The Pros and Cons of Passive Hedge Fund Replication

Noël Amenc and David Schröder
EDHEC Risk and Asset Management Research Centre

Introduction

The remarkable rise of the hedge fund industry in the last decade of the twentieth century would not have been possible without the great demand of wealthy private clients for sophisticated investment opportunities. Institutional investors, by contrast, long remained reluctant to invest in hedge funds. Although clearly drawn to the returns and the risk reduction potential of these investments, they have only recently started to shift a part of their assets to hedge funds.

The main reasons for this reluctance are the high fees charged by successful hedge fund managers and the relative opacity of the funds, along with the operational risks associated with investments in weakly regulated entities. The conflict between the institutional investor's requirements for highly transparent investments and the black-box nature of hedge funds has prompted attempts to obtain hedge fund-like returns without actually investing in hedge funds. Investment banks seized the opportunity and have started to create synthetic hedge fund products whose aim is to replicate hedge fund-like returns at lower cost.

However, whether these replication products really offer replication of actual hedge fund returns remains to be seen. The academic debate, as reflected in a recent publication of the EDHEC Risk and Asset Management Research Centre (Amenc et al 2007)[1], revolves around two major issues:

- What is the best means of replicating hedge fund returns?
- Is the replication thus obtained really a close approximation of hedge funds?

The objective of this paper is to describe practitioners' views on hedge fund replication products. For this purpose, the EDHEC Risk and Asset Management Research Centre asked practitioners for their opinions. The results are that many investors also share the concerns of academics. They doubt that replication products can really deliver the benefits they promise. Moreover, hedge fund replication products are still new to many of the respondents, and very few have hands-on experiences with this new asset class.

Executive Summary

A number of major investment banks and asset management consultants have recently launched investment products that promise to replicate hedge fund returns by following rule-based strategies that invest in liquid financial products. The argument is that such products provide hedge fund-like returns while making it possible to avoid paying high fees charged by hedge funds.

In a recent publication, the EDHEC Risk and Asset Management Research Centre analyses the replicating performance of the two main approaches to hedge fund replication (Amenc et al 2007). It concludes that, although hedge fund replication is theoretically appealing, it does not, in practice, deliver satisfactory results. Following the study, EDHEC called for practitioner views on replication products. They find that very few of the asset managers who responded to the survey have invested in such products. Many investors are critical of passive hedge fund replication and have doubts about its potential benefits.

Results of the EDHEC study: current hedge fund replication products fail to deliver in practical tests.

In theory, the advantages of replication products over hedge funds themselves are higher transparency, higher liquidity and lower fees. Two distinct concepts for replicating hedge fund returns have been brought to the market by investment banks: factor replication and payoff distribution replication.

Empirical tests described in the EDHEC study show that both methods fail to deliver satisfactory results in terms of exact replication of hedge fund returns. While the linear factor replication achieves only a very poor out-of-sample performance in replicating hedge fund returns, the payoff distribution replication falls short of providing hedge-fund style time series properties.

[1] This article is forthcoming in the Journal of Alternative Investments.

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The industry perspective: asset managers are not yet convinced of the advantages of hedge fund replication products and are thus very reluctant to invest.
Although asset managers agree on the two main advantages of hedge fund replication – high liquidity at rather low cost – criticism outweighs praise. Many investors believe that the behaviour of hedge fund managers is not replicable as such, and consequently that any replication product is unlikely to replicate any managerial skill.

In addition, managers criticise the poor performance, the lack of transparency and the deficient technology of the replication products on offer. Not surprisingly, only 15% of the respondents have invested in replication products. The EDHEC study concludes that many investors are likely to wait for the development of better products, such as those using non-linear factor models. For the time being, they prefer actual hedge funds or other substitutes for hedge funds to passive replication products.

Noël Amenc is professor of finance and director of research and development at EDHEC Business School, where he heads the Risk and Asset Management Research Centre. He has a masters in economics and a PhD in finance and has conducted active research in the fields of quantitative equity management, portfolio performance analysis and active asset allocation, resulting in numerous academic and practitioner articles and books. He is also associate editor of the Journal of Alternative Investments and a member of the scientific advisory council of the AMF (French financial regulatory authority).

David Schröder is a senior research engineer at the EDHEC Risk and Asset Management Research Centre. He obtained his PhD in economics from the University of Bonn. During his doctoral studies, he was also affiliated with the Centre de Recherche en Economie et Statistique (CREST) in Paris. His research focuses on empirical asset pricing, the predictive power of equity analysts' forecast, and decision-making under ambiguity. He is a member of the Econometric Society and has presented at many international economic and finance conferences.

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