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## *THE MYTH OF THE ABSOLUTE RETURN INVESTOR:*

*Sheep in wolves' clothing*

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*THE MYTH OF THE ABSOLUTE  
RETURN INVESTOR:  
Sheep in wolves' clothing*

*Table of Contents*

Executive summary . . . . . 2

“Absolute return” investing finds an audience . . . . . 3

Why absolute return investing is a myth. . . . . 3

Hedge funds the way they ought to be . . . . . 10

Conclusion: Pay alpha fees only for real alpha, not beta!. . . . . 11

References . . . . . 13

# *EXECUTIVE SUMMARY*

The recent enthusiasm for so-called absolute return investing is based on a misunderstanding of the way active investment returns are generated. All investment returns consist of a market, or beta, part (representing the correlation of the active portfolio with one or more market benchmarks or normal portfolios) and a purely active, or alpha, part. Thus all investing is relative-return—not absolute return—investing, in which active returns are earned relative to the appropriate benchmark or mix of benchmarks.

Hedge funds are currently the most visible and popular of would-be absolute return investors, but there are others in this category including some concentrated long-only active managers. Just about all of the managers who disdain benchmarks say they do so because benchmarks limit the creativity and aggressiveness that can be achieved by those with superior skill. Actually, benchmarks do nothing of the kind: They merely achieve a fair apportionment between the return from skill and the return from being exposed to markets. Investors need this information to make successful decisions about active managers, including hedge funds.

While most investment strategies mix alpha and beta exposures, a well-engineered market neutral long-short hedge fund does not. Such a fund—if it is really market neutral in all the dimensions of market risk—allows investors to earn pure alpha,

although even this is not an absolute return: It is alpha relative to the properly specified benchmark, in this case the return on cash. Investors can add beta exposures as desired, using inexpensive futures contracts or other vehicles, in what is popularly called a “portable alpha” strategy but that might be better described as portable beta.

Thus, all investing is benchmark relative. Even Warren Buffett has a benchmark, an opportunity cost of capital that he must beat if he wants Berkshire Hathaway to go up more than the market. So does your favorite hedge fund. And having a low or even a zero beta, as many hedge funds do, does not mean you have a high alpha. One has nothing to do with the other; alpha must always and everywhere be earned by having insights superior to those of the other players in the market, and that’s very difficult, although not impossible, to do.

## *“Absolute return” investing finds an audience*

**I**n meetings with clients and colleagues over the past few years, we’ve noticed that many otherwise hard-headed and clear-eyed investors are excited about “absolute return” investing. The notion is spreading like wildfire. Many institutional investors have already added, or are planning to add, an absolute return “asset class” to their policy mix. In an age when pension funds, foundations, and endowments are under pressure to increase their investment returns, absolute return investing is often positioned as “the answer,” with its enthusiasts arguing that it will do a better job of meeting institutional return requirements than other types of investing.

The concept seems to have struck a special chord with those who have struggled to fully accept the perceived confines of benchmark-relative investing. If you’ve never really understood why all investing is, at bottom, relative-return investing, then the notion that absolute returns might be superior sounds like it makes good sense.

Alas, we fear we’ve disclosed our conclusion in the title, and we have more than a mild suspicion that our bias shows in this introduction. So what is absolute return investing? What’s wrong with it—from where does our skepticism spring? Is there something valuable and redeemable there, and if so, what is it?

### *Why absolute return investing is a myth*

#### *FIRST, JUST WHAT ARE “ABSOLUTE RETURNS?”*

We originally assumed we could start this essay by simply reporting an agreed definition of the term “absolute return investing.” Instead we found ourselves repeatedly offering up ideas to each other for what the definition would have to be (for the term to make sense) because definitions that were both sensible and true to the sense of the term eluded us. That experience further piqued our interest in the term.

So let's explore the term a bit. It is widely used, and since we know that words have meaning and power and that they are chosen to a purpose, we can find some of that purpose by observing the context in which it is used.

*We surveyed websites to see how purportedly absolute return investments are portrayed. Not surprisingly, many of the descriptions are cagey, simply using the term without precisely defining what they mean by it.*

And one important bit of context is that the word pair "absolute return" has been used most by those managers who resist the practical and theoretical successes of relative-return investing and who are looking for terminology that supports their opposite view. The term captures this rebellion: If benchmark-relative investing is believed to be inadequate or wimpy by these rebels, then the term absolute return investing implies that one can take the opposite approach, one that is not benchmark relative. (Real men don't use benchmarks!)

What does it mean to be opposite in spirit to relative-return investing? We surveyed websites to see how purportedly absolute return investments are portrayed. Not surprisingly, many of the descriptions are cagey, simply using the term without precisely defining what they mean by it. But some are less guarded, particularly those outside the US.

Here are some samples. The first is taken from a well-known financial pundit writing for *SmartMoney.com* (Hoenig 2003):

But when the bubble burst, and indeed up until this year, just staying above water has been perceived as commendable. In fact, plenty of managers have boasted of their good "relative" performance, having lost only single digits, for example, at a time in which the S&P 500 index was down significantly more. Of course, I don't know many groceries that can be bought using good "relative" performance, if that performance . . . happens to be negative.

I don't have a degree in economics, just a stack of bills to be paid. So I start, perhaps naively so, with the basic notion that a good year is one in which I make money—end of story. My benchmark might be low, but it's

very strict. A good return is a positive return, even at a relatively low level. In hedge-fund speak, it's what we call absolute return.

Here is another, from Macquarie Bank (2004), emphasizing higher-than-market and positive returns:

Absolute return investments can offer you potential benefits such as:

- the potential for *higher returns* than traditional asset classes
- the potential to achieve *positive returns* when traditional sharemarkets are falling—because they often adopt hedging strategies.

And another, from the Australian Stock Exchange (2004), to the same point:

Absolute return funds have the ability to produce positive investment returns regardless of general market conditions. The strategies they adopt can produce returns in both rising and falling markets.

These quotes are consistent with the notion of providing a return pattern that is different in spirit from those of relative-return investments. If a definition could be teased out of these, it might well be that absolute returns are positive (as in absolute value), and always (or at least mostly) better than the market. The idea appears to be that the total return pattern would have less downside risk and more upside returns, as a result of these combined attributes, than total returns produced in a relative-return environment.

We acknowledge that many readers of this article will have already rejected this expansive approach to defining absolute returns and will have worked to come up with their own more sensible and less rebellious definition. We will offer our own view, in due course, a view that will give some comfort to many of those sensible readers. But our view is perhaps a bit stronger—we will not support continued usage of the term.

Of course we wouldn't disagree that such a return pattern would be a good thing—if it really exists—*ex ante*. (And as we'll see below, something like it can exist—it just isn't an absolute return.)

One more bit of context: Today the term “absolute return” seems to be used most often to describe what wealthy individual investors have always just called hedge funds. Perhaps the term is thought to give more legitimacy or sophistication to the hedge fund approach in the institutional context. But absolute return investing is really a more general term, and it has been applied to alternative strategies other than hedge funds as well as to certain conventional long-only managers (particularly those with concentrated portfolios that bear little resemblance to their benchmark). Here we focus on hedge funds because that is where the interest is today.

#### WHAT ARE RELATIVE RETURNS AND WHY ARE THEY IMPORTANT?

If absolute returns are supposed to be different from—and better than—relative returns, perhaps a place to start is with a discussion of relative

returns. Beginning in 1964, William Sharpe laid the foundation for how we understand and decompose total returns on portfolios today. His work showed how the total return on any portfolio—note the emphasis on “*any*”—can be decomposed into a part that is due to the return on the market benchmark, which he called beta, and an idiosyncratic—in this case, manager-specific—part that is uncorrelated to the market, which he called alpha (plus the risk-free rate, or cash, of course).<sup>1</sup> In the slightly condensed form popularized by Grinold and Kahn (2000a), this relationship is expressed as:

$$r_p = \beta_p r_{bm} + \alpha_p$$

To restate the equation in plain English, the excess return of a manager's portfolio (excess over the riskless rate) is the product of the expected beta of that portfolio multiplied by the excess return of the manager's normal portfolio or custom benchmark (the risk premium), plus an alpha, or a residual term that is uncorrelated to the beta return.

Sharpe's observation is perhaps the most profound insight in modern finance. The return on *any*, repeat *any*, portfolio consists of a market part and a nonmarket part. In the jargon of finance, we often abbreviate this and simply say there is a part that is beta and a part that is alpha.

The beta part results from the average future exposure to total market returns, often expressed in terms of one or more market benchmarks. This mix of exposures is sometimes called a *normal portfolio*. Most long-only managers know with relative

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1 In perfectly efficient markets, the expectation for manager alpha is zero. But if there is some degree of inefficiency, a manager of above-average skill could have a positive expected alpha. Realized alpha, on the other hand, will always have a random component that is quite substantial; but for the skillful manager, the mean of the distribution will be elevated. A discussion of these issues is in Waring and Siegel (2003).

We don't intend to be glib in skipping over some technical details. Our comments fit within the context of either the single-index model, the market model or the CAPM, with the caveat that we allow for a positive expected value for alpha under the conditions just stated. For an exposition of these closely related models, see Sharpe, Alexander and Bailey (1995).

Full disclosure and fair play require us to note that the CAPM was independently, and roughly simultaneously, discovered by John Lintner, Jan Mossin and Jack Treynor, as well as Sharpe. Sharpe is, however, by far the most prolific and persuasive exponent of it.

clarity what their normal portfolio is: large-cap value and fixed income credit are simple, single-factor examples (we could offer more complex examples). A purportedly absolute return manager's normal portfolio may not have been purposefully or thoughtfully designed—and may be more implicit than explicit—but somewhere in the manager's investment style there is a “home,” a set of factor exposures or betas that the manager goes to when there is no reason to go somewhere else.

So this notion that every return has a beta component and an alpha component applies to *any* portfolio, that is, to a portfolio with any normal portfolio or benchmark including complex multi-factor benchmarks. A portfolio that normally contains multiple asset classes (or a fixed income portfolio) could thus be analyzed using the same framework, the only difference being that the betas represent exposures to style or asset-class factors other than (just) the equity market.<sup>2</sup>

Why is this important? We know that the returns of normal portfolios or custom benchmarks are easily achieved through mixes of index funds or derivatives contracts, or for more exotic market exposures through some sort of recipe-driven portfolio that is essentially passive although perhaps not available as an actual index fund.<sup>3</sup> So beta returns are inexpensive, provide an expected risk premium *without* requiring skill, and are easy to achieve.

But positive expected alpha is hard to achieve. A manager must add realized returns over and above the returns of these beta exposures (and above the cash return from a zero-beta exposure) to generate pure alpha. The manager's clients, moreover, will surely expect pure alpha in subsequent years, and may consider firing the manager if they do not get it.

These pure alphas result from manager deviations from the contents of the benchmark through security-selection decisions or from beta timing decisions.<sup>4</sup> (This principle would apply to a portfolio with a cash benchmark, i.e., zero betas, just as it does to a portfolio with a benchmark consisting of a more traditional mix of betas.) The original version of Sharpe's capital asset pricing model presumed that the expected alpha would be zero, but for those of us who believe in active management, this alpha could *conditionally* have a non-zero positive expected value if the two conditions of inefficiency and skill discussed in Waring and Siegel (2003) are satisfied. Positive *realized* alphas might well be had simply through luck, but positive *expected* alphas require special skill, skill that is sufficient to beat the rest of the very skillful crowd that plays the markets.

And since expected alpha depends on a perception of skill that is agreed upon between buyers and sellers, it is not only hard to achieve, but also (quite naturally) expensive.

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2 Returns-based style analysis—an application of multiple regression in which the regressors are the returns on various investment styles or asset-class factors—is the tool most widely used to determine the historic mix of betas for a given portfolio, which in turn is very useful for evaluating the expected future normal portfolio. See Sharpe (1988, 1992). Holdings-based style analysis may also be used to achieve similar goals.

3 An example of the latter type of portfolio, providing exposure to exotic beta, might be a merger-arbitrage strategy that involves buying the top 10 (by market capitalization) acquisition-target firms each year and selling the acquiring firms short. Note that such a strategy, like most exotic-beta strategies, cannot be completely passive. It is impossible to know until the end of the year which deals will be in the top 10; one needs to figure out when exactly to place the trades, and other decisions need to be made. Thus exotic beta cannot typically be delivered at the extremely low fees that apply to traditional index funds.

4 The latter is sometimes called tactical asset allocation (TAA) or (often with an unfairly pejorative tone) market timing. Beta timing decisions consist of moving one's beta position away from the normal portfolio beta position to capture a gain from being underweight when the market underperforms or overweight when the market outperforms its equilibrium expectations.

*USING THIS KNOWLEDGE TO SORT  
OUT ABSOLUTE RETURNS*

This explanation of betas and alphas is offered for a reason: Just because we call something an “absolute return investment” does not mean it is

It is quite aggressive and probably not sustainable to charge clients hedge fund fees for the component of returns that could be replicated with an index fund. But “two and twenty” for beta is nice work if you can get it!

*This notion that every return has a beta component and an alpha component applies to any portfolio; that is, to a portfolio with any normal portfolio or benchmark including complex multifactor benchmarks.*

granted an exception to the first law of financial gravity described above—that the returns of *any* portfolio can be broken down into market (beta) components and an alpha component.

So here is the money question we’re asking every hedge fund manager who fancies himself or herself an absolute return investor: Is the expected return you offer investors attributable to your expected average exposure to the *beta* (single or multiple) that characterizes your normal portfolio, or is it attributable to expected *alpha* generated through skillful beta timing or security selection? (“Both” is an admissible answer, but it won’t change our conclusion.)

And we give fair warning: Stop and think carefully before you answer! Here is how the conversation might go:

*Is it beta?* If the answer is “beta” (or “both beta and alpha”), this is an acknowledgment that returns are attributable in whole (or in part) simply to the expected average exposure to beta factors, that is, to the fund’s normal portfolio.

So if this is the answer, clients could get that portion of the return stream very inexpensively—nearly free relative to hedge funds or many actively managed products—by holding index funds and various market-replicating derivatives. Your returns are “just beta,” and as discussed, beta can be purchased readily and inexpensively.

In fact, this may be a more truthful answer than many managers are comfortable accepting. Many studies suggest strongly that hedge funds have returns that are, to a significant degree, explained by persistent beta exposures.

So we’ve warned our absolute return manager friend away from giving an answer that includes “beta.” He or she may have thereby outsmarted us and is planning to answer “alpha.” After all, we all know that the skillful manager with a positive expected alpha has a very valuable product that deserves a substantial fee. So “alpha” sounds like a pretty good answer, right?

*Is it alpha?* But be careful! By describing fund returns as alpha, the manager acknowledges he or she is a relative-return investor! Alpha is *defined* as a relative return, the return generated over and above the manager’s normal beta exposure, or benchmark.

Thus we’ve demonstrated that there is no such thing as an absolute return investor. It is just a myth: a financial air ball, cold fusion with Other People’s Money. Like most myths of active management (see Waring and Siegel [2005]), it appears to be promulgated to aid the marketing of yet another cynical investment practice: the mixing of alphas and betas at a single fee level (the higher one, naturally). But “real” investing is about understanding the differences between alpha and beta, picking a mix of betas as the normal portfolio, and trying to add alpha to that

portfolio through security selection or market timing bets.<sup>5</sup> Real value-added only comes from relative-return investing.

No wonder we couldn't sensibly define absolute return investing—there is no such thing. The term is intended to capture investor attention by offer-

not. And of course hedge funds are subject to the same zero-sum-game rules as those that apply to all active investing. Carefully designed studies have found that, as a group and after making reasonable corrections for survival bias, hedge funds haven't exhibited statistically significant realizations of alpha.<sup>6</sup> No real surprise here for the

*A well-managed hedge fund is at heart just a portfolio with a low or zero beta and a (hopefully) high expected alpha (that's a relative return!), whether the manager wants to admit it or not.*

ing an intuitively appealing alternative to the disciplines required by relative-return investing, but at the end of the day it delivers beta returns plus or minus relative (alpha) returns. A sensible meaning for the term just doesn't exist, unless one concedes that absolute return equals relative return, in which case there is no need for the term. It may appear to be a distinct type of investing, but if there is a distinction, it is a distinction without a difference.

A well-managed hedge fund, to be more specific, is at heart just a portfolio with a low or zero beta and a (hopefully) high expected alpha (that's a relative return!), whether the manager wants to admit it or

hard-headed and clear-eyed investor: Hedge funds are not the "magic asset class" that some would like you to believe. They rely on special skill for special success, like any other actively managed fund.

In this light, it is easy to see that hedge funds and other purported absolute return strategies are not a distinct asset class. As the betas of a hedge fund go to zero, which we'll argue is the ideal level of beta exposure for such a fund, then the natural (unconditional or market) return is just the return on cash, plus or minus the realized alpha. Technically, a zero-beta hedge fund should be in the cash asset class, not in some separately named class, given that asset classes are always market

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5 Market timing can be regarded as trying to add alpha relative to a benchmark consisting of a fixed mix of betas (a normal portfolio) by timing among the beta exposures.

6 See, in particular, Asness, Krail and Liew (2001). Using the ordinary market model, Asness et al. calculate positive, significant alphas (t-statistics of +2 or more) for two out of nine strategies; negative alphas for two out of nine; and positive but not significant alphas for the remaining five. The aggregate of all nine strategies has an alpha t-statistic of 0.76. These results are for CSFB/Tremont data during the period January 1994 through September 2000.

Using a Dimson-Scholes-Williams adjusted market model (that is, with the led and lagged market return as additional regressors), the alphas are positive and significant for two out of nine strategies, positive and insignificant for one, and negative for the others. The aggregate alpha t-statistic is also negative. Market neutral equity funds had the highest alpha t-stats using both tests.

Hedge fund enthusiasts argue that the average hedge fund manager could actually be above average because the high compensation and freedom of the strategy attracts the "best" managers. They can then take money away from retail, boring old long-only institutional and other "dumb" investors. It isn't apparent that there is much real meat on the bones of either argument; there are simply too many hedge fund managers with too much money under management to claim credibly that they are, as a class, extraordinarily skillful. And the academic studies don't give much (if any) support to the reality of persistent true alphas from hedge funds.

risk categories.<sup>7</sup> To say there is an “absolute return” asset class is the same as saying there is a “pure alpha” asset class, but we don’t do that for any other actively managed funds—we put them in the asset class that best matches their *beta* characteristics.

Please understand—we are not slamming skillful hedge fund managers or any other truly skillful manager with a positive expected alpha by virtue of that skill. All hedge fund managers can’t be above average, so the group as a whole can’t outperform a fair benchmark. But let us celebrate the

*THE UNIVERSAL GOAL OF ACTIVE  
MANAGEMENT IS TO ADD VALUE  
OVER A BENCHMARK*

Thus, whether they want to admit it or not, all managers making the effort to add special value to a portfolio have to do the same thing: beat a benchmark (a normal portfolio or mix of betas). This is true whether they are a hedge fund, a long-only manager, a market neutral long-short manager, a traditional active, quantitative active, or whatever type of manager. Even Warren Buffett has a benchmark, a cost of capital or blend of beta

*Thus, whether they want to admit it or not, all managers making the effort to add special value to a portfolio have to do the same thing: beat a benchmark (a normal portfolio or mix of betas).*

fact that the *best* can be expected to outperform, *ex ante*. We are simply pointing out that such managers depend on skill like any other manager, and their goal is not an absolute-return goal but a relative-return goal, the goal of producing expected alpha.

If we understand what is really happening—that all forms of active management consist of making bets relative to some sort of benchmark—then we have a better chance of identifying managers, including hedge fund managers, who really do add value. And that understanding must be founded in relative-return space.

payoffs that he must beat if he wants Berkshire Hathaway to go up more than the rest of the market (a cost of capital is just the expected return on the market risks in the portfolio; it is the return to the firm’s beta). So the most famous absolute return investor in the world is in fact a relative-return investor—as are *all* absolute return investors. They’re sheep in wolves’ clothing!

Relative-return investing may seem timid and constrained to those who don’t understand the difference between beta and alpha, but it is the only means through which real value can be added to portfolios. Relative-return investing is the only kind of value-added investing that really exists. Get over it!

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7 But we won’t see many organizations putting their hedge funds in the cash asset class—because of their highly volatile active returns and their relative lack of liquidity (they are useless as collateral for a futures position, for example); it just doesn’t feel like it fits this category. But asset classes at heart are typically defined as fully diversified market segments (betas), so an investment with zero beta is technically a cash-asset-class investment. This observation highlights the need for increased proficiency in alpha-beta separation by institutional investors. While hedge funds really do most naturally fit in the cash asset class based on their beta characteristics, it probably makes more sense to port the alpha to some other asset class, or hedge funds could just simply be looked at separately from all of the asset classes. (In the latter case, to be consistent, one should separate the alphas in all of the asset classes, full alpha-beta separation.) We confuse ourselves when, as here, we insist on putting a type of investment in the wrong asset class because of characteristics associated with its alpha.

## *Hedge funds the way they ought to be*

We can't salvage the term "absolute return," but we can salvage the concept of the hedge fund, that is, of a fund that takes both long and short positions as originally envisaged by Alfred Winslow Jones.<sup>8</sup> To do so requires us to acknowledge that, as stated above, all efforts to add special value are at their heart relative-return investing—a search for pure alpha—and success requires meeting the two conditions of (1) inefficiency in the relevant market

*A hedge fund or any other active manager operating in an inefficient market that has special skill at exploiting those inefficiencies can be fairly expected to add alpha, to beat the great zero-sum game and therefore, is a thing of rareness and value.*

and (2) skillful selection of investment positions. A hedge fund or any other active manager operating in an inefficient market that has special skill at exploiting those inefficiencies can be fairly expected to add alpha, to beat the great zero-sum game and therefore, is a thing of rareness and value.

As we implied earlier, but let's be explicit: Hedge funds do have a normal portfolio, a set of exposures they go back to when they don't have any special insights. Sometimes hedge funds are characterized as having a benchmark of cash. It is certainly possible to imagine a hedge fund for which this is appropriate: the normal portfolio for a hedge fund with no net expected average exposures to any styles, markets or other beta factors could be correctly understood as a zero-beta portfolio, and its benchmark would simply be cash. (We say *no net* expected betas because hedge fund managers take both long and short positions, and the betas from these opposing positions within each beta category may offset each other to a greater or

lesser degree. For establishing the normal portfolio, remember, we are focused on the forward-looking expected average beta positions and not on deviations from them for market timing purposes.)

In fact, when data from actual hedge funds are evaluated, most of these funds show persistent net positive beta exposures over time. On average, the equity beta of long-short equity hedge funds seems to range between 0.3 and 0.6, and they also have some beta exposure to bonds. See, for example, Asness, Krail, and Liew (2001); Dopfel (2005);

Ennis and Sebastian (2003); and Malkiel and Saha (2004). In effect, most hedge funds normally put fewer dollars into short positions than into long positions, and their net betas do not completely cancel and go to zero.

As it happens, there is a very good reason to have one's long positions offset by short positions in such a manner that they do in fact give a net zero-beta position as the normal portfolio. The reason for this lies in the proven lack of efficiency of portfolios that are subject to the long-only constraint: For a given level of skill, constrained long-only portfolios deliver only a fraction of the alpha of an unconstrained or market neutral portfolio. This is explained very fully in Grinold and Kahn (2000a, 2000b) and Clarke, De Silva, and Thorley (2002), and is summarized by Waring and Siegel (2003).

This is not a casual observation: It is one of the cornerstone principles on which modern active management is based. If an investment manager

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8 The investment strategies of the hedge fund pioneer Alfred Winslow Jones were first described in Loomis (1966), cited in Brown and Goetzmann (2003). Loomis, in private correspondence, suggests to us that the term "hedge fund" or "hedged fund" may have been originated by Benjamin Graham.

has skill at making investment bets, then that skill is amplified by incorporating these bets in portfolios that are not constrained to hold only long positions or to hold any particular amount of beta. The most efficient portfolio across a set of buy-and-sell signals is for the expected average net beta position to be zero (so that the normal portfolio is zero beta, or cash).

The term in the market for this type of investing has come to be “market neutral long-short.” The long-short part of the term captures its hedge-fund-like behavior. The market neutral part of the

striking contrast to traditional hedge fund managers who, in their resistance to benchmark-relative investing, reject the importance of the difference between beta and alpha in their portfolios and see little or no value in these risk-control techniques. They completely miss the benefits of this technology: If they were using it, the hedge fund manager (and the fund’s investors) could clearly distinguish alpha—the result of skill—from beta.

A high-quality market neutral long-short fund, driven by skillful insights, is the highest expression of the art of active management, and it represents

*A high-quality market neutral long-short fund, driven by skillful insights, is the highest expression of the art of active management, and it represents what traditional hedge funds ought to be.*

term makes it clear that this type of fund is beta neutral, truly zero beta. It is like a hedge fund in that it has both long and short positions, but it is significantly better in that it incorporates a clear-eyed view of which part of returns is alpha and which part is beta. Think of a hedge fund but with modern risk-control technology, so that it really does have a net-zero-beta normal portfolio in many dimensions of beta—its benchmark really is cash, that is, the risk-free rate.<sup>9</sup>

Using such technology, this neutrality in beta is, in fact, an expected average neutrality across as many market risk factors as possible, up to and including—and for the best exceeding—the number of market risk factors in the models sold by BARRA and its able competitors. The term “risk control” is very much evident in the portfolios built by the most skilled practitioners of this form. This is in

what traditional hedge funds ought to be.<sup>10</sup> But traditional hedge funds have a long way to go before they are as desirable an investment as an equally skillfully managed market neutral long-short fund. As risk-control technologies become more widespread, expect to see the better hedge funds adopt them.

*Conclusion: Pay alpha fees only for real alpha, not beta!*

Let’s recall what we asserted at the beginning: that the notion of absolute return investing has seduced many people into believing that superior returns can be achieved by those with strong views and little or no regard for benchmarks. But why do people think that absolute return managers exist, and why do they think that such (imaginary) managers ought to earn supercharged returns?

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9 This portfolio, which starts with zero beta exposures, can then be “equitized” or given any beta exposure or mix of beta exposures that the investor wants (not just equities) without affecting portfolio efficiency.

10 A manager who makes market timing (beta timing) bets can be market neutral and risk controlled. Such a manager’s expected or average betas would be zero over, say, a market cycle—even if, at every given moment, the betas of the portfolio are nonzero. Active beta timing is a legitimate active management discipline, although for some technical reasons it does demand very high skill levels.

*Because they want to believe!* Beating the market is difficult, and in an environment in which responsible forecasters envision a 7–8% annual expected return on equity benchmarks, those who want or need a substantially higher return are looking for an easy solution, for more return and/or less risk. If they're hiring so-called absolute return managers or setting up an absolute return asset class, then they must either believe in the magic of the category or be convinced that skill levels are much higher for hedge fund managers than for the mere mortals who run ordinary long-only funds. But the laws of financial gravity have not been abrogated; long-short active return is just as much a zero-sum game as long-only active return, and you need special skill—not just average skill—to win the game. And it seems highly unlikely that the 8,000-plus mostly newly minted hedge fund managers are on average all that much more specially skilled than their long-only counterparts, press hype to the contrary.

The solution of hiring highly compensated entrepreneurs who do not feel bound by a benchmark is powerfully marketed, and some of these funds have actually experienced some very attractive historic returns, lending support to the faulty conjecture that absolute return portfolios are intrinsically a better portfolio design (it is common to confuse *realizations* from the past with *expectations* for the future). What investors actually get when they hire one of these would-be absolute return managers, however, is a variety of market-like or beta exposures (which can be hedged away to a net-zero level, but which rarely are in practice), plus (minus) positive (negative) alphas as one would obtain with any investment, minus fees and other costs. And on average, before fees and costs, they are merely average.

Back to the notion, from our earlier definition discussion, that absolute return investing somehow delivers returns that are positive and high regardless of the direction of the market: What is wrong

with this is that it portrays absolute return investing as a magic investment approach able to earn outsize total returns with little or no risk of negative returns simply because the manager disdains benchmarks and may have a low net market exposure (low beta). Markets don't work like this, and active management can't generate returns like this. A hedge fund will deliver the risk-free rate, plus a beta return related to its normal portfolio, plus an alpha return that comes from beta timing, security selection or whatever.

So there isn't any value in the term "absolute return investing." It misleads the listener into thinking it has substance that it does not have, and in our opinion, the term just shouldn't be used. All investing is about managing a bundle of beta and alpha attributes. Your goal as the investor is to understand your beta exposures, but to pay active fees only where you actually expect positive alpha, that is, benchmark-beating performance. Managers, including hedge fund managers, with true expected alpha (from above-average skill) are hard to find, but they do exist.

If you want to invest in the hedge fund category, a given quantity of skill will have the highest alpha payoff if the manager is a market neutral long-short manager, the modern risk-controlled version of a hedge fund, a version that works hard to have a normal portfolio that is very close to zero net beta.

But whether you limit yourself to those modern incarnations of the hedge fund or to traditional hedge funds, you're looking for special skill at beating benchmarks. By definition, you're a benchmark-relative investor.

Beating a benchmark is all that matters; it's the only thing that is worth paying high fees to achieve.

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