The Alternative Investment Management Association's

AIMA Journal

The global forum for the global hedge fund industry

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Which strategies can trustees trust?

By Cédric Kohler, Head of Advisory, Fundana SA

Despite the negative press, hedge funds are reaching all-time highs in terms of worldwide asset under management, with $2.8 trillion, thanks to $57 billion of inflows in the first half of 2014[1].

The main source of these inflows is institutional investors. Why do they need hedge funds? Because they must find alternatives to traditional portfolios and above all, reduce their fixed income allocation. While equity markets are an obvious solution, their dramatic volatility has frightened more than one investment committee. Indeed stock prices have halved not just once but twice since the turn of the millennium. As a result, investors are looking for alternatives they can trust and hedge funds version 2.0 is becoming a must in institutional portfolios. Indeed, investments which provide *asymmetric returns* and a real dose of risk management are in high demand.

Did you say asymmetric returns?

Every day, our life is influenced by asymmetric choices. By asymmetry, think of a situation where you can win more than you can lose for a positive (or favourable) asymmetry and vice-versa for a negative (or unfavourable) asymmetry.

The lottery ticket is the obvious example of a positive asymmetry where you can win millions by purchasing a ticket for a couple of dollars. Likewise for your house insurance where yearly premiums buy you a new house in case of fire. On the other hand, selling options is a good example of a negative asymmetry. The upside is limited to the premium but the downside is unlimited. Recognising that a lot of our life choices are asymmetric can dramatically improve our life, and our portfolio's returns.

Asymmetries are omnipresent in finance. While positive asymmetries are usually well known and understood, this is not the case for negative asymmetries. For instance, take the example of an investor purchasing a corporate bond. As long as there is no company default, the bond will pay a coupon. However, in the case of a default, the investor can lose a significant portion of his nominal as well as the coupons. Similarly, an investor buying a catastrophe bond (also called cat bonds or ILS/Insurance Linked Securities) receives a coupon (premiums received for insuring a catastrophic event) until there is an event such as a hurricane, an earthquake or a tsunami. Worse however, if several of these events occur during the *same* year, then the investor stands to lose a big portion of his principal. In short, all strategies based on some sort of convergence, like risk arbitrage or convertible arbitrage, exhibit a negative asymmetry as you stand to make a few dollars but risk losing a multiple of that[2].

A new prism

An investor who learns to recognise these asymmetries creates a new prism that can help him better understand the risks in his portfolio and ultimately improve the quality of his portfolio returns. A timely example is with long / short equity, a strategy which is currently highly in demand given equity markets' high valuations.

1. *As of June 2014 and according to Hedge Fund Research. Total Hedge Fund AuM surged to an 8th consecutive quarterly record in 2Q14.*

2. *For a wide review of asymmetric strategies, consult Nassim Nicholas Taleb "Anti-Fragile: things that gain from disorder", Penguin Books Limited, 2012.*

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The table below provides a good illustration of the asymmetry that this strategy can offer. Taking five-year rolling time periods over the last 20 years, an investment in long / short equity would provide a cumulative return of 40% on average, when the return was positive. When the return was negative, the investor would lose on average 2%. In addition, over the last 20 years, you had 98% of the five-year periods which were positive versus only 2% which were negative. Thus, an investor had a 98% chance of having a positive return of 40%. This is in essence a double positive asymmetry: on the return (you make more than you lose) and on the frequency (you win more often than you lose). Compare this with the MSCI World Index which provides a bigger positive return (65%) but only in 58% of the cases. In addition, when this return is negative (42% of the time), you lose on average 15%. Clearly, this is the main drawback of long-only equity investments: you lose more and more often. The rest of the table compares other asymmetric strategies such as long-only convertible bonds as well as the minimum variance strategy.

Comparing five-year rolling cumulative returns from 1993-2014

	Cumulative Gain / Frequency	Cumulative Loss / Frequency
MSCI World	+65% / 58%	-15% / 42%
Long / Short Equity	+40% / 98%	-2% / 2%
Convertible Bonds	+38% / 94%	-5% / 6%
Minimum variance	+38% / 100%	- / -

Notes: All statistics are in US Dollars. The analysis period is April 1993 to April 2014 for the MSCI World, long / short equity, and convertible bonds and June 2002 to April 2014 for minimum variance. For long / short equity, a fund of hedge funds was used as a proxy to avoid index biases such as survivorship or self-reporting. For convertible bonds the UBS Global Convertible Bond Index was used. For minimum variance, the Stoxx Global 1800 was used.

Sources: UBS, Stoxx, Bloomberg, Fundana

Win more or lose less?

As opposed to physics or chemistry, there are very few permanent laws in finance. However, one of the few existing ones is often overlooked probably because it is very simple. Warren Buffet describes it perfectly: "Rule No. 1: Never lose money. Rule No. 2: Never forget Rule No.1!" Managing losses is crucial for long-term performance. Remember the obvious point that one needs to generate a 100% return after a 50% loss to get back to the original investment amount. This is exactly where asymmetric strategies help: they limit the losses while still providing very good upside.

Smarter than John Maynard Keynes

Many investors will claim to be able to achieve good returns by *timing markets* - buy low and sell high. Unfortunately, reality is not that simple. Even John Maynard Keynes, one of the most influential economists and financiers of the Twentieth Century, did not forecast the 1929 crash. In fact, no one would hire him today based on his personal track record and his approach which used market timing a lot: by 1929, 10 years after he started investing, his initial assets had halved. From 1924 (peak assets) to 1929 (trough), he posted an 88% negative return! And to annualize a 13% return over his entire 26-year track record, he needed three years where he would make more than 100% per year[3]. Clearly, it seems much easier

3. *Source: The Collected Writings of John Maynard Keynes, volume XII, edited by Donald Moggridge, published by Cambridge University Press. Dynamo Capital LLP.*

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to use asymmetric strategies than trying to be smarter than John Maynard Keynes…

What is foreign does not have to be strange

For many investors, alternative investments and hedge fund strategies appear complex and akin to "black boxes". Simply put, because they do not understand them, these strategies seem strange to investors. A safe and common sense approach, however, is to start with strategies which investors can understand with simple explanations and that are liquid in case they change their minds. The acid test is straightforward: if one member of the investment committee cannot explain the essence of the strategy to another committee member, then the strategy is not suited for that institution. Said differently, as soon as a trustee does not understand an explanation he must clearly let everyone know that he has not understood and request another explanation. Too many times, trustees do not dare to ask the basic questions, which are often the most important. In addition, since equity markets are some of the most liquid markets in the world, this strategy is by its nature very liquid. And as trustees know, liquidity is important since it gives them the option to be wrong.

Half the risk

Amongst the many hedge funds strategies, one of them fits the two criteria mentioned above particularly well: long / short equity. This simple management technique is based on buying fundamentally undervalued stocks (long side) while selling overvalued stocks (short side). Many investors are already familiar with the concept of fundamentally undervalued stocks from their long-only equity allocation.

While not necessarily well understood by many trustees however, the extension on the short side is intuitive. The manager could sell short the stock of a company for a number of reasons: perhaps he expects lower earnings or guidance versus consensus; or maybe the company is being too aggressive in its corporate strategy; or worst, he suspects the company is fraudulently manipulating their numbers. Hence, it does not take much for a committee to grasp the essence of this strategy. And what's more, most professionals invested in long / short equity think of their investment not as "hedge funds" but as a complement to their overall equity allocation. Long / short equity is thus thought of as a management technique providing asymmetric returns: it captures as much as possible of the market upside while limiting losses during market corrections. Over the long-run, this can provide equity-like returns but with half of the equity markets' volatility and drawdowns.

In fact, many institutional investors use this strategy not as an alternative strategy but as a complement to their equity allocation to improve the risk / return profile of that bucket. It is not coincidental that this strategy has the biggest weight in many hedge fund indices and that it attracted close to $40 billion of inflows over the last 18 months[4].

Building trust

Learning to favour positive asymmetric strategies can make a significant difference on portfolio performances but also on trustees' emotions. Indeed, too much return volatility can generate stress on trustees, ultimately resulting in bad investment decisions. Staying invested in a strategy that loses 50% (like equities in 2002 or in 2008) can be nerve wracking for an investment committee. And typically, because of risk management concerns, investors tend to sell their holdings during big drawdowns only to regret it when they

4. *For example as of June 2014, it represented 28.2% of the HFRX Global Hedge Fund Index and 45.8% of the HFRI Fund Weighted Composite Index. Total hedge fund industry inflows from Q1 2013 to Q2 2014 was $120.6Bn. Equity long / short inflows over the same period was $39.2Bn. Source: Hedge Fund Research.*

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do not get back in during the next rally: “buy and hold” is not that easy. While pension funds are evaluated over the long-run, trustees seem to be judged over the short run.

Using asymmetric strategies, like long / short equity, enables trustees to build performance via an investment technique that is simple, liquid and understandable. In short, and for once, a strategy trustees can trust!

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Would you like to write for the 101st edition of the AIMA Journal?

We encourage all AIMA member firms worldwide to contribute to the *AIMA Journal*, the global forum for the hedge fund industry. If you are interested in doing so, please contact Dominic Tonner at dtonner@aima.org by the end of October 2014.

Only AIMA members may write for the AIMA Journal. If your firm is not currently a member and you would like to learn more about the benefits of joining, please contact us at info@aima.org.