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Ibbotson reveals the ABCs – alphas, betas and costs – of hedge funds

SIMON MUMME February 17, 2010

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Hedge funds, in aggregate, have generated positive alpha in the past 11 years. This finding, made by Roger Ibbotson, founder of Ibbotson Associates and Professor of Finance at Yale University, proves the strategies can resist powerful market declines but often fall short of providing absolute returns to investors. He spoke with Simon Mumme about the ABCs – alphas, betas and costs – of hedge funds.

“Hedge fund alpha was positive each year since the Asian crisis, even in 2008,” Ibbotson says, commenting on the updated figures in a research paper he is writing with Peng Chen, president of Ibbotson Associates, and Kevin Zhu, senior research consultant at the firm.

Their finding comes as many hedge funds attempt to regain the trust of institutional investors, many of whom were dissatisfied with their performance in the financial crisis and their inability to redeem capital from some credit strategies, which imposed ‘gating’ provisions to preserve their portfolios.

The final version of the paper, which is titled *The ABCs of Hedge Funds: Alphas, Betas and Costs* and will be released soon, analyses the returns of the 13,383 hedge funds within the TASS database between January 1995 to December 2009. It finds that the equally weighted return from the strategies – ranging from convertible arbitrage, equity market neutral and managed futures – was 7.63 per cent, after fees, for the 15-year period. Of this, 3.01 per cent is attributable to manager alpha, and 4.62 per cent to market beta in the form of stocks, bonds and cash.

For Ibbotson, Chen and Zhu, market beta includes non-traditional betas, such as momentum and derivative-based factors. Their justification for this is such non-traditional betas are not as readily available to investors as stocks, bonds and cash instruments, and that hedge funds are a primary means of accessing the other betas.

Among the hedge fund strategies, long/short equity generated the most alpha, serving up an annual 5.16 per cent, followed by emerging strategies with an annual 5 per cent, then event-driven funds with an annual 3.73 per cent. Shorting strategies and managed futures produced the least alpha, delivering 1.74 per cent and 1.17 per cent annually.

But as investors know, hedge fund alpha does not come cheaply. Assuming the managers charge a 1.5 per cent management fee and 20 per cent performance fee, the researchers calculate an average alpha/fee ratio of 0.8. This means the alpha received by investors is equivalent to 80 per cent of the fees they have paid to managers.

“Of the alpha, managers get to keep at least half of it. But there’s still substantial net alpha,” Ibbotson says.

Among the hedge funds, emerging strategies provided the most alpha for investors’ fees, generating an alpha/fee ratio of 1.21, followed by long/short equity with 1.16. Equity market neutral, global macro and managed futures delivered less alpha for clients’ fees, producing alpha/fee ratios of 0.68, 0.58 and 0.36.

An earlier version of the paper, written in September 2009, found hedge funds produced a return of 9.9 per cent, before fees, which consisted of 1.95 per cent alpha and 4.47 per cent beta. This means that 3.48 per cent of the return was absorbed by manager fees.

In this working paper, the authors note that hedge funds are a collection very dynamic and relatively young investment strategies, and are expected to evolve further in time. But since they now hold more than \$1 trillion, and continue to attract capital, “we cannot be assured that the high past alphas we measure are a good prediction of the future alpha in the hedge fund industry,” the researchers write.

Survivor: hedge fund land

Over the 15-year research period, more than half of the hedge funds Ibbotson, Cheng and Zhu tracked either blew up or dropped out of the TASS database. The researchers observed that 7,413 funds were withdrawn. Worryingly, the performance of these funds does not contribute to the aggregate returns data. Because TASS only monitors successful funds, the researchers adjusted for ‘survivorship bias’ by including the

By stripping out these biases, the researchers effectively took an axe to the headline returns published by TASS: the original 13.23 per cent performance of the funds over the study period was almost halved to 7.63 per cent.

Such an outcome indicates that survivorship and backfill bias are potentially serious problems, Ibbotson says, which can only be detected if dead funds and backfilled returns can be separated from aggregate performance data.

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