Editorial

The subject of this Editorial is hedge-fund risk. It is clear from a number of sources that the risk premium on equity looking forward is low, and stocks do not (currently) seem attractive. Institutional investors feel the need to look at alternative investments to get returns, hedge funds being a particular example of alternative investments. It is also clear that there are some very good hedge funds with credible performance histories. Upon discerning past alpha, the investor should ask him/herself whether this performance is sustainable. If a large amount of funds were to be invested in this process, would the alpha decline? This is a hard question to analyse, but understanding what the hedge fund does in creating its alpha is a first step.

A second concern is what I would call the Lloyds phenomenon. Not so long ago, it (briefly) became fashionable to become a Lloyds name, B-list celebrities queued to do so; however, there was only a finite amount of quality underwriting available and, in some cases, rather dubious practices were undertaken in providing new names with

Lloyds exposures. This was one of the factors leading to heavy losses in the period 1988 to 1992. Similarly, there are only a finite number of good hedge funds around, and they have limited capacity. Thus if institutional investors switch a few billion into the hedge-fund industry, it is possible that, like Lloyds before it, the industry will spawn various funds whose sole purpose is to soak up investment, while charging attractive fees, to invest in non-existent opportunities.

None of the above comments can be addressed by the usual analysis of a fund; its alpha, Sharpe ratio or tracking error tell us nothing about industry composition. A whole new set of tools is required. Research that addresses these issues might look like reports written in the UK by the Competition Commission, in that they would address issues of market structure in that particular segment of the hedge-fund industry.

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