

PERSPECTIVES

The Myth of the Absolute-Return Investor

M. Barton Waring and Laurence B. Siegel

In meetings with clients and colleagues in the past few years, we have noticed that many otherwise hardheaded 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. At a time when pension funds, foundations, and endowments are under pressure to increase their investment returns, absolute-return investing is often positioned as The Answer—with 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 have never really understood why all investing is, in the end, relative-return investing, then the notion that absolute returns might be superior seems to make good sense.

Alas, we fear we have 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 is wrong with it; from where does our skepticism spring? Is there something valuable and redeemable in the concept, and if so, what is it?

Why Absolute-Return Investing Is a Myth

The first question is: 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. Definitions that were

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both sensible and true to the sense of the term eluded us. That experience further piqued our interest in the idea.

So, let us explore the term a bit. It is widely used, and because words are chosen to a purpose, one can find some of that purpose by observing the context in which a term is used.

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 rebellious spirit. The term captures this spirit: If benchmark-relative investing is considered inadequate or wimpy by these rebels, then absolute-return investing implies that managers can take the opposite approach, one that is not benchmark relative. (Real men do not use benchmarks!)

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

The first is taken from a well-known financial pundit writing for *SmartMoney.com*:¹

But when the bubble burst, and indeed up until this year, simply 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, only 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, that emphasizes higher-than-market, positive returns:²

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 share markets are falling—because they often adopt hedging strategies.

And another, to the same point, from the Australian Stock Exchange:³

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 quotations 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 statements, it might 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, as a result of these combined attributes, the total return from absolute-return investing will have less downside risk and more upside return than the total return produced in a relative-return environment.

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 later—a view that will give some comfort to many of those sensible readers. But our view is stronger: We do not support continued use of the term.

Of course, we would not disagree that a return pattern that beats the market in rising markets and that does not lose money in falling markets would be a good thing—if it really existed *ex ante*.⁴ (And as you will see, something like it can exist—but it is not 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 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 benchmarks). Here, we focus on hedge funds because that is where the interest is today.

Definition and Importance of Relative Returns

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 1963, Sharpe laid the foundation for how investment professionals understand and decompose total returns on portfolios today.⁵ His work showed how the total return on *any* portfolio—note the emphasis—can be decomposed into a part that is ascribable to the return on the market benchmark, which he called “beta,” and an idiosyncratic—in this case, manager-specific—part that is uncorrelated with the market, which he called “alpha” (plus the risk-free rate, or cash, of course).⁶

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), r_p , is the expected beta of that portfolio, β_p , multiplied by the excess return of the manager’s normal portfolio or custom benchmark, r_{bm} (that is, the risk premium), plus an alpha (or residual term), α_p , that is uncorrelated with 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, this idea is often abbreviated to simply: A portfolio has 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 clarity what their normal portfolios are; simple, single-factor examples are large-cap value and fixed-income credit. (Other, more complex examples are also possible.) For a purported absolute-return manager, the 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 lies a “home,” a set of factor exposures or betas that the manager goes to when he or she has no reason to go somewhere else.

Therefore, the 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. A portfolio that normally

contains multiple asset classes (or a fixed-income portfolio) could thus be analyzed within the same framework, the only difference being that the betas would represent exposures to style or asset-class factors other than (only) the equity market.⁷

Why is this principle important? The returns of normal portfolios or custom benchmarks are easily achieved through mixes of index funds or derivative 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 fund⁸). Thus, 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 the 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.

The pure alphas result from manager deviations from the contents of the benchmark through security selection or from beta timing.⁹ (This principle would apply to a portfolio with a cash benchmark—that is, 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 nonzero positive expected value if the two conditions of inefficiency and skill discussed in Waring and Siegel (2003) were 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 skillful crowd that plays the markets.

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

Sorting Out Absolute Returns

This explanation of betas and alphas is offered for a reason: Just because something is called an "absolute-return investment" does not mean it is granted an exception to the first law of financial gravity described in the previous section: The returns of *any* portfolio can be broken down into market (beta) components and an alpha component. So, here is the money question we are asking all hedge fund managers who fancy themselves

absolute-return investors: 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"), the manager is acknowledging 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, with this 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. The returns are "just beta," and as discussed, beta can be purchased readily and inexpensively. The "2 and 20" fee for beta is nice work if you can get it! But to charge clients hedge fund fees for the component of returns that could be replicated with an index fund is aggressive and probably not sustainable. The fact is, however, that "just beta" may be a more truthful answer than managers are comfortable accepting. Many studies strongly suggest that hedge funds have returns that are significantly explained by persistent beta exposures.

So, we've warned our absolute-return manager friends away from giving an answer that includes "beta." They may have us outsmarted, however, and plan to answer "alpha." After all, everyone knows that the skillful manager with a positive expected alpha has a valuable product that deserves a substantial fee. So "alpha" sounds like a pretty good answer. Right?

Is It Alpha? Be careful. By describing fund returns as alpha, managers acknowledge that they are relative-return investors! Alpha is *defined* as a relative return, the return generated over and above the manager's normal beta exposure, or benchmark.

Thus, we have demonstrated that there is no such thing as an absolute-return investor. The phrase propagates 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 is apparently being promulgated to aid the marketing of yet another cynical investment practice—namely, the mixing of alphas and betas at a single fee level (the higher one, naturally).

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.¹⁰ Real added value comes only from relative-return investing.

No wonder we could not sensibly define absolute-return investing: There is no such thing. The term is intended to capture investor attention by offering 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 simply does not 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.

More specifically, a well-managed hedge fund is at heart simply 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. And, of course, hedge funds are subject to the same zero-sum-game rules 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 do not exhibit statistically significant realizations of alpha.¹¹ No real surprise here for the hardheaded and clear-eyed investor: Hedge funds are not the "magic asset class" that some would like you to believe. Like any other actively managed fund, they rely on special skill for special success.

In this light, one can 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 will argue is the ideal level of beta exposure for such a fund, the natural (unconditional or market) return is simply the return on cash plus or minus the realized alpha. Technically, given that asset classes are always market risk categories, a zero-beta hedge fund should be in the *cash* asset class, not in some separately named class.¹² Saying there is an absolute-return asset class is the same as saying there is a pure-alpha asset class, but the industry does not engage in that practice for any other actively managed funds; we put them in the asset class that best matches their *beta* characteristics.

Please understand that we are not disparaging skillful hedge fund managers or any other truly skillful manager with a positive expected alpha by

virtue of that skill. Not all hedge fund managers can be above average, so the group as a whole cannot outperform a fair benchmark, but let us celebrate the fact that the *best* can be expected to outperform *ex ante*.

What we are pointing out is that such managers depend on skill as any other manager does and their goal is not an absolute-return goal but a relative-return goal, the goal of producing expected alpha. If investors understand what is really happening—that all forms of active management consist of making bets relative to some sort of benchmark—then they 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. *The universal goal of active management is to add value over a benchmark.*

Thus, all managers who make the effort to add special value to a portfolio, whether they want to admit it or not, must do the same thing: beat a benchmark (a normal portfolio or mix of betas). The challenge is the same for a hedge fund, a long-only manager, a market-neutral long-short manager, a traditional active manager, a quantitative active manager—whatever type of manager. Even Warren Buffett has a benchmark, a cost of capital or blend of beta payoffs, that he must beat if he wants Berkshire Hathaway to go up more than the rest of the market.¹³ So, the most famous absolute-return investor in the world is, in fact, a relative-return investor—as are all absolute-return investors.

Relative-return investing may seem timid and constrained to those who do not 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!

The Way Hedge Funds Ought to Be

We cannot 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 envisioned by Alfred Winslow Jones.¹⁴ To do so requires us to acknowledge that, as we have stated, 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 and (2) skillful selection of investment positions. A hedge fund or any other active manager that is operating in an inefficient market and has special skill at exploiting those inefficiencies can fairly be expected to add alpha, to beat the

great zero-sum game and, therefore, is a thing of rareness and value.

But hedge funds do have a normal portfolio, a set of exposures they go back to when they do not have any special insights. Sometimes, hedge funds are characterized as having a benchmark of cash. One certainly can 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 be cash.¹⁵

In fact, when data from actual hedge funds are evaluated, most funds show persistent net positive beta exposures over time. On average, the equity beta of long-short equity hedge funds ranges between 0.3 and 0.6, and they also have some beta exposure to bonds.¹⁶ 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.

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

This observation is not casual: It is one of the cornerstones on which modern active management is based. If an investment manager has skill at making investment bets, then that skill is amplified by incorporating the 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 strategy has come to be "market-neutral long-short" investing. The long-short part of the term captures the strategy's hedge fund-like behavior. The market-neutral part makes it clear that a fund following this strategy 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 its return 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 port-

folio in many dimensions of beta); its benchmark really is cash—that is, the risk-free rate.¹⁷

When risk-control technology is used, the 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 funds, exceeding—the number of market risk factors in the models sold by such firms as Barra. The term "risk control" is very much evident in the portfolios built by the most skilled practitioners of this form of investing. This approach is in striking contrast to that of 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 modern 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 what hedged investments ought to be.¹⁸ But traditional hedge funds have a long way to go before they are as desirable an investment as a market-neutral long-short fund that is equally skillfully managed. As risk-control technologies become more widespread, expect to see the better hedge funds adopt them.

Conclusion: Pay Alpha Fees Only for Real Alpha!

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?

Because they want to believe! Beating the market is difficult, and in an environment in which responsible forecasters envision a 7–8 percent 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 are hiring so-called absolute-return managers or setting up an absolute-return "asset class," 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 as much a zero-sum

game as long-only active return, and a manager needs special skill—not merely average skill—to win the game. It is 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—media 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 attractive historical returns, which lends support to the faulty conjecture that absolute-return portfolios are intrinsically a better portfolio design (it is common to confuse *realizations* with *expectations* for the future). What investors actually get when they hire one of these would-be absolute-return managers 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 (or minus) positive (negative) alphas—as one would obtain with any investment—minus fees and other costs. And, on average, before fees and costs, the absolute-return funds are merely average.

Consider again the notion, from our discussion of defining “absolute return,” that absolute-return investing somehow delivers returns that are positive and high regardless of the direction of the market. What is wrong with this notion is that it portrays absolute-return investing as a magic investment approach able to earn outsized 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 do not work like

this, and active management cannot generate returns in this way. 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, the term “absolute-return investing” has no meaning. It misleads the listener into thinking it has substance that it does not have, and in our opinion, the term simply should not be used.

All investing is about managing a bundle of beta and alpha attributes. The investor’s goals are to understand the beta exposures of the portfolio and to pay active fees only when the investor expects positive alpha—that is, only for benchmark-beating performance. Managers, including hedge fund managers, with true expected alpha (from above-average skill) are hard to find, but they do exist. The investor who wants to invest in a hedge fund needs to keep in mind that 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 close to zero net beta.

But whether using the modern incarnations of the hedge fund or traditional hedge funds, the investor is looking for special skill at beating benchmarks. By definition, all investors are benchmark-relative investors.

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

This article qualifies for 0.5 PD credit.

Notes

- Jonathan Hoenig, “How Are You Doing” (26 November 2004): www.smartmoney.com/tradecraft/index.cfm?story=20031126.
- “Absolute Return Funds,” Macquarie Bank (accessed 6 December 2004): personal.macquarie.com.au/personal/investment_strategies/accelerate_wealth/alt_long_term/absolute_return_funds_detail.htm.
- “Absolute Return Funds Fact Sheet,” Australian Stock Exchange (accessed 7 December 2004): www.asx.com.au/markets/pdf/HedgeInfoSheet.pdf.
- A return pattern that beats the market in up markets and earns a positive return during down markets could, theoretically, be achieved with a portfolio consisting of the following: the market benchmark plus puts on the market benchmark plus a high expected alpha. (The rub is, of course, the high expected alpha.) Thus, the “strong form” absolute-return payoff, higher than the market and also positive, could be seen as optionlike. But this payoff is still, as is obvious from the components required to construct it, a relative return.
- Full disclosure and fair play require us to note that the capital asset pricing model was independently, and roughly simultaneously, discovered by several other researchers, but Sharpe has been the most prolific and persuasive exponent of it.
- In perfectly efficient markets, the expectation for manager alpha is zero. But with some degree of market inefficiency, a manager of above-average skill can have a positive expected alpha. *Realized* alpha will always have a substantial random component, but for the skillful manager, the mean of the distribution will have risen. We discuss these issues in Waring and Siegel (2003); we don’t mean to be glib in skipping over some technical details. Our comments apply in the context of the single-index model, the market model, or the capital asset pricing model, 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).
- 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 historical mix of betas for a given portfolio, which, in turn, is useful for evaluating the expected future normal portfolio (see Sharpe 1988, 1992). Holdings-based style analysis may be used to achieve similar goals.
8. An example of a recipe-driven portfolio, one that provides exposure to exotic beta, might be a merger arbitrage strategy that involves annually buying the top 10 (by market capitalization) acquisition target companies each year and selling the acquiring companies short. Note that such a strategy, like most exotic-beta strategies, cannot be completely passive. One cannot 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.
 9. Beta timing is sometimes called “tactical asset allocation” and sometimes (often with an unfairly pejorative tone) “market timing.” Beta-timing decisions consist of moving the beta position away from the normal portfolio’s beta position to capture a gain from being underweight when the market underperforms or overweight when the market outperforms its equilibrium expectations.
 10. 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.
 11. See, in particular, Asness, Krail, and Liew (2001). Using the ordinary market model, Asness et al. calculated 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 had an alpha t -statistic of 0.76. These results are for data from Credit Suisse First Boston/Tremont for the period January 1994 through September 2000. Using a Dimson–Scholes–Williams adjusted market model (that is, a model with the led and lagged market returns as additional regressors), Asness et al. found the alphas to be positive and significant for two of nine strategies, positive and insignificant for one, and negative for the others (Dimson 1979; Scholes and Williams 1977). The aggregate alpha t -statistic was also negative. Market-neutral equity funds had the highest alpha t -statistics in both tests. Hedge fund enthusiasts argue that the average hedge fund manager may actually be above average because the high compensation and freedom of the strategy attracts the “best” managers. They can then take money away from boring old long-only institutional, retail, and other “dumb” investors. Not much real meat covers 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 do not support the reality of persistent true alphas from hedge funds.
 12. Perhaps not many organizations would put 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), hedge funds simply do not seem to fit this category, even though they do. Asset classes are typically defined as fully diversified market segments (betas), so an investment with a zero beta is technically a cash-asset-class investment. This observation highlights the need for increased proficiency in alpha–beta separation by institutional investors. Although hedge funds most naturally fit in the cash asset class, the sensible approach is probably to transport the alpha to some other asset class. Or hedge funds could simply be considered to be in their own category, an asset “class” with a cash-like beta but a highly volatile alpha. (In this case, to be consistent, one should separate the alphas in *all* of the asset classes, for full alpha–beta separation.) We in the industry confuse ourselves when, as in the case of hedge funds, we insist on putting a type of investment in the wrong asset class because of characteristics associated with its alpha.
 13. A cost of capital is simply the expected return on the market risks in the portfolio; it is the return to the company’s beta.
 14. The investment strategies of hedge fund pioneer Jones were first described in Loomis (1966) and were cited in Brown and Goetzmann (2003). Loomis, in private correspondence, suggested to us that the term “hedge fund” or “hedged fund” may have originated with Benjamin Graham.
 15. We say “no net expected . . . beta[s]” because hedge fund managers take both long and short positions and the betas from those opposing positions within each beta category may offset each other to a greater or lesser degree. Remember that for establishing the normal portfolio, we are focused on the forward-looking expected average beta positions, not on deviations from them for market-timing purposes.
 16. See, for example, Asness et al.; Dopfel (2005); Ennis and Sebastian (2003); Malkiel and Saha (2005).
 17. 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 (using not only equities) without affecting portfolio efficiency.
 18. A manager who makes market-timing (beta-timing) bets could 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 were nonzero. Active beta timing is a legitimate active management discipline, although for some technical reasons, it does demand great skill.

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