

# Alternative views on alternatives

Is it alpha, or is it "camouflaged beta?"

## ALT ASSETS

BY PIERRE SAINT-LAURENT



Alternative investments, including hedge funds, are subject to myths and limitations.

Last time, we saw that first-quartile private equity funds truly outperform, while those at the median level and below significantly underperform. But what about hedge funds?

R. McFall "Mac" Lamm, chief investment strategist for Deutsche Bank, splits most of his time between London and New York, when he's not side tripping to conferences in Toronto, Shanghai and elsewhere. In a recent talk he showed some interesting findings

from his research group.

For Mac Lamm, funds of hedge funds look at returns according to whether they outperform their benchmark, which is typically cash. So, if a hedge fund turns in, say, 6% in a 3% cash world, that's a 3% outperformance.

But is that 6% return the result of alpha, or is it generated by what Lamm calls "camouflaged beta?"

In particular, Lamm has found that hedge funds hold a lot of beta, suggesting that in a field where claims of alpha fly freely, reality is possibly less than meets the eye. His research over the past two years on a sample of regional long/short equity funds (U.S., Europe and Asia) shows that every one of them has gone long small-cap equities and short large-cap

equities in the same markets. This is what Lamm labels "simple beta." In his view, this type of investing can be replicated relatively easily and he questions the sometimes hefty fees levied on such simple beta. Unfortunately, many investors, both high-net-worth and institutional, just can't sufficiently partition performance between

alpha and beta.

This is not the same as complex beta. In fact, Lamm's analysis shows up to 90% of hedge fund returns may be attributed to beta. There is nothing wrong with this: several hedge fund styles allow investors access to illiquid, less developed and highly specialized investments. Often the only way in is through the contacts, knowledge and skill of hedge fund managers. For Lamm, this is beta worth paying for.

Another of Lamm's claims is that hedge funds depend on market fundamentals, just as long-only investments do. Hedge funds are cyclical – different strategies react differently to given stages of the market cycle.

From this, Lamm has further developed the concept of "dead strategies," approaches that have dropped out of favour (and out of performance contention). An example he suggests is convertible arbitrage. A recent dud, convert arbitrage was a truly winning strategy in the late '90s. What happened?

First, the trading of convertible bonds was a more arcane skill back then – you needed to understand option pricing models in order to correctly value the equity option embedded in the convertible. Hence, there were fewer skilled arbitrageurs capable of identifying the underlying true value of the convert and to arbitrage the security's convergence to fair price.

Second, there was significant mispricing of convertibles: the market value of converts was not the sum of its underlying bond and equity exposures. As a result, there was more opportunity to arbitrage these mispricings away.

Third, since necessity is the mother of invention, there are now more than enough smart traders and issuers capable of modeling optionality to keep the converts market very close to fair value.

This begs the question: are hedge fund strategies doomed to be the victims of their own growth? Is hedge fund success predicated on relatively scarce knowledge, which will become widespread in time, thus arbitraging away the strategy? This question, of course, is central to assessing the state of the hedge fund industry: is it sustainable and are there too many players in the field?

Hardly, according to Lamm. In his view, hedge fund strategies wax and wane in accordance with their sensitivity to different fundamental market conditions. An excellent example is the commodity trading advisor/managed futures strategy (and it's robust because CTAs have been around for decades). In the '80s and through most of the '90s, this strategy was a strong outperformer. However, CTAs had periods of weak performance in the '90s. Recently, the strategy has underperformed. But is it dead? It may be for now, but Lamm believes it will reappear when market conditions are right. What cyclicalities means for the hedge fund strategy is this: when conditions sour, smaller players may disappear, while entrenched and deep-pocketed managers will withstand the storm and prevail in the long run.

In the final analysis, skill will be compensated and will remain the main driver of the hedge fund industry. Exceptionally skilled managers will continue to be hired as hedge fund compensation structures are optimized to recompense outstanding ability. Hedge fund strategies will endure because superior skill applied to markets in a relatively free fashion, offers return-risk mixes that are appropriate to many investors. **AER**

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## RETURNS ATTRIBUTABLE TO BETA FACTORS

