ABSOLUTE TRACKING: MOVING PAST ABSOLUTE RETURN FOR HEDGE FUND BENCHMARKING

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Introduction

Recent bouts of market volatility underscore the shortcomings of absolute return benchmarks in evaluating hedge fund manager performance. By most metrics, absolute return benchmarks behave differently from actual hedge fund performance, and their usage blurs the line between manager skill and market exposure. In this paper, we recommend an alternative way to assess the capabilities of hedge fund managers.

What is the problem with absolute return?

Absolute return benchmarks represent spreads over risk-free or nearly risk-free rates, for instance, US Treasury Bills + 4%, or LIBOR + 3%. Over the long-term a hedge fund investor should expect these types of return premiums for taking on risks—such as the lack of transparency and lower liquidity—that accompany hedge funds. Absolute return benchmarks, however, are poor yardsticks over short-to-intermediate timeframes. For instance, the DJ Credit Suisse Hedge Fund Index underperformed T-Bills + 4% by 25% in 2008, but outperformed by 14% in 2009.

THE FUNDAMENTAL PROBLEM WITH ABSOLUTE RETURN BENCHMARKS: THEY REFLECT ONLY RETURN, UNDERSTATE RISK

In addition to these variations in returns, vast differences exist in correlation and volatility measures *(Exhibit 1 and 2)*.

- *Exhibit 1* shows the DJ Credit Suisse Hedge Fund Index's rolling correlation versus commonly used market benchmarks. In this instance, T-Bills—our absolute return proxy—show consistently low or negative correlation with hedge funds.

- *Exhibit 2* compares the volatility of hedge funds with the same commonly used market benchmarks. Here, hedge fund volatility lies between minimally volatile and virtually risk-free T-Bills, and, more volatile risk-bearing stocks. With volatility serving as a reasonable proxy for risk, this exhibit illustrates the fundamental problem: absolute return benchmarks reflect return without risk, while hedge funds bear obvious risk.

Exhibit 1

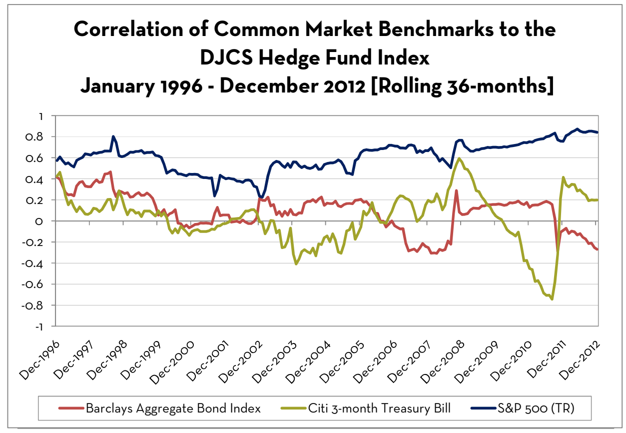
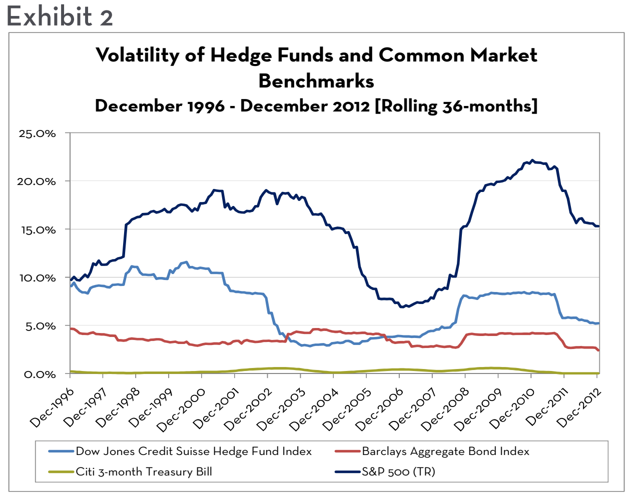


Exhibit 2



The pairing of the two is at odds with financial theory and basic investing logic. Hedge fund performance will consistently lag absolute return benchmarks in declining capital markets (and vice versa*),* and show higher volatility.

HEDGE FUND AVERAGES ARE THE BEST WAY TO BENCHMARK HEDGE FUNDS

What about market-based benchmarks?

Market-based benchmarks, such as the Standard & Poor's 500 Index and the Barclays Capital Aggregate Bond Index, may be appropriate for some long-biased managers. However, they often overstate market risk while failing to encompass the unconstrained nature of hedge fund strategies, for instance, shorting, leverage and options.

Do hedge fund replication benchmarks have a role?

Replication benchmarks attempt to manufacture 'hedge fund beta' by investing in a variety of liquid market products. Some investors may find it appropriate to require a risk-adjusted return premium over replication benchmarks to compensate for the operational, investment and liquidity risks of actual hedge fund strategies. Given the diversity and relative infancy of replication benchmarks, NEPC does not currently recommend them as primary hedge fund benchmarks. For more information on hedge fund replication, refer to our whitepaper published April 2013, entitled *"Hedge Fund Replication: Traditional Beta, Alternative Beta, and Alpha" , available at www.nepc.com.*

What is NEPC's recommendation?

We believe hedge fund averages are the best option for benchmarking hedge funds because managers are compared with a universe of other hedge fund managers. That said, this approach, which is still far from perfect, presents several key challenges:

– Survivorship bias: Poor performers drop out of the industry, thereby inflating average performance.

– Selection bias: Managers choose whether to participate.

– Investment limitations: Hedge fund benchmarks are generally not investable. Those that are exclude nonparticipating and capacity-constrained funds.

– Heterogeneity: Benchmarks vary widely with regard to long/short exposure, leverage, capitalization, sector focus, international diversification, and optionality.

– Reporting issues: Returns are reported by managers and may not be independently verified. They may use different valuation methodologies.

– Limited information: Restricted visibility into what peers are doing can make it difficult to manage against and outperform averages.

Which hedge fund averages does NEPC use ?

There are many providers of hedge fund averages, including DJ Credit Suisse, Hedge Fund Research (HFR), BarclayHedge, EDHEC, Eurekahedge, FTSE, Hedgefund.net (Tuna), Hennessee, Morningstar, and RBC.

At NEPC we recommend using widely accepted hedge fund benchmarking families, such as DJ Credit Suisse and HFR, which, despite inherent limitations, are well-conceived. We provide details on these two providers on the following page.

Bringing it all together

Hedge funds provide important diversification to client portfolios even though they are a challenge to benchmark. In most cases, NEPC favors using hedge fund averages for evaluating manager success because these averages best capture the risk and return characteristics of the investing opportunity set. Given the complexity of this subject, clients should work with their consultants to develop a benchmarking approach that takes into account their implementation and investment objectives.

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Comparison of DJ Credit Suisse and HFRI		
	DJ Credit Suisse (as of 1/31/13)	HFRI (as of 12/31/12)
Inception	1994	1990
Funds in the Database	>9,000	~6,600
Database Fund Qualified for Inclusion into Indices	465 single managers; no fund of funds	~2,000 single managers; ~650 fund of funds
Market Coverage in Database (in $)	$1.8 Trillion	$1.9 Trillion
Reported net of all fees	Yes	Yes
Manager charged for inclusion?	No	No
Independent verification of manager information	At times, there are limited reviews of financial statements	Generally no
Frequency of Monthly Reporting (Non-investable indices)	Flash is produced on the ~9-10th calendar day; and final number on the 15th (or following business day if the 15th falls on a weekend or holiday). Restatements of manager returns are reflected through up/down adjustment of following month's return.	Flash at 5 business days; updated on 15th business day; updated again on 1st business day of the next month; and final return is locked-in after 3 months.
Asset or Equal Weighted	Asset	Equal
Requirements for inclusion	Audited financials; consistent reporting of performance; at least $50 million in assets; and one-year track record.	US Dollar denominated; monthly manager reports; and at least $50 million in assets or one-year track record
Database Includes Closed, Terminated, and Illiquid Funds	Yes	Yes
Backfilling	No	No
Determination of Sub-Group Classification	CS after review of documents and in consultation with the manager	Jointly determined by HFR and manager
Rebalancing	Quarterly	Monthly, as funds are added

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- Past performance is no guarantee of future results.
- Information on market indices was provided by sources external to NEPC, and other data used to prepare this report was obtained directly from the investment manager(s). While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
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In addition, it is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds, real estate and private equity:

1. Performance can be volatile and investors could lose all or a substantial portion of their investment
2. Leverage and other speculative practices may increase the risk of loss
3. Past performance may be revised due to the revaluation of investments
4. These investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms
5. A secondary market may not be available for all funds, and any sales that occur may take place at a discount to value
6. These funds are not subject to the same regulatory requirements as registered investment vehicles
7. Managers may not be required to provide periodic pricing or valuation information to investors
8. These funds may have complex tax structures and delays in distributing important tax information
9. These funds often charge high fees
10. Investment agreements often give the manager authority to trade in securities, markets or currencies that are not within the manager's realm of expertise or contemplated investment strategy