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The Myth of the Absolute-Return Investor

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Abstract

The notion of "absolute return" investing is spreading like wildfire. Many people believe that superior returns can be achieved by managers with strong views and little regard for benchmarks. This article attempts to define absolute-return investing and figure out whether it exists. The conclusion is that all investment returns consist of a beta part (representing the correlation of the active portfolio with one or more market benchmarks or normal portfolios) and an active alpha part. Thus, all investing is relative-return investing in which active returns are earned relative to an appropriate benchmark or mix of benchmarks.

The recent enthusiasm for so-called absolute-return investing is based on a misunderstanding of the way active investment returns are generated. All investment returns consist of a market, or beta, part (representing the correlation of the active portfolio with one or more market benchmarks or normal portfolios) and a purely active, or alpha, part. Thus, all investing is relative-return—not absolute-return—investing, in which active returns are earned relative to the appropriate benchmark or mix of benchmarks.

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. So does your favorite hedge fund. And having a low or zero beta, as many hedge funds do, does not mean you have a high alpha. One has nothing to do with the other; alpha must always and everywhere be earned by having insights superior to those of the other players in the market, and that is very difficult, although not impossible, to do.

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Do Hedge Funds Hedge?

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