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Perspectives

# The Myth of the Absolute-Return Investor

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## Abstract

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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
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