

Why do we oversell?

I am always fascinated by the ongoing market mysticism and bravado pushed by hedge fund marketers when discussing hedge funds as an asset class.

Although this may appear to be the most appropriate strategy to garner funds from investors, particularly institutional investors, it often has the reverse effect as a number of these decisions makers, whether they are pension fund trustees or their gatekeepers, are often better informed about the industry than one realises.

Why not place the facts on the table and let them know most of the strategies are correlated to markets in different ways?

The big selling argument is hedge funds enhance both returns and diminish risk when added to any traditional portfolio. Second, the losses are less severe than one experiences on the traditional side. This is more than good enough.

One does not have to make untrue statements that hedge funds always make money in all market conditions, which is rubbish, as we all know they can lose money as well.

So what does that mean in terms of the most adequate approach to gatekeepers and trustees with the specific intention in mind of trying to get them to accept hedge funds as a necessary integral component of every portfolio?

First, it is important to understand more institutional investors are evaluating their investments in terms of beta and alpha components. This is being taken further, where one looks at the beta and alpha components within the hedge funds asset class on a standalone basis.

The beta component would be the return which one could replicate easily at low costs, and alpha is the value add part for which one is willing to pay higher fees.

One would find a combination of both beta and alpha within hedge fund returns. Therefore the amount of hedge fund beta is becoming more and more prevalent within the minds of the gatekeepers when evaluating hedge fund investments.

Investable indices, supposedly cheap replicable hedge fund beta, are fraught with issues such as high fees. Furthermore, gatekeepers are starting to understand alpha in itself can be cyclical.

Given these trends, one can understand the person who interfaces with these decisions makers, must be cognisant of the

fact they themselves are further down the line in understanding some of the real issues facing the industry.

A major concern is as volatility shrinks partly due to the growth in hedge funds, the generation of alpha will depend on longer time scales. You will have to lock up your money for longer in order to get alpha. These are real issues facing this industry and we will be called to respond.

Cautious risk management

Another interesting area where one needs to tread carefully is the area of risk management. Trustees and gatekeepers fully appreciate the difference between risk monitoring and risk management.

Everyone operating within the hedge fund space has developed some kind of risk process which they feel would be robust enough to stand up to any scrutiny by investors. Without a well-documented and coherent risk process, the chances of you receiving institutional monies is hampered.

What questions are decision makers asking? Who has the teeth? Can risk managers effectively manage risk, or are they simply producing impressive risk-monitoring reports? Everyone looks at VaR and downside deviations, but who pulls the trigger when a possible scenario has been flagged?

Often the chief investment officer owns the business, which would mean whoever covers risk will have their remuneration dictated by that person. However, this does not mean risk management tools are of no value, but the consideration of the softer issues is absolutely vital. Idiosyncratic risk or the risk related to a person is paramount in this industry, and it is difficult to quantify.

So what does this mean? Institutional decision makers have a greater understanding of the whole industry, which necessitates a direct approach when dealing with them. They ask insightful questions about alpha generated, understanding how differing cycles affect different strategies, understanding the shortcomings of several well-accepted risk monitoring ratios as well as understanding the fact that taking action equates to risk management, rather than producing a myriad of ratios without action.

The message is clear – we need to take the necessary time covering these issues with our future investors.

This issue, Robbie Alexander addresses the issue of how to approach potential investors



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