Perspectives

Should Hedge Funds Hedge?: Why Some Alts Should Have a Beta of 1.0

March 28, 2025

In 2001, I co-authored a paper entitled "Do Hedge Funds Hedge?" The short answer to the title question was "not nearly enough." I have been in high dudgeon about this for the last quarter century, repeating and repeating my analysis of reported[1] hedge fund returns and finding that after accounting for their significant market betas and super high market correlations, they collectively didn't add value net of fees. In recent years I've expanded my personal crusade against beta masquerading as alpha to the #volatilitylaundering that goes on in private investing.[2]

I stand behind the above. But looking back. I think I perhaps too often gave the impression that "beta is bad" when the actual point has always been "paying alpha fees for beta is bad," which is very different. This led me to emphasize "zero correlation alternatives" as the pure honest form. Honesty is good. I'll die on that hill. But it also led me to deemphasize two things: 1) Fairly priced beta is a very good thing long-term (this is NOT a near-term or even 10-year market forecast), and 2) pure uncorrelated alternatives are not necessarily the most efficient way to add uncorrelated alpha to your portfolio (yes I know that sounds confusing, it won't be soon).

It all comes down to capital efficiency. Uncorrelated alternatives can be wonderful things, but they can also have trouble moving the dial (particularly if run at modest volatility—more on that later). In fact, a common, sometimes unfounded but sometimes telling, criticism of alternatives is they don't move the dial enough. In particular, at the modest allocations most will consider, low-volatility uncorrelated alts may improve the risk-adjusted return of the overall portfolio, but not the total return (i.e., they improve it by lowering the denominator, not raising the numerator).

Consider my example from an earlier essay (with all the assumptions therein). You have three assets—stocks, bonds, and alts— with the following assumed characteristics (and for this simple example we'll assume everything is well-behaved and "normal," with the correlation between stocks and bonds being 0.3, alts uncorrelated to both stocks and bonds, and the expected return of cash at 5%).

	E[excess]	Vol	Sharpe	E[compound total return][3]
Stocks	6.0%	15%	0.40	9.9%
Bonds	2.1%	7%	0.30	6.9%
Alts	3.0%	10%	0.30	7.5%

Source: AQR. For illustrative purposes only.

Under these assumptions[4] the classic 60/40 stocks/bonds portfolio has an expected return of 4.4% over cash, a volatility of 10.2%, a Sharpe of 0.44, and an expected compound return of 8.9%.

Now imagine you take 25% proportionally out of 60/40 and put it into the uncorrelated alternative. What's the portfolio look like? Well, you get an expected return of 4.1% over cash, a volatility of 8.0%, a Sharpe of 0.51 , and expected compound return of 8.8%. Yay you have a higher Sharpe! You are more skilled and smarter than the average bear (and bull)! But, sadly, you make (very slightly) less money long-term. This is one version of the old market saw "you can't eat risk-adjusted returns." Of course, much of the point of this and my prior missive on taking high volatility in your alts is that you really can dine on them if done a bit differently.

So, let's do the simplest financial engineering in the world. Let's run the alt exactly the same but equitize the returns (i.e., add an equity beta 1.0 futures position to the alt). And now, instead of allocating proportionally out of 60/40, allocate 25% of the portfolio directly from equities (effectively leaving the equity allocation the same, since the alts now also have a beta of 1.0). What does the resulting overall portfolio look like?

Now you get an expected return of 5.2% over cash, a volatility of 10.5%, a Sharpe of 0.49, and expected compound return of 9.6%. You

still improve the Sharpe (0.44 to 0.49), just a tad less. You raise the volatility of the portfolio a whit (30 basis points versus 60/40). But, you raise the expected compound return more than a whit (I'd call going from 8.9% to 9.6% two-and-a-half whits[5]). What's essentially happening is you added the alt for free.[6]

I am not new to these topics, nor is the industry. I was writing about the basics behind this about 30 years ago and have recently reprised it.[7] In fact, well-known products like risk parity rely on similar efficient use of the underlying cash value of the portfolio. Nor am I alone these days. Industry stalwarts like my friend Corey Hoffstein write about basically the same ideas (he calls it return stacking, a great name I wish I had come up with) and produces investment products that use this concept. Another friend Wes Gray, writing with now AQR colleague Pete Hecht (he was elsewhere when they wrote this) did a great job of explaining how breaking up beta and alpha is very clarifying to portfolio analysis and in thinking about fees for the volatility taken (low vol, for attempted alpha, should mean low relative fees, and vice versa), a concept very applicable to my discussion here. Respected competitors offer products based very closely on my earlier papers which, for some very stupid reason, I never quite got around to.[8] Many other examples exist (sure, I've chosen my friends for the ones to highlight here :)). I'm not reinventing the wheel (though, IMHO, I think I was a serious contributor to inventing it in the first place!).[9]

Essentially this note, focusing on adding beta to uncorrelated alts, and my prior one on why investors might want to consider alts that are more aggressive than they are used to, are highly overlapping. They essentially tackle the same problem with the same ideas: capital efficiency. High-vol alts are more capital efficient, as you need to invest less in them to move the dial (meaning your money can be invested elsewhere at the same time). Equitized alts are more capital efficient as you can invest in the alt out of equities without reducing your equity exposure.[10] Of course, the two work quite nicely together! More aggressive and equitized alts.[11, 12]

I can't believe any of my readers, known universally for their intelligence and good sense, haven't guessed that AQR will be introducing a series of strategies that put into practice what I'm describing here (equitized liquid alts run at higher alpha targets than the norm which, of course, are implemented tax efficiently—an important topic we've written a lot about elsewhere).[13, 14, 15]

We are calling these the Fusion strategies because they are fusing a few ideas we love and because numerous focus groups said that name slays.

One big caveat. The investing world talks constantly about the difficulties of sticking with a good but imperfect investment strategy at any volatility, let alone a high one. The agency problems are indeed huge, and I've talked about them, and lived (barely) through them, myself. So high volatility is definitely not for everyone (equitized or not). As Ben Franklin said about the U.S.A. emerging as a republic, "that's cool, if you can keep it.'[16] It's the same thing with high-vol alts. But, I do believe if entered in with open eyes and if you can stick with it, then it is just ex ante better. But the ride will be wilder and the difficulties and agency problems harder. Essentially, I'm advocating leaning into precisely what many in asset management think is impossible.

Interestingly, and I'm definitely speculating here, while higher vol clearly makes alts harder to handle for most, equitizing alts might actually make them easier to stick with over time. Some of investors' frustrations with low-correlated alts have been worse during extreme bull markets when even if the alts were "ok" they didn't come close to keeping up with equities. To the extent investors view the total return as a package it would make these times easier, and even "ok" alts would be adding to the portfolio with no loss of return from giving up beta.[17]

But, while yes difficult—high vol clearly is more difficult and equitizing perhaps usually leans easier—for we few, we happy band of high-vol equitized brothers, it's just the right way to invest. But for those who can handle the swings, we want to offer the best ex ante tool possible. But again, be forewarned. Even if we're every bit as good as we think we are, the ride will be a wilder one. Who's with me? Anyone? Bueller?

Finally, I take back none of my prior ranting. Charging alpha fees for the passive equity risk premium is still a cardinal investing sin (and sadly a popular one—figuring out how to pull off that trick seems to backstop a lot of the asset management business). That is not what we'll be doing here. We're just adding beta (not charging more for it) to a higher volatility alt. I'm psyched. A little scared. But psyched.

---

[1] Yes, the major hedge fund indices leave much to be desired and there is tremendous heterogeneity, for good and bad, at the individual fund level.

[2] In particular I have satirized privates underperforming public equities when their beta became unavoidable during the disappointing 2025-2034 decade, given they were priced going into that period at an inverted illiquidity premium. Sadly, we never got around to introducing our own #volatilitylaundered fund before that bubble popped.

[3] Calculated as the expected return minus half the variance.

[4] Frankly, I hope and believe that the Sharpe assumption on alts is pretty conservative. But I think that's appropriate for this type of analysis.

[5] And I'd call one who didn't prefer this portfolio a half-wit (sorry!).

[6] Free in terms of not having to give up any other exposures—I assume the managers don't provide their services for free!

[7] Some of my colleagues have also been recently writing on the topic here, here, and here.

[8] I did do some other things. Also, why exactly am I shilling for competitors on my blog? To be fair, they were quite nice about it.

[9] Over 25 years ago I had a paper rejected at the Journal of Portfolio Management (yes, it happens to me too) that explained active management as A = I + (A – I). That is, an active portfolio is an index fund plus a market neutral portfolio of the active portfolio minus the index fund — an identity. I then showed if you levered the (A – I) part you create a useful market neutral hedge fund. I also discussed how if you levered by L the fee should be L times the regular active management fees. Finally, of course I noted that once you were doing this you don't have to just short the index. I'm still a little bitter about the referee on that one… Though I did manage to get these points across in some subsequent papers (after I was a little more well-known and got rejected less often :)).

[10] I focus on equitization but, of course, you could also "bondize" the returns or "60/40-ize" the returns.

[11] More specific to AQR, our worst periods have mainly been valuation bubbles (1999-2000, 2018-2020) when, as befits a bubble, beta was going straight up and our recoveries when beta either collapsed or simply stalled have been large. That in theory should make our alternative funds far more— not—less attractive (counter-cyclical all else equal is good). It doesn't always work that way, as when you're losing in a bubble not only are you losing but you look like a moron versus the competition who is often (sometimes sneakily) loaded with beta! But combining beta and this counter-cyclical alpha would, in the past, make the overall ride up and down smoother in these periods. Though I would note that we hope and believe we've made our processes decently less sensitive to valuation bubbles going forward (living through 1999-2000 and then 2018-2020 twenty years later will motivate you to do that), so while I think it's interesting enough to mention I don't think one should rely on this for the future.

[12] Two points here, both pertaining to fees. The first, just touched on in the body of this piece, is that "fair" fees should rationally scale with volatility. For example, assume the same manager runs the same alternative strategy (this only applies directly to true long-short alternative strategies; if you just up the vol on long only, you just get more concentrated which isn't necessarily worth more), but at two levels of targeted volatility. Let's say the first implementation targets 5% volatility, and the second 10% volatility. Since the higher-vol version gives you twice the economic exposure, the "fair" fee should also be twice that of the lower-volatility strategy. There might be sticker shock with the higher-volatility alternative, but economically, it's as good a deal as the lower-volatility one. The second point is when a manager equitizes the alternative. I don't think that should add much, or anything, to the fee (beta, after all, is cheap). But the equitized alternative will likely end up looking a lot higher fee than most other things in an equity portfolio (maybe not privates, of course!), even when the fees are "fair," as you are really buying a package deal of cheap beta and less cheap attempted long-short alpha (again, how much higher depends on the attempted vol taken in pursuit of alpha).

[13] Also not really new to us. We've been running aggressive alts and/or relaxed constraint equity portfolios for a long time. Just getting more explicit and taking the concept up a notch.

[14] Sadly though, in a practical portfolio we can't get very close to the 25% volatility I studied in my paper on high vol alts (extremes are good for clear discussions).

[15] I'm particularly excited some of these strategies will be managed "tax aware," a capability we've developed over nearly a decade now, which focuses not only on delivering attractive pre-tax returns, but more important for taxable investors, their after-tax return.

[16] I am paraphrasing.

[17] Of course, there is a world where alts hurt in a bear market exacerbating the pain. The GFC offers a mixed bag of evidence on that.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC ("AQR") to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.