HEDGE FUNDS

The Future Role of Hedge Funds

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Hedge funds represent the future of active management, and that future will consist of two complementary elements: (1) hedge funds that offer alpha and (2) index funds that generate the benchmark rate of return or perhaps some alpha in a disciplined manner. Combined, these two approaches will replicate and eventually replace traditional active management. But first, hedge funds must shake off certain negative characteristics of their current behavior and embrace some necessary changes.

- Hedge funds should exist to take sources of expected return, such as idiosyncratic skill (alpha) and nontraditional arbitrage (hedge fund beta), and turn them into separate investable assets.
- Hedge funds should not be an expensive stock market index fund with a few shorts thrown in for credibility.
- Not only are hedge funds here to stay; the market model of the future could likely be a combination of index funds and hedge funds.
- Institutionalization of hedge funds, with its pros and cons, is definitely under way, although best practices for both investors and managers require serious improvement.
- Risks and issues abound in traditional markets (long-only stocks and bonds), so if a time ever existed to look for nontraditional sources of return, the time is now.

When investing in hedge funds, investors expect a combination of positive expected returns, alpha and diversification of risk through low to zero correlation with traditional asset classes. The hedge fund world does not always achieve such low correlations, but certainly that is one of its primary goals.

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