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"There's a way to do it better – find it." - Thomas Edison

The number of arguments against hedge funds appears to be near an all-time high. We frequently find ourselves debating what the term "hedge fund" even means anymore. Over time, hedge funds are "hedging" increasingly less, as measured by their rising correlation to the S&P 500. Furthermore, the idea of a commingled fund has lost its luster as investors are demanding greater transparency through separately managed accounts.

Beyond the myriad choices of hedge fund businesses lies a bigger issue: what are investors getting for their money these days? The industry must be able to justify an average hedge fund manager's fees given the lack of alpha generation. This is not a new topic for debate among members of the alternatives industry.

The frustration continues to grow after another challenging year for many managers. In addition to the dissatisfaction of alpha relative to fees, the laundry list of concerns in today's investment climate is not getting any shorter: leverage, liquidity, transparency, diversification, concentration and correlation all merit consideration.

Correlation remains one of the biggest concerns for institutional investors carrying a portfolio of seemingly different hedge fund strategies. We compared the pairwise correlations between the 13 Dow Jones Credit Suisse hedge fund strategies from 1994–2003 and 2004–Present. The increase in recent correlation is stark.

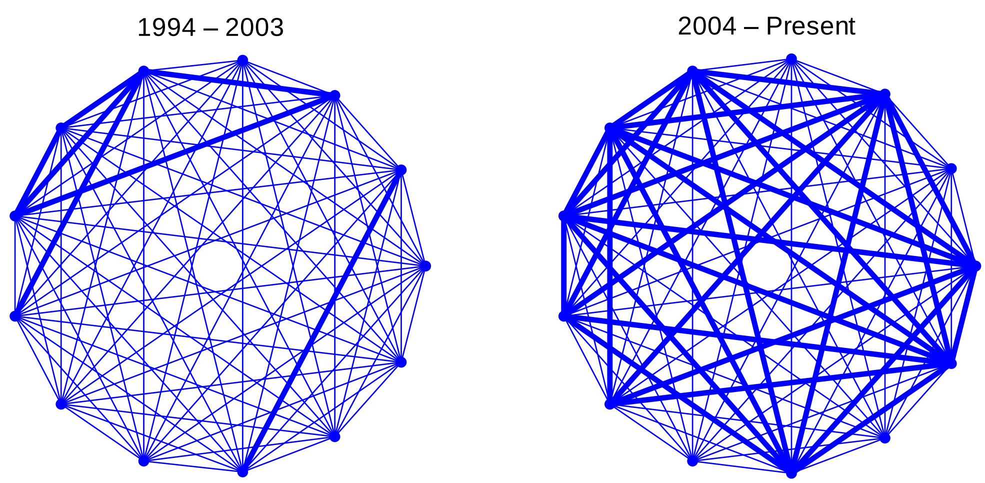

Figure 1: Pairwise correlations between the 13 Dow Jones Credit Suisse hedge fund strategies from 1994–2003 and 2004–Present. Thicker lines indicate a higher correlation among the strategies.

If we dig deeper, we also find that the average correlation between these 13 hedge fund strategies and the S&P 500 increased significantly in the past decade. This may help explain why some managers found 2011 to be more challenging than 2008.

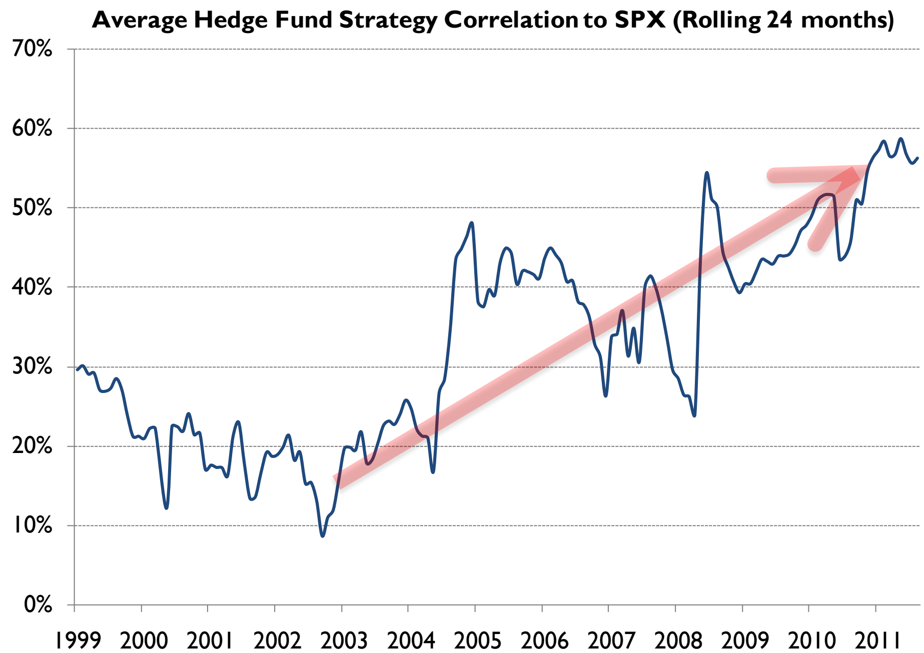

Figure 2: Average correlation between the 13 Dow Jones Credit Suisse hedge fund strategies and the S&P 500 using a 24-month rolling window.

Some financial analysts suggest investors revisit the simple notion of owning diversified index funds. In an article published by Reuters[1], the author finds that alpha generation has turned negative. He advocates owning the index and paying lower fees. The trouble is, if you subscribed to a buy and hold strategy in an index fund tracking the S&P 500 in 1999 or 2007, you haven't earned a return.

[1] http://blogs.reuters.com/felix-salmon/2011/11/21/correlation-chart-of-the-day-hedge-fund-edition/

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