Not so long ago hedge funds were marketed to high-net-worth individuals and family offices as pure return vehicles. Third-party marketers happily touted past returns along with the explicit caveat that past returns are no guarantee of future success.

Only recently have alternative-market investors begun to recognize the benefits of diversification that hedge funds can offer, so the marketing buzz has shifted to the catchphrases of pure and portable alpha. Now hedge funds tend to be described by subjective “strategy” classifications, leading investors to assume that such funds exhibit behavior that resembles a strategy index proxy. Unfortunately, hedge funds often are poorly correlated to their stated strategy indexes, which don’t accurately reflect their risks.

Although historical returns are no guarantee of future success, they do contain a significant amount of important information about the systematic market drivers that underpin performance. Using conditional probability techniques established by the Reverend Thomas Bayes in the mid-18th century, we discover that in many cases the diversification benefits are illusory, particularly during a market crisis—when we rely upon them the most.

Investors clearly expect that by controlling allocation across several strategies they can ensure that their alternative investment portfolios are well-diversified. Unfortunately, some events affect a number of seemingly unrelated hedge fund classes in an unexpectedly correlated manner.

While it certainly is true that most hedge fund strategies are uncorrelated with traditional directional market betas, this relationship often is exclusive to normal market conditions. In a business-as-usual market regime, an equity-market neutral strategy is unaffected by the direction of equity-market moves. But if you scratch the surface, you likely will find that many alternative strategies are systematically driven by other, more exotic, market bets.

We call these systematic bets “alternative betas.” Alternative betas are important because many seemingly diverse hedge fund strategies are exposed to similar underly-
It is precisely when there is a market crisis that investors exhibit “flight to quality” behavior, causing liquidity premiums to jump and forcing the small-cap segment to dramatically underperform large cap.

Across all strategies, the investor easily can aggregate the exposures across managers to identify and manage unintentional or unwanted risk concentrations.

Rather than blindly accepting the “pure alpha” pitch, educated investors actively must search out alternative-market factor exposures, which can help them understand the systematic drivers of risk in both normal and extreme market conditions. By identifying the sources of risk, the investor also can understand which market scenarios are likely to hurt performance and can stress test a range of potential crisis scenarios.

Recent research at the L’École Supérieure de Commerce et de Management (EDHEC) Risk and Asset Management Research Centre indicates that as much as 70 percent of hedge fund returns are attributable to alternative betas and only about 30 percent are attributable to pure alpha. Riskdata’s own research supports that view, and we are committed to ensuring that alternative betas are clearly understood, communicated, and carefully managed in line with market expectations.

By identifying alternative betas, investors could have realized that “Red” October was the result of a market correction following a year of positive returns, earned through exposure to precisely the same underlying sources of risk. We further can reiterate this point by highlighting the poor performance of convertible arbitrage in 2005, which largely was due to historically low market volatility and doesn’t indicate such funds necessarily should be avoided in 2006.

We believe that investors should take a precise, surgical approach to risk allocation. Take the risks you believe in and believe in the risks you take. In so doing, the trade-off between risk and return can be actively managed for hedge fund portfolios and performance can be correctly attributed to the directional movement of alternative betas.

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