

Style Pure Hedge Fund Indexes Will Clarify These Popular but Opaque Investment Vehicles

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Since the inception of the first hedge fund in 1949, the four basic characteristics of this investment vehicle have largely remained unchanged. These characteristics are (1) the use of short selling to hedge risk, (2) the use of leverage to enhance return, (3) managers who are vested in the portfolio or investment strategy through the use of their own money, thereby sharing in the risks, and (4) the use of incentive fees that are used to keep the manager's focus on profits. Many hedge funds now also invest in distressed, thinly-traded or illiquid securities thereby capitalizing on the "illiquidity-risk" premium.

What has changed since the inception of the first hedge fund is the sheer size of the hedge fund industry. Today, more than 5,000 hedge fund managers use as many as 25 self-proclaimed hedge fund strategies to manage more than USD 1 trillion in these investment vehicles. A majority of this money is invested in about 10 strategies with the lion's share allocated to equity long/short.

Another feature of the industry that has evolved in the last 50 years is the increased focus on risk management issues. With increased allocation of assets to these alternative vehicles, investors have also demanded more transparency of the investment process; an increase in the frequency and precision of portfolio valuations; a more thorough understanding of hedge fund styles; and better measurement tools with which to benchmark their investments.

The hedge fund industry has invested considerable resources to satisfy some of the demands of their clients. The need for hedge fund benchmarks was fulfilled by objective, third-party measurers of the financial markets, such as index providers.

From the perspective of index providers, measuring the performance of a market – whose participants (hedge fund managers) historically have had no incentive to be benchmarked and/or compared to their peers – posed a challenge. In particular, measuring the performance of a set of investment vehicles whose NAVs were not only difficult to verify, but whose investment styles may not be as clear-cut as, say, equity and fixed income, made the task very difficult.

The secret lay in ensuring the “style purity” of components that make up the hedge fund strategies that are being measured and in obtaining an accurate snapshot of the NAVs of the components on a daily basis. The latter objective can be achieved through the implementation of a managed account structure to track assets.

Style purity is a prerequisite to benchmarking because the hedge fund industry is made up of managers that pursue many different strategies or styles. Only consistent style-pure managers pursue one and only one strategy across time and consequently are a good representation of that hedge fund strategy. If it is not possible to verify the style purity of a hedge fund manager, then that manager should not be contributing to the measurement of that strategy’s benchmark. This means that broad hedge fund indexes cannot be style pure, while fund-of-funds that focus on selecting outperforming managers are not very likely to be style pure.

Style-pure indexes ensure that an investor seeking exposure to a particular hedge fund strategy is able to obtain that exposure. Multi-strategy managers and/or managers that exhibit style drift may or may not provide exposure to the strategy the investor is seeking. This not only puts the investor at risk of not getting enough exposure to the strategy, but could also put the investor in a situation where they unknowingly get too much exposure to another strategy – a strategy where the investor already has exposure elsewhere.

Was the need for hedge fund benchmarks satisfied by index providers? Though index providers made

a concerted effort to provide investors hedge fund strategy measurement tools, so as to lend a degree of clarity to a confusing marketplace, the number of indexes available may have actually made it more difficult for investors to navigate this space. The main reason is that different indexes are based on different component selection methodologies. They also differentiate on a whole slew of different characteristics such as fees and liquidity. So the problem of opacity within the hedge fund industry, which the indexes were trying to address, has, in fact, shifted to hedge fund indexes themselves. The hope is that with time, investors will learn to differentiate among the indexes, and at that time will be able to make a fully informed decision as to which indexes satisfy their needs.

Dow Jones Hedge Fund Indexes provides style-pure benchmarks covering six hedge fund strategies using data provided by an asset management platform. The objective of the Dow Jones Hedge Fund Strategy Benchmarks is to provide the marketplace with the most precise measure of hedge fund strategy performance. The DJHFSB offer daily valuation for individual, style-pure hedge fund strategies and cover the following style classifications: convertible arbitrage, distressed securities, event driven, equity long/short, equity market neutral and merger arbitrage.

As hedge fund investing becomes more mainstream, continued capital inflows will lead to new opportunities and to new levels of investor support. Investors will gravitate toward an index that consistently represents the quality they are seeking and that innovates with the pace of the market.