ARE HEDGE FUNDS AN ASSET CLASS?

Strategic Investment Group®

Fiduciary Insights

THE GROWING USE OF HEDGE FUNDS IN INSTITUTIONAL PORTFOLIOS HAS RAISED THE ISSUE OF WHETHER HEDGE FUNDS SHOULD BE CONSIDERED A SEPARATE ASSET CLASS. Although hedge funds do not satisfy the traditional criteria for an asset class, fiduciaries may need to segregate them in policy to reflect their special characteristics.

© Copyright 2014, Strategic Investment Management, LLC. All rights reserved. This document may not be reproduced, retransmitted, or disseminated to any party without the express consent of Strategic Investment Group. This material is for informational purposes only and should not be construed as investment advice or an offer of, or solicitation or invitation to subscribe for or purchase security. The information contained herein represents the opinions of Strategic Investment Group® and is subject to change at the sole discretion of Strategic Investment Group. This document is not intended as a source of any specific investment recommendations and does not constitute investment advice or the promise of future performance.

Traditionalists vs. Separatists

As allocations to hedge funds in institutional portfolios have expanded in recent years, fiduciaries have struggled with the question of how to treat them in their policy portfolios. Are hedge funds simply investment vehicles containing assets from other asset classes, like mutual funds, or are they an asset class unto themselves?

The answer to this controversial question can have important practical effects on how fiduciaries view and manage hedge fund risk. The issue can also spark a lively debate between traditionalists, who believe hedge funds are not an asset class, and separatists, who say they are. Traditionalists, although probably in the majority among academics, appear to be in the minority among practitioners.

In 2005, the National Strategic Investment Dialogue put the question to 51 leading investment professionals, including both fiduciaries and investment managers. Forty-five percent of the participants responded that they view hedge funds as a separate, distinct asset class. Only 12% answered that they integrate hedge funds into traditional asset classes. A third straddled the fence, replying that they treat hedge funds both ways, while 10% subscribed to neither view.

First, What is an Asset Class?

Twenty years ago, a simple and intuitive definition of asset classes was sufficient. An asset class was a category of assets, such as stocks, bonds, cash, real estate, and private equity, or a subdivision thereof. But in recent years, as new financial instruments and investment vehicles that share characteristics of multiple asset classes have emerged, the lines between asset classes have become blurred. With so many new boundary-crossing assets, the old taxonomy of asset classes no longer neatly subdivides the world of investments.

The traditional definition of an asset class is based on the inherent attributes of the assets. For example, an asset class should be composed of investment opportunities that have a common, identifiable underlying economic driver, have a common legal and regulatory structure, correlate highly with one another, have fairly stable risk and return characteristics, and can be captured by investable passive benchmarks. In the traditional sense, hedge funds are not an asset class, but a dynamic collection of alternative strategies that derive their return from the active management of other asset classes.[1]

In contrast, the separatist view takes a more functional approach to asset class definition. From this perspective, hedge funds constitute an asset class because they are bound together by a common regulatory/legal structure, are treated by managers and investors alike as a separate market segment, require a specialized risk management approach, and in particular distinguish themselves by their collective dissimilarity with other established asset classes. From this standpoint, hedge funds are a separate asset class because fiduciaries feel the need to account for hedge funds explicitly in policy portfolios, to monitor explicitly their actual allocations to the funds, and to control related portfolio risk.

Does a group of assets that does not constitute an asset class belong in the policy portfolio and, if so, where?

The larger the desired allocation to hedge funds, the greater the tension caused by their absence from the policy portfolio, and the stronger the motivation to incorporate them explicitly in policy.

1 "Determining the Appropriate Allocation to Alternative Investments," Brian D. Singer, CFA, Renato Staub, and Kevin Terhaar, CFA, AIMR Conference Proceedings, Hedge Fund Management, April 2002, Vol. 2002, No. 2:4-15

The Hedge Fund Policy Problem

The debate over whether hedge funds are an asset class has its roots in a vexing policy problem: Does a group of assets that does not constitute an asset class belong in the policy portfolio and, if so, where?

Hedge funds produce returns and risks unlike those of other asset classes. If hedge funds are not in the policy portfolio, the risks they generate are outside. So if fiduciaries want to invest in hedge funds to any significant degree, their desire to define acceptable risk and to control asset allocation through policy provides a motivation to define hedge funds as an asset class. The larger the desired allocation to hedge funds, the greater the tension caused by their absence from the policy portfolio, and the stronger the motivation to incorporate them explicitly in policy.

The dizzying variety of hedge funds also makes it hard to consider them a single asset class. There are more than 8,000 hedge funds of all types and descriptions, with radically different and unstable risk and return characteristics. The makeup of this motley group is constantly changing, as strategies go in and out of favor and funds go in and out of business. The hodgepodge of strategies called hedge funds cannot simply be defined as a single asset class just because a sizeable industry has grown up to promote them. Otherwise, mutual funds would be an asset class.

Hedge funds, in the end, are just an extension of active management, or a different form of portfolio construction, with the only real distinctions between them and other asset classes being business structure, illiquidity, the ability to sell short, leverage, and potentially higher levels of manager risk.[2] Fiduciaries, instead of mislabeling hedge funds as an asset class in order to include them in policy, make allocations to them, and appropriately estimate risk, should just deal directly with the risk issue: set a policy allocation to hedge funds and do so on the basis of their differentiable risk characteristics.

...just deal directly with the risk issue: set a policy allocation to hedge funds and do so on the basis of their differentiable risk characteristics.

An Unnecessary Hurdle

Fiduciaries do not really need to resolve the question of whether hedge funds are an asset class, as interesting as it may be, in order to include hedge funds in policy portfolios. Fiduciaries can set policy for any group of assets, as long as they can determine that the assets belong to the group. Nowhere is it written that only asset classes can be in policy portfolios.

Nowhere is it written that only asset classes can be in policy portfolios.

From a fiduciary's point of view, the purpose of an asset class definition is to help categorize risks into reasonably discrete groups so that constraints can be assigned. However we view hedge funds, everyone can agree that the main concern for fiduciaries should be to set policy so as to control the funds' special risks. An asset class definition should not be an intellectual stumbling block that prevents fiduciaries from performing this function. Nor should defining investments as an asset class be a prerequisite for controlling risk.

The present reality is that hedge fund risks are difficult to measure because of lack of transparency, high turnover, leverage, and other features. Although hedge funds are not an asset class in the classic sense, if it is impractical to allocate them to other asset classes, as it usually is today, then fiduciaries may reasonably group the funds together to permit them to take advantage of the opportunities these active strategies present, while setting limits to the exposure and related risk they are prepared to take on. In the future, if hedge funds can be broken down easily and accurately into other asset classes, they will be, and the question of whether hedge funds are an asset class will be moot.

2 "A New Perspective on Hedge Funds and Hedge Fund Allocations," Jean L.P. Brunel, CFA, AIMR Conference Proceedings, Investment Counseling for Private Clients V, July 2003, Vol. 2003, No. 6:9-22

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

For more information, please email us at inquiries@strategicgroup.com.

1001 Nineteenth Street North
16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com

® A REGISTERED SERVICE MARK OF STRATEGIC INVESTMENT MANAGEMENT, LLC.