They're here:

INVESTABLE

hedge fund indices

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Indexation has always proven to be a vexing issue for the hedge fund industry. Considerations on benchmarking, historical performance comparisons, and data biases are common topics in industry journals and conference panels alike. These discussions have taken on an additional wrinkle in the past 12 months as a variety of industry heavyweights have launched a new set of products that are designed to provide investors with access to returns generated by a hedge fund index.

With industry sources estimating assets invested in hedge fund index products exceeds US$10bn, discussing these matters is no longer confined to academics or investment researchers. Real money is directly on the table in these products, and from all indications, more is on the way.

This article outlines some comparative highlights of some of the major investable index-linked products, including those assembled by Credit Suisse First Boston-Tremont (CSFB-Tremont), Dow Jones, Hedge Fund Research (HFRX), Morgan Stanley Capital International (MSCI), Standard & Poor's (S&P), and Van Hedge Advisors. We do not yet include discussions of more sector-based investable indices, such as managed futures products assembled by The Barclay Group and RQSI/Access.

The article focuses on key points and summarises a working appendix we have created which compares and contrasts these index product across more than 20 categories. It also raises some of the major questions investors in these products should be considering.

ALTERNATIVE INVESTMENTS AND INDEXING

Hedge funds are loosely regulated by the SEC and are not required to publicly disclose earnings or holdings. Given this reality, a hedge fund index cannot claim to definitively represent this asset class; however, the indices do claim to capture the mean return of the hedge fund industry. The major investable index products include only 35-80 managers representing 5 – 13 hedge fund strategies among a universe consisting of approximately 6,000 funds and 500 fund of funds.

Rigourous fund selection criteria are cited as evidence of the representative nature of each index. CSFB-Tremont, Dow Jones, HFR, and MSCI indices use rule-based selection criteria, while the S&P index is committee-based.

Both approaches have pros and cons. While the rule-based selection criteria attempt to create an impression of objectivity, it could be argued that this method of selecting funds is rigid and not responsive to a rapidly changing industry. The committee-based selection process is more flexible, but injecting individual opinions in the process creates a product that could be viewed as focusing more on quality and less on representation, which ultimately makes hedge fund indices more like funds of funds.

BENCHMARKING: WILL THERE BE AN ICON?

There are numerous benchmarks for hedge funds, but almost all have different methodologies and criteria for collecting and organising data. So while there is no clear hedge fund performance icon, organisations considering their first foray into the alternatives space all have the same questions: What is the proper benchmark to evaluate performance? What is a standard performance expectation?

DATA BIASES AND TRACKING ERROR

Many investors are familiar with the variety of existing, research-oriented hedge fund indices. In many cases, investable hedge fund index products are related to one of these existing indexes; however, the differences between the investable and non-investable indices can be substantial and investors must be able to digest the distinctions. For investors who want a quick general read on hedge fund performance, a fund of fund index may be more accurate because it is an actual dataset where all performance is included.

Each index provider has different rules and methods for collecting data, and it's no mystery that a variety of data biases persist in the formation of these indices. The biases outlined by Bill Fung in "Hedge Fund Benchmarks: Information Content and Biases" include survivorship bias and selection bias. The first bias "arises when a sample of hedge funds includes only funds that are operating at the end of a sampling period and excludes funds that have ceased operations during the period." The second bias results from the voluntary nature of hedge fund reporting and the different selection criteria used by the creators of the indices. Most professional investors who have experience working with hedge funds have been able adopt processes for navigating these biases, in many cases by evaluating funds in the context of peer groups based on style, leverage, and beta characteristics. Investable hedge fund indices are typically created as a subset of these broader indices and share the biases inherent in the data collection process (and similar means for addressing the issue).

Moreover, the investable indices are susceptible to an additional bias related to tracking error. Most of the large investable index creators have developed a set of criteria for inclusion in the investable index. The biggest hurdle for some managers may be the willingness to provide a managed account (which provides additional transparency and liquidity); others may not meet minimum asset requirements. Additionally, many indices want capacity lock-ups with managers. Regardless of the reason, not all of the funds tracked by the research oriented indices are included in their investable counterparts. MSCI, for example, tracks close to 2,000 hedge funds within its research products, while its investable index is constructed from approximately 90 funds.

While an investable index may be constructed as a subset that targets representation of the universe at-large, the operational realities of constructing an index that is investable will mean performance discrepancies that will persist for the foreseeable future.

ASSET-WEIGHTING VS. EQUAL-WEIGHTING

Asset-weighted sector allocations are based on industry flows. For example, if more money flows into convertible arbitrage (as represented by the broad index), the index allocations will reflect this. Dow Jones, however, does not offer a composite index of the five sectors they track, so sector allocations are not an issue. Advocates claim that this approach is more representative to operations in the actual hedge fund universe, while critics claim that it detracts from diversification and makes the indices more susceptible to cyclicality. While S&P takes an equal-weighted approach, MCSI, Tremont, and HFR prefer asset-weighting at the sector level.

At the manager level, however, most providers argue that equal-weighting among the hedge funds within a sector helps to diversify manager risk. Only CSFB has chosen asset-weighting at the manager level, choosing the top six managers open and accepting new investment capital in a given sector. While HFR looks at equal-weighting with some efficiency constraints, S&P, Dow Jones, MSCI take an equal-weighted approach. Still, the issue of asset-weighting versus equal-weighting is open to judgment by investors. This question ties back to the index creator's ultimate goal. If the index is to be representative of the greater hedge fund universe, it should be asset-weighted by sector and somewhat equal-weighted at the manager level.

REGULATIONS, PRODUCTS, AND FEES

Changes in hedge fund oversight requirements represent yet another aspect of the hedge fund universe where investors need to pay close attention. Investors need to realise that hedge fund products that are "registered" still have many of the risks that are inherent to the fund or strategy. Additional regulation might actually lead to a bifurcation of managers who seek alpha over assets, and may lead others to choose to manage assets offshore where operating costs are lower and regulation hassles are fewer.

How does all of this affect investors in investable hedge fund index products? SEC oversight would not likely alter the mechanics of the indices themselves but have more impact on the index products. Each provider will most likely begin to market a suite of investable hedge fund index products targeted at institutions and others created for retail distribution.

The rules for marketing to retail customers are typically more stringent than those for the institutional marketplace. Prices for retail products are often higher due to additional marketing costs, vehicle engineering (e.g., custom-fitting product around a regulatory environment), and higher liquidity. All of the indices and their investable "tracker" funds are competitively priced, but a buyer may pay a higher price for ease of access.

FUNDS OF FUNDS VS. INVESTABLE INDICES

Since the representative funds of an investable index are often selected by an investment committee, one might ask how indices differ from funds of hedge funds. Since both the larger fund of funds and the indices are faced with the task of using capacity, managers of larger funds of funds could eventually lose market share to the continued growth of indices.

Investors also believe that selecting managers that consistently generate alpha is an extremely difficult practice. They do know, however, that these managers are out there, and many believe that an investable index might not be the best vehicle for capturing smaller "niche" alpha in their returns. Will this decision also potentially bring less skilled managers to the table? This is possible, but many investors have decided that this is a chance that they are willing to take.

WHO SHOULD INVEST?

Groups that are making an initial foray into alternative investments may be more comfortable with indices, where the management is considered passive, brand name recognition is a plus, and diversification extends across all strategies. However, others who utilise the services of a consultant in making investment decisions may be more inclined to use a fund of funds, because hedging needs may be more specific and a consultant should be able to put together a critical peer group to determine the strengths and weaknesses of a particular product.

One can also envision scenarios that appeal to both the expert and novice. A sophisticated group could use the index as a means of capturing general sector returns while supplementing its alternatives strategy with single managers, or even funds of funds, to capture niche alpha returns. Groups approaching alternatives for the first time could utilise an index as a straight-forward means of tapping into a hedge fund return stream.

After examining the construction and product details of each of the offerings, the target audiences may essentially self-select. For example, Notes created by Societe Generale that are linked to the MSCI index can accept investments as low as US$50,000, while the Dow Jones product requires minimum investments of US$10m, making it institution-focused. In the near future, as a plethora of index-related products with different features and competitive pricing are released, investors may face a great deal of comparison shopping in order to find the most suitable product. Accreditation standards can vary across products. Taxation on hedge funds is typically ordinary income, but depending on the ultimate vehicle, taxes might be deferred or treated as long-term capital gains.

In conclusion, we assume here that hedge fund indices will continue to solidify their position as industry benchmarks. The financial world is one of comparisons and rankings and the alternatives corner is no different. While today's efforts may be imperfect, continued fine-tuning will lead to better representation of the total asset class. In addition, as more investors become familiar with these instruments and ask for them by name, many, if not most, organisations will judge their own performance relative to one of them. Hedge fund indices are not coming; they are already here. Now it is up to the industry to figure out what to do with them.

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Investable Hedge Fund Index Matrix

I. Index Structure

	CSFB-Tremont	Dow Jones	HFRX	MSCI	S&P
1) What is the goal of the index/investable index?	Designed to provide a representative, rules based and fully investable index, enabling investors to participate in a liquid and diversified baramoter of the hedge fund universe.	Add value in a best-of-breed product. Strategies that can be measured by market factor analysis.	Designed to be representative of the broader hedge fund universe.	To reflect the aggregate performance of a diverse and representative sample of hedge fund processes and strategies in such a way that they can serve as a basis for tradable and liquid investments.	Like all S&P Indices, seeks to balance representativeness and investability. From the onset, designed as an investable index; is not a subset or derivation of a larger benchmark.
2) Is the structure rule-based or committee-based and why?	Rule-based. Six largest eligible funds based on AUM in each of the ten strategies.	Rule-based with a globally respected advisory committee.	Rule-based. The HFRX Index follows a defined, academically sound index methodology.	Rule-based. Rules attempt to provide strategy diversification, limit fund concentration, limit management concentration, and manage fund capacity constraints.	Committee. Constituent managers are selected based on their ability to represent a specific style. The Committee adds a level of judgement and discretion to often complex and difficult selection valuations.
3) Number of strategies represented in the index/investable index?	10: Convertible Arbitrage, Dedicated Short Bias, Emerging Markets, Equity Market Neutral, Event Driven, Fixed Income Arbitrage, Global Macro, Long-Short Equity, Managed Futures, Multi-Strategy	5 styles separated into individual indices: Convertables, Mergers, Distressed, Event and Equity Market Neutral.	The HFRX Global Index is comprised of 8 single strategy indices that make up over 85% of hedge fund assets.	13 processes and 27 strategies. Strategies include: Systematic Trading, Discretionary Trading, Merger Arbitrage, Statistical Arbitrage, Long Bias, No Bias, Short Bias, Event-Driven, Multi-Process, Variable Bias.	9: Equity Market Neutral, Fixed Income Arbitrage, Convertible Arbitrage, Merger Arbitrage, Distressed, Special Situations, Long/Short Equity, Managed Futures, Macro
4) Number on managers/funds in the index/investable index?	409/60	Currently 35 with a goal to have 6 to 10 managers per strategy.	The HFRX Global Index is comprised of 50 managers all through separate accounts.	82/Approximately 1,900	40/No non-investable index
5) Correlation between the index/investable index?	The Investable Index has not been designed with the objective to track the broad Index. It is a blue chip, liquid investable Index focusing on the larger funds. It has its own risk-return characteristics. The correlation between the broad index is 0.81 for the period Jan 00 - Dec 03.	Investments are made directly with Lyra Capital in separately managed accounts. Direct trackers are in development for derivatives and other structures.	The HFRX is designed to be representative of the overall composition of the hedge fund universe.	.61 correlation	There is no uninvestable index.

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Investable Hedge Fund Index Matrix

	CSFB-Tremont	Dow Jones	HFRX	MSCI	S&P
II. Portfolio Structure					
1) Weightings to each strategy, how and why?	Asset-weighted for better representation and consistent with standard index calculation practice.	Client can choose their own weighting.	Assets to each strategy are asset weighted based on their relationship to assets in the larger hedge fund universe. Additionally, all strategies can be invested individually.	Asset-weighted as the goal of asset-weighting is to create an index that mirrors the greater hedge fund universe.	Equal weighted within each strategy.
2) Weightings within each strategy, how and why?	The member funds weight is determined by their AUM, aiming at maximum representation of universe, reason same as above.	Managers are substantially equally weighted.	Managers weights are optimized to increase the correlation to the strategy return profile.	Equal-weighted within strategy.	Funds are equally weighted within a strategy, but since the number of funds within each strategy may vary, not each of the 40 funds will have the same weight.
3) Rebalancing: how and to what goal?	Broad index quarterly, investable index twice yearly.	Quarterly.	Quarterly.	Quarterly, to keep subprocesses representative of the larger universe.	Yearly rebalancing, or as needed.
III. Risk Monitoring and Due Diligence					
1) Who Hires and Fires the Managers?/Who's responsible?	Index committee has right to remove funds based on Rule 11 which relates to regulatory and criminal investigations.	Independent index committee of industry experts.	Initial due diligence is performed and funds are presented to an internal investment committee. This committee also fires managers.	There are two levels: the platform and the index. Lyxor is responsible for the platform, MSCI for the index. Lyxor makes suggestions to MSCI, the majority of which are approved.	S&P Index Committee approves all hiring and firing, independent of investment manager.
2) Who is responsible for initial and ongoing due diligence?	CSFB conducts background checks on managers.	Lyra Capital and Starview Capital.	Initial due diligence is performed and funds are presented to an internal investment committee. This committee also fires managers.	Lyxor	The S&P Index Committee is responsible and has hired Albourne Partners to manage the due diligence process.
3) How is data collected or verified?	NAV collected by external administrator and verified by CSFB/Tremont Index LLC.	Lyra Capital along with Bancorp Services provides a daily estimate of the portfolio value. Third party brokers are used to verify manager marks. Olympia Bermuda provides monthly hard NAV.	HFR independently reprices all positions daily and monitors portfolios against investment guidelines for style drift. Bank of Butterfield also computes a hard weekly NAV.	Lyxor, Euro VL (a French fund administrator) and other third party brokers.	Pricing from the managed accounts is independently verified by third party administrator.
4) What happens to a manager at capacity?	Omitted from the index at the next rebalancing date.	Platform capacity is estimated at $5 billion. Appoximately 100+ million per manager.	HFR will continue to add managers to the index. If a manager refuses to take additional assets, they may be removed.	Funds must be open to investment from tracker vehicles. Funds facing capacity constraints will receive reduced weight to alleviate capacity issues.	Every manager has agreed to $100M minimum capacity. When capacity is reached, capacity is increased or other managers are added.
5) How do you deal with style drift?	Constant monitoring by CSFB/Tremont Index LLC. For the investable index the fund is removed at the rebalancing date and would need to qualify for the new style.	A manager may be fired for going out side their original agreed upon parameters.	HFR monitors portfolios daily to ensure compliance with investment guidelines and monitor for style drift.	Lyxor monitors this information. MSCI could reclassified the manager and/or removed the fund from the index.	Each manager signs an agreement to maintain the agreed upon strategy/style. S&P views trades daily, and provides limited constraints as long as strategy/style is maintained.

Investable Hedge Fund Index Matrix

IV. Managers: Hiring Criterion?

	CSFB-Tremont	**Dow Jones**	**HFRX**	**MSCI**	**S&P**
1) Managed accounts	No	Yes	Yes	Yes	Yes
2) Capacity agreements	Capacity agreements are not mandatory and not part of index construction requirements.	Yes, but they are not made public.	$100M	Yes, but not diclosed.	Minimum of *at least* $100 million capacity with each manager.
3) AUM min or max?	The six largest eligible funds in each style are selected into the investable index.	$50M	$50M for 2 years	No	$100-75M
4) Track record minimum?	1 year unless fund above $500 million. The average track record in the index is 7.5 years.	2 Years	2 Years	No	3 Years
5) Transparency - depth and frequency	Several products provide up to daily pricing.	Managed account format with the managers provides daily transparency down to the individual managers positions.	Managed accounts offer full transparency of the managers holdings.	All indices provide constituent names, performance and assets to qualified investors.	Constituent list, methodology, daily index values, deletions/additions, changes are all public on website. Individual fund returns and holdings are not disclosed.

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V. Investable Product Details	CSFB-Tremont	Dow Jones	HFRX	MSCI	S&P
1) How are redemptions met?	Products are available with daily, weekly, monthly and quarterly liquidity.	Monthly.	A hard NAV on the tracker fund is produced weekly. Tracker fund liquidity is monthly with no hold back on redemptions.	Weekly.	At least quarterly.
2) General fee break down?	0.07%/month calculation fee.There may be additional product specific fees (e.g. for leverage, principal protection etc.).	2% and 20% is inclusive of all fees.	All manager fees are included in the published index returns. 125bps is charged at the Tracker fund level with no performance fee.	The tracker fees are 55bps.	Fees to end investors vary. PlusFunds is responsible for S&P licensing fee. Index values are net of hedge fund manager fees.
3) Tax implications	Most products are aimed at offshore investors, but a US tax efficient product is available.	Depends on the client/structure.	Depends on the structure.	Varies greatly with product.	Varies according to product and investor.
4) Where can we find pricing?	www.hedgeindex.com, Bloomberg and Reuters.	Wall Street Journal, Barron's, Dow Jones Newswires, and Dow Jones Indexes Websight.	HFR website, Reuters, Bloomberg.	Bloomberg, Reuters, MSCI.	Daily Index on the S&P website, additionally Reuters, Bloomberg and other data vendors.
5) Current assets in investable index as of 7/1/04.	$2.2 Billion	$1.45 Billion	$1.8 Billion	$2.4 Billion	$2.6 Billion
6) Minimum investment size?	Product specific, can be as low as $1,000 offshore, $250k US.	$10M (Institutional product)	$1M for tracker fund	Varies by product and product type. Tracker is 250K, notes in US are 50K.	Varies by product and product type. Can be as low as 25,000 for a registered fund.