***"Whenever you find yourself on the side of the majority, it is time to pause and reflect."***
***— Mark Twain***

The definition of a hedge fund has changed drastically over the years. The hedge fund industry dates back to the 1950s when Alfred Jones created a new investment vehicle with a group of limited partners, attached an incentive fee as his compensation, and began trading a portfolio of long and short stocks—what he referred to as a "hedged fund." He was later designated as the "father of the hedge fund." Jones successfully picked stocks coupled with hedging activities for many years, until he eventually deployed risky strategies using leverage and suffered heavy losses.

Since the 1950s, there have been many similar periods when the hedge fund industry ramped up with excitement only to be followed by a few spectacular failures that left investors befuddled. Despite the seemingly cyclical nature of hedge fund success and failure, investors continue to demand more sophisticated ways to preserve and create wealth. With thousands of hedge funds to choose from today, investment managers have created vehicles for investing in everything from stocks and bonds to colored diamonds or farmland.

As a greater number of hedge funds chase similar alphas, the outperformance of these investments has dwindled when compared to a standard benchmark like the S&P 500. One can argue that returns generated from the hedge fund industry today are more indicative of broad-based market returns. The increasing correlation between hedge fund returns and traditional equity benchmarks, as we discussed in our January letter, certainly helps to support this view.[1] In Figure 1 below, we chart the 5-year rolling alpha of the Dow Jones Credit Suisse Hedge Fund Index to the S&P 500.

Today, as always, the onus is on the investor, or their respective teams of advisors and consultants, to determine which hedge funds have a sustainable edge in generating real returns and *why*? We stress the why because it is the real question investors must ask themselves as well as their current and potential managers. Instead of "*what* are the returns?" we believe the first question must be "*why* are the returns?" Alpha provides a partial answer to this question and, while alpha is one of the driving forces behind investor demand, it appears that alpha is recently harder to come by in the hedge fund space. Consequently, it is more important than ever for investors and allocators to take the time to understand why the business should work. The ability to consistently outperform and generate alpha is challenging and, given the increasing number of funds to vet, finding these strategies is an arduous task.

[1] http://www.lakehillgroup.com/files/Lake_Hill_Capital_Management_January_2012_Investor_Letter.pdf

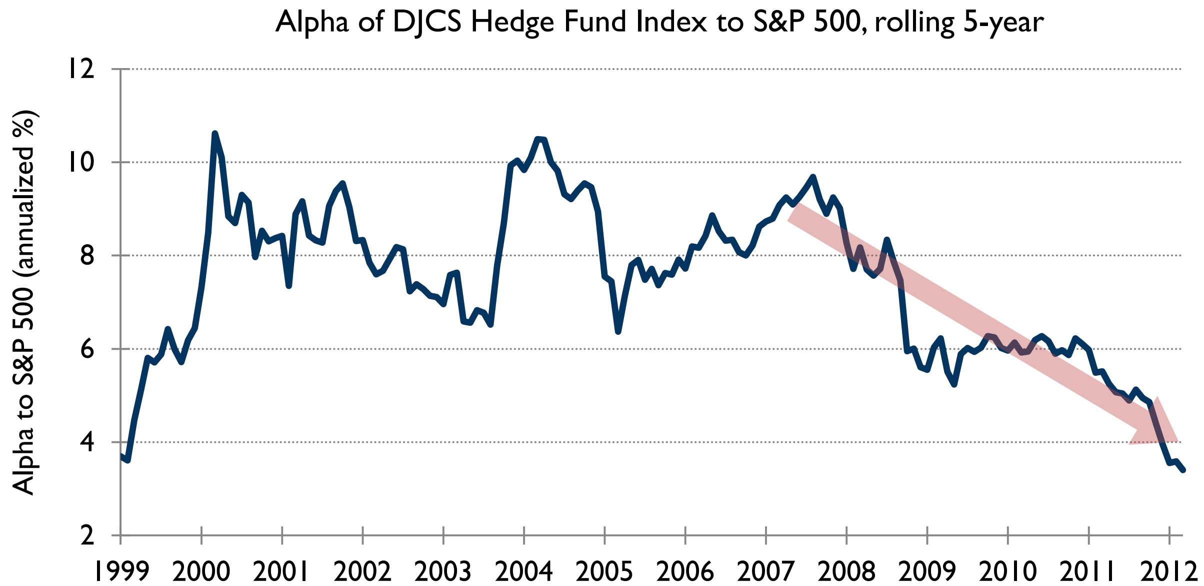


Figure 1: Annualized alpha of Dow Jones Credit Suisse Hedge Fund Index to the S&P 500 using a rolling 5-year window.

Historically, a significant portion of hedge funds' persistent alpha is related to liquidity providing. This has included anything from market-making, facilitating large block trades, convertible or junk bond issuance, and reinsurance transactions for market participants seeking to transfer risk. Investors must continue to search for disciplined and seasoned hedge fund managers who can identify and capture real, sustainable and uncorrelated alpha. Start by asking "why?"

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