Alternative Investing

An Alternative Future: Part I

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Depending on whom you ask, hedge funds are either the wave of the future or a dangerous fad that has been grossly overcapitalized and all will end in ruin. Both sentiments contain elements of truth.

Allocating to hedge funds will not solve the problems of a low equity-risk premium, low real interest rates on bonds or infinitesimal rates on cash. The hedge fund structure does not create investing skill out of thin air, where other traditional structures have failed to do so, and the tools that hedge funds use (leverage, short-selling and derivatives) certainly come with risk.

That said, the potential benefits of hedge fund investing are real. To the extent investing skill exists, its application in an unconstrained hedge fund structure may produce a better outcome than more-constrained, traditional formats. Hedge funds also, through a set of reasonably well-defined systematic strategies that we call hedge fund betas, allow liquidity to be provided to those who need it from those who have it, and risk to be transferred from those who do not want it to those who do. Many of these strategies would not be possible without the tools of leverage, short-selling and derivatives common to hedge funds.

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