

The launch of yet another investable hedge fund index stinks of blatant opportunism, says Robbie Alexander

All aboard the index gravy train

THE NEWS that FTSE has introduced a new hedge fund index to add to the proliferation of investable hedge fund indices can only mean this – the gravy train's in town and let's hop aboard before it leaves the station. Index compilers have smelled the opportunity to make a fast buck on the back of the explosion in interest in hedge funds.

Is this harsh? No, several investable hedge fund indices have been put together with fees charged in a similar fashion to your traditional fund of hedge funds.

Some of the biggest names have brought out investable hedge indices that strive to achieve the following: representative, investable, replicable, accurate, with independent verification.

That's quite a challenge. Specifically, there are more than 6,500 hedge funds and

For example, HFR believes 50 managers across eight strategies is the most appropriate index, while Dow Jones agrees on the number of managers, except it thinks five strategies are appropriate. CSFB believes 60 managers across 10 strategies. MSCI believes 88 managers across 13 strategies, and S&P believes 40 managers across nine strategies represent the most appropriate investable index. Who's right – if any?

REPRESENTATION

They all decided what they thought would best represent the most appropriate managers, numbers of managers, strategy allocation and so forth. The million-dollar question is how this differs from a well-diversified fund of funds (FoF). Would a normal FoF also not sit down and decide on the most appropriate managers and strategies? The answer is yes, the core difference being the FoF will actively change managers.

Second, in order to include managers in the index, a minimum amount of open capacity needs to be negotiated – usually in the region of US\$100m. Intuitive wisdom tells us the best managers close and will probably not agree to large open lines of capacity. I'm not saying the managers included in the indices are second rate, but merely present an intuitive conclusion in an industry that is hamstrung by capacity constraints.

Third, some of index management teams set up separate accounts, with underlying hedge managers, as do a number of FoF managers. Both FoF teams and index teams purport to do

a thorough due diligence before selection.

The construction methodologies and biases result in five different investable indices that purport to represent an investment universe, but look and perform quite differently. Therefore the selection of which index to choose is 'active' in and of itself!

Last, the important issue of fees. You will be surprised the management fees are comparable to FoFs, but usually the FoFs charge a performance fee as well. One of the largest groups charges a management fee of 75bp – 150bp, depending on the size of the investment. Added to this a number of groups participate in structures which centre on their indices.

So what does it all mean? On the traditional side a number of indices encapsulate a large part of market capitalisation, such as the S&P500, and can claim to be broadly representative. On the other side the total number of hedge fund managers used for the index, is less than 1% of the total number of managers out there. Moreover, shares do not close for new investment.

This is not the fault of the index providers, but rather a characteristic of an industry, that is devoid of accurate benchmarks as well as being cloaked in a veil of non-transparency.

However, investors new to hedge funds and seeking the same kind of comfort they gain from passive investing within the traditional environment may not be aware of the limitations of these indices. They will quickly need to familiarise themselves with the issues and fully understand the implications of their decision, especially as it pertains to FoF comparisons.

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more than 1,000 fund of hedge funds. Limited capacity and access to good managers is an ongoing challenge for all participants.

Against this backdrop HFR, MSCI, CSFB, FTSE and Dow Jones have launched investable indices. There are at least 10 rival hedge indices providers – all employing different calculation methodologies.

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