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Perspectives

# The Myth of the Absolute-Return Investor

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Pages 14-21 | Published online: 08 Apr 2019

Cite this article <https://doi.org/10.2469/faj.v62.n2.4080>

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## Abstract

The notion of "absolute return" investing is spreading like wildfire. Many people believe

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Hedge funds are currently the most visible and popular of would-be absolute-return investments, but the term "absolute return" is also applied to certain other structures, including some concentrated long-only active managers. Practically all of the managers who disdain benchmarks say they do so because the use of benchmarks to measure performance limits the creativity and aggressiveness that can be achieved by those with superior skill. Actually, benchmarks do nothing of the kind: They merely achieve a fair apportionment between the return from skill and the return from being exposed to markets. Investors need this information to make successful decisions about active managers, including hedge funds.

Although most investment strategies mix alpha and beta exposures, a well-engineered market-neutral long-short hedge fund does not. Such a fund—if it is really market neutral in all the dimensions of market risk—allows investors to earn pure alpha, although even this return is not an absolute return: It is alpha relative to the properly specified benchmark—in this case, the return on cash. Investors can add beta exposures as desired, using inexpensive futures contracts or other vehicles, in what is popularly called a "portable alpha" strategy but which might be better described as portable beta.

Thus, all investing is benchmark relative. Even Warren Buffett has a benchmark, an opportunity cost of capital that he must beat if he wants Berkshire Hathaway to go up more than the market. If he doesn't, he's just earning the market return, or zero. If he does, he's earning alpha. Buffett has nothing to do with the market, but he has nothing to do with the market's insights into the market. He has superior insights into the market, but he has nothing to do with the market, although he is not immune to the market's insights.



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