Passive Capital Management

Alpha and Absolute Returns: Marketing Strategies for Hedge Funds

In the high priced world of hedge fund investing there is a lucrative reason to craft an effective sales pitch. Using terms like "positive alpha" and "absolute return investing" can put a sparkle in an investor's eye and allow them to dream about consistently out-smarting the rest of the investing world – or those terms can confuse the investor just enough so they agree to pay the extraordinarily high fees associated with hedge fund investing (even if a mediocre product is ultimately provided). An article in the CFA Institute's *Financial Analysts Journal* by M. Barton Waring and Laurence B. Siegel provides some interesting insights into the myth of absolute returns and other marketing ploys used by hedge funds and other active managers. The conclusion is that many investors are paying phenomenally high fees and taxes for what is really beta, or market, exposure. Alpha, which is really a measure of relative performance versus the manager's normal beta exposure (it *can* be negative!), remains elusive in the zero-sum (before fees and taxes) game of investing. It also remains very difficult to separate the skillful investor from the lucky investor and years of data are needed before you know definitively.

Waring and Siegel make the argument that not only is absolute return investing not a separate asset class, but they explain how absolute return investing is a misnomer because alpha, the absolute return investor's holy grail, is *defined* as the return generated over and above the manager's normal beta exposure, or benchmark. Therefore, all investing is *relative to something* and it must be so. Portfolio performance can be broken down into two parts: one part that is determined by exposure to various market segments (beta) and one non-market part that is attributed to manager-specific decisions (alpha). Since alpha, whether it is positive or negative, is relative to a base-case market exposure, the authors make the case that the term "absolute return" is nonsensical, misleading and factually incorrect. Nonetheless, they acknowledge that this term currently sells well in a hedge fund world with many fairly naïve investors. The authors state, and I agree, that beta exposure is best achieved through mixes of various passively managed funds with very low cost and much better tax efficiency. Beta returns ought to be relatively inexpensive.

It is important to remember that alpha and "absolute returns" can be, and oftentimes are, negative. In any particular quarter or year, many hedge fund investors receive absolutely negative results! To quote the article, "Hedge funds are subject to the same zero-sum-game rules that apply to all active investing. Carefully designed studies have found that, as a group and after making reasonable corrections for survivorship bias, hedge funds do not exhibit statistically significant realizations of alpha. No real surprise here for the hardheaded and clear-eyed investor: Hedge funds are not the 'magic asset class' that some would like you to believe. Like any other actively managed fund, they rely on special skill for special success." Of course the challenge is to separate the skillful managers from the bad or merely lucky managers and to do that *in advance*. Identifying who did well last year doesn't help you make money this year. Especially after including fees and taxes, many hedge fund investors should see that they did not select one of the few skillful managers. If a manager does claim to deliver positive alpha perhaps he has simply gotten lucky timing the market ("beta timing") or perhaps the level of risk being taken is higher than commonly perceived, thus overstating alpha and using an inappropriate benchmark.

Just because a manager says he or she pursues "absolute returns" or "positive alpha" does not increase the likelihood that those goals will be attained. Stephen Colbert of *The Colbert Report* would call this marketing strategy "truthiness" – something you *wish* or *want* to be true. The reality is that hedge funds often deliver returns that are generated by beta exposures, yet they charge alpha fee levels for all the returns. To quote Waring and Siegel again when discussing absolute returns and alpha, "Like most myths of active management, it is apparently being promulgated to aid the marketing of yet another cynical investment practice – namely, the mixing of alphas and betas at a single fee level (the higher one, naturally)." So buyer beware. If you are getting market (beta) exposure then don't pay outrageous fees for it. If you are one of the few fortunate investors in the world who knows with confidence that positive alpha will be delivered then a higher fee is warranted. Evaluate your returns and understand if the results are market-driven or manager-driven. The authors discuss how most hedge funds show consistent net positive beta exposures (equity beta of 0.3-0.6 in addition to bond beta).

"A hedge fund will deliver the risk-free rate plus a beta return related to its normal portfolio plus an alpha return that comes from beta timing, security selection, or whatever….Beating a benchmark is all that matters; it is the only thing that is worth paying high fees to achieve." Of course if you cannot, with any level of confidence, identify the managers who will deliver positive alpha in advance then it is not worth the cost and risk. There is generally huge variability in hedge fund returns by style category and the risk of selecting the wrong or unlucky manager is very high. So understand how your returns are generated and don't pay a lot of money and taxes for what is oftentimes beta exposure to various market segments – beta returns disguised as alpha returns are very expensive.

Passive Capital Management understands how results are generated and structures portfolios that capture returns from various market segments and risk categories in a cost-effective, tax-efficient manner.

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M. Barton Waring and Laurence B. Siegel, "The Myth of the Absolute-Return Investor," *Financial Analysts Journal*, Volume 62, Number 2, March/April 2006