

INVESTABLE INDICES

APPETITE FOR ALTERNATIVES

Among the array of products that has sprouted from the fast-growing hedge fund universe is the investable index, which, with its specific criteria for fund selection, widens the asset allocation options for investors in alternative classes

Strong growth within the hedge fund industry continues, with the number of hedge funds rising fivefold in the past decade to amount to more than 6000 today. Hedge fund assets are now at an estimated high of \$700–750bn worldwide.

The bursting of the technology bubble in 2000 highlighted the limitations of long-only investing and increased the appetite for investments that generally exhibit low correlation to equities.

As a result, institutional investors, including pension funds and endowments, are showing a growing interest in exploring the role of hedge funds in their strategic asset allocation.

Holding a diversified portfolio of hedge funds can mitigate the specific risk associated with investing in individual hedge funds. Access to a portfolio of hedge funds can be obtained through two principal vehicles: fund of hedge funds (FoFs) and hedge fund indices.

» FUND OF FUNDS

The concept behind fund of hedge funds is simple and appealing: an investment manager evaluates and researches a large number of hedge funds and creates a portfolio of between 20 and 40 underlying funds. In addition to providing diversified exposure to hedge funds, fund of funds aim to add value by picking superior managers and allocating capital among the different investment styles.

Fund of funds activity focuses on the following criteria: manager research, due diligence, strategy allocation and risk management.

Chart 1 shows the historical performance of fund of funds managers as a group. The three-year and five-year numbers indicate that managers of FoFs have had an average return of 3–5 per cent per annum and an attractive return/volatility ratio of approximately 0.8.



‘Hedge fund indices serve as a benchmark for evaluation of individual hedge fund and actively managed FoFs performance’

Oliver Schupp, CSFB Tremont Index

» INDICES

Hedge fund indices are a combination of individual funds representative of the broader hedge fund universe, which provide investors with extensive exposure to one or more hedge fund strategies. Moreover, they serve as a benchmark for evaluation of individual hedge fund and actively managed FoFs performance.

Numerous hedge fund indices have been created over the past 10 years. Typically, each index develops its own set of criteria for underlying hedge funds that are

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FOFS COMPOSITE INDEX

	1 yr to 30/06/03	3 yrs to 30/06/03	5 yrs to 30/06/03
Annual Return	5.05	2.79	5.51
Annual Volatility	3.02	3.31	7.02
Return/Volatility Ratio	1.7	0.8	0.8

Source: HFR Group

2 CSFB/TREMONT HEDGE FUND INDEX

	1 yr to 30/06/03	3 yrs to 30/06/03	5 yrs to 30/06/03
Annual Return	9.78	6.17	6.42
Annual Volatility	3.55	3.76	8.27
Return/Volatility Ratio	2.8	1.6	0.8

Source: CSFB/Tremont Index LLC

included in their index, and hedge fund indices usually include more funds than a typical fund of funds would hold in its portfolio. The most credible and widely used indices include the HFR, MSCI and CSFB/Tremont hedge fund indices.

Recently, a new breed of hedge fund indices has developed – the investable hedge fund indices. These indices are comprised of fewer funds, typically 40–80 “open” or investable funds that meet certain liquidity conditions.¹ While managers of index portfolios employ quantitative portfolio construction models that seek to closely track the index performance of the broad hedge fund indices, full replication is invariably used for portfolios linked to the investable hedge fund indices.

The CSFB/Tremont Investable Index was at the forefront of this trend. This investable index includes only funds that are generally open to investors and have regular liquidity. The investable index is rules-based and aims to provide the same standards as well established traditional equity indices. Based on pro-forma and live performance, the index provides comparable risk/return characteristics of the CSFB/Tremont broad hedge fund index. It therefore offers investors a realistic and representative platform by which to gain diversified hedge fund exposure. Chart 2 lists the historical performance and risk of the CSFB/Tremont Hedge Fund Index.

» ANALYSIS

As in the long-only world, index tracking funds and investable indices provide investors with alternatives to actively managed fund of hedge funds in order to obtain diversified hedge fund exposure.

The following analysis examines fund of funds’ historical performance. This includes performance analysis on FoFs and hedge fund index data.²

Investable indices today have short “live” track records and, as a result, the broader indices are used for the analysis.³

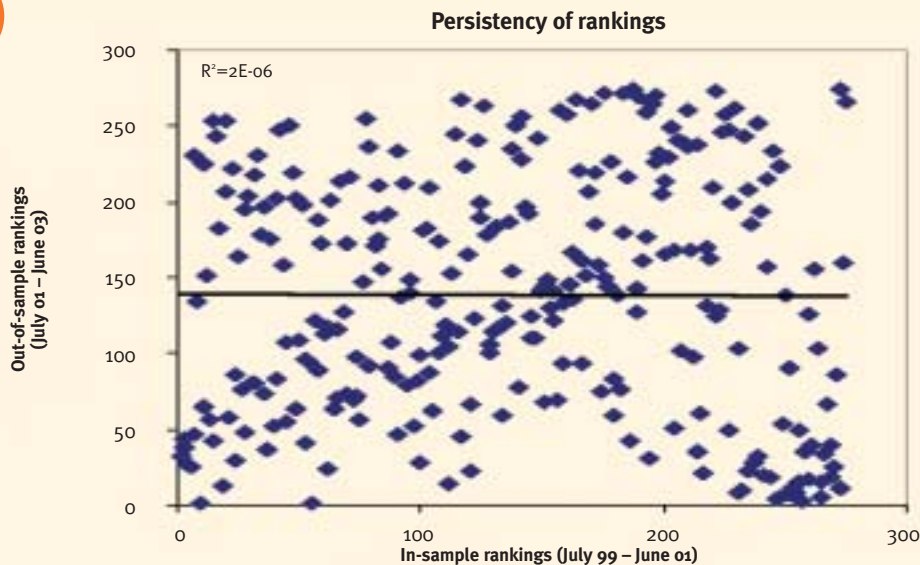
The first issue investigated is the persistence in fund of funds performance. Chart 3 shows the performance of 275 FoFs in the TASS database from July 1999 to June 2001 against their performance in the subsequent period, July 2001 to June 2003. The analysis only includes fund of funds that existed in both time periods. If historical performance were an indicator of future performance, returns from FoFs would cluster around an upward sloping line starting from the origin. The correlation is not statistically different from zero, indicating the difficulties of using historical performance to project future returns. As shown, the data suggests there is a less compelling argument for persistency among fund of funds managers to deliver consistently “good” performance.

» PERFORMANCE

Historically, the ability of FoFs to outperform the index has not been consistent.* The performance of the

*Comparison includes the performance of FoFs that report monthly returns to the TASS database to the CSFB/Tremont Hedge Fund Index over the July 1999 to June 2003 period.

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Note: The analysis includes all FoFs in the TASS database throughout the covered periods

Source: CSFB/Tremont Index LLC

CSFB/Tremont Hedge Fund Index is slightly higher than the average and median fund of funds, but with a higher degree of volatility. On an absolute and risk adjusted return basis, 44 per cent and 50 per cent of FoFs managers outperformed the index, suggesting that over half of the FoF managers considered did not generate the necessary excess return to justify the level of volatility in excess of the index. (See Chart 4.)

» DIFFERENCE

The difference between fund of funds and index performance can be attributed to two main FoF decisions: strategy allocation and fund selection. One area of focus is the ability of FoFs to add value by picking superior managers.

A typical multi-strategy FoF will have up to 50 per cent of its portfolio in high volatility strategies such as long short equity and global macro, with the remainder in more relative value-oriented strategies such as event driven and convertible arbitrage. The returns of the managers in these two groups of strategies are significantly different due to their low level of volatility.

Furthermore, for example, in the case of long short equity hedge funds, the dispersion of points is very wide, indicating that the difference between the “good” and “bad” funds is substantial. The manager historical returns indicate that superior manager selection offers

great potential, but that the risk of underperformance is also significant. Fund of hedge funds are faced with the problem that a significant number of funds are in strategies with high dispersion, requiring managers to pick the “right” fund.

With the emergence of hedge fund indices, investors have a growing number of alternative investment options. We believe that hedge fund investing, based on its generally higher risk adjusted returns compared to traditional asset classes, will continue to play an increasingly important role in institutional portfolios. While actively managed fund of hedge funds today dominate the field of diversified hedge fund portfolios, indexation increasingly offers a viable investment alternative.

¹ For further information on Investable Index rules and regulations, please refer to www.hedgeindex.com

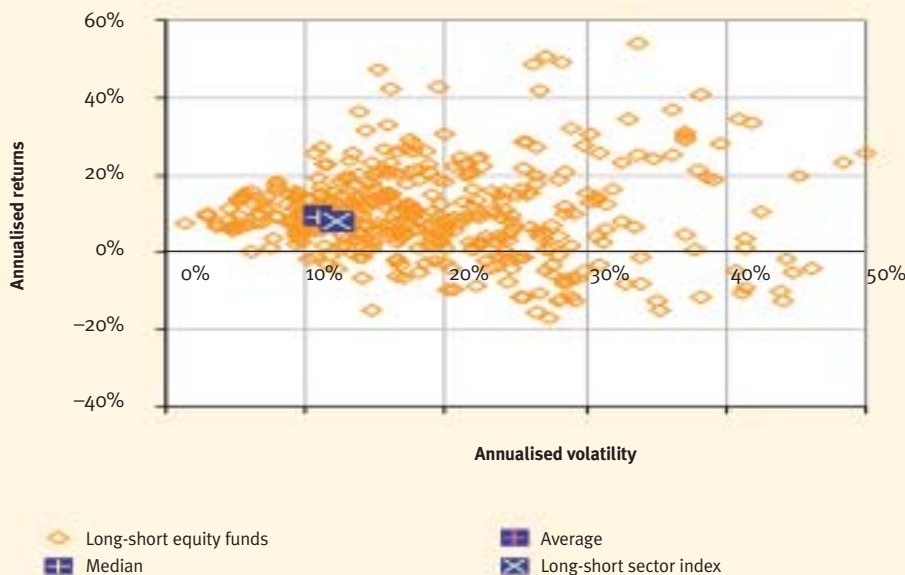
² In our analysis we are mindful of the fact that, unlike fund of fund returns, hedge fund indices exhibit survivorship bias. In our opinion the methodology used for constructing the CSFB/Tremont Index significantly decreases the bias. Please note that due to the significant lag in the reporting of FoFs performance, the data in this article is as of June 30, 2003.

³ The CSFB/Tremont Hedge Fund Index, a rule-based asset-weighted index of hedge funds is used for the analysis.

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Tremont Index

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Risk-return scatterplot (long-short equity, July 99 – June 03)



Source: CSFB/Tremont Index LLC

» CORPORATE STATEMENT

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