HDF
20 Years in Funds of Hedge Funds

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HDF Briefing

Investable hedge fund indices

The purpose of investable hedge fund indices is to provide a quick and easy way of investing in alternative assets. But how do these indices match up to funds of hedge funds?

An investable index is just a passively managed blend of funds
Typically, an investable index is made up of a group of hedge funds that meet a published list of objective but unbending criteria. The aim of using these criteria, which include aspects like size, liquidity and track record, is to build a group that represents an adequate benchmark for the investable hedge funds universe. Despite this shared goal, performances vary sharply from one index to another (see table). These differences stem from the arbitrary decisions that index sponsors make when setting their own rules for fund eligibility, such as minimum size, liquidity or track record, or the weighting of eligible funds in the index. Once these rules are established, they do not change. In some cases, when funds in an index have seriously underperformed, some sponsors have tried to add qualitative eligibility criteria. Such moves have been only moderately successful, however, since they can make sponsors look less neutral than originally intended.

A well managed fund of funds adds value compared with a passive index
Here at HDF, we believe that management decisions are what create value for investors, not passive decision-making. This is true in at least three areas:

1) **Asset allocation**: Unlike static allocations of an index, it is vital to vary the weighting of alternative strategies over time to reflect prospective returns, based on how macroeconomic fluctuations are affecting market conditions.
2) **Manager selection**: a rigorous process is needed to assess a manager's integrity, the appropriateness of its investment process, its expertise and the effectiveness of its risk controls. This process cannot be boiled down to a set of pre-determined rules. For one thing, size is not necessarily an indication of quality. Picking managers is not a science; it is an art that takes experience, a no-nonsense approach and frequent re-examination.
3) **Portfolio construction and risk control**: by blending a wide range of complementary fund styles into a coherent and diversified portfolio, it is possible to control risk and shield investor capital. The optimal portfolio is constructed by combining the qualitative knowledge of managers with assessments of what each fund can contribute to risk mitigation and portfolio performance. The static rules followed by indices cannot deliver this kind of result.

As the following table shows, a well managed fund of funds offers a better risk/return trade-off than investable indices.

If investable hedge fund indices eventually receive UCITS III status, entitling them to be passported in Europe, then the ARIA III funds of hedge funds authorised by the French regulator should receive similar treatment, in the interests of investors.

Data as at end-August 2007	**2007**	**2006**	**2005**	**Volatility**
$ Edhec non investable	6.06%	11.25%	6.80%	4.09%
$ CS/Tremont Investable HF Index	3.51%	9.65%	3.61%	3.34%
$ MSCI Hedge Fund Invest Index	1.93%	7.63%	4.68%	3.46%
$ HFRX Global Hedge Fund Index	2.71%	9.26%	2.72%	4.73%
€ CS/Tremont Investable HF Index	2.27%	6.73%	2.05%	3.29%
€ MSCI Hedge Fund Invest Index	1.93%	7.63%	4.68%	3.34%
€ HFRX Global Hedge Fund Index	1.62%	6.73%	2.35%	4.46%
€ HDF Global Opportunities	4.20%	9.66%	11.88%	4.43%
€ HDF Multi Alternatives	4.01%	7.46%	5.53%	2.41%

Sources: HDF, Edhec, Credit Suisse, MSCI, HFR

NB: Because index returns in dollars do not reflect the cost of a euro currency swap, they cannot be compared directly to the returns on euro indices and funds.

Please contact your usual HDF account officer if you require further information.

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