A word about Style Drift and what it means to be a hedge fund

Style drift is when a trader is flexible about their trading strategy and it doesn’t work. Nimble is when a trader is flexible about their trading strategy and it works. It isn’t style drift if it remains within the experience and expertise of the trader. It’s style drift if its out of their comfort zone.
One of the important ways that hedge funds differ from traditional investment strategies is their flexibility.

The concept of the hedge fund bears consideration. Hedge funds are not perfectly hedged, nor do they always hedge, even imperfectly. A more useful characterisation of the hedge fund strategy is that it is an optimal solution in a constrained optimisation where the constraints are a bit more complicated than one finds in traditional long only unlevered investment strategies.

The traditional view is that a hedge fund strategy involves augmenting the traditional long only strategy with short selling and leverage and use of hybrid and derivative instruments. From an economic efficiency perspective, the converse view is that the hedge fund strategy is a less, albeit more complex constrained way of investing. The traditional strategy is therefore a very tightly, and simply constrained (no shorting, no leverage, no derivatives, little cash) investment strategy.

Hedge fund strategies are more flexible and useful since the objective function can be specified to reflect absolute returns (alpha), benchmarked returns (portable alpha), risk adjusted returns (high information ratio), or any number of metrics that best reflect an investors goals over various time horizons.

The feasible set is similarly flexible and can handle the constraints imposed by an investor for reasons of risk management, liquidity or regulatory compliance. By reason of its flexible constraints hedge fund strategies can also be constructed to higher or lower risk tolerances to suit investor appetites. This flexibility allows the investor to define a suitably spacious set within which to express their skill. Too restrictive, and although the risks become more clearly defined, the less room there is to manoevre and the more difficult it is to generate returns. In fact, the more one becomes dependent on certain factors, although such dependence may not be immediately apparent. Too relaxed and the risks become less well defined and the opportunity for style drift and accidents increases.