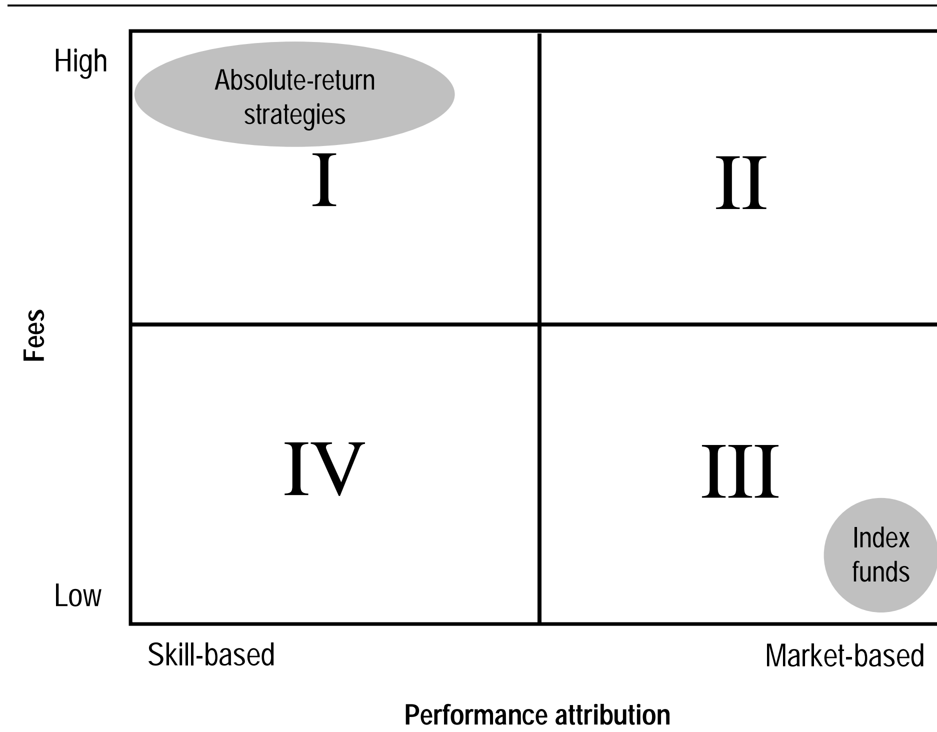
[7] The pure form of indexation (zero tracking error tolerance) is being replaced by less constrained forms of passive investment styles.

Alpha-generating strategies are normally skill-based strategies. If the flexibility of the manager is reduced to zero, the ex-ante alpha is zero as a result. However, as with every other industry, the asset management as well as the hedge fund industry will most likely transform (or converge) over time. A possible future scenario is that those asset managers with a competitive advantage will be offering skill-based strategies. One of the pillars supporting this belief is that a competitive advantage, to some extent, is determinable in advance whereas the path of a market is not. A firm with prudent, intelligent, experienced and hardworking managers will have an advantage over a firm with fraudulent, uneducated hooligans. However, if both follow a long-only strategy in an information-efficient market, the latter can outperform the former due to luck.

In Chart 3 below we have tried to classify the most active and most passive investment styles into a two-dimensional grid, where the vertical axis is the level of fees and the horizontal axis the performance attribution. Absolute-return strategies are in quadrant I: fees are high and performance is, in theory and to some extent practice, determined by the manager's skill. The other extreme is quadrant III, where margins are low and performance is attributed to the market.

Chart 3: Different Business Models



Source: UBS Warburg

Not only is there a trend for specialist strategies in quadrant I but also for passive forms of investing (quadrant III). Greenwich Associates estimates that 38% of institutionally held assets in the US are indexed. Watson Wyatt estimates that the degree of indexation is 25% for the UK, 20% for Switzerland and 18% in the Netherlands, with the rest of the world in the process of closing the gap.

The reason for the increase in passive investment alternatives is primarily cost and, ultimately, performance. In price-efficient markets, passive strategies are cost-efficient. A cost-efficient investment vehicle is, ceteris paribus, superior to a cost-inefficient alternative. Passive strategies have become available outside

the US only in the past couple of years as the liquidity in equities outside the US has increased. Increasing liquidity reduces the cost of execution and therefore increases the number of alternatives to get market exposure.

Strategies in quadrant II might be facing tough times ahead. Those strategies stem from a time when there was no passive, ie cost-efficient, alternative. Today even retail investors can participate in developed markets on a cost-efficient basis through ETFs or market-replicating delta-one investment vehicles. A point could be made that asset managers currently in quadrant II will have to migrate either into quadrant I or III. Remaining in quadrant II might not be a sustainable option. No one inhabits quadrant IV and probably never will, as alpha will always trade at a premium.

In the Anglo-Saxon biased investor universe this is already happening through the core-satellite approach, where the core is passive and active satellites are added. These satellites are mandates given to managers operating in areas where the market is less price-efficient and there is no cost-efficient passive alternative.

Conclusion

Two changes in recent years have changed the landscape of institutional investment management. First, the perception of risk has changed. Market participants have begun to examine and analyse the downside tail of the return

distribution more closely. Second, portfolio management is mutating into risk management. Long-held methodologies and investment styles are gradually being replaced with more scientific approaches and tools to manage money, assets and risk.

Whether hedge funds are a bubble or new paradigm in asset management is open to debate. However, it is difficult to imagine that what today is referred to as a ‘hedge fund’ – searching for alpha while managing risk – is a short-term phenomenon.

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