

# Exclusive, And Increasingly Elusive: You Can't Judge A Hedge-Fund Index By Its Coverage

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**NEW YORK — More hedge-fund indexes are on the drawing board, and they're fundamentally different from those already in the market.**

Existing indexes measure the returns of hedge fund managers, sorted by the various types of strategies they pursue (equity long/short or convertible arbitrage, for example). The indexes with the most managers represented would seem to be the best reflection of this investment product, following the logic that the broader an index is, the more accurately it reflects the market it's measuring.

Trouble is, these broad indexes aren't investable because many funds in them—typically the best-performers—are closed to new investors. These indexes' juicy returns, which help lure investors to the product, aren't in fact attainable.

Hedge fund indexes that are investable simply limit their components to funds still open to new customers. The number of funds in them ranges from 145 in the MSCI Hedge Invest Indices, to 34 in the six Dow Jones Hedge Fund Strategy Benchmarks.

While these investable indexes have attracted several billion dollars of investment capital, they run far behind funds-of-hedge-funds, currently with about 40% of the estimated \$1.5 trillion in hedge fund assets. Funds-of-funds take investors' money and parcel it among the best fund managers they can find. In return for this diversification service, they collect a fee (generally, 1% of assets and 10% of returns, annually) on top of the steep fees (2% of assets and 20% of annual returns) charged by the hedge funds themselves.

## INDEX OF INDEXES

The new indexes on deck don't measure hedge fund returns at all. Rather, they aim to deliver high single-digit or low double-digit returns with portfolios of highly liquid investments, or by mechanically mimicking the trading tactics typical of certain hedge fund strategies.

In short, they cut the active manager from the investment process. Products tied to these indexes will be offered at fees far below the current going rate for hedge funds (though probably not as low as now charged by many index-based mutual funds and exchange-traded funds).

These indexes are described in a Merrill Lynch research report published in October. The first type springs from academic research that suggests hedge fund-like returns can be replicated "using liquid investments such as equities, bonds, currencies and commodities," the report said. The idea is to identify liquid investment vehicles that can be held long or sold short in various combinations and optimized to track, say, an index of real hedge funds.

Because asset classes are the foundation of this and every other investment strategy, the logical vehicles to use would be representative indexes on which liquid products—ETFs, futures and options, for instance—are based. It would be an index of indexes, in other words.

How would each component index be weighted? The Merrill report cites a 2006 academic paper from MIT's financial engineering school in which the weights of each asset were derived by analyzing rolling 24 months of hedge fund returns against returns for that asset class. Rules would be required to determine how often and to what degree the assets and their weights would be adjusted in the index of indexes.

## GAINING AN EDGE

Though the Merrill report doesn't indicate when or from whom such an index might be coming, the word is that Merrill itself is designing a product like this. Merrill confirms this in a statement responding to my inquiry: "Merrill Lynch has an investable index which emulates diversified hedge-fund exposure with complete transparency, low fees and

daily liquidity, with no direct investment in hedge funds.” Many others are busily doing the same, including a couple of professors who wrote some of the academic studies.

The second type—mechanically applying hedge fund trading tactics to real securities and indexing the result—has at least one identified developer. I was on a hedge fund panel recently at a London conference, and one of my fellow panelists announced that his bank, Julius Baer in Zurich, Switzerland, was building exactly such a thing.

In this approach, the object is “replicating similar strategies that hedge funds execute, using a systematic rules-based methodology instead of active management,” the Merrill report says. Both Merrill and the Julius Baer banker used the example of merger arbitrage to illustrate. “We might have a rule that says buy the stock of the target company and short the stock of the acquiring company,” the banker said.

What about picking which deals to invest in and those to steer clear of? The Merrill report suggests formulating rules “to decide which deals to buy with the belief that the lower costs required to follow these rules will more than offset the benefits of attempting to actively avoid those deals that will fail.” Merrill cites a 2001 study of 4,750 mergers over 35 years that found a passive strategy generated a risk-adjusted excess return of 4% annually after accounting for transaction costs.

## NEW AND IMPROVED?

What to make of these indexes? It isn't fair to be super-critical because we aren't privy to the details of their methodologies. But what we do know justifies a few comments.

First, both types seem to be predicated on the notion that hedge funds are an asset class delivering fat returns and that individual investors ought to have low-cost access to them.

The part about indexing being able to reduce costs is true enough, but hedge funds aren't an asset class. They're investment vehicles, akin to mutual funds, which take positions in a variety of assets in a variety of markets. It's misleading to think in terms of “exposure” to hedge funds in the same way a portfolio might have to stocks and bonds.

Of course, this brings up the question of why more investors are choosing to put more money in hedge funds. The “right” reasons are to diversify portfolios—hedge funds tend to have low correlations to stocks and bonds—and to reduce overall portfolio volatility. Their purpose is to hedge (thus the name) against adverse market moves in classic stock and

bond portfolios, which is why many institutional investors tend to limit their hedge fund investments around 10% or so of their overall assets.

The “wrong” reason is to chase returns. It's no accident that the big surge in hedge-fund investing occurred during the bear market earlier this decade and subsequent years of lackluster performance in stocks and bonds. But the big influx of capital and the proliferation of hedge funds being offered are reducing the number of market opportunities that can be exploited and squeezing the returns obtainable from those that remain. All of which leads us back to the stated rationale for creating these new synthetic hedge fund indexes: equivalent returns at lower cost.

Second, new risks are introduced, which the Merrill report, to its credit, acknowledges: “While there are benefits to replicating hedge fund returns with liquid instruments, there are also risks in that the statistical techniques must look in the past to estimate how hedge funds will behave in the future. If hedge funds change their investment style quickly, replicating portfolios may lag behind as they require a certain number of return observations in order to update their asset weightings. Also, there is a question of which tradable factors to include in the replicating portfolios and whether these factors need to change over time.”

As for mechanically imitating the trading techniques of certain hedge fund strategies, the risk is they won't work in all market conditions. Because they are methodologically frozen, they can't adjust to changing circumstances as an active manager can. Moreover, portfolios tracking these kinds of indexes will generate huge trading costs that will come out of investors' returns and, unlike management fees, are not predictable.

Both types of synthetics probably will deliver more volatility in their returns than real hedge funds. If so, this undercuts one of the reasons sophisticated investors appreciate hedge funds in the first place. If investments in these synthetics increase the volatility of the portfolios, it's imperative that they bring sufficient additional returns to justify the risk.

Third, these aren't hedge fund indexes, though they surely will be marketed that way. While it's true that market factors can explain a large part of the returns in certain hedge fund strategies (the Dow Jones Hedge Fund Strategy Benchmark indexes are built on this proposition) manager skill still accounts for much of a strategy's net return -- around 40% over the long haul. That's what will be missing from the synthetic indexes coming soon to a broker near you.