Factor/Style Investing

Alpha Transfer in a Hedge Fund World

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In theory, portable alpha is a good idea. There is no reason why an investor's choice of benchmark or asset class exposure needs to be tied to the source of alpha. If alpha can be generated from more fertile areas, such as hedge funds, investors should be allowed to take advantage of them.

Given the structure of the marketplace, a portable alpha strategy can be readily applied to a fixed-income mandate. Before alpha can be ported, however, it must be found, which raises several interesting points:

- Hedge funds are a natural place to look for uncorrelated alpha.
- In the search for alpha, investors must cautiously examine hedge funds' reported returns, because the broad universe of hedge funds may be more correlated with the market than many think.
- Our analysis shows definite lags (whether accidental or intentional) in the mark-to-market valuations of hedge funds, and once these lags are accounted for, hedge fund betas rise significantly.
- If these higher betas are taken into account, at least at the index level, hedge funds do not appear to add a lot of value.

Basically, our research does not intend to make any statements about whether hedge funds in general are good or bad, but when investors look to hedge funds as a source of portable alpha, they should be careful when interpreting the return data. In particular, investors should be mindful of the illiquidity problem for securities held in hedge funds; this issue is not trivial.

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