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Theta Research Notes #4

The Alpha Myth: Investable Hedge Fund Indices Uncovered

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Introduction

With many investors looking for an easy way to jump on the bandwagon and start investing in hedge funds, investable indices have gained in popularity and new versions are being launched all the time. However, while the index funds are enjoying stealth growth, their added value is still highly debated. Today, there are more than 40 different index products available, varying from broad market indices to specific hedge fund style indices or regional indices. We estimate that about USD 15 billion worth of assets are currently invested in index products. The main advantages often touted are: transparency, diversification, liquidity and the potential to provide high returns like the underlying hedge funds themselves. In this research note we will touch on these issues, starting with the latter.

Since investable index products are often presented as a cheaper alternative to funds of hedge funds, we assess

whether this claim is actually valid. In other words, we test the claim that fund of funds add value (generate alpha with active portfolio management and manager selection) to passive indices. First, we note that management fees are lower in most cases but not that much: they vary from about 0.55% per annum for the MSCI Hedge Invest Tracker Fund to up to 1.3% for the HFRX Global Investable Index. In Exhibit 1 we show the annualised alpha of fund of fund indices over investable indices, calculated from April 2003 (launch date of the HFRX Investable Index) to July 2005. Please note that fund of fund returns are always presented net of management and performance fees while investable index returns are *before* management fees (the actual fee level will depend on the type of product). This means that, in order to make a fair comparison, we should deduct an additional 1% management fee from the investable index returns (which we have **not** yet done in the analysis below).

Exhibit 1 Annualised alpha of fund of funds over investable hedge fund indices

	Theta Multistar Medium Volatility	Theta Multistar Low Volatility	HFRI Fund of Fund Index	EDHEC Fund of Funds Index	CISDM Diversified Median FOF Index	CISDM Niche Median FoF Index	Barclays/GHS Fund of Fund Index	Tuna Fund of Fund Average
Average annual alpha over:	3.59%	3.46%	3.21%	3.46%	3.60%	7.12%	2.99%	3.23%
HFRX Investable Index (AW)	5.29%	3.91%	4.47%	4.62%	4.57%	7.86%	4.11%	4.44%
HFRX Investable Index (EW)	5.22%	3.85%	4.53%	4.69%	4.60%	7.83%	4.16%	4.50%
CSFB Investable Index	1.47%	2.96%	1.79%	2.17%	2.52%	6.42%	1.78%	1.87%
MSCI Hedge Invest Index	2.88%	2.83%	2.45%	2.70%	2.89%	6.58%	2.16%	2.45%
FTSE Hedge Index	3.10%	3.74%	2.82%	3.13%	3.43%	6.88%	2.74%	2.88%
Average beta to:	1.13	0.55	0.92	0.90	0.78	0.54	0.88	0.93
HFRX Investable Index (AW)	0.85	0.48	0.72	0.71	0.62	0.42	0.70	0.73
HFRX Investable Index (EW)	1.07	0.61	0.88	0.86	0.77	0.53	0.85	0.89
CSFB Investable Index	1.38	0.58	1.08	1.03	0.89	0.60	1.00	1.07
MSCI Hedge Invest Index	1.24	0.65	1.05	1.02	0.89	0.63	1.02	1.05
FTSE Hedge Index	1.12	0.45	0.91	0.88	0.74	0.53	0.85	0.90

Source: Bloomberg, Calculations Theta Capital Management

Exhibit 1 clearly shows that active fund of funds generate substantial alpha over (passive) investable index funds. To the extent that investable indices properly represent the hedge fund universe and can be used to benchmark and evaluate fund of fund managers, our analysis shows that fund of funds do add value with an average annualized alpha of 3.25%. Note that not one single fund of fund index generates a negative alpha in our analysis. This should not really come as a surprise since the fund of fund manager is actively searching for alpha and trading talent, while the investable index manager is effectively “averaging the alpha” which by definition will lead to lower returns (note that, on a global scale, alpha extraction is a zero sum game).

A similar picture arises when we compare investable and non-investable hedge fund style indices (see Exhibit 2 on the following page, we have adjusted the data for management and performance fees to make both index groups “investable” and comparable to fund of fund returns, see footnote for details). Although this difference can not be attributed to alpha generation since hedge fund style indices do not reflect active management, it does show that the underlying hedge fund managers in the investable index exhibit less skill than those in its non-investable counterpart.

We believe there are several reasons for the observed underperformance by investable indices of about 3%-4% per annum and will discuss them below.

Adverse selection

First, funds of funds aim to select the best managers while (most) investable index funds simply try to replicate the hedge fund market place without regard to performance potential. Second, some fund of funds (e.g. ourselves) strive to build an optimal portfolio of hedge funds pursuing complementary investment strategies, whereas there is no reason why a portfolio that aggregates the average performance of a basket of hedge funds represents an optimal portfolio. Third, not all hedge fund managers have significant skill and the performance difference between good and bad managers seems to be widening over time, as more capital flows into the industry and more new managers enter the industry¹. This implies that hedge fund index investing provides exposure to a growing pool of unskilled managers, which is obviously inferior to a portfolio of actively picked good hedge funds. Finally, in our view, investable index funds may suffer from *adverse selection bias*: only the hedge funds that have difficulty raising assets from other investors will subject themselves to the often more strict requirements (e.g. more transparency, guaranteed capacity and better liquidity) that the manager of an investable index platform will impose on its underlying hedge funds.

Exhibit 2 Outperformance of style indices vs. investable indices

Apr 2003 – Jul 2005, Ann. Return Difference*

	HFR	CSFB Tremont
Multi-Strategy	1.42%	1.84%
Convertible Arbitrage	1.11%	-1.77%
Merger Arbitrage	1.76%	-
Equity Market Neutral	4.55%	2.80%
Event Driven	5.82%	2.70%
Distressed	7.81%	-
Long-Short Equity	6.73%	-0.97%
Global Macro	6.04%	3.73%

* Style indices adjusted for typical Fund of Fund fee structure (1.5% man fee/10% perf fee). Investable indices adjusted for typical Investable Index management fee (1%)
Source: Bloomberg, Calculations Theta Capital Management

¹ Liew, J. (2002), *Hedge Fund Index Investing Examined*, finds that only 30% of the managers examined exhibit significant skills.

Transparency

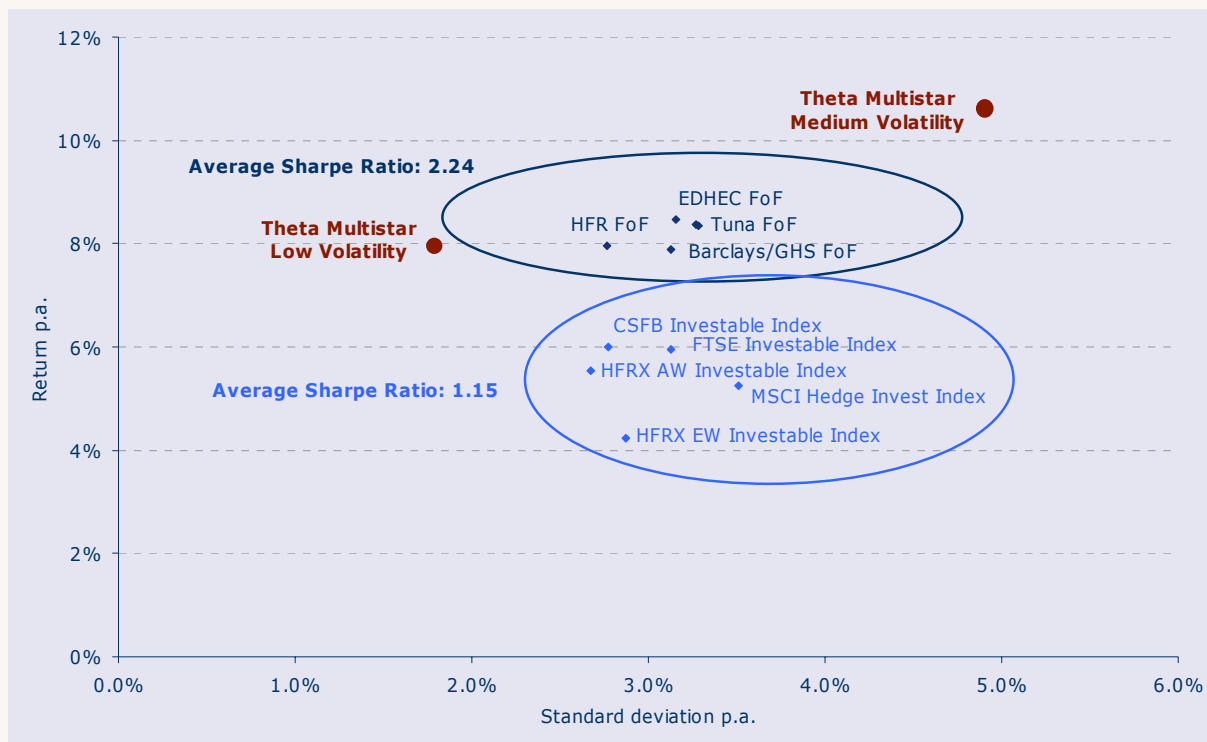
As for the claim of providing better *transparency*, we note that investable index funds and fund of funds both suffer from the fact that many hedge funds consider their investment strategy, assets under management and underlying trading positions proprietary information. This makes the construction of pure style indices or funds virtually impossible. So, investable index funds do not inform investors more accurately about the investment risks they take than fund of fund managers do. Also, both will be willing to disclose the names of their underlying hedge fund investments, provided that confidentiality is maintained. Finally, while the rules-based index methodology of most providers is fairly complex, it is indeed transparent. But how relevant is it to know that your passive portfolio is always constructed following exactly the same procedures, if the actively managed fund of funds is generating positive alpha of more than 3% per annum?

Diversification

While the diversification claim is valid for most composite investable indices (with the number of underlying managers ranging from 40 to 140), this is certainly not true for the investable style indices. For example, the number of hedge funds in the HFRX Investable Style Indices ranges from 4 (merger arbitrage) to about 20 (long-short equity). Moreover, we have found that to maximize the benefit of diversification, one must focus on the cross-correlations between managers. Simply constructing an asset-weighted or equal-weighted portfolio of hedge funds will not provide the downside protection that investors can expect from a diversified hedge fund portfolio. For example, Liew (2002, see footnote 1) finds that index funds do not provide adequate diversification benefits in times of market dislocation – just when it is needed. Exhibit 3 on the following page shows that fund of funds' risk-adjusted returns (as represented by the Sharpe Ratio; excess returns divided by volatility) are clearly superior to those of investable indices. For comparative purposes, we included the risk-return profiles of our Theta Multistar Low Volatility and Medium Volatility Funds.

Exhibit 3 Risk-return profiles of various indices

Apr 2003 – July 2005



The main requirement for a representative index is that the asset class it aims to represent is relatively homogenous. However, hedge funds are highly diverse and their strategies and trading styles are subject to dynamic change. Moreover, most index funds require their managers to fit a specific investment strategy, using quantitative tools to define the strategy median: this means they are looking for the average manager within that strategy! In contrast, at Theta Capital we strive to select niche players with independent minds that shun the market average, simply because that is what hedge fund investing is all about. It's a small step from median to mediocre...

Conclusion

Interestingly, it appears that a new investor class in investable index products is arising: fund of funds. In some cases, investable style indices are used to tactically allocate to specific strategies on an opportunistic basis. Others may use the indices as a liquidity reserve, benefiting from the weekly liquidity of some investable funds. We have also heard rumours of a very large fund of fund organization allocating to

investable index products, simply because it can not deal with its stealth growth in assets under management. For those readers who are lost: the investor in this fund of funds is paying 1.5% management fee plus 10% performance fee per annum to a fund of fund manager who in turn invests in a passive index product (i.e. without the objective of generating alpha by active management) which itself charges a 1% management fee. What happened to the Search for Alpha?

If you have the answer, please contact us at:

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