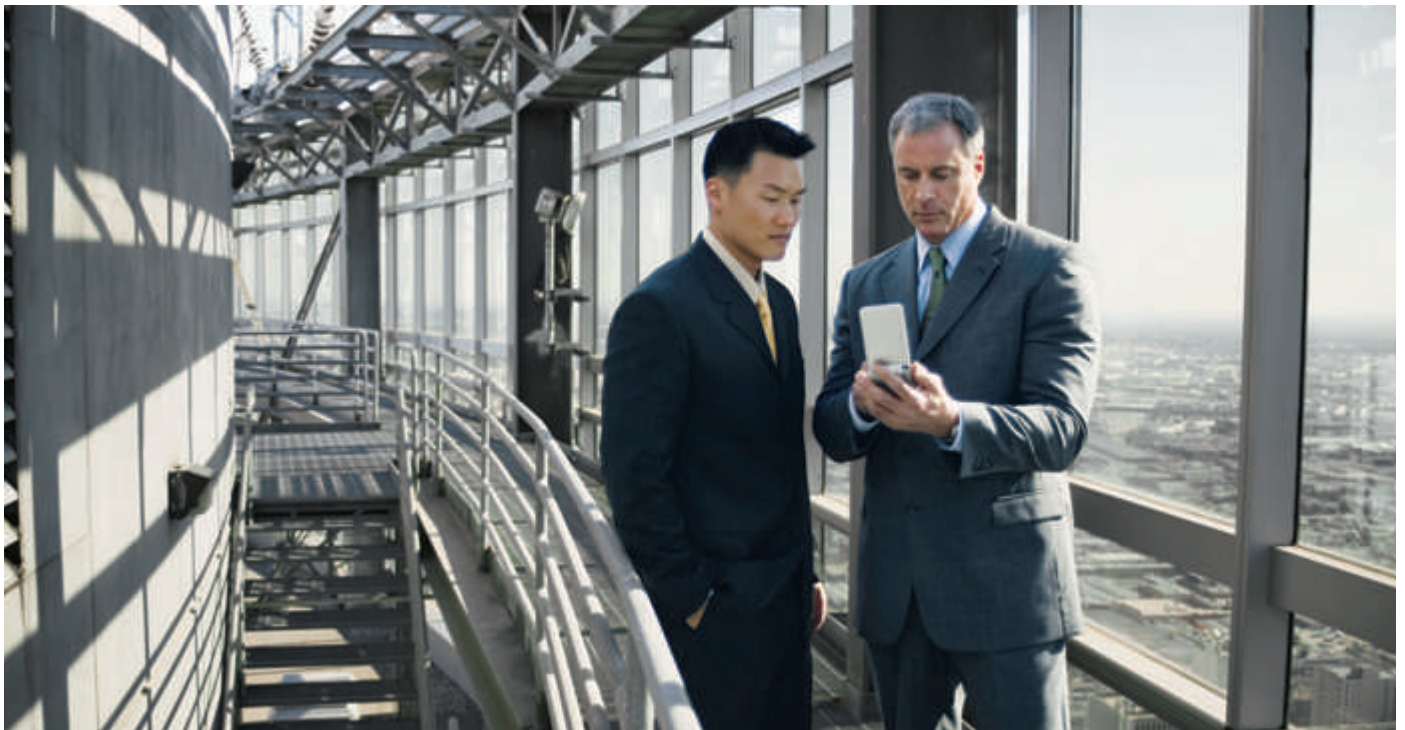


EXPLORING THE HEDGE FUND UNIVERSE

With an increasingly crowded marketplace, the challenge in hedge fund investing will be identifying new market inefficiencies.



As institutional investors seek to better manage their liabilities, diversify their portfolios and generate alpha, they increasingly are considering hedge fund strategies. However, the rush of institutional investors into the space could potentially create a dearth of opportunities.

Consensus estimates indicate that U.S. institutional investors will increase hedge fund allocations from about \$60 billion in 2006 to \$300 billion within the next five years. As more managers crowd into similar hedge fund strategies, the market

inefficiencies that initially made those strategies attractive to investors have begun to disappear and returns have ultimately started to diminish.

In addition to the potential scarcity of return opportunities, investors will face the challenge of identifying real manager skill in generating alpha. "Institutions looking at strategies such as portable alpha should be careful that what they're getting is truly alpha. That is, unsystematic, or idiosyncratic, returns, rather than systematic returns," says Ken Stemme, director of hedge fund investments for Northern Trust.

What's purported to be alpha often results simply from the fact that it's difficult, if not impossible, to benchmark hedge fund managers, Stemme says. "How do you replicate the universe of the convertible bond arbitrage manager, for instance? With an irrelevant benchmark, any outperformance you see may not be true alpha because the strategy is not trying to manage to that index. Long-short managers are a good example because they often are gauged against the S&P 500 Index. But the S&P 500 is not a relevant benchmark for those because it doesn't take into account shorting strategies."

In order for investors to unearth the true sources of alpha in a hedge fund strategy, "you have to do a lot more work deconstructing alpha to make sure it's coming from uncorrelated returns rather than a veiled source of beta," Stemme notes. "That's what these managers are being compensated for. It's a challenge to get under the hood of a hedge fund and understand what's driving its return. You need to identify how much return is position-specific, how much is coming from the overall market and what's driving each market."

Lori Runquist, senior alternative investments specialist for Northern Trust, reiterates this point. "If investors can obtain the beta exposure of the equity markets for single-digit basis points, they are not going to pay 2% management fees plus 20% of profits for absolute-return strategies that represent beta rather than value-added alpha," she notes.

Finding New Hedge Fund Opportunities

"In the past, hedge fund managers were truly opportunistic," Runquist says. "As the industry has grown and there have been attempts to codify the strategies, managers are increasingly trying to conform to a sort of mythical industry standard. But as more managers start to mimic these standards, the inefficiencies originally found within the strategies dissipate partly due to managers pouring too much money into those strategies."

Investors looking to exploit true inefficiencies in uncultivated markets will have to move away from crowded U.S. markets and adopt an increasingly global perspective. Hedge funds are not static vehicles like large-cap or small-cap stocks, Stemme notes. U.S. equity markets are the most efficient markets in the world, and therefore, the hardest place to generate alpha. So where are the new opportunities? Both on the long and the short side, there's more inefficiency in Europe and Asia, he says.

"The opportunities lie where managers can apply their research skills to generate alpha — that unsystematic return — and get compensated for the risk they're taking," Stemme says. "Inefficient markets include asset-backed lending, Asian restructurings, European bank debt, weather-related derivatives, water rights trading, carbon trading and energy derivatives."



"The fund-of-funds approach, compared with the direct route, typically means more liquidity, along with better communication and disclosure."

— Lori Runquist, senior alternative investments specialist at Northern Trust

"There's less money in those spaces," Stemme says, "and there are barriers to entry. That's where you'll find true alpha and where you're going to find real inefficiencies that are worth paying hedge fund fees."

Staying With More-Focused Strategies

As investors seek to diversify their portfolios, more hedge fund managers are turning to multi-strategy approaches, Stemme says. "While they have decided to allocate to hedge funds, investors don't want to make decisions to move in and out of strategies or suffer the volatility of returns," he explains. "So some managers, rather than limit themselves to distressed debt investing, for example, will position themselves as credit managers and play all along the credit cycle."

Although a multi-strategy approach allows more potential for stable returns, it also affects the portfolio's upside potential. Hedge fund managers are thought to possess some special skills, but the more that skill set is expanded, the more it's diluted.

An alternative to multi-strategy managers is to diversify hedge fund allocations within a fund-of-funds framework containing a collection of managers skilled in specific strategies. "The fund-of-funds approach, compared with the direct route, typically means more liquidity, along with better communication and disclosure," notes Runquist.

"Institutions have been more willing to go direct rather than going through an intermediary," Stemme says. "But several spectacular hedge fund collapses last year showed the danger of that. The key risk in hedge fund investing remains, not strategy risk, but manager risk."

As the hedge fund industry grows, Stemme says, there remains a wide dispersion of returns — even among managers who purportedly trade the same types of strategies. Return dispersion and challenges of manager research are two reasons institutions cite for choosing the fund-of-funds approach.

Stemme adds, "The successful investors in the hedge fund space will be those who integrate hedge fund strategies into their overall portfolio rather than as a separate slice of the asset allocation pie." ❖