A new breed of computer-run investable indices claims superiority for capturing hedge fund betas.

In Quants We Trust?

By James Picerno

THE INVESTABLE HEDGE FUND INDEX BUSINESS IS A 21ST CENTURY invention, but already it's in need of reinvention, asserts Marc Malek, managing partner of Conquest Capital Group.

Malek's no idle observer of the market for portfolios that track hedge fund benchmarks. His New York firm is among a small but determined group of players trying to convince the world that there's a better way to run an investable index in the alternative investment space. Four-year-old Conquest Capital runs a quantitatively managed index fund for institutional investors and wealthy individuals. The goal: Capturing the lion's share of returns in the commodity trading advisers (CTA) market, one of several strategies within the broadly defined hedge fund universe.

Conquest Managed Futures Select, the firm's CTA index fund, was launched in 2004, and so it has barely had time to prove itself. Yet Malek already talks of extending his nascent indexing franchise, speaking of plans for other quant-based investable hedge fund indices. In fact, he boldly aspires to be the alternative investing world's John Bogle, a reference to Vanguard Group's founder who launched the first equity index mutual fund 30 years ago.

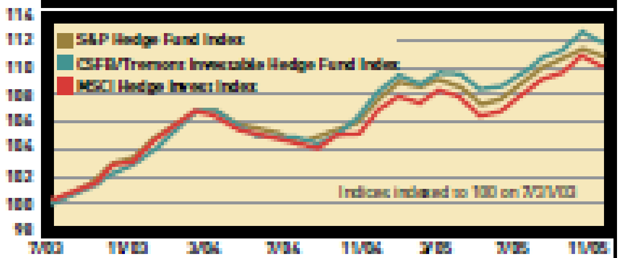
The twist is that Malek's firm uses computer models to run what he claims is a superior indexing process for replicating the returns of hedge funds and managed futures. That's in contrast to the first wave of investable hedge fund products which began appearing a few years back and share a common feature of buying pre-existing hedge funds to track a benchmark.

Malek's vision is controversial in some, if not most hedge fund circles. Indeed, some dismiss the idea of quant-based indexing as, at best, an experiment and at worst, a hopelessly naïve scheme that can't possibly replace the talent of those human managers who've proven themselves. Meanwhile, Malek's not winning any friends in the industry by charging just a mere 1 percent fee for his CTA index fund, a pittance in a business where the so-called two-and-20 standard pricing dominates—2 percent of assets and 20 percent of profits, if any.

Yet Malek's not alone in arguing that quant-based efforts are a better indexing mousetrap for capturing a representative performance sample of hedge fund strategies. Nonetheless, it remains to be seen if the quants grab a significant slice of the market for investable hedge fund indices. The arrival of indexing is always a contentious affair, and that history seems likely to repeat itself here.

As with most attempts at reinventing some corner of investing, the first step is rolling out product. By that standard, the new new age of investable hedge fund indices has begun. The most conspicuous example arrived in September, when Rydex Investments, the mutual fund company known for its innovative list of index funds, launched Rydex Absolute Return Fund.

THE DEFENDING TEAM



The first generation of investable hedge fund indices, such as the three shown above, has new competition from quant-based benchmarks.

Rydex bills its new fund as a quantitatively driven, multi-strategy hedge fund in a mutual-fund format. The investment goal, which is a first for a mutual fund, is generating "return and risk characteristics of the hedge fund universe," according to the prospectus. There are a number of mutual funds that pursue hedge fund-like strategies, such as market-neutral and long-short, but Rydex Absolute Return is the first mutual fund to quantitatively pursue multiple hedge fund styles under one roof.

As the label implies, quantitative-based strategies are distinguished by a slavish dependence on computer models. A different model prevails with the first wave of investable hedge fund indices, which track benchmarks published by Standard & Poor's, MSCI, Dow Jones, CSFB/Tremont and others. The S&P Hedge Fund Index, for example, is comprised of roughly 40 hedge funds. The focus on individual hedge fund managers makes the first investable indices comparable, at least superficially, to the traditional hedge fund of funds—a far older strategy that also seeks to offer a diversified mix of hedge funds, albeit by relying on a qualitative approach to picking funds.

Investing in multiple managers and repackaging the strategy in one fund could hardly be more dissimilar from a quant-eyed view of hedge funds. The latter is a world where computers identify and then spit out rules for producing the factors, or unique investment characteristics that define a given strategy. "It's trying to capture the return stream, basically the beta, of the index," Justin Dew, a senior hedge fund specialist at Standard & Poor's in New York, says of quant-based indexing for hedge funds. "Attempts at recreating the beta of certain hedge fund styles are becoming more and more popular."

Jeff Joseph, managing director of Rydex Capital Partners, prefers the term skill-based betas for describing the focus of his firm's Absolute Return Fund. But this isn't your father's beta that dictates the mechanics in running conventional equity indices like the S&P 500. "Unlike going long only, skill-based betas require leverage, derivatives and/or shorting to execute, and that's why your typical investor can't do it," Joseph explains. "But they're still betas." The Absolute Return Fund's betas are spread across six categories: fixed-income arbitrage, long/short equity, merger arbitrage, market neutral, currencies and commodities.

THE NEW BREED OF QUANT-ORIENTED HEDGE FUND INDEXERS CRITICIZES BOTH TRADITIONAL HEDGE FUNDS AND THE FIRST GENERATION OF INVESTABLE HEDGE FUND INDICES. THE FORMER ARE ALL TOO OFTEN CHARGING FOR ALPHA BUT DELIVERING BETA, GOES THE COMPLAINT.

The use of computers for executing buy and sell decisions is hardly new, although quantitatively replicating a broad swath of alternative investment results is largely a new arrival on the financial scene. However, there is at least one exception: Mount Lucas Management, a Princeton, New Jersey company that's been quietly running an investable index of managed futures performance for institutional investors since 1993. Roughly $1.5 billion is currently tracking the MLM Index, says Ray Ix, senior vice president at Mount Lucas. The benchmark is diversified among 22 futures markets in currencies, commodities and fixed income, and the strategy allows for going long or short in each group, depending on market trends.

"We've always believed there's a beta to hedge fund investing, but hedge funds don't want to tell you that because that would screw with their incentive fee," Ix contends. MLM's founders, Chairman Frank Vannerson and President Timothy Rudderow, believe that a true index should demonstrate the returns of an asset class that's independent of manager skill, Ix continues. But there's a limit to how much you can charge for such a service. Accordingly, the price of the MLM Index is no more than a flat 75 basis points.

The issue of fees ultimately finds its way into any discussion of investable hedge fund indices, a realm that promotes itself as a far-less expensive entry to hedge-fund land. It's a sensitive subject for an industry that otherwise justifies hefty fees by claiming that hedge funds excel in alpha, or manager skill. Predictably, the quant-based indexers beg to differ, arguing that beta makes up the bulk of hedge fund returns, and so beta pricing should be the norm.

"There's more beta than alpha in [hedge fund] returns," says Lars Yaeger, who heads the research division of Partners Group, a Zug, Switzerland firm that recently created a quant-driven multi-strategy investable hedge fund product that charges no more than a 1.5 percent fee. "You can actually model [hedge fund] beta quite well. Once you can model it, you can replicate it passively and create solid benchmarks and investment vehicles that replicate hedge funds through their beta exposure."

The new breed of quant-oriented hedge fund indexers criticizes both traditional hedge funds and the first generation of investable hedge fund indices. The former are all too often charging for alpha but delivering beta, goes the complaint. Meanwhile, building investable hedge fund indices by investing in a variety of individual managers is inherently misguided at any price, runs the other charge. Conquest Capital's Malek says that building a managed futures index by purchasing other hedge funds is as misinformed as a "passive" strategy trying to capture the equity market's returns by owning a mix of actively managed stock mutual funds.

Still, some argue that the first generation of investable hedge fund indices has a valuable role to play. One reason, S&P's Dew insists, is that some hedge fund strategies can't be quantitatively modeled. As a result, manager-based indexing offers strategies that are off limits to quant-run indices. What's more, quant-based indexing is untested, Dew adds.

As such, no one really knows if modeling and then building an investable index of multiple hedge fund betas will succeed as a long-term proposition. As the skeptics like to point out, quant indexing is complicated stuff, which draws charges from some that the strategy is really just a black box of uncertainty.

In any case, separating alpha and beta remains popular in the investment industry generally, and the trend doesn't end at the doorstep of alternative investments. "Hedge fund beta strategies clearly resemble traditional index fund strategies, as we can write rules for how to implement them, and these rules are not secret," wrote Cliff Asness, managing/founding principal of AQR Capital Management, a quant-oriented hedge fund in Greenwich, Conn., in the Fall 2004 issue of *The Journal of Portfolio Management*.

Simply put, it's not getting any easier to dismiss the notion of hedge fund betas. "Theoretically, there's enough research out there on how you can quantitatively replicate hedge fund strategies," says Thomas Schneeweis, a professor at the University of Massachusetts, Amherst, and director of the institution's Center for International Securities & Derivatives Markets.

One of the authors of such research is David Hsieh, a professor of finance at Duke University who's studied so-called factor models for hedge funds. Among his findings are that seven factors explain as much as 80 percent of monthly return variations in diversified hedge fund portfolios, a conclusion discussed in an article he co-authored that was published in the September/October 2004 *Financial Analysts Journal*. *Wealth Manager* recently asked Hsieh if such a finding provided the basis for running factor-based hedge funds. In an email response, he replied that the seven-factor model was a starting point for "understanding the typical risks in hedge funds."

Making the leap from theory to real-world money management is still tenuous, Hsieh adds. "If the objective is to replicate hedge fund returns using some quantitative model, I would say that the answer is still very much up in the air."

One problem, according to Hsieh, Schneeweis and others who otherwise accept the existence of hedge fund factors, is that some strategies lend themselves to quantitative modeling, but some don't. The quantitative approach is "very applicable to a certain set of strategies, but not to others," agrees Barry Colvin, president of Tremont Capital Management, a Rye, N.Y.-based hedge fund consultancy and hedge fund of funds manager. Rydex's Joseph concurs, noting that several hedge fund strategies, such as global macro, aren't targeted in his Absolute Return Fund.

But for those hedge fund/managed futures strategies that can be generated quantitatively, the case for a quant approach is compelling, at least on paper. That's partly because the competition among hedge funds generally is growing. If, as some strategists predict, hedge fund returns will diminish as more dollars chase performance, the relatively inexpensive path to investing in the alternative space that Rydex, Conquest and Mount Lucas Management offer may find a bigger audience.

Malek sums up the opportunity by opining, "I think the hedge fund world is ripe for a Vanguard of hedge funds."

Whether quant-based hedge fund indexing fails or succeeds, for the time being the first wave of investable hedge fund indices seems to be in the cross hairs of a new generation of indexing upstarts. "The investable indices out there right now have nothing to do with extracting risk premia," alleges Yaeger. "They're basically a bunch of managers being pulled together, in a more or less random way. They're much more fund of funds than indices."

It's unclear if the market will accept the progressive view of the Yaegers and Maleks or take a more nuanced approach by agreeing that the earlier generation of investable indices have merit next to their quant-based alternatives. Rydex, for one, has an inclusive philosophy, offering both a manager-oriented fund of funds for investable indexing via its Sphinx Fund (which tracks the S&P Hedge Fund Index) and its new quant-run Absolute Return Fund.

No matter the debate over who's got the better index fund, this much seems clear: There's a growing acceptance that hedge fund betas exist and that those betas can, to a degree, be exploited in the real world. The real debate will center on how best to capture those betas, and that promises to be a long and increasingly technical discussion about implementation.

Indexing overall may be about leveraging simplicity and efficiency on behalf of enhanced risk-adjusted returns, but no one ever said passive investing's evolution would be easy.

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For Our Next Trick

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Populism is spreading to the convertible arbitrage market as well. Yusko, for one, believes that convertible bond arbitrage is an invaluable investment strategy that should be available to a wider swath of investors. "By every measure of risk—standard deviation, semi-variance downside volatility, risk of absolute loss—convertible arbitrage strategies are far less risky than most investments," he says. "In the worst years of a convertible arbitrage fund you might lose 10 percent of your money, but compare that to the worst year in equities where you might easily lose 30 percent or more of your money. Yet most investors are precluded from incorporating these arbitrage strategies because of SEC edicts."

While opinions vary on convertible portfolio percentages and suitability, they conform on account location: Convertible bond funds—arbitrage or long—are best suited for tax-advantaged accounts. Annual turnover for most funds is high. "Compared to an equity fund, our turnover rate ranges from 50 percent to 100 percent," says Dinsmore. "I don't know how you manage a convertible portfolio, even in a normal market, that isn't at least in the 50 percent turnover range."

Because of recent anemic performance, both convertible bonds and convertible bond arbitrage have lost some of their luster. The Froley, Revy Convertible Security Index was down 0.50 percent in 2004 and up 1.72 percent through October 2005. Meanwhile, through October 2005, the CSFB/Tremont HEDG Convertible Arbitrage Index was down 3.06 percent after gaining 1.98 percent in 2004. Investors responded predictably: Convertible bond funds, which took in $644 million in 2004 and about $3 billion in 2003, suffered outflows of $744 million through June 2005, according to data aggregated by Financial Research Corp.

Recent market weakness in the convertible bond market coupled with investor antipathy could spell opportunity for contrarians and disciplined asset-rotation adherents. "Like anything else, the price you pay influences the attractiveness of the security," says Yusko. "Two years ago, paying a premium for a convertible bond was very risky, though it happened with regularity because of the hot market. Today, buying straight convertibles at a discount is starting to look attractive."

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