

The Expanding World of Investable Hedge Fund Indexes

By: Carl Beckley | Director, Research and Development,
FTSE Group
Simon Hookway | Director and Co-Founder MSS
Fund Management Limited)

Introduction

In response to increasing demands from institutional investors, who desire benchmarks that accurately inform them about real investment risks and rewards, and retail investors who simply tend to desire simple marketing promises, a whole new generation of investable Hedge Fund indexes and related tradable products are evolving to service these needs.

There are large differences between index providers in the way in which funds are selected, classified, weighted and rebalanced. As a result, the picture of the investment universe that emerges when comparing competing products can at times be very confusing.

In recognition of these problems a number of new investable indexes are emerging that recognise these deficiencies. The FTSE-Hedge Fund Index Series aims to fairly represent the performance of the underlying global universe of investable hedge funds. The index series is calculated using prices from an investable index fund, The FTSEHx Fund SPC, that implements the Index methodology, thus ensuring that index returns are genuinely achievable and not subject to poor data or lack of transparency.

The broad hedge fund Indexes

As of mid-2003, there were at least 14 providers of hedge fund indexes and data¹. These services have been established to provide data upon which to base the analytical tools that both managers and investors rely to measure risk and return in the asset class. However, all hedge fund indexes are built from databases of individual manager returns and are thus all ultimately peer-group benchmarks that suffer from the usual self-reporting deficiencies and biases² associated with this type benchmark.

There are three main databases upon which the index providers base their indexes (TASS, MAR, HFR), with other databases available principally from Van, Altvest and Hennessee. Due to the self-reported nature of hedge fund returns, none of these databases can be exhaustive (individually or collectively), nor are they mutually exclusive. All the indexes built from these databases take the form of a weighted global composite³ and a series of sub-style indexes. However, because the hedge fund industry is relatively new, terminology has not been standardised⁴ and thus the same strategy can be referred to under multiple different sub-index names.

Furthermore, as a result of all the differences between providers in the way in which funds are selected, classified, weighted and rebalanced, a somewhat confusing picture of the investment universe emerges when comparing the performance of similar indexes from different providers. For example, in 1999 the HFR Composite Index returned 30.8% and the CSFB/Tremont 23.4%, a difference of 7.4%, more than half of which can be accounted for by the difference in weighting scheme between the two given the post 1998 rebound in Emerging Markets. Similar reasoning lies behind 7.7% of the 9.1% difference between the two indexes in 1997 (HFR +16.8%, CSFB/Tremont+25.9%) due to the much higher weighting in the CSFB/Tremont in Global Macro at the start of that year.

The same is also true at the sub-index or trading strategy level. ZCM reports a 20.48% return in long/short strategies in Feb 2002, while EACM reports a -1.56% return in that month. Furthermore, the correlation between two indexes for the same strategy can be low (e.g. 0.13 for MAR and Hennessee equity market neutral indexes) or even negative between two competing indexes for the same strategy (-0.19 in the case of EACM and ZCM long/short indexes). Naturally, these differences can have profound implications for how to allocate assets to various hedge fund styles/strategies in the interest of diversifying traditional sources of asset class risk.

The growth of investable hedge fund indexes

Given the disappointing performance of traditional asset classes since mid-2000, the acceptance of hedge funds as a core portfolio holding has

gained significant momentum in the early part of the decade. However, serious hurdles to truly broad based acceptance remain: Any number of recent industry surveys reveal lack of transparency, risk control difficulties, lack of understanding (principally due to the confusing picture of performance of the investment universe that emerges from the comparing different broad-based indexes noted earlier), poor media image, lack of regulation and liquidity concerns as being high on the institutional investors' list of concerns when evaluating initial and/or increased allocations to hedge funds and funds of hedge funds.

Typically based on data from dedicated managed account platforms⁵, the new investable indexes aim to confront all these institutional concerns head on, address most of the academically identified biases in the broader non-investable indexes, and appeal to retail investors to the extent that they are also associated with «household» index brand names.

It is now generally accepted that, in order to be useful, benchmarks either for performance measurement or investment, indexes must be:

- › Representative
- › Investable
- › Transparent
- › Evolving (so remaining relevant to the asset class)

As Table 1 indicates, the extent to which this is often a trade-off is an important factor. All index providers tend to be rule driven (albeit by varying degrees), and therefore reasonably transparent⁶. Most, but not all, evolve to the extent that the numbers of funds they include ebbs and flows with the underlying universe. However, they differ markedly in terms of representation and investability.

Table 1 | Representation versus investability

Investability \ Representation	Low	High
High	<ul style="list-style-type: none"> › Broad benchmarks › Data issues › Self-classification › Monthly data › Fund access issues 	<ul style="list-style-type: none"> › Ideal index position › Ideal for tradable products
Low	<ul style="list-style-type: none"> › Customised baskets › Not a useful benchmark 	<ul style="list-style-type: none"> › Quantitative fund of funds › Not a useful benchmark

Source: IndexUniverse.com

Not only do the major index providers differ in terms of their selection criteria (for example, the treatment of funds that are «closed» to new investment), they also do so in terms of their style classifications, weighting and schemes. Furthermore, as noted earlier, many of the indexes suffer from underlying sources of bias/measurement error (survivorship, selection, self-reporting liquidity and instant history bias) that cannot be diversified away. Taken together,

¹ Including EACM, HFR, CSFB Tremont, Zurich Capital Markets (ZCM), Van Hedge, Hennessee, HF.net, LJI, MAR, Altvest, Magnum, S&P, MSCI.

² Including survivorship, instant history and liquidity biases.

³ All except MAR which does not produce a global composite.

⁴ At the time of writing there is an AIMA project in progress to establish just such a standard categorisation.

⁵ Except CSFB/Tremont Investible Index.

⁶ However, Van Hedge does not make its index performances freely available to the public. HFR and MSCI do not publicly disclose the funds in their investable indexes. EACM does not disclose the funds in any of its indexes.



Fung and Hsieh 2002, Brown, Goetzman and Ibbotson 1999 and others estimate that this has the effect of giving an upward bias to the historical returns of the TASS database by as much as 3-4.5% per annum⁷.

The combination of all of these perceived hurdles and drawbacks⁸ has so far kept retail and institutional capital largely out of the hedge fund arena. Institutional investors desire benchmarks that accurately inform them about investment risks they are taking and rewards they are likely to receive, while retail investors desire simple marketing promises preferably based off «household» brand names they know and trust.

To satisfy both, a new breed of index is emerging that is both representative and investable (i.e. the top right hand quadrant of Table 1 on the previous page). Representation is achieved by rigorous quantitative techniques and investability is assured through qualitative due diligence and suitability testing.

Evolving tradable products

The mechanics of the hedge fund world mean that, in order to be able to provide investors with representative, investable, transparent, daily priced indexes, the index itself has to be an investor in the underlying funds. This means that the performance of such an investable index can only be derived from the performance of a fund of funds vehicle⁹ that invests solely in the designated index constituents¹⁰. This is quite a unique role for an index provider, and further underscores one of our major points. Namely, that «Hedge Fund Indexes» are really a form of transparent, scientifically-built manager universes. Second, concerns over adequate risk monitoring and control, investment liquidity (to help mitigate «blow up» event risk) and worries over inadequate regulation of public fund vehicles, have typically driven the investable index providers towards having their own dedicated managed account platforms¹¹ to drive the calculation of the related fund of funds structured index.

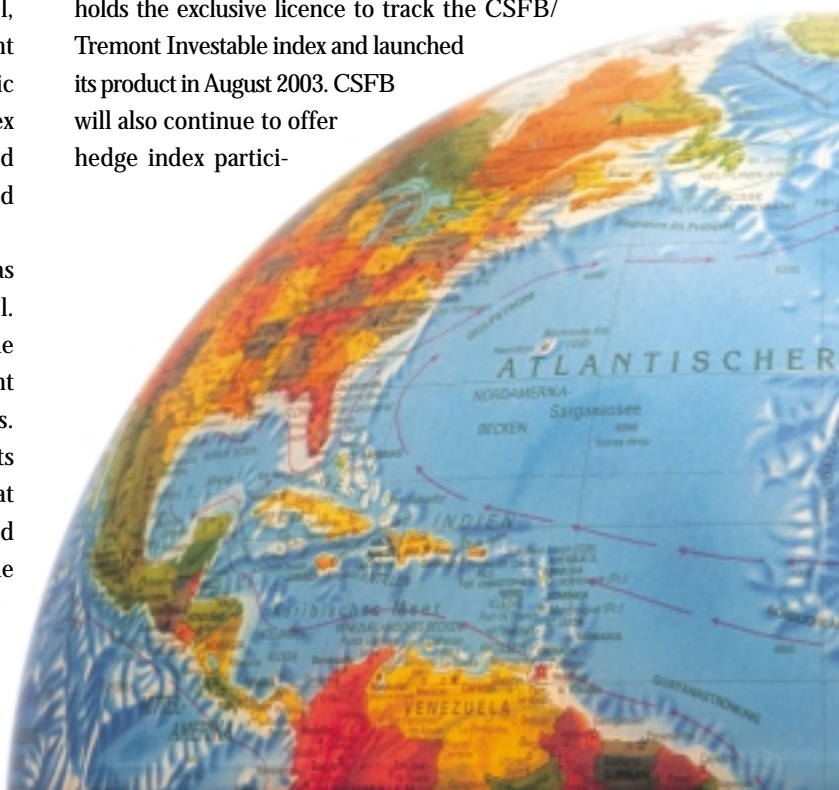
This is both an elegant and practical solution as well as being, currently, the most successful business model. Index rule structures tend to be transparent and provide a representation of the universe via exposure to constituent funds that are open and ready to receive subscriptions. The fund of funds structure built on managed accounts with the constituent funds ensures, on a daily basis, that all exposures are transparently monitored, controlled and independently valued as well as providing a ready-made

investment conduit for investors. In addition, these structures have the added benefit of eradicating all that plagues the broader, non-investable indexes¹².

As of Q4 2003, there are five principal investable hedge fund index providers: S&P, HFR, CSFB/Tremont, MSCI and Dow Jones¹³, and this universe will expand to six when FTSE launches its FTSE-Hedge fund index product in Q1 2004. Other index tracker products are available from VAN, LJH and Magnum. These products are significantly different in that they are not based on managed accounts and use an optimised sample of funds to track those companies' own proprietary indexes.

All publicly distributed funds and structured products related to tracking the S&P Hedge Fund Index are invested via the «SPHINX» (S&P Hedge fund Index) product, launched in 2002 and managed by Plusfunds, who holds a global exclusive licence to do so. ZCM (now Dow Jones) began life three and half years ago in 2000 with a product specifically tailored to the needs and requirements of the US insurance industry. ZCM originally offered tracker funds matched to all its indexes and many of the MAR indexes too. However, the Dow Jones indexes currently only follow five of the non-directional MAR trading strategy indexes. For some time now HFR has had an «investable» index that it made privately available to its institutional clients, but in May 2003 it launched a tradable index that it will licence to all interested parties. The first takers have been five investment banks: Lehman Brothers, DKW, Bear Stearns, Barclays Capital and Deutsche Bank.

Of the leading investable index providers, the only one not to be structured as a managed account platform is the CSFB/Tremont Investable index. Credit Suisse Asset Management holds the exclusive licence to track the CSFB/Tremont Investable index and launched its product in August 2003. CSFB will also continue to offer hedge index partici-



pation shares (HIPS) and sector index participation shares (SIPS) on its original CTI index. MSCI is the only investable index provider to have launched an index that is not based on a fund of funds vehicle. MSCI's product is essentially constructed by reweighting some of the funds that are already on the SocGen Lyxor managed account platform.

As this vanguard of investable index providers encourages the construction of tradable products for investors and those products succeed in gathering funds for related distributors and asset managers, it is not unreasonable to expect that the remaining index providers will produce investable indexes of their own too. However, whereas the number of investable hedge fund indexes is likely to increase, those that will be successful in attracting investor's interest over the long run will be those with a known global brand, investment objective and a delivery mechanism that produce superior risk and return diversification benefits.

The FTSE-Hedge Fund Index Series

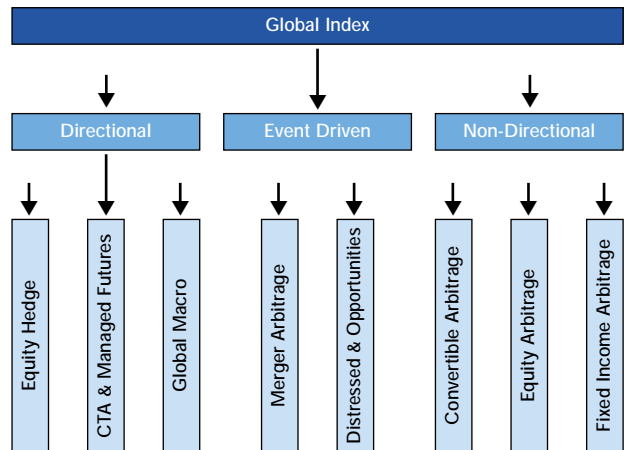
The FTSE-Hedge Fund Index Series is a set of investable benchmarks maintained and published by FTSE that aim to provide a daily measure of the aggregate risk and return characteristics of the broad-based universe of open, investable hedge funds whilst being representative, diversified, transparent and evolutionary.

The FTSE-Hedge Fund Index Series is weighted on a bottom up basis in proportion to investability. Investability is the hedge fund equivalent of equity free-float. The index simply aims to weight every hedge fund investment opportunity in proportion to how large the opportunity is. Index constituents are chosen to maximise the

investability (and hence representativeness) of the index whilst ensuring that the subscriptions to constituent man-

agers of the index fund are large enough to meet minimum manager investment requirements. Initially, there will be approximately forty constituent funds and this is expected to increase over time.

Chart 1 | FTSE-hedge fund index series classification system



Source: FTSE

To join the index, funds must first be in the FTSE-Hedge Fund Database. An initial statistical screen is then used to exclude funds that are outliers within their assigned trading strategy. Additional screens are performed to exclude funds that do not have a two-year track record, have less than US\$50m unleveraged assets under management or do not offer at least quarterly liquidity. The remaining funds are then ranked within trading strategy by investability. The funds which rank highest are then included in the index at investability proportional weights subject to passing due diligence performed by Harcourt Investment Consulting AG.

The FTSE-Hedge Fund Index Series aims to fairly repre-

⁷ See Anson M, Chapter 9, Active Index Investing, (2004 forthcoming).

⁸ In addition, some very real regulatory and asset admissibility issues driven principally by the fact that hedge funds do not have to be listed on any exchanges and are largely unregulated.

⁹ Except MSCI whose constituents are all members of SocGen's Lyxor managed account platform. Members of this platform are not publicly disclosed.

¹⁰ LJH, VAN and Magnum offer fund of funds vehicles that track their own proprietary indexes with an optimal sample of funds drawn from their respective indexes.

¹¹ Except CSFB/Tremont investable which is totally invested in publicly available fund shares.

¹² However, much care must be taken when interpreting the investable indexes published pro-forma back histories. These all rely on significant assumptions which, inter alia, may well do nothing to mitigate survivorship, selection, liquidity, instant history and/or self-reporting bias.

¹³ Lyra who runs the managed account platform was formed via a management buy-out from ZCM.



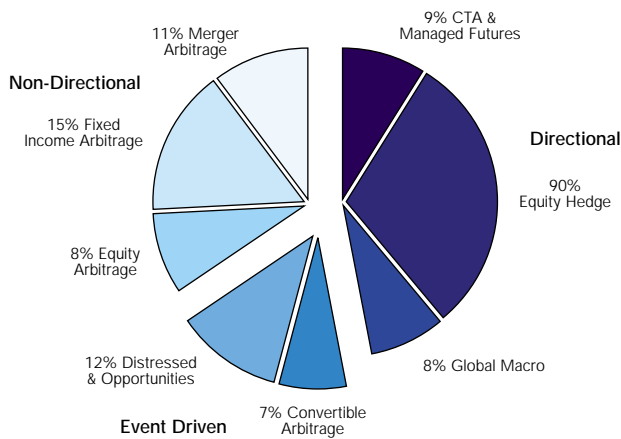
sent the performance of the underlying global universe of investable hedge funds. The rule structure is entirely passive and so does not seek to select funds on the basis of past or expected performance. Instead, it seeks to produce an index that best represents the aggregate performance of the underlying broad universe of open hedge funds. Index performance is calculated using prices from an investable index fund (The FTSEhx Fund SPC¹⁴) that implements the index methodology, thus ensuring index returns are genuinely achievable and not subject to bad data or lack of transparency (survivorship bias, self-reporting bias, etc).

Conclusion

The FTSE-Hedge Fund Index Series provides a set of benchmarks that appropriately represent the performance of the large and growing investment opportunity presented by the global universe of investable hedge funds. Such indexes are required for investment analysis, performance measurement, asset allocation and creating the basis for liquid investment products.

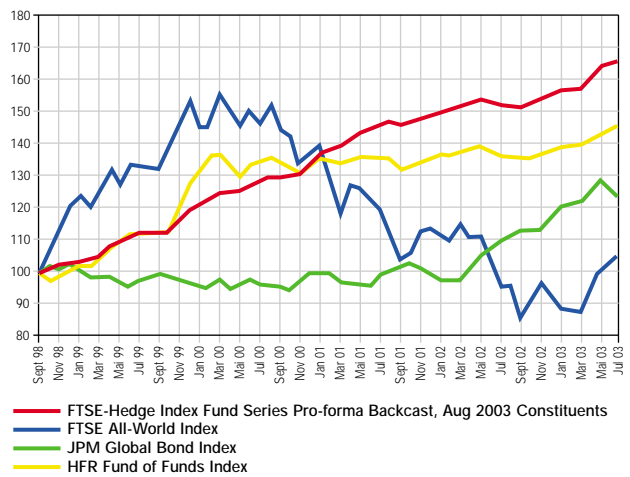
¹⁴Managed by MSS Fund Management Limited

Chart 2 | Classification by management style and trading strategy (August 2003 pro-forma constituents)



Source: FTSE

Chart 3 | FTSE-Hedge Fund Index Series pro-forma performance Aug 1998 - Aug 2003



Source: FTSE, Datastream, HFR

Chart 4 | FTSE-Hedge Fund Index series unofficial backcast

1998 - 2003	FTSE-Hedge Fund Index Series Unofficial Backcast, Aug 2003 Constituents	HFR Fund of Funds Index	FTSE All-World Index	JPM Global Bond Index
Compound Annual Return (%)	11.0	8.1	1.6	4.2
Annualised Volatility (%)	3.2	5.9	16.9	6.9
Information Ratio	3.5	1.4	0.1	0.6
Percentage of Positive Months	84.7	66.1	50.8	50.8
Maximum Continuous Drawdown (%)	-1.3	-4.9	-18.3	-5.6
Correlation to FTSE All-World Index	0.46	0.48	1.00	-0.04
Correlation to JPM Global Bond Index	0.04	-0.05	-0.04	1.00

Source: FTSE, Datastream, HFR

