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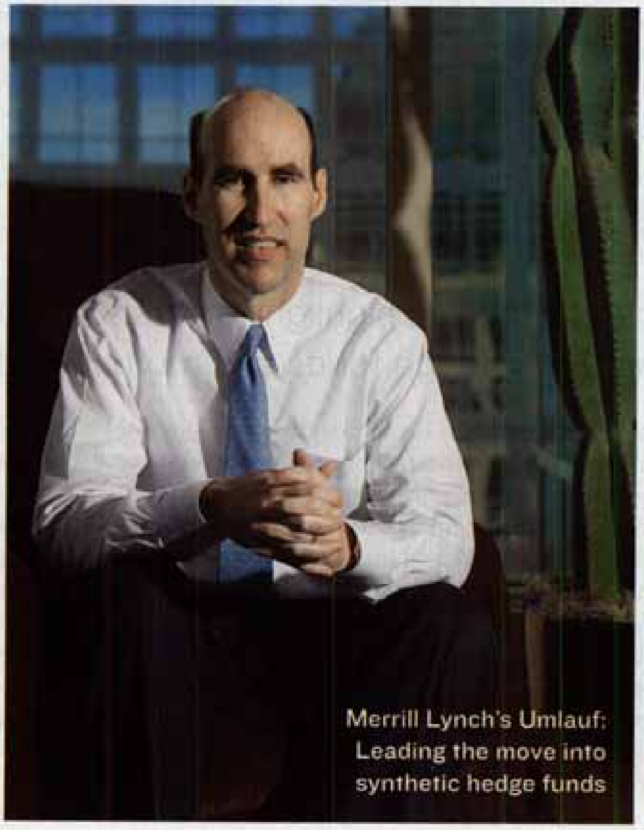
Cloning comes alive

Goldman Sachs and Merrill Lynch have introduced investment products that deliver hedge-fund-like returns without the high fee burden. • By Neil O'Hara

The race is on to commercialize synthetic hedge funds. For the past few years, academics have been discussing the possibility of replicating hedge fund performance using composites of market benchmarks. But it is the most recent research, including a paper from Massachusetts Institute of Technology finance professor Andrew Lo and Jasmina Hasanhodzic, an MIT Ph.D. candidate — first published in *Institutional Investor*'s sister publication, *Alpha* ("Attack of the Clones," June 2006) — that has finally spurred securities firms into action.



Merrill Lynch's Umlauf: Leading the move into synthetic hedge funds

Goldman, Sachs & Co. and Merrill Lynch & Co. are the first two to put academic theories on hedge fund cloning to the test. Both have products that they contend can deliver hedge-fund-like returns without investments in hedge funds. Using factor models similar to those proposed by academia, their indexes analyze historical monthly hedge fund returns and use weighted baskets of market indexes to replicate them.

Goldman Sachs' Absolute Return Tracker relies on a pool of roughly 17 benchmarks — including indexes related to equities, commodities, fixed income, credit and volatility — and an unspecified, publicly available third-party database for its hedge fund returns.

The Merrill Lynch Factor Index is more transparent. Six total-return indexes drive the model: the Standard & Poor's 500, the Russell 2000, the MSCI EAFE, the MSCI emerging markets free, the U.S. dollar index and one-month LIBOR. For performance data, Merrill's product relies on well-known hedge fund benchmarks like the HFRI fund weighted composite index.

Steven Umlauf, who is in charge of new product development in Merrill's global markets division, says the Factor Index averaged a better than 90 percent correlation to hedge fund returns for the past ten years in backtesting. He says the tracking error — the amount Merrill's index deviates from actual hedge fund performance — has declined as the hedge fund industry has matured. Merrill Lynch believes the huge influx of money into hedge funds has made the market more efficient and is the reason the correlation between performance and the model portfolio has increased.

To create its clones, Merrill uses 24 months of performance data. Although the index is rebalanced monthly, Umlauf admits that the model can't immediately respond to rapid changes. "In really bad markets, like this past May, we initially underperform before we outperform," says Umlauf, a former finance professor at the London Business School who has spent the past 14 years working in equity capital markets and derivatives in New York, Tokyo and London. In May, Merrill's index fell 2 percent, compared with a 1.5 percent drop in the HFRI composite. But Umlauf says Merrill's index made up the difference, and then some, during the next three months — though he wouldn't give specifics.

Merrill began running the strategy for its index, without any funding, in April 2006. Merrill Lynch Factor Index started taking investments four months later. Umlauf will not specify how much has been raised so far but says initial investments have come from private placements with institutions, including funds of hedge funds, insurance companies, pension funds and private banks. For January through November 2006, the Factor Index was up 11.2 percent, with 4.5 percent volatility — the annualized standard deviation of monthly returns. By comparison, the HFRI was up 11.31 percent for the same period, with 4.9 percent volatility. So far the product, which is being offered worldwide, has taken an early lead over Goldman's.

Goldman's Absolute Return Tracker is only available in a limited number of Eu-