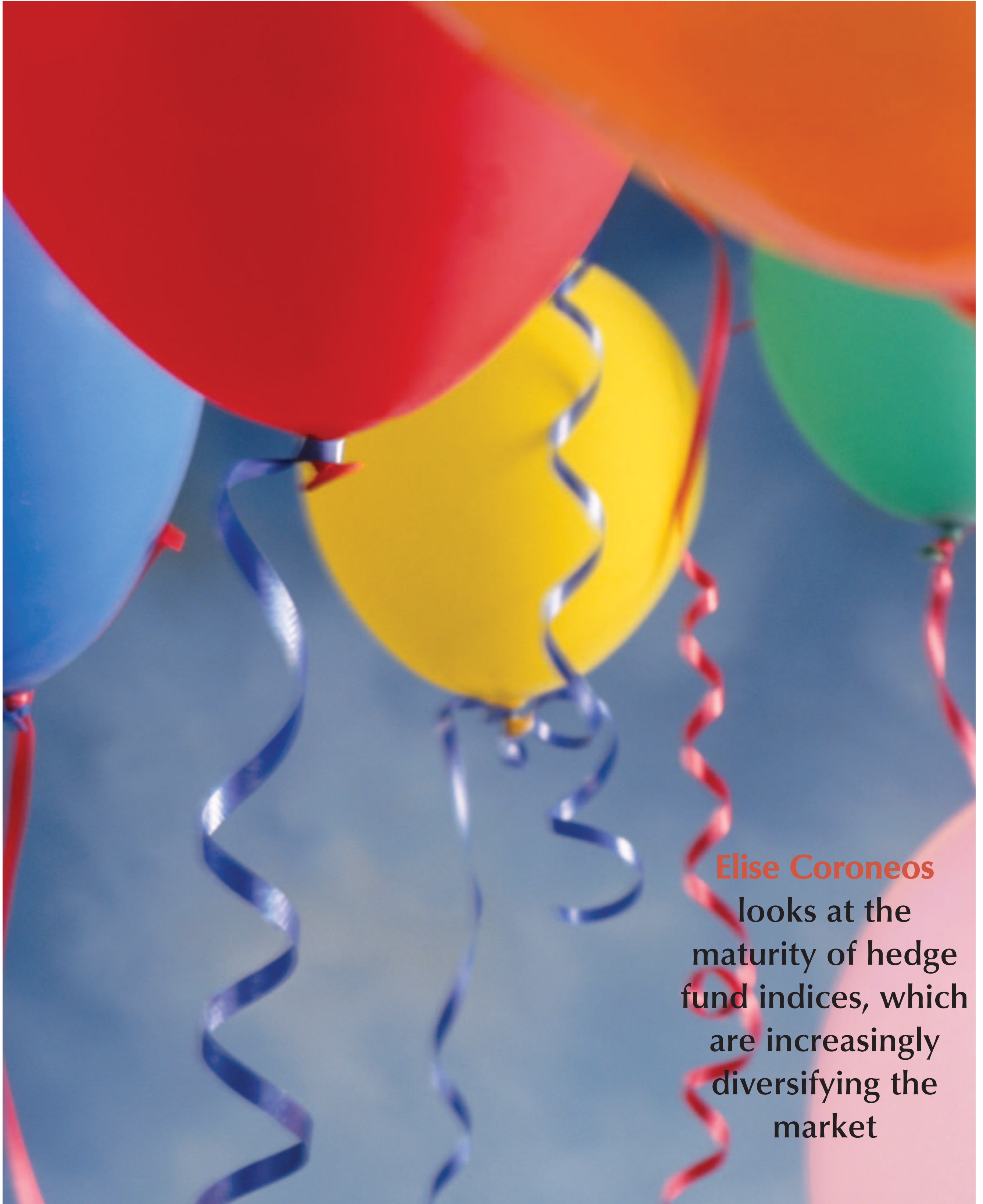
# Coming of age



**Elise Coroneos** looks at the maturity of hedge fund indices, which are increasingly diversifying the market

Hedge fund indices are coming of age. No longer are they seen as purely a threat to funds of hedge funds, which also provide access to multiple hedge fund managers via one product. In fact, fund of hedge funds are now getting in on the act, with many launching their own benchmark and investable hedge fund indices.

But some industry participants are now questioning why the broad indices seem to be outperforming the investable indices. If the investable indices are supposed to be a reflection of the overall universe, then why do their returns differ? And if the investable indices are supposed to choose the crème of the hedge fund manager crop, as some like Standard & Poor's' (S&P) claim to do, then why are they not producing better returns than their broader hedge fund index cousins?

"The differential between investable and non-investable hedge fund indices seems to be growing especially in those indices with less liquid securities," says Brian Chung, from SSARIS Advisors. Connecticut-based SSARIS is State Street's fund of funds platform, which manages over $1 billion in hedge fund assets.

As an example, year to date to the end of September 2005, Greenwich-Van's non-investable Van Global Hedge Fund Index was up 6.2%, while its Van Investable Hedge Fund Index was up only 4.4%.

CSFB and Tremont Capital Management's non-investable index, the CSFB/Tremont Hedge Fund Index with 400 funds across ten style-based sectors lodged 4.36% at the end of October year to date, well ahead of the CSFB/Tremont Investable Hedge Fund Index, which posted 2.21% for the same period. The investable index derives its 60 member funds from the non-investable product.

Some hedge fund watchers such as Chung, say that investable indices have often lagged their non-investable counterparts, however, investors are yet to get a clear answer as to why this is the case.

Chung attempted to help answer the question in a paper titled *Hedge Fund Indexing: The Art of Discipline*, which he co-authored earlier this year with fellow SSARIS members James Tomeo and Robert Covino.

The paper argues that hedge funds are not an asset class, but rather a collection of investment positions, "because the critical capital allocation role of the market's price discovery function does not occur".

According to Chung, most hedge fund indices are constructed using correlation with a broader index as the key quantitative criteria. "This reduces the list of potential candidates and then relies on the discretion of the investable index provider. This leads to our conclusion that the majority of investable hedge fund indices are essentially fund of funds," he says.

## Covering all bases

In considering whether investable hedge fund indices are really just proxy funds of funds, it may well be worth considering the types of firms currently entering the indexing space, many of them funds of funds themselves.

One of the most recent entrants is Maxam Capital Management, launched in April 2005 by Sandra Manzke, who was previously CEO of Tremont Capital Management, which she founded in 1984.

Since founding Connecticut-based Maxam, the firm has become advisor to several European and US funds of funds, many of which moved with Manske upon her departure from Tremont in the spring. Maxam will also launch a brand new fund of funds, called the Maxam Attucks Diversified Fund, which invests in emerging, minority and women owned hedge funds in December 2005.

In addition to its funds of funds, Maxam recently announced that it will team with independent hedge fund research firm Eurekahedge to launch three investable indices on 1 January 2006. Additionally, the firm expects to have assets of $1.3bn across both its funds of funds and indexed products.

The three new indices will be called the MaxEureka Asia Index, a pan Asian product covering Japan, Australia and New Zealand; the MaxEureka Japan Index, which will offer access to managers exclusively with Japan mandates; and MaxEureka Global Emerging Markets Index, which will include emerging Asia, emerging Americas, Eastern Europe, Russia, the Middle East and Africa.

**"We are attempting to provide the beta of the alpha generation capabilities of the hedge fund universe."**

**Justin Dew, S&P**

Each index will launch with at least 30 managers, a number expected to grow to 50 in the first three to six months, according to Rosemary Gilchrist, MD at Maxam.

"These will be the first exclusively regional investable hedge fund indices," says Gilchrist.

"We believe in offering both funds of hedge funds and investable hedge fund indices because there are different kinds of clients out there, some of whom are looking for an allocation to hedge funds through a passive product and some that are looking for a more specific active product. We also think that the opportunities in Asia and in the emerging markets are some of the most exciting opportunities in hedge fund investing available today."

Maxam hopes to have a minimum of $500m invested in each index by the end of 2006. Available for investment only to non-US investors, Maxam's indices will charge a 1% management fee.

In constructing the indices, Maxam starts with Eurekahedge's vast list of Asian hedge funds and then performs its own due diligence on the underlying managers. This approach differs to

that of many of the investable indices that have previously come onto the market.

"In some of the other indices, anyone who is in the index can get in the investable product, but for us, these managers have to pass our due diligence, which includes operational diligence to make sure that the firms running the funds are solvent, that the investment process makes sense and that the individuals running the fund are credible," says Gilchrist.

While Maxam is taking an active role in doing due diligence on the underlying managers in its indices as well as its funds of funds, it will not seek to manipulate the types of managers in its indices as it does in its funds of funds.

"In an active fund we manage the asset allocation to the sectors as well as selecting the best managers, but this will not be the case with our indices. If we don't think it is a good time for emerging market debt, we are not going to eliminate the emerging market debt managers in the indices as we might in the active fund," says Gilchrist.

## Benchmarking alpha

While many hedge fund indexers such as Maxam fall short of calling themselves 'manager pickers', others seek to blur the lines by promoting their products as a way of harnessing the alpha generating capabilities of the most accessible and desirable hedge fund managers – managers that as a collective should be expected to outperform a benchmark index representative of the overall universe.

For example, S&P's applies significant discretion in the formation of its indices. By applying discretion, S&P is not merely seeking to produce indices to reflect the performance of the hedge fund universe and its sub-strategies, but rather to provide better returns than a theoretical benchmark.

In short, to be an index that produces a kind of alpha.

"We are attempting to provide the beta of the alpha generation capabilities of the hedge fund universe," says Justin Dew, S&P's senior hedge fund specialist.

Its investable hedge fund index, which it commenced calculating in October 2002, is called the S&P Hedge Fund Index. The S&P HFI has 42 constituent hedge funds, which are divided into three style sub-indices. These sub-indices are the S&P Arbitrage Index, the S&P Event Driven Index and the S&P Directional/Tactical Index. These sub-indices are each further divided into three strategies. These nine strategies are weighted equally, although the number of funds in each varys.

Unlike most of its competitors, S&P has not released a benchmark hedge fund index with which to compare its investible product.

In developing its indices, S&P's approach is two pronged. "First we use a quantitative process that is very rules based using such things as correlation, return analysis and cluster analysis, then we overlay this with a qualitative aspect whereby we ourselves do the initial and ongoing due diligence," says Dew.

"The rational is that we want to be representative of not only the nine different alpha generating strategies that we have chosen to be representative of, but we want to be representative of managers people could and would invest in after doing reasonable due diligence," adds Dew.

S&P's hedge fund indices have limits predetermining the minimum size of a constituent manager's assets and the length of his track record. "It is all a part of avoiding managers most people would not invest in," says Dew.

Dew believes this approach will mean it is less likely to get caught up in any fallout associated with a single hedge fund that time shows to be less than desirable.

Dew uses the example of Enron. "If you had had full transparency into Enron, would you put them in the S&P500 knowing it has a high probability of exploding? You would have for a benchmark index, but not for an investable index and this is where our hedge fund indices benefit," he notes.

## Consider correlation

The issue of whether an index should seek to simply reflect the hedge fund universe in order to protect its uncorrelation to other asset classes or actually attempt to produce alpha, is a matter of some contention.

Thomas Whelan, president and CEO of Greenwich-Van, says pension plans and endowments can often prefer investing in hedge fund indices to funds of funds because their portfolio allocation models are typically built around filling certain slots with performance representative of a particular asset class, not necessarily the best performance in that asset class.

"Our belief is that institutions new to the hedge fund space should be

trying to capture the asset class performance as provided by an index because it gives them the opportunity for returns un-correlated with the rest of their portfolio," says Whelan.

Connecticut and Tennessee-based Greenwich-Van is better known as Van Hedge Funds, its name before being acquired by Muirhead Holdings, also based in Connecticut, in early November 2005.

The strategies represented in its investable index, the Van Tracker Fund SPC, which was launched on 1 May 2004 are weighted to replicate each strategy's weight in the larger universe. So as the hedge fund universe changes its strategy mix to better cope with changing market conditions, so too the weightings of the investable index are changed accordingly.

The firm's investable index tracks the performance of the broader hedge fund universe as measured by its benchmark, the Van International Hedge Fund Index. Greenwich-Van began calculating the Van International Hedge Fund Index in 1994 and publishing it in 1995 using constituent fund performance dating back to 1 January 1988.

MSCI, Morgan Stanley Capital International, is stringently in the camp promoting pure benchmark indices.

Launched in July 2003, MSCI's Hedge Invest Index takes its constituent hedge funds from a range of managed accounts owned by Lyxor Asset Management, a subsidiary of Société Générale Group. The index aims to reflect the overall structure and composition of the hedge fund universe from the funds available on Lyxor's platform.

For a hedge fund to get on the Lyxor platform, they have to undergo Lyxor's process of due diligence. MSCI's role in the process is limited to classifying the constituent funds into its own classification standards.

"From MSCI's perspective, we tend to be inclusive so we allow any fund on the platform to participate in the index, they simply have to agree to be part of the index," says to Christopher Lennon, a hedge fund index specialist at MSCI. "We feel comfortable about this because we are confident in Lyxor's ability to do the due diligence and ongoing monitoring."

This inclusive approach makes MSCI one of the few truly passive investable hedge fund indices on the market content on simply reflecting the hedge fund space. As such, it does not see itself as being in competition with funds of hedge funds.

The index includes 125 funds from a wide range of hedge fund investment strategies. In March this year, MSCI subdivided this index into eight strategy level indices, each with between ten and 22 underlying hedge funds.

The eight strategies represented by the indices are systematic trading, equity non-directional, discretionary trading, convertible and equity arbitrage, long bias, event-driven and merger arbitrage, variable bias, and fixed income.

"Each of the individual strategy indices can be viewed as the companion piece to the first investable product," says Lennon.

## Direct versus separate investments

Chung believes that one factor to consider in assessing the better performance garnered by non-investable compared with investable indices is that of whether the index invests in its underlying managers via direct investments or separate accounts.

"It is those that invest via direct investments that seem to do better," says Chung.

CSFB is one of the only major hedge fund indexers that invest via direct investments, however Maxam will soon be added to that short list when its indices are launched in January. "CSFB continues to outperform the separate account investable indices," says Chung.

Direct fund investments mean that when a portfolio manager, such as an index manager can be considered, is marking their portfolio at the end of the month, they can call up their broker for any mis-marked positions to get a mark for that security.

"The thing is that that broker is your broker, so they are probably going to give you a slightly better mark and this may continue until the liquidation of the security. Very few people have truly independent valuation," says Chung.

This gives indexers with direct investments a slight advantage, because those who invest via separate accounts because their marks may be more conservative.

"Bascially, a fund investment's valuation is subject to the managers valuation principals, whereas a separate account valuation, which is the majority of hedge fund indexers, are subject to the valuation set forth by the index," Chung concludes. ❑

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