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Convergence and Transparency: Keys to Successful Market-Neutral Performance - analysis of market-neutral hedge funds

By Michael Dubes

Since the early 1990s, market-neutral hedge funds have been widely embraced by the investment community for their steady, if unspectacular, performance. Institutional investors typically view these funds as a higher-yielding alternative to traditional fixed-income vehicles. Often, however, funds purporting to produce so-called "market-neutral" returns appear to be highly correlated to the underlying markets. How can funds specifically created to hedge against market fluctuations miss their intended objective?

Part of the answer lies in understanding the term "market neutral." True market-neutral hedge funds first appeared in the 1950s. A hedge fund can be any type of private investment partnership with a wide investment mandate, from global macro to esoteric derivatives strategies to long equities. [a] Because hedge funds are not subject to the same Securities and Exchange Commission regulations governing mutual funds, hedgefund managers can use strategies that are unavailable to mutual funds to employ far greater leverage within their portfolios. Many financial executives and institutional investors regard hedge funds as riskier than mutual funds, but that is not always the case. The ideal characteristics of a true market-neutral fund include risk comparable to that of a conservative fixed-income strategy and return comparable to a conservative equity strategy Most so-called market-neutral funds fall short of their objective because the securities in their portfolio lack a discernable correlation with underlying securities, otherwise known as convergence.

Critical Convergence

Dimitri Sogoloff, principal of New York-based Alexandra Investment Management, says most market-neutral funds lack the critical convergence needed to produce market-neutral performance. "A lot of fund managers try to buy undervalued stocks while simultaneously selling stocks they deem overvalued," says Sogoloff, adding, "It's a valid strategy if a correlation exists between the two groups. But convergence-deprived funds own stocks with no real relationship or interconnectivity. They may be companies in the same industry or ones that share some similarities, but that does not qualify as convergent or correlated; they are simply a collection of stocks the fund manager believes may go up or down."

Sogoloff explains that a truly market-neutral hedge fund contains securities with a contractual interrelationship. A convertible security (or other equity derivative) and the underlying equity is one example. Here, the two securities are related through a conversion option. Typically, the strategy is to buy long a convertible security that can be exchanged for a predetermined number of common shares at a preset price, and sell short the equivalent amount of the underlying equities. The interrelationship between the two securities provides assurance that, at some future point, the two securities will become fairly priced in relation to each other. This eventual convergence between the two securities is vital because it establishes the underpinning for market-neutral performance and separates true market-neutral funds from those that are not market-neutral.

In addition to convertible arbitrage, another true convergence strategy is risk, or merger, arbitrage, where two merging companies establish a relative price for their securities at the time the merger is finalized. The market-neutral fund manager, betting that the merger will take place and the prices will converge, simultaneously buys the cheaper security and sells short the more expensive one, then waits for the merger and the equalization of the securities.

Another example of true convergence is corporate structure arbitrage, where the fund simultaneously buys and sells different classes of a company's securities. The two stock classes represent different investor groups and may be mispriced in relation to one another. This is a different approach than, for example, being long Ford stock and short General Motors stock in hopes that, because the two stocks have had a historic correlation, they may interconnect again. This ploy does not shield investors from adverse market movements because it is not a true market-neutral strategy. Instead, the fund simply has two independent speculations on companies in the same industry.

Dangerous Hedging Strategies

In the early 1990s, institutional and individual investors alike were searching for market-neutral strategies. Many erroneously turned to long/short equity funds as a solution. Today, many otherwise knowledgeable people in the financial community continue to hold the misguided notion that these funds provide a market-neutral strategy

In 1998, the Long-Term Capital Management hedge fund employed extraordinarily high leverage, in which the risk of the fund's short positions failed to offset the risk of its long positions. The predictable results caused a lot of sleepless nights for the fund's investors. [b]

Another example of a dangerous hedging strategy involves cross-hedging, or hedging two dissimilar instruments. This approach failed in the 1987 market crash when long preferred-stock positions were hedged with Treasury futures. In 1987,

the value of the preferred stocks fell and the Treasury futures rose. Because the two securities are not contractually related, the prices diverged and the loss was doubled by both positions moving against each other.

The Investor's Horizon

Funds with convergence strategies, such as convertible arbitrage, fixed-income arbitrage, or corporate-structure arbitrage, typically establish positions with an expected convergence of at least three to five years. As the fund moves toward the convergence, it may experience interim mark to market losses. A "mark to market" of a securities portfolio is an adjustment in the valuation of the portfolio to reflect the current market values of the securities in the portfolio. This mismatch between the expected time of position convergence and the time frame of the corporate investor is perhaps the most significant risk faced by true market-neutral funds. Obviously, a market-neutral fund with a three-year convergence is inappropriate as a short-term, cash-flow vehicle. But if the time horizon of an organization's intermediate to long-term investment objectives mirrors that of a fund's convergence, the expected return to convergence can be estimated easily. An appropriate investment horizon and the financial stability to withstand interim market movements can eliminate the danger of being forced to sell at an inopportune time, that is, before convergence can occur.

Sogoloff cautions that while investors generally can expect quarterly or monthly liquidity, if enough investors get jittery and begin redeeming their holdings, the fund may be forced to sell positions in the middle of a dip in market valuations. This could imperil the portfolio. He advises healthcare executives to investigate any fund being considered to ensure it not only has an appropriate convergence period, but also that the fund manager scrutinizes the organization's portfolio objectives and accepts only sophisticated, financially stable investors with a thorough understanding of the strategy.

The performance of true market-neutral funds, and specifically convertible arbitrage funds, has been enviable in light of recent market conditions. The Hedge Fund Research Convertible Arbitrage Index returned + 15.35 percent for 2000 and + 12.8 average compounded annual return for the past five years. When these returns are compared with an equity index, such as the Russell 2000, for the same period, the Russell shows an average five-year annual return of + 8.88 percent and a loss of -4.2 percent for 2000. The risk side of the same equation also favors market-neutral funds. As measured by the five-year volatility of returns, investment risk for the Hedge Fund Research Convertible Arbitrage Index is 3.33 percent, while for the Russell 2000 it is a startling 21.3 percent.

Although true market-neutral funds do not lend themselves to traditional asset-class analysis, a convergence strategy like the convertible arbitrage described above displays risk commensurate with a conservative fixed-income strategy with a return comparable to a conservative equity strategy.

The Need for Transparency

In an article in the newsletter of the Alternative Investment Management Association (AIMA), David Russo states:

Largely as a result of the market turmoil experienced during the Russian meltdown of 1998, regulators began to demand greater risk disclosure from hedge funds. Already, two bills have been proposed in the U.S. Congress that would require significantly increased risk disclosure from hedge funds.

At the same time, major investors such as endowments, family offices, and plan sponsors have increased their external investment manager reporting requirements. Such institutions must receive enough information about their investments to demonstrate that they have fulfilled fiduciary responsibilities. As many funds continue to accept growing amounts of pension money, it is likely that these institutions will have the greatest impact on funds' disclosure to investors. Given these growing demands for increased disclosure, the question that hedge funds should be answering is not when but how they will meet these disclosure demands. The most promising approach is often referred to as benign transparency, a reporting method that provides quantitative and qualitative risk information that meets or exceeds investors' information needs without sacrificing the secrecy of a fund's individual positions. [c]

Russo makes a valid point. The issue of transparency is controversial in the hedge-fund community. Even experienced institutional investors sometimes fail to understand the risks in a portfolio or to monitor a manager's adherence to stated mandates. Of course, the latter is contingent upon having an unrestricted communication avenue with the hedge-fund manager and the manager's willingness to share meaningful information with investors.

Only a small group of hedge funds embrace the concept of transparency as a way to ease communications with investors and make accessible the complexities of a relative-value arbitrage strategy. A "transparent" fund is likely to have a comprehensive, frequently updated Web site containing sufficient information to enable portfolio analysis from various grid perspectives. The Web site should provide answers to queries regarding risk exposure, leverage, performance attribution, portfolio diversification, hedging, and related issues.

According to Angelo Cavello, PhD, in an article for the Hedge Fund Center, "This search for transparency will be driven by a heightened, more rigorous due diligence process. Prudent investors will continue to recognize that hedge funds have an important place in a well-designed investment portfolio but they will likewise recognize that they will invest only with asset managers who can meet their standards of due diligence." [d]

There is a level at which transparency becomes counterproductive. A certain level of confidentiality is necessary for a hedge fund to avoid compromising its holdings. Revealing specific positions about individual holdings could be precarious, for both the fund and its investors, as it could jeopardize portfolio performance. If, for example, the fund takes large positions or is involved in a corporate transaction or finance deal, it could be detrimental to make that specific information public prior to the completion of the transaction. If a fund begins to accumulate issues en route to achieving a strategic position in a company, it would not want to publicly announce what it is doing until it has finished accumulating the position.

However, the majority of hedge funds do a disservice to their investors by not providing much information beyond their performance numbers. If a fund suggests that investors call monthly or quarterly for performance numbers, or refuses to disclose fundamental information about the portfolio's contents, the fund is only perpetuating the mystery and uneasiness surrounding the hedge-fund industry. The investor may find it worthwhile to seek a fund that is less secretive.

Investors occasionally need reassurance that, in the case of an adverse market move, the hedge-fund portfolio will behave as expected. It is not necessary for the fund manager to disclose every position, but the investor should have access to key risk parameters. That information can be disclosed without jeopardizing the quality or performance of the portfolio.

In summary, if the investing organization's time horizon matches that of a true market-neutral fund's convergence, and the organization is aware that there may be temporary mark to market losses, the reward is a return that is as close to being assured as possible in the world of finance.

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(a.) A "long" position on a security is the purchase of the security either for investment or speculation, with the anticipation that the value of the security will rise. Selling long is the sale of the securities that have been purchased and held (for a profit, it is hoped). A "short" position on a security is the act of selling a security that the seller has borrowed from a broker or other holder of the security in anticipation that the value of the security will decline. The seller makes the sale with the hope of purchasing other shares of the security at a lower price sometime in the future. The repurchased shares (at the lower price) then are used to replace the borrowed stock, and the difference between the two becomes the profit.

(b.) For an excellent discussion on long-term capital management, see Dowd, Kevin "Too Big to Fail," Briefing Paper #52, September 23, 1999; <http://www.cato.org/pubs/briefs/bp-052es.html>.

(c.) Russo, David/CMRA, "Transparent to Opaque and Everything in Between," AIMA Newsletter, February 2000.

(d.) Calvello, Angelo, "The Dawn of a New Era an Hedge Funds," Chicago, Illinois Hedge Fund Center, November 1998, www.hedgefundcenter.com/wrapper.cfm?article_type=archive&content_id=69&content_type=articles&aff_id=0.

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