# BETTER ACCESS FOR A WIDER AUDIENCE

Investable hedge fund indicies should be viewed as a complement to funds of hedge funds because the two provide for different needs

The widely reported increase in the flows of capital into the hedge fund space, now taking the industry through the $1000bn (€763bn) mark of invested capital, has brought changes to the industry beyond a mere increase in size. The way in which the hedge fund world presents itself to the investing community has necessarily altered to reflect the changing demands from, and indeed changing type of, investors.

Remarkable progress has been made since the turn of the century in the packaging of hedge fund products to better meet the requirements of the new group of investors including pension funds and the 'mass affluent' market. Such investors have found difficulty engaging with fund structures that provide very different levels of information and liquidity compared with European collective investments despite getting comfortable with the central trading differences such as the use of leverage to exploit arbitrage opportunities or the use of shorting.

The maturity of the hedge fund space has provided products that yield risk-reporting equivalent to long-only funds, risk-reporting/controls in line with the best practices in the long-only world, robust, independent valuation regimes and much stronger liquidity profiles. This has in turn enabled more investors to gain access to hedge fund returns.

## ACCESSIBILITY

A further significant development enabled by the increased level of reporting and valuation accuracy is that of the investable hedge fund indices, which are easily accessible and are designed to bring the economics returns associated with hedge fund investment to a wider audience and allow existing investors to access these returns in a more efficient and more focused way.

Having seen the rapid growth of the funds of hedge funds community which has been best placed to deliver the risk-controlled, diverse product that has been demanded, investors are now faced with a massive array of choice from the 1700 or so different fund of hedge fund providers offering an incredible pallet of investment flavours. A natural progression of this dynamic, mirroring

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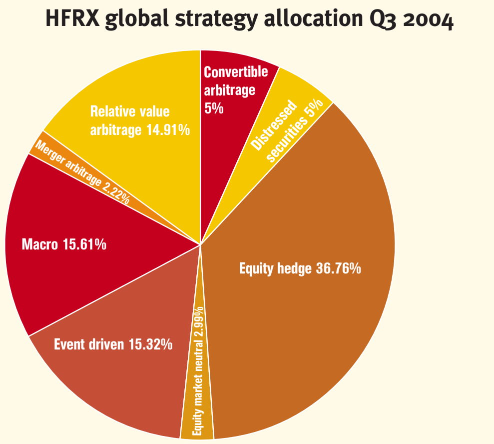

*Source: HFRX*

high-information, high liquidity investment vehicles, which satisfy most of the barriers to entry into hedge funds.

Creating a global index for hedge funds can appear difficult at first sight due to the broad spread of different strategies that make up the universe for long/short large-cap equity through to fixed income arbitrage via credit and currency plays. Capturing the entirety of this community can be achieved in various ways depending on the view of the interaction/separation between these strategy groups, however, there is a clear logic to the indexation of an individual strategy such as merger arbitrage as each of the strategy groupings exhibit strong clustering.

As the label of hedge funds is applied to a widely diversified collection of strategies, an important attribute of which is the low-levels of correlation between the various elements, any attempt to provide an accurate proxy must be constructed using a bottom-up strategy approach defining and populating each strategy group separately with any global representation being in a component form in order to provide the potential for different elemental construction such as an asset-weighted allocation across the strategies for example.

The HFRX investable hedge fund indices offer eight single strategy indices covering 90 per cent of the strategies in the hedge fund community:

- HFRX Convertible Arbitrage
- HFRX Distressed Securities
- HFRX Event –Driven
- HFRX Equity Hedge
- HFRX Equity Market Neutral
- HFRX Macro
- HFRX Relative Value
- HFRX Merger Arbitrage

In order to deliver a representative of the full community, HFRX offers two global indices, one an asset-weighted allocation to the eight strategies, the other an equally weighted basket. Users are then left to decide which provides appropriate representation for their particular requirements. Alternatively, users can select their own

developments in other investment areas, is a move to passive manager selection and strategy allocation techniques, which have commanded up to one third of assets in long-only investing.

Following their arrival in 2003, investable indices have rapidly established themselves on the hedge fund landscape and have attracted a significant portion of capital invested in hedge funds from several sources.

Approximately $15bn has been allocated in to investable hedge fund Indices over the past two years attracting a diverse community of investors from first time hedge fund users from the pension fund world and mass-affluent market through to experienced investors looking for focused strategy allocation vehicles.

The HFRX indices are a development of the original HFRI benchmark indices that have been the established hedge fund indices since 1993. The intent of the HFRX investable hedge fund series is to provide an easy to use, style pure access point for hedge funds with all of the usual attributes of a representative Index. The tracker funds spawned by the investable indices offer low-cost,

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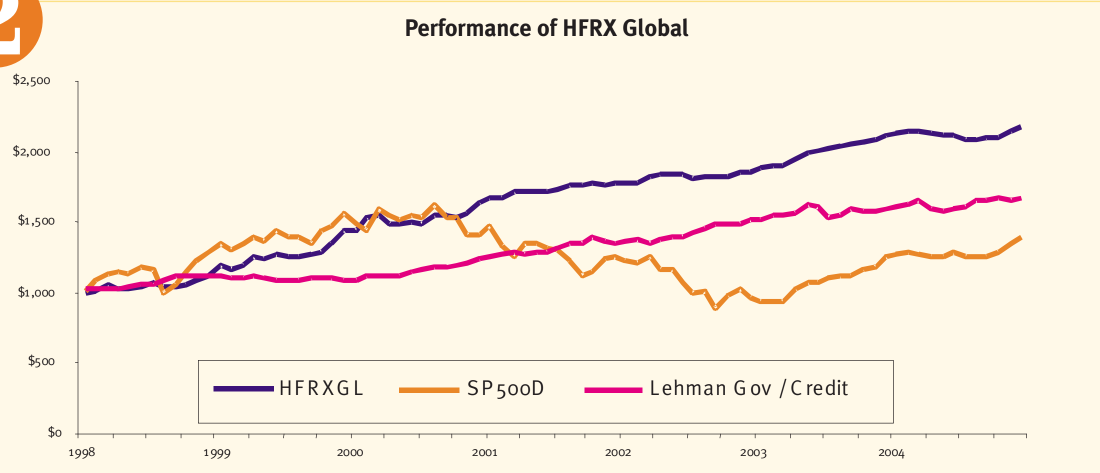

*Source: HFR*

## PERFORMANCE CHARACTERISTICS 3

| HFRXGL 1/98-03/05* | | | |
|---|---|---|---|
| Annualised compound return | 11.09% | Number of positive months | 62 |
| Annualised standard deviation | 6.31% | Number of negative months | 25 |
| Annualised Sharpe ratio (Rolling RFR)** | 1.19 | % of positive months | 71.26% |
| Correlation to S&P 500 with dividends | 0.40 | Largest monthly return | 5.95 |
| Correlation to Lehman Gov/Credit | 0.11 | Smallest monthly return | -3.85 |
| Alpha versus S&P 500 with dividends | 0.83% | Maximum drawdowm (peak to valley) | -3.92 |
| Beta versus S&P 500 with dividends | 0.15 | | |

* Back tested monthly values through March 2003; live daily data from April 1, 2003

**Rolling risk free rate is the monthly average of the mid bid/ask annual yield to maturity for the 90-day T-Bill for specified period

*Source: HFR*

weighting to achieve a customised benchmark.

The appeal of hedge fund indices lies in the ease of use and the ability to access, easily, the economic returns required without any compromise on infrastructure security, valuation or risk control.

## STRATEGIES

Global indices are one-size-fits-all and might or might not match the requirements of an investor whereas FoHFs can be more tailored in their approach. However, use of the individual strategy indices can achieve the same effect by weighting the allocation to each to provide the appropriate risk/exposure profile but this requires the skills of a FoHF manager to execute. Such index-plus funds are already in evidence.

The ability of a given strategy index to out-perform a managed basket is dependent on two factors:

- **Fees**. While not all of the investable indices are priced as indices are in other asset classes, some are a low as 25bps tracker fund charge which provides a clear advantage against FoHFs.
- **The relative performance dynamic of the individual funds**. It can be argued that it is difficult to consistently select managers that remain in the top half of a peer group let alone the top quartile. The survivor rates of managers in the top quartile from one year to the next are low in some strategies which gives a theoretical advantage to the indices where managers are drawn based on representation not qualitative measures. However, FoHFs can counter this by shifting allocations .

There is evidence that institutional investors in particular are using the investable indices as the first step on the ladder towards a serious participation in hedge funds. A holding in an investable index brings a strong source of information, which enables institutions to move up the learning curve rapidly as they are able to see the dynamics of their investment unfold. This experience can then be used to invest in a fund of funds and then possibly for direct investment into individual strategies or even funds.

The creation of the investable indices can be viewed as a natural progression in the maturity of the hedge fund sector and will assist in the encouragement of institutional investors to step in using the indices as a measure of relative skill and value or as an entry-point in their own right.

Proof that the two regimes are not mutually exclusive is borne out by the fact that the individual strategy indices are already being used by funds of funds that wish to make swift strategy shifts without the requirement for resource-heavy manager research. Indeed there is evidence that hedge fund indices are being used to develop core/satellite investment strategies in the same way as has been done in long-only equities for some time.

Capturing core exposures to a range of hedge fund strategies with very low fees and no risk of underperforming the median, with an additional, perhaps levered, allocation to individually selected managers/strategies to provide the added alpha is now entirely possible.

Therefore indices should not be viewed as a threat to funds of hedge funds but rather as a complement. The two provide for different needs. Indices are easy to use tools perfect for the first time investor or for relatively rapid strategy exposures, funds of funds will continue to provide highly focused investment formats. Between the two, most investor needs will be met.

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