HEDGE FUNDS REVIEW
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Deconstructing alpha

Benchmark Plus seeks to isolate the alpha component of hedge fund returns by benchmarking and hedging the systematic risk embedded in alternative strategies. Kris Devasabai reports.

Conventional asset managers are judged on their performance relative to an appropriate benchmark. Benchmark Plus Management, a $1.8 billion fund of hedge funds (FoHF) manager, believes the same rules should apply to hedge funds.

Benchmarking hedge fund performance is complex and resource intensive but the benefits far outweigh the costs, according to Robert Ferguson, founder and chief investment officer of Benchmark Plus.

"It takes the mystery out of hedge funds. We can separate the alpha and beta components of hedge fund performance and provide isolated exposure to the excess returns generated by skilled managers," says Ferguson.

This opens up a world of possibilities. Benchmark Plus is able to identify managers that consistently generate excess returns, neutralise their beta exposures with derivatives and construct portfolios of complementary alphas.

The flagship Benchmark Plus Institutional Partners Real Alpha Fund targets returns of 3%-7% above 90-day US Treasuries with standard deviation of less than 5% and near zero correlation to equities.

The fund can also be combined with measured amounts of beta to create a portable alpha solution for investors. "The benchmarking process enables us to de-construct hedge fund returns. If you can measure and isolate alpha, you can repackage it with beta to provide optimal solutions to investors," says Scott Franzblau, a principal at Benchmark Plus.

Benchmark Plus, established in 1996, can trace the genesis of its investment process to the early 1980s when Ferguson was head of futures and options at First Chicago Investment Advisors (now Brinson Partners).

Hedge funds were only just arriving on the scene but Ferguson was quick to spot both the alpha potential and the shortcomings of this new breed of alternative investments.

"Hedge funds are able to generate alpha because they can invest without constraints. But only a handful of managers have the ability to generate excess returns on a consistent basis. A lot of it is beta masquerading as alpha," says Ferguson.

Ferguson realised if hedge fund betas could be identified and isolated through a benchmarking process, they could be hedged with derivatives, leaving only the excess returns attributable to alpha.

"I initially saw beta hedging as a means to institutionalise the risk management of hedge funds," Ferguson says. "If you employ derivatives to neutralise the systematic risk of hedge funds, you can create an institutional product that has the best of both worlds: the alpha of hedge funds and the risk controls associated with traditional asset management."

Ferguson got the chance to pursue his ideas on alternative investments when he joined Weyerhaeuser Company as director of pension investments in 1986. Weyerhaeuser began investing in hedge funds in 1985 and was one of the first institutional investors to embrace alternatives. Its allocations to hedge funds have historically been among the highest of all US pension plans, often exceeding 50% of total assets.

The theoretical framework which underpins Benchmark's investment process is based on the premise that the efficient market hypothesis (EMH) within the capital asset pricing model (CAPM) is a reasonable description of capital markets activity. However, Benchmark recognises that some of the assumptions inherent in EMH are not consistent with the real world. These 'violations' of EMH lead to irrational or anomalous price moves which are the building blocks of alpha-generating strategies.

Benchmark has identified nine main violations of EMH which are observable in real-world market structure and investor behaviour (see box).

One obvious fallacy of EMH is that all pertinent information concerning an investment is freely and simultaneously available to market participants. "That may be true for the top 100 stocks but for the bottom 1,000 companies the only information that is freely and simultaneously available to market participants is contained in government filings," says Ferguson.

"If a manager has the skills and capabilities to gather information on a company beyond what is freely available, they may be able to generate alpha by exploiting this violation of EMH," says Ferguson.

This theoretical framework helps Benchmark identify strategies and managers that benefit from pockets of inefficiency in the financial markets.

Benchmark's investment process steers it towards some relatively unusual strategies, including corporate activism, closed-end fund arbitrage and volatility trading.

Explaining the logic for investing in activist funds, Franzblau says: "Activists have the ultimate information advantage within the bounds of the law. They know their intentions for unlocking value in a company before it becomes public knowledge and they are in a position to act on it."

Benchmark also invests in long/short and event driven funds but it tends to

favour managers trading micro-cap stocks or those with expertise in niche assets, such as trade claims.

"We prefer strategies with higher barriers to entry because that keeps competition at bay and helps preserve the inefficiency," says Franzblau.

The alpha generated by individual managers is measured by constructing a benchmark representing the systematic risks or betas embedded in their specific strategy. The benchmark is based on quantitative analysis of the manager's historic exposures and returns. The manager's alpha is defined as the excess return over the benchmark minus the risk-free rate and fees.

"The benchmarking process provides a very clear measure of the alpha the manager has generated in the past," says Ferguson. "We combine quantitative analysis of past performance with a forward-looking qualitative assessment of the environment for the manager and their strategy to determine their future alpha potential."

The Real Alpha Fund has exposure to the managers with the highest expected alpha potential across the spectrum of market inefficiencies identified by Benchmark. The excess return of each manager is isolated by hedging their respective benchmarks with derivatives. "We employ over 700 risk indices to construct the best beta hedge for every manager in the portfolio," says Ferguson. The residual risk factors, such as style or factor biases, are neutralised through diversification.

Beta neutralisation puts the focus squarely on the manager's ability to beat their benchmark. If a manager has a 0.5 correlation to equities, Benchmark will hedge this exposure with S&P 500 futures. If stocks gain 10% and the manager is only up 4%, Benchmark will realise a 1% loss on the position. But if stocks fall 10% and the manager only loses 4%, the position will net a 1% gain.

"The fund is designed to benefit only from the alpha generated by the managers we invest in. We aim to provide investors with a consistent stream of low-risk returns which are uncorrelated to the markets," says Franzblau.

The investment team is in constant communication with the managers in the portfolio and hedge ratios are dynamically adjusted in response to changes in underlying exposures. Benchmark also aims to neutralise the impact of incentive fees through hedging.

If the manager is above his high water mark and positioned for an up month, Benchmark will hedge only 80% of the beta exposure. In the event the benchmark gains 10% and the manager delivers an 8% return after fees, Benchmark would break even on the position. If the manager is below his high water mark or is having a negative month, the hedge ratio is adjusted to 100% to reflect the absence of an incentive fee.

"One of our core beliefs is that investors should not be paying hedge fund fees for beta. Beta is easy to replicate. It can be done for a few basis points. We don't charge to neutralise beta exposure and we can also provide beta to investors for no additional fee," remarks Franzblau.

Benchmark's beta hedges do not make it immune to losses. The Real Alpha portfolio suffered a 20.39% decline in 2008, punctuated by steep drops of 9.47% and 12.73% in the third and fourth quarters. Despite Benchmark's carefully constructed beta hedges, every strategy group in the portfolio other than volatility trading finished the year with a negative return.

"Alpha can have two sides. It is not always positive," says Franzblau. "We did everything possible to neutralise beta exposure in 2008 but for the first time in our history we experienced a negative alpha year."

In 2008 many hedge fund trades with an expected positive excess return realised a loss due to the sudden deleveraging which caused assets to be priced irrationally. Ferguson explains the scenario by drawing an analogy with a hypothetical closed-end fund invested in two-year US Treasury notes. If investors were forced to sell to access liquidity, the fund may trade at a discount despite the strength of its underlying holdings. Forced sellers will realise a mark-to-market loss on the investment but those that hold the fund until the T-notes mature will recover their principal plus interest.

"That's essentially what happened in 2008. We experienced a mark-to-market loss on fundamentally sound investments," Ferguson says. "Our managers would have realised a profit on many of their positions if they held them to maturity but the liquidity pressure forced them to exit trades with an expected positive return at a loss."

Benchmark became a forced liquidator during the crisis. "We had to redeem some of our holdings to provide liquidity to our investors, many of whom were facing private equity calls," says Franzblau. "We did not gate or suspend redemptions but in the process we locked in the mark-to-market loss on alpha."

On the plus side the crisis created enhanced alpha opportunities for those willing and able to commit risk capital. Benchmark was able to capitalise on many of these opportunities in 2009. The Real Alpha Fund was fully invested in January 2009 and Ferguson increased the funds leverage ratio to the highest level in its history. The fund gained 32.38% in 2009, recovering its losses from the previous year and outperforming the HFRI Fund of Funds Composite Index by over 20%.

Ferguson and Franzblau remain optimistic about the capacity for alpha production in the next few years. "The alpha potential at the end of 2008 was the highest we have ever seen and continues to be above average. The crisis revealed tremendous inefficiencies in the markets and hedge funds are benefiting from reduced competition for alpha opportunities, especially given the decline prop trading. We think the outlook will be positive for some time to come," Ferguson concludes. ■

INHERENT VIOLATIONS

Benchmark believes excess returns can be earned by exploiting nine false assumptions inherent in the efficient markets hypothesis.

All pertinent information is freely and simultaneously available to all investors: asset managers have ready access to information on the most widely traded stocks but information on the stocks and bonds of small companies is not widely available.

Investors have homogeneous expectations of risk and return: even if all investors have the same information, they may come to different conclusions about risk and return.

Investors make rational choices on the basis of risk and return: investors are not rational and they do not make decisions based solely on risk and return.

There are no transaction costs, all assets are marketable and infinitely divisible: transaction costs exit, some assets are not sale and you cannot buy $1 of IBM stock.

There are no taxes: there are taxes and they are complex.

There are no restrictions on holding, buying or selling particular securities: many institutions are restricted to holding securities with certain characteristics, such as investment grade bonds.

There are no restrictions on shorting securities: there are hard-to-borrow and impossible-to-borrow securities.

Unlimited borrowing or lending at the risk-free rate: changes in borrowing and lending rates introduce a different efficient portfolio for those who prefer to reduce risk relative to those with a higher risk appetite.

Identical investor time horizons: some investors are not concerned with whether a stock is under – or over-valued but with whether it is going up in the next day.

FUND FACTS

Full name of fund:	Benchmark Plus Institutional Partners Real Alpha Fund
Name of portfolio manager:	Robert Ferguson
Name of investment/ management company:	Benchmark Plus Management
Contact information:	820 A Street, Suite 700, Tacoma, WA 98402 (+1 253 573 0657; info@bpfunds.com)
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