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## Passive Versus Active Investment in Hedge Funds

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In 1972, the 'Reserve Fund' was established as the first money market fund, enabling investors to invest cash balances in an efficient and effective manner. Fidelity and Scudder, Stevens and Clark were also putting the final touches on their own funds and quickly revolutionised the mutual fund world. Today, there are more than 1,300 money funds in the United States alone, and money market funds are offered in all the major currencies throughout the world.

From 1969 to 1971, Bill Fouse, an academic at Wells Fargo Bank, was busy creating models that would lead to index investing. The first index fund was created for Samsonite's pension fund, which equally-weighted all equities on the New York Stock Exchange. What few people know is that this product was abandoned in 1976 and replaced with a market-weighted strategy using the S&P 500.

In 1971, Dean LeBaron, founder of Batterymarch, independently pursued the idea of index investing, but it was not until 1974 that the firm attracted its first index client. Rogers, Casey and Barksdale, a pension consulting firm that embraced Batterymarch's 'computer-driven' active management style at an early stage and later, its indexed products.

Indexing created an industry debate as the investment management businesses were built on the premise that active managers can beat market benchmarks. However, many consultants were wary of this claim, as the majority of active managers failed to consistently beat their benchmarks. Rogers, Casey and Barksdale came to the conclusion that it should focus a large part of its pension clients' assets in passive index-matching programmes while allocating the remainder of the assets to extremely talented active managers who had a distinct edge in their management style. The latter usually came in the form of newer and smaller independent firms rather than the large banks or insurance companies, which had previously dominated pension fund management.

In 1984, Tremont Partners (later Tremont Capital Management) was formed as a pension consulting company. Luckily, one of its first clients was a high-net-worth individual. At that time no pension fund could invest in hedge funds as performance fees were prohibited, but this initial investor allowed the opportunity to visit with the famous hedge fund managers of the 1980s. The results of Tremont's research hooked the firm on hedge funds and it became the first consulting firm to explore investing in hedge funds.

In 1998, Tremont acquired the distributable Tass hedge fund database and combined it with its own propriety database, resulting in a large, robust hedge fund database. Tremont then joint-ventured with Credit Suisse/First Boston to create one of the first benchmarks for the hedge fund industry, and foresaw the opportunity to create passive products. Tremont wished to remain an active manager, while Credit Suisse embraced the passive approach and launched the investable index products.

While many of the hedge fund indices that have been created do not disclose their methodology, let us first examine the two most predominant differences: equally-weighted versus market capitalisation-weighted. Market-cap indices are useful in determining how the hedge fund community has performed, but equally-weighted indices are the only practical benchmarks for comparing the performance of a hedge fund manager against the entire universe and a relative peer group. These indices also allow investors to determine if their choice of strategies is appropriate. However, there should be a size cut-off in each index, so as not to give equal weight to a manager with a very small asset size, which would not be appropriate for the average investor. The size cut-off for broad-based indices would be more lenient than some strategies such as emerging markets, where the average hedge fund is in the US$100 million range, as opposed to more broad-based strategies such as fixed income, distressed debt and multi-strategy where larger assets bases ( over US$500 million) are the norm.

There is no reason not to create indices of the largest 500 or 3,000 hedge fund managers, similar to the S&P and the Russell 3000, but the ability to match these benchmarks becomes problematic. It is relatively easy to create an index, but it is quite another issue to replicate it for investment. Managers may be closed to new business, or have long lock-ups, which may not coincide with the liquidity of the index tracking.


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The inability of the industry to reconstruct the broad-based published indices in a practical product resulted in a brand-new industry term: the investable index. The investable index is a new benchmark introduced by product producers that is supposed to be a realistic index of funds accessible for investment. Unfortunately, many of these so-called benchmarks are simply the products that were created, and are not closely correlated to the broader indices they were created to track. This is best illustrated in the table below.

**Analysis of Investable Hedge Fund Index Products and their Correlations to the Broader Index**

| | *Investable Hedge Fund Index* | | | | *Broad Hedge Fund Index* | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Index Provider** | **2005** | **2004** | **2003** | **2003-2005*** | **2005** | **2004** | **2003** | **2003-2005*** | **Tracking Error** |
| Greenwich-Van | 5.0% | 7.2% | 20.4% | 10.7% | 8.6% | 7.7% | 18.6% | 11.5% | 0.9% |
| CSFB/Tremont | 3.2% | 5.3% | 11.1% | 6.6% | 7.2% | 9.6% | 15.4% | 10.8% | 4.2% |
| MSCI | 4.7% | 3.1% | 7.2% | 5.0% | 8.1% | 6.9% | 15.4% | 10.1% | 5.1% |
| HFR | 2.7% | 2.7% | 13.4% | 6.1% | 9.3% | 9.0% | 19.5% | 12.5% | 6.4% |
| S&P | 2.7% | 3.9% | 11.1% | 5.9% | n/a | n/a | n/a | n/a | n/a |
| FTSE | 2.6% | 2.7% | 12.4% | 5.8% | n/a | n/a | n/a | n/a | n/a |
| Dow Jones | 2.4% | 5.3% | n/a | n/a | n/a | n/a | n/a | n/a | n/a |

* Annualied return
Source: Greenwich-Van (www.vanhedge.com)

There are a number of 'indices' that are really just funds of funds. They are called indices because they may comprised 100 managers and thus, be concluded as constituting an index, or they may be a group of funds that have agreed to run a separate account for the index manager. These inconsistencies lead to the question of whether there can be an adequate index for the hedge fund community.

Unfortunately, there is no requirement that hedge funds report returns to databases. Thus the first problem with the universe of hedge funds is that many good and bad managers do not report. However, the number of managers and the size of the reported universe should create a representative sample. Therefore, indices with a large sample of managers are relevant. Unfortunately, an increasing number of managers are reluctant to report to the ever-growing number of universes. They may pick one or two, but not all. Second, the US SEC regulations have led to many management companies precluding US investors from their investor base. As such, they will not report to US databases as they do not want solicitations from US investors. Consequently, indices created outside the US databases may gain an advantage over their US counterparts.

**Investable vs Non-Investable**

It is rare that a closed fund is closed forever. Funds go through periods when they may close, only to reopen at a later time. However, successful funds that reopen are usually available to existing investors, not new investors. Therefore many non-investable funds become investable.

At MAXAM, we predict that passive investing in hedge funds will become a highly acceptable approach to gain access to large groups of diversified hedge funds. If comprised correctly, these index funds will be difficult for the active fund manager to beat. The sheer size of the hedge fund community (estimated at over 15,000 funds and growing) makes it difficult for any firm to effectively monitor the entire universe. The growth of managers in different geographies also makes it very expensive for consultants, financial planners or providers of fund of funds to cover all the bases. As many of the fund of funds firms become extremely large, they need only to focus on larger funds to maintain capacity across all their client accounts.

At MAXAM, we created index products that make sense and are representative. We have identified the Eurekahedge database for emerging markets, Asia and Japan as being the most representative database, with more than 2,700 funds measured. Moreover, Eurekahedge's location in Singapore offers an ideal time zone for Asian fund managers, one of the fastest-growing components of hedge funds. Further, it is our belief that the emerging markets will give investors the most upside potential over the next decade. Eurekahedge publishes its indices on a monthly basis. It is our job at MAXAM to replicate these indices.


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Like Bill Fouse, we have worked with computer models to determine how we can replicate these published indices. In the three geographical regions – Asia, Japan and the emerging markets – the majority of the funds are open and 85% continue to offer monthly or quarterly liquidity. Just as one does not have to buy all 500 stocks of the S&P to replicate the index, we do not have to buy all 600 funds in the universe. We have found, on a back-tested basis, that we are able to replicate the index with 50 of the largest funds that pass our due diligence. Every month, we determine our tracking error and analyse the geographical and strategy allocations, then make adjustments accordingly. If a fund closes, we keep it in the index and add to the position when it reopens. Each month, we work with all the data to minimise our tracking error.

So far, the indices have been difficult to beat.

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