Hedge Fund Investment: A Sound Approach

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The full article may be accessed here.

Central Issue of the Paper

In the paper titled "Hedge Fund Investment Philosophy," Kostas Iordanidis explores the complexities of investing in hedge funds and offers tools that could help investors navigate the murky waters of hedge fund investing.

Hedge funds are vehicles that invest in different asset classes in a flexible and unregulated way. Contrary to popular perception, hedge funds are not a separate asset class like equities, government bonds or commodities. Hedge funds are heterogeneous and diverse. Even hedge funds that invest in the same asset class and follow similar investment strategies exhibit large differences in behavior over time. As a result, most (but not all) academic and practitioner studies of aggregate hedge fund performance and risk taking are deeply flawed and meaningless. It is this exact reason why it's important to approach hedge fund investing with a sound framework.

Approach Employed by Paper

The most desirable component of a manager's return stream is his/her ability to generate uncorrelated alpha. As multiple studies have concluded, there are only two sources of alpha; market inefficiencies and the ability (skill) of a manager to forecast (time) markets. Within this framework there are several factors on which this paper focuses (below are a select few):

- **Investment Beliefs**
  - Successful investing in financial markets requires a clearly articulated set of investment beliefs. These beliefs should be consistent with the accumulated academic knowledge in economics and finance but also in other fields that study investor behavior, such as psychology, decision making theory and neuroscience. Beliefs should be empirically sound and account for the observed microstructure of financial markets.

- **Manager personality traits**
    - Managing hedge fund portfolios is inherently a "people business." Beyond qualitative and quantitative analysis of a manager's strategy, there are distinct personality traits that characterize successful portfolio managers. The key difference between average and great hedge fund managers is to know when to sell positions and reduce risk.
- **Portfolio Construction**
    - Hedge fund portfolio construction has three primary aims: (i) invest in a group of select managers who diversify across different systematic risks; (ii) do this in a manner that minimizes the exposure of the portfolio to traditional market beta; and (iii) maximize manager alpha at the portfolio level.
- **Insurance**
    - Purchasing portfolio insurance selectively in periods when such insurance is cheap and looking for protection across asset classes can mitigate some of that cost and reduce left tails.
- **Diseconomies of scale**
    - Manager size (assets under management) is a significant factor impacting hedge fund performance. The hedge fund industry lacks the discipline to face its biggest delusion: that hedge funds can get endlessly large and still deliver the benefits that made them "alternatives" in the first place – diversification, absolute returns and alpha. One must never forget, alpha is finite and not scalable.

Findings of the Paper

What this paper presented is a rigorous investment process tailored to hedge fund investing. His framework combines multiple sources of qualitative and quantitative information for manager selection, portfolio construction and risk monitoring.

Hedge funds are exposed to complex market and business risks that are poorly understood by investors. Successful hedge fund investing necessitates a detailed understanding of the precise sources of hedge fund returns and risks. By applying a rigorous framework around hedge fund investing, the investment process can pave the way for the potential generation of alpha.

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