

# ABSOLUTE TRACKING: MOVING PAST ABSOLUTE RETURN FOR HEDGE FUND BENCHMARKING

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## Introduction

Recent market volatility illustrates the shortcomings of absolute return benchmarks in evaluating hedge fund manager performance. By most metrics, absolute return benchmarks behave quite differently from actual hedge fund performance, and their usage obscures the distinction between manager skill and market exposure. This paper recommends an alternative means of benchmarking hedge fund manager performance.

### What is the problem with absolute return ?

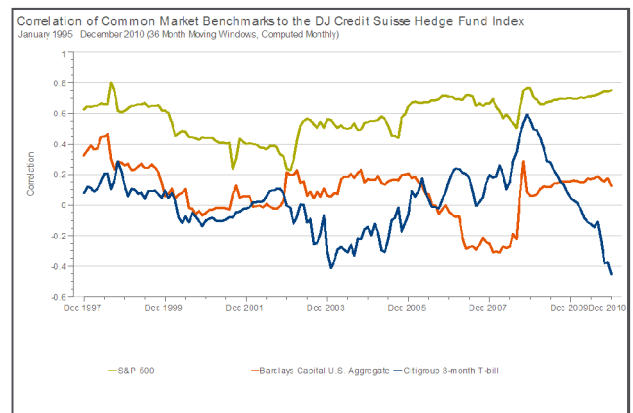
Absolute return benchmarks represent spreads over risk-free or nearly risk-free rates, and are typically named in this fashion (e.g. US Treasury Bills + 4%, LIBOR + 3%, etc.). Over the long term, a hedge fund investor should expect this type of return premium for taking on the risks that come with hedge funds. Absolute return benchmarks, however, are very poor yardsticks over short-to-intermediate timeframes. For example, the DJ Credit Suisse Hedge Fund Index underperformed T-Bills + 4% by 25% in 2008, but outperformed by 14% in 2009.

## THE FUNDAMENTAL PROBLEM WITH ABSOLUTE RETURN BENCHMARKS: RETURN WITH NO RISK.

Beyond the issue of varying returns, vast differences also exist in correlation and volatility measures. The two charts on this page illustrate these disparities.

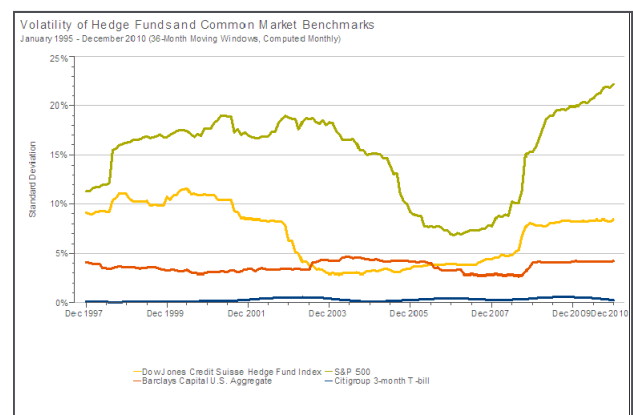
- **Chart A** displays the DJ Credit Suisse Hedge Fund Index's rolling correlation versus common market benchmarks. In this case, T-Bills – our absolute return proxy – show consistently low or negative correlation with hedge funds.

Chart A



- **Chart B** compares the volatility of hedge funds with the same common market benchmarks. Here, hedge fund volatility lies in the gap between that of minimally volatile T-Bills and risk-bearing stocks. With volatility serving as a reasonable proxy for risk, this chart illustrates the fundamental problem: absolute return benchmarks reflect return without risk, while hedge funds bear obvious risk. The pairing of the two runs counter to financial theory and basic investing logic, as hedge fund performance will consistently lag absolute return benchmarks in declining capital markets (and *vice versa*), and show higher-than-benchmark volatility.

Chart B



## What about market-based benchmarks?

Market-based benchmarks such as the S&P 500 and BarCap Aggregate may be appropriate for some long-biased managers. However, they often overstate market risk while failing to encompass the unconstrained nature of hedge fund strategies such as shorting, leverage, options, and others.

## HEDGE FUND AVERAGES ARE THE BEST WAY TO BENCHMARK HEDGE FUNDS

### What is NEPC's recommendation?

We believe hedge fund averages are the best option for benchmarking hedge funds because managers are compared with a universe of other hedge fund managers. However, this approach is still far from perfect and presents several key challenges:

- Survivorship Bias: Poor performers drop out of the industry, thereby inflating average performance.
- Selection Bias: Managers choose whether to participate.
- Investment Limitations: Hedge fund benchmarks are generally not investable. Those that are exclude nonparticipating and capacity-constrained funds.
- Heterogeneity: Benchmarks vary widely with regard to long/short exposure, leverage, capitalization, sector focus, international diversification, and optionality.
- Reporting Issues: Returns are reported by managers, may not be independently verified, and may use different valuation methodologies.
- Limited Information: Restricted visibility into what peers are doing can make it difficult to manage against and outperform averages.

## Which hedge fund averages does NEPC use?

There are many providers of hedge fund averages, including DJ Credit Suisse, Hedge Fund Research (HFR), BarclayHedge, Dow Jones, EDHEC, Eurekahedge, FTSE, Hedgefund.net (Tuna), Hennessy, MSCI, and RBC.

At NEPC, we recommend using widely accepted hedge fund benchmarking families such as DJ Credit Suisse and HFR which, despite inherent limitations, are well-conceived. The following page provides details on these two providers.

### Bringing it all together

While creating benchmarking challenges, hedge funds provide important diversification to client portfolios. In most cases, NEPC favors using hedge fund averages for evaluating manager success because these averages best capture the risk and return characteristics of the investing opportunity set. Given the complexity of this subject, clients should work with their consultants to develop a benchmarking approach that considers their particular implementation and investing objectives.



Comparison of DJ Credit Suisse and HFRI (as of 12/31/10)

	DJ Credit Suisse	HFRI
Inception	1994	1990
Funds in the Database	>8,000	~6,000
Database Fund Qualified for Inclusion into Indices	465 single managers, no fund of funds	~2,000 single managers, ~650 fund of funds
Market Coverage in Database (in \$)	\$1.1 Trillion	\$1.9 Trillion
Reported net of all fees	Yes	Yes
Manager charged for inclusion?	No	No
Independent verification of manager information	At times, there are limited reviews of financial statements.	Generally no
Frequency of Monthly Reporting (Non-investable indices)	Flash is produced on the ~9-10th calendar day, <u>final</u> number on the 15th (or following Monday if 15th falls on a weekend). Restatements of manager returns are reflected through up/down adjustment of following month's return.	Flash at 5 business days, updated on 15th business day, updated again on 1st business day of the next month, <u>final</u> return is locked-in after 3 months
Asset or Equal Weighted	Asset	Equal
Requirements for inclusion	Audited financials, consistent reporting of performance, Minimum \$50 million in assets, AND 1 year track record	US Dollar denominated, manager reports monthly, and minimum \$50 million in assets OR 1 year track record
Database Includes Closed, Terminated, and Illiquid Funds	Yes	Yes
Backfilling	No	No
Determination of Sub-Group Classification'	CS after review of documents and in consultation with the manager	Jointed determined by HFRI and manager
Rebalancing	Quarterly	Monthly as funds are added

