

Jaeger, Lars – Alternative Beta Strategies and Hedge Fund Replication

Wiley & Sons, 2008, [Finance] Grade ★★★★★

Are hedge funds turning into mutual funds? The question might not be as ridiculous as it appears. This book argues that within a few years there will be a multitude of alternative beta indexes to be used as benchmarks for hedge funds. Hedge funds will look to relative returns and they will be compensated if they create alpha on top of their benchmarks. This would certainly make them a lot more like mutual funds. The author Lars Jaeger is a hedge fund expert and he heads up the Alternative Beta Strategies business at the Partners Group.

What is alpha? As alpha is what's left after beta, one first has to understand beta. Pre modern portfolio theory no one divided returns into alpha and beta, it was all alpha. The returns were subsequently divided into what we now can call traditional beta plus alpha. More or less from the formation of MPT a number of so called anomalies started to turn up. Over time, and with increased computing power, these theoretical thorns in the backside grew in number and turned into what is today called alternative betas. The main point of the book is that the major part, but certainly not all, of hedge fund returns does consist of alternative betas and not alpha. Jaeger notes: *"if the specific return is available to a handful of investors and the scheme of extracting it cannot be simply specified by a systematic process, then it is most likely real alpha. If it can be specified in a systematic way, but involves nonconventional investment techniques such as short selling, leverage and the use of derivatives [...], then it is possibly beta but in an alternative form [...]. If it does not require these special 'hedge fund techniques', then it is traditional beta."* It's chiefly the ability to systemize returns that differentiates between alpha and alternative beta.

The book is divided into three parts where the first gives an excellent review of most major hedge fund categories. Their strategies are examined and their positions are exemplified. Through this the author disentangles which risk premias that are extracted to make up the returns of the various strategies.

These risk premias can be everything from more traditional return sources such as equity risk, term structure risk, credit risk or FX carry risk to slightly more exotic ones such as volatility premias, illiquidity risk, complexity risks etc. etc. Part two of the book goes further to categorize the return sources into bundles of systematized alternative betas. This deepens the reader's understanding but also creates some overlaps with the descriptions in part one. Eager to convince the reader that hedge fund returns mostly are comprised of alternative betas Jaeger repeats himself slightly too often.

In the last part of the book, the topic of replication of hedge fund returns is discussed. Earlier generation top down techniques used regression analysis, focused on hedge fund indexes and aimed to replicate these through a mix of passive long only, buy-and-hold-strategies. This mostly turned out to be inadequate. The author instead argues for a bottom-up model where the constructor basically builds his own hedge fund portfolio from the building blocks of alternative betas. All but a few strategies such as activists, distressed and global macro turn out to be replicable, often with results comparable to that of investable hedge funds or even better due to the disappearance of the 2-and-20-fees. The author argues for a core-satellite model where asset owners such as pension funds build their own portfolios of alternative betas to suit their risk, return and liquidity preferences and then complement this with desired external hedge funds that either are not replicable or that contributes pure alpha.

So, is all this just the vain pipe dream of the mundane pension industry? Time will tell. The hedge fund industry has lived well on the misguided notion that most of their returns were alpha. My bet is that in today's low yielding world, with more and more sophisticated customers this will gradually become increasingly difficult. The years of easy gains may be over.

Mats Larsson, June 2, 2013