Hedge fund strategies

What is a hedge fund for? There is renewed urgency to answering that question as more institutional money targets an industry that defies neat definition. A recent report prepared for the European Commission says rich individuals' share of the capital allocated to European hedge funds dropped from 62 per cent to less than half between 1996 and 2005.

One of the issues that mainstream fund managers face is deciding what they want from a hedge fund. The standard answer is "alpha", or absolute returns in excess of those provided by passive exposure to the market – usually attributed to clever fund managers. But verifying the achievement of true alpha in a rising market is difficult.

Searching for the brightest managers can be time-consuming and expensive. One alternative involves thinking of hedge fund strategies as offering exposure to types of risk – and their associated returns – that mainstream methods do not provide. In a recent study, Andrew Ho and Jasmina Hasanbodze, both at the Massachusetts Institute of Technology, constructed hedge fund 'clones' using a handful of standard, liquid instruments like the S&P 500 index. Historic returns on those clones replicating equity long-short and convertible arbitrage strategies were not far short of their actual hedge fund counterparts.

Most hedge fund managers will not feel too threatened by such theoretical models. In those strategies where alpha is intuitively more important, such as event-driven, the clones were beaten easily. That said, recent performance in more volatile markets conditions remind investors that the industry's quota of true alpha-males (and females) is finite. Professor Ho's research suggests there are other ways to tap different types of risk-adjusted returns. It is also a reminder that not all hedge fund strategies are created equal.

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