

# How to box the baby

**Hedge funds are not a separate asset class but are simply a style of money management – and investors should be made aware of this, argues Robbie Alexander**

One of the greatest difficulties facing new entrants to the alternatives market, whether they are pension fund trustees or consultants, is that of putting hedge funds into a particular box that makes sense when looking at the traditional asset classes. Incorrectly, a number have viewed hedge funds as a different asset class.

While considering this point, it is also worthwhile looking at the investment industry's current metamorphic phase. Starting with the most obvious issue – the definition of an asset class – one would need to take heed of the fact that hedge fund managers invest the bulk of their assets in financial instruments, such as bonds and equities, as well as derivative instruments that are themselves classified as asset classes. Hedge fund management, however, concerns the way in which assets are managed.

Simply put, the rules applicable to a hedge fund manager are looser or wider-ranging than would be the case for a traditional manager. Therefore the hedge fund manager has more tools at their disposal. As one would define a growth or value manager, one could in the same sentence define a hedge fund manager. Hedge fund management relates to a style of money management and not to an asset class.

## Same but different

Are hedge funds the same? If too much money were to flow to hedge fund managers, at some point some managers would no longer be able to deploy these inflows as effectively as they had done in the past. This would probably result in underperformance, but it would not result in a meltdown as could potentially happen to any asset class. The more money that flows into hedge funds, the more difficult it will be for the managers to extract alpha – and the more important it will be for them to find new ways of exploiting market mispricings.

Why is it so important to understand that hedge funds are in fact not an asset class but a way of management? A number of naysayers are declaring that hedge funds as an asset class will blow up – meaning the hedge fund industry as a whole will give rise to significant losses, as was the case with the Nasdaq. However, hedge funds are not prone to bubble symptoms as other asset classes are. Being the whipping boys of the

industry, hedge fund managers often receive peripheral and uninformed critique from their long-only brethren. One would happily concede that with a universe of more than 8,000 hedge funds, there will be a number of high-profile blow-ups (as will be the case on the long-only side).

Having said that, the hedge fund industry needs to lose its mystique. Hedge fund salesmen should try to be less jargon-intensive and should focus rather on helping to demystify the asset class. The industry has done a poor job of explaining itself and has contributed to the lack of understanding by institutional investors.

Hedge funds are no longer a boutique industry, but are now part of the investment mainstream. Ten or 12 years ago, Goldman Sachs wrote a report that you needed to be big to survive – this was in fact not the case. We saw a lot of consolidation in the early-1990s and now we are seeing the likes of Citigroup selling off its investment factories. This new trend has largely been driven by open-architecture models where clients want the best and don't want to be locked into the in-house product.

So we are seeing the distribution and factories being unbundled and hedge funds are in the middle of it. The hedge fund industry will remain a fragmented industry for some time to come. Investors are no longer looking at asset classes when looking at a solution for their particular risk budget, but rather at alpha and beta components. Furthermore they are now only willing to pay higher fees for alpha generated and minimal fees on the beta side.

However, one still finds a rather unsophisticated approach by some investment consultants. One of my client's consultants informed the client that the hedge fund component had underperformed the traditional component for the last six months of 2004. This was done by comparing two performance numbers without any thought been given to anything else, the least being risk-adjusted returns. How scary is that – and these guys look after billions.

So where does that leave us as far as boxing the baby? Well we know for sure that the baby is not an asset class. Second, the baby has to find its own identity in a world that promotes open architecture, and is only willing to reward for alpha generated. It sounds like a Darwinist approach.



**Robbie Alexander** is chief executive of Octane Holding, based in Switzerland.