TACTICAL ALPHA AND PERSISTENCE IN HEDGE FUND RETURNS

A vexing issue with hedge funds is the lack of persistence of returns. Last year's winners generally are no more likely to be this year's. Consequently, while quantitative screening tools help investors to identify strong historical performance, they are of little use in determining which funds will perform better going forward.

Beachhead's proprietary research demonstrates that, while alpha overall does not persist, "tactical" alpha does. Broadly speaking, hedge fund alpha can be broken down into two sources: position alpha and tactical alpha. Position alpha represents outperformance due to security selection, illiquidity and other factors, such as optionality. Tactical alpha represents medium-term relative value trades across asset classes – such as investing in credit post-crisis or shifting back to developed markets equities in 2012-13.[1] Both position alpha and tactical alpha have a low correlation to equities over time, and hence are valuable diversifiers.

In order to study the persistence of tactical alpha, we examined the performance of 679 funds over the seven year period from 2007 to 2013. The key conclusions are as follows:

- Managers that generated high tactical alpha (top quintile) in a given year outperformed the overall pool by **246 bps** per annum on average in the following year.
- Outperformance was driven by greater alpha, not higher leverage: alpha to the overall pool was **275** bps per annum with comparable beta.
- High tactical alpha funds had a much higher Sharpe ratio (0.84 vs. 0.59) over the full time period.
- As expected, high tactical alpha funds performed materially better during the crisis, with aggregate outperformance over 2008-09 of almost 17%.
- Relative value funds show the most consistent outperformance due to tactical alpha: although representing only 18% of all funds, they accounted for 30% of top quintile funds.

These results lead to several important conclusions about hedge funds. First, unlike position alpha, tactical alpha tends to persist. This makes sense: high tactical alpha suggests the manager has a good understanding of the current market and, since tactical alpha positions tend to shift relatively slowly, this understanding provides a valuable edge in the near future.

Second, hedge fund managers can add material value through asset allocation. One potential implication is that hedge funds with broader mandates may have greater flexibility to capitalize on alpha opportunities among markets. It is noteworthy that equity long/short funds added less value through tactical alpha, although it is unclear if this is due to a narrower mandate or lack of skill.[2]

Consequently, in order to maximize returns, allocators to hedge funds may be better served by focusing on tactical alpha than position alpha. First, for many hedge funds, position alpha is rarely greater than all in fees; therefore, most alpha generation after fees tends to be tactical alpha. Second, since tactical alpha persists, a portfolio of high tactical alpha managers is more likely to outperform going forward. Finally, tactical alpha exposures can provide important, and highly valuable, insights into how managers collectively view the relative attractiveness of markets.

Please contact Andrew Beer or Mathias Mamou-Mani at Beachhead Capital for additional information.

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[1] Tactical alpha is distinguished from near term net exposure management, which generally does not produce consistent alpha.

[2] Interestingly, macro funds tended to add little value through tactical alpha, although this may be due to a difference in investment time horizon.