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Perspectives

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
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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
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The Dimensions of Active Management

Source: The Journal of Portfolio Management
Portfolio Constraints and the Fundamental Law of Active Management
Source: Financial Analysts Journal
Estimating betas from nonsynchronous data
Source: Journal of Financial Economics
Hedge Funds: Risk and Return
Source: Financial Analysts Journal
Debunking Some Myths of Active Management
Source: The Journal of Investing
Asset allocation
Source: The Journal of Portfolio Management
Hedge Funds with Style
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A Critical Look at the Case for Hedge Funds
Source: The Journal of Portfolio Management
A Simplified Model for Portfolio Analysis
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