

Intelligent Hedge Fund Investing: An Introduction

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By just about any metric, the assets allocated to hedge funds continue to grow rapidly. At the time this volume is being published, data for the calendar year 2003 is just becoming available. The approximate number of extant hedge funds is 6,700 (including 1,700 funds of funds), and the estimated total US dollar value of the assets of these funds is US\$725 billion (or more). The estimates provided here are according to TASS as reported by Reuters (2004). More interesting, perhaps, is the (changing) composition of the investor base. Traditionally, the majority of invested capital came from high net worth individuals (with greater than US\$1 million in financial assets). Merrill Lynch Cap Gemini Ernst & Young (2003) estimated that 60% of hedge fund investments came from such individuals in 2002. That percentage has been declining as institutional investments have been growing rapidly. Endowments have become a major source of funding. The National Association of College & University Business Officers (2004) estimated that, in 2003, about 13% of investment assets were allocated to hedge funds. A breakdown by size of endowment is shown in Table 1. Most recently, pension funds have begun to devote more attention to hedge funds. Surveying more than 1,000 pension funds and endowments in 2003, Greenwich Associates (2004) found a continued increase in planned allocations to hedge funds, with pension funds significantly increasing their targeted allocations from under 1% of assets

INTELLIGENT HEDGE FUND INVESTING

Table 1 Fiscal year 2003 average allocations (in pct)

Investment pool assets	Equity	Hedge funds	All other
Greater than US\$1 billion	44.8	19.9	35.3
US\$501 million–US\$1 billion	54.4	13.4	32.2
US\$101 million–US\$500 million	56.5	8.3	35.2
US\$51 million–US\$100 million	58.7	4.3	37
US\$26 million–US\$50 million	60.2	4.2	35.6
Less than US\$25 million	57.0	1.6	41.4

Source: National Association of College & University Business Officers
2003 Endowment Study of 705 institutions. Used with permission

to about 5% of assets. Greenwich Associates estimated that, in US dollar terms, this represents over US\$250 billion in allocations.

It's a risk manager's job to worry about potential danger signs. If a sudden, massive increase in demand for maple syrup were to materialise, the response in supply in the short term would be limited by production capabilities, and only by cutting corners or diluting quality, could significant new quantities be produced. Although there may be a better analogy, this one serves well enough. The production of "alpha" from hedge funds in the short run is not highly elastic. Many strategies don't scale well and there is no latent army of new, quality hedge fund managers. Furthermore, as the universe of hedge fund investors expands (the latest wave due to pension fund managers), lack of familiarity with the asset class becomes more prevalent.

For both these reasons, investors face obstacles to intelligent hedge fund investing which can only be surmounted with deeper understanding. One such obstacle is a lack of understanding of the characteristics of hedge funds that are different from other asset classes. The difference between the focus on hedge funds on absolute return, and the relative return focus that is ubiquitous in the mutual fund industry, is significant. Trading on the short side in addition to the long side is another important attribute of hedge funds. The nature of manager compensation and the fiduciary relationship is another. The regulatory environment is also special to hedge funds. The diversity of strategies also belongs on this list. All these differences have implications for properly evaluating the asset class for asset allocation.

INTRODUCTION

The feasibility of properly evaluating the asset class is another obstacle. Hedge fund data, even those provided privately to prospective investors, have the potential to lead investors to incorrect decisions. For example, data can suffer from biases from return smoothing attributable to positions in illiquid securities. Data can embed biases from the process used to accumulate the data history. Even clean data can exhibit difficult properties. For example, departures from normality have been widely documented in hedge fund returns, meaning that measures such as Sharpe Ratios and tools such as Markowitz style portfolio allocation models may not work well.

The chapters in this volume focus on the questions that investors should be asking about hedge funds. The first goal of this volume is to illuminate the hedge fund landscape (so to speak), and thereby to identify the pitfalls to sound investment decisions. The second goal is to suggest a path (or paths) to help investors reach those decisions (such as performance evaluation and asset allocation). It is important to note that the research presented here is part of an ongoing process of discovery. Future research, building on the insights offered here, will continue to deepen our understanding of hedge funds.

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