A looming challenge for the fund-management industry

A LOT of people would like to earn hedge-fund returns. But they are nervous about paying the fees that hedge-fund managers like to charge, and about the risks those managers take.

That creates a great opportunity for those fund managers who can bridge the gap by creating vehicles that might be described as hedge funds "lite". Doing so has raised a host of interesting issues, among them how to measure the skill, or alpha, of fund managers, and what an index is really for.

The "lite" version of the hedge-fund industry includes products known as "130-30" funds, which allow managers the limited use of hedge-fund techniques, such as going short (betting on falling prices) and leverage (using borrowed money to enhance returns). The name stems from the structure of the product; if the fund has $100m of assets, it will buy $130m of shares, funding the difference by selling $30m of short positions.

Provided the manager has the ability to choose the right stocks to buy and sell, the product should yield superior risk-adjusted returns. And theory suggests that giving the manager the chance to short stocks allows him greater scope to put his skills into effect.

Another popular approach has been to replicate hedge-fund strategies as closely as possible. This can be done in one of two ways. Where a hedge fund has a well known strategy, such as merger arbitrage, the replicator can follow a simple rule—buying the shares of every target company in bid situations, for example, and shorting the shares of the predator. Alternatively, replicators have attempted to deconstruct the sources of the hedge-fund industry's returns, finding, for example, that they are driven by the performance of the American stockmarket or by movements in bond yields. By working out the right combination of these factors, hedge-fund clones are able to offer the industry's advantages at low cost.

Now these various techniques are being combined. A recent paper*, by Andrew Lo of the Massachusetts Institute of Technology and Pankaj Patel of Credit Suisse, constructs a 130-30 index. Such a benchmark would allow investors not only to see whether the 130-30 manager they hired is performing well, but also to create low-cost, quasi-hedge funds of their own.

Messrs Lo and Patel use many factors to assess stocks, ranging from those based on valuation (the ratio of the share price to sales) to business prospects (rising profits) and price patterns such as momentum (shares that have performed well over the previous six months tend to keep doing well). The index consists of long positions in the stocks with the best scores and short positions in the stocks with the worst.

Testing this system over the period 1996-2007 produces returns that beat the S&P500 index by more than a percentage point a year with similar volatility. Of course it is always possible, by massaging the data sufficiently, to come up with a way of retrospectively beating the market. On the other hand, investors have no guarantee that traditional fund managers (who also use past performance as a sales tool) will perform as well in the future.
Purists would say that the Lo-Patel approach is not really an index, but a stock-picking strategy masquerading as a benchmark. An index should be passive, not active, critics argue; it should also be measuring market performance, rather than trying to beat it. But investors are likely to be relaxed about such intellectual niceties if the technique provides attractive returns. The deeper question is what such approaches tell us about “active” managers, who charge high fees.

Many of those managers run portfolios with the help of models similar to that devised by Messrs Lo and Patel. They claim that the excess returns they generate are the result of alpha, or skill. But if those returns can be reproduced by a set of mechanical rules, is skill really involved?

Fund-management skill is becoming rather like the 19th-century concept of a “God of the gaps”. Once humans attributed the weather or earthquakes to divine intervention; then they discovered high-pressure systems and plate tectonics. The number of events that required a heavenly explanation (the gaps) grew ever smaller.

Skill, or alpha, is fast becoming a residual: the explanation that remains when all other factors have been discounted. That is not yet a crisis for the industry, mainly because it is still so hard for clients to distinguish skill from luck. But for any thoughtful fund-management executive, it ought to be a long-term worry.

* "130/30: The New Long-Only" by Andrew Lo and Pankaj Patel, December 2007