



# HEDGE FUNDS

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## Sources of Change and Risk for Hedge Funds

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Hedge funds are becoming much more institutionalized. In this paper, I focus on five key issues that come up as a result: benchmarking, transparency, articulation of the investment strategy, fee rationalization, and risk control.

The paper discusses several different benchmarks that are useful at different time horizons, and lays out the idea of "process transparency" — a willingness to show clients what we actually do at AQR in a generic, but fairly open, sense.

Articulation of the investment strategy is another form of transparency: explaining "why it works" after laying out "what we do." Describing and explaining investment strategies are critical to institutional investors. They want to go beyond the results and understand why the process should work going forward. Institutions also want to better understand — and control — expenses, including hedge fund fees. Alpha, or true skill, is always in high demand, so its price will likely remain high. The price for beta — for just executing widely known hedge fund strategies — should be lower than the price for alpha, although it should exceed that of beta in the stock market.

Having a concern about risk control is certainly not unique to institutions, but it is an area where institutions are more apt to focus. As one can image, trying to measure risk within a hedge fund can become quite complicated considering all the different variances, covariances, frequencies, and weights within a portfolio. Three specific sources of risk — beta, leverage, and headline risk — are important to institutions, so I discuss each in detail.

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