Comment

Honesty is the Best Policy – Is Enron a Hedge Fund?

Thomas Schneeweis

January 2002

As we start the New Year, many investment managers have the task of explaining last year's returns to investors. This is especially true for those managers who described their strategies as absolute returns and as being able to make positive returns in all markets. For those managers who were more honest in the portrayal of their funds as accessing certain return opportunities that are fundamental to their strategies as well as adding return due to manager-based security selection and leveraging, hopefully investors will see the past year not as a surprise but simply an experience to be remembered.

Unfortunately, not all managers are honest with their investors as to the source of return of their strategy. Many managers portray themselves as wizards instead of quality strategy mechanics. However, the problem of honesty is not limited to investment managers. Recent experience with Enron illustrates that corporate firms likewise often have problems with full transparency. Unfortunately, many 'public reporters' have commented that Enron is less of a corporation than a hedge fund. In their minds, real corporations produce real goods whereas Enron was primarily a trading firm. The question is then: Is Enron a hedge fund?

Can all firms be regarded as hedge funds? Most corporations hold both liquid and illiquid assets and liabilities. Most corporations have extensive investment trading operations in their firm with the directive of obtaining positive return to risk tradeoffs. If firms do not have these investment operations internally, those firms with defined pension plans certainly have investment in trading opportunities externally. Most firms also have positions in a wide range of what are often considered illiquid alternative investments through their real estate holdings as well as their patent rights or what must be considered seed investment, mezzanine, or later stager private equity. In addition, almost every firm uses derivative markets to hedge existing assets and liabilities as well as actively leveraging and deleveraging these positions (swaps etc.). In short, if many hedge funds are now trying to sell themselves as corporate firms (e.g., closed-end funds), many corporations must be viewed as not all that dissimilar to most hedge funds. In fact, academic research has often viewed the value of equity of a corporation as simply a call option on the value of a firm's debt. To the degree that some hedge fund strategies are viewed as reflecting the returns to a call option, corporations may be viewed as an investment in a similar strategy.

Others may argue however, that the fundamental difference between hedge funds and corporations is the degree of transparency. It is in this regard that Enron is most like hedge funds. In fact, many hedge fund strategies have transparency (separate accounts) and liquidity (exchange traded instruments) that exceed that of most corporate firms. While one may hold the stock of a General Motors (a firm whose pension plan (trading operation) has greater value than the firm itself), one has little transparency as to the value of their underlying holdings or as to their daily strategy.

In short, the question is not if Enron is a hedge fund but the responsibility of any investor to have a clear understanding of the potential source of returns and the risks associated with that hedge fund strategy or corporate investment. In brief, honesty is the best policy.

Looking forward to your comments.

Tom Schneeweis

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Comment

Who is the Lead Dog or Just Follow the Money

Thomas Schneeweis

February, 2002

In the first quarter of each year, many investment managers are reallocating among investment strategies. For many investors, the basis for reallocation is primarily recent market performance. Academic research on 'behavioral finance' indicates that the investment decisions of many investors are affected by recent market experiences rather than by a more complete analysis of future expected return scenarios.

In the first quarter of each year, many investment managers are reallocating among investment strategies. For many investors, the basis for reallocation is primarily recent market performance. Academic research on 'behavioral finance' indicates that the investment decisions of many investors are affected by recent market experiences rather than by a more complete analysis of future expected return scenarios. Over the past ten years (1992-2001), investors who have, on an annual basis, simply rebalanced their portfolio to the highest performing strategy out of the following series of EACM Hedge Fund Indices: Long/Short Equity, Convertible Hedge, Rotational, Multi-Strategy, Domestic Long and Domestic Opportunity would have underperformed relative to a simple equal weighted portfolio.

	Invest in Top Strategy in this Year			Invest in Last Year's Top Strategy		Equal Weighted Portfolio	
	Average Return	Standard Deviation		Average Return	Standard Deviation	Average Return	Standard Deviation
Top Strategy	17.3%	7.9%	Top Strategy Last Year	6.4%	6.4%	8.8%	6.6%
	14.1%	7.2%		11.9%	8.0%		
	10.9%	7.5%		7.0%	8.8%		
	8.0%	6.5%		7.9%	10.0%		
	6.3%	7.1%		6.6%	8.9%		
	4.6%	7.5%		12.3%	7.7%		
Bottom Strategy	0.2%	8.4%	Bottom Strategy Last Year	9.4%	9.5%		

If last year's highest return strategy attracts large pools of capital, then the poorest performing strategy may have the reverse impact. In short, if last year's top investment may under perform in the following year, is it true that the worst strategy will over perform? While the results indicate that investing in the lowest return strategy of last year outperforms investing in the top strategy of the previous year, the results are not statistically significant. As important, investing in last year's worst performer does not result in a risk adjusted return superior to just investing in an equal weighted portfolio of the set of strategies. The Sharpe ratio of the equal weighted portfolio is .58 while the Sharpe ratio of investing in last year's worst performer is .47.

None of this should surprise us. First why should one make a decision in January or February based on a previous year's strategy return. Even if one believes in a contrarian strategy why is it not based on some random 12-month previous return and any one point in time. Second, given economic policy to constantly adjust economic conditions, one would not expect that economic policies are necessarily in favor one particular strategy over another (except in unique cases economic policy aimed at adjusting levels of interest rates or credit conditions and even in these cases the timing of impact would be uncertain. In short, unless one as an informational model which focuses on information not currently imbedded in market prices or one which can capture changing conditional variables, there is little evidence that one should follow the lead dog, the dog at the back of the pack, or simply put money on all of them. Show me your shocked face.

Looking forward to your comments.

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Comment

How Much is Too Much and How Little is Too Little

Thomas Schneeweis

March, 2002

Before one even addresses the issue of what the predetermined benchmark should be or if high water marks are an essential aspect of proper manager compensation systems, one may wish to rethink the very basis of manager compensation. In brief, one pays anyone a particular fee to provide the investor (consumer) with a particular product. One may pay more for a particular product, in comparison to other similar products, if that product offers unique services, performance, etc. One hopes of course, that one has enough information as to the comparable products to make a judgment as to the marginal cost/benefits of one product versus another.

As hedge fund performance failed to reach many investors' expectations last year, the question of manager compensation remains and manager fees, in general, have again become a major focus. While hedge fund fees vary across managers as well as strategies, in general the 'market average' is often being described as 1 and 20, that is, 1% on assets and 20% on gross profits (above a high-water mark) above some predetermined benchmark (e.g., risk free rate).

Before one even addresses the issue of what the predetermined benchmark should be or if high water marks are an essential aspect of proper manager compensation systems, one may wish to rethink the very basis of manager compensation. In brief, one pays anyone a particular fee to provide the investor (consumer) with a particular product. One may pay more for a particular product, in comparison to other similar products, if that product offers unique services, performance, etc. One hopes of course, that one has enough information as to the comparable products to make a judgment as to the marginal cost/benefits of one product versus another.

Books and libraries, I dare say whole academic careers, have been spent pounding nail after nail into the coffin of manager performance and fee structure. The essential points are that one should find a compensation plan which aligns investor interest with manager interest (e.g., make them want to build a better mousetrap) as well as offer this service at the lowest marginal cost to the investor (e.g., free option).

In this section, I am not going to cover all the topics related to manager performance (I have too many future comment sections to write and need the material for later), however, I wish to say categorically that the present 1 and 20 fee based system is completely random and offers little basis for fundamental comparison.

Note that I understand all that academic research on 'Agency Theory' and investor/manager aligning interests and the benefits of option-like payoffs as a basis for encouraging common goal setting. I dare say less than 1 in 20 hedge fund managers, in setting their fees, have any idea as to what "Agency Theory" really is and instead would prefer 'Nash's Game Theory' as a better means of describing relative fee structures (how much can I charge and not drive people away?).

A couple of points and in future issues we will focus on these problems in greater detail.

1) *Fees based on assets only drives managers to stress asset attainment, not performance.* Okay, but in the mutual fund industry (which can also charge performance fees based on symmetry, i.e. I receive above a benchmark and pay below a benchmark), do we not also look at performance as a basis for manager selection? Given that performance drives selection, why give the manager a double dip?

2) *Performance fees align manager and investor interest.* OK, I want my manager to stress positive performance (not to lock in average returns to keep assets) but performance fees may also lead to levels of asset risk above that desired by the investor. In any event, why does each strategy have the same performance fee base given the differential risk in the various strategies?

3) *High water marks ensure that investors only pay for positive performance.* This seems like a sweetheart deal for the investor. However, in fact, it is a marketing gimmick. If managers have a poor year and cannot 'claw back' the performance, they simply 'close shop.' Most managers of 50 to 100 million dollars cannot simply run an operation on 1%. So why not offer higher fixed fees and a lower performance fee for new managers with less assets under management?

4) *Common benchmarks drive managers to a common strategy*. But this is what I want. I want to be able to track distressed etc.

Well, I have said enough. Again, simple one-size-fits-all compensation plans for the entire industry are pure garbage. I have multiple choices amongst many products, and I realize that different investors pay different charges for the same item. I realize that large purchasers pay less than small, etc. But I also realize that the current fee pattern in which the first are last, the last are first and all get taken together must eventually change.

Looking forward to your comments.

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Comment

Pick a Card, Pick any Card

Thomas Schneeweis

April, 2002

The nice thing about standards is that there are so many of them to choose from. In recent months, there has been increased discussion about the creation of a 'rating' system for hedge funds and other alternative investments. While still at the formative stages, one may presume that these proposed rating systems would be similar to Moody's or Standard and Poor's ratings for bonds or Morningstar or Lipper ratings for mutual funds. Given the recent performance of a wide range of ratings or other information services to provide adequate forecasts of the strength of corporations or fund performance once may question if the world really needs another attempt to simplify what is inherently complex.

It is certainly not the purpose of this Comment to review the entire history of ratings or their use in asset management. But by way of background, it is important to realize that equity as bond issues once were rated. The primary reason for rating stocks (as bonds) was that investors did not have access to enough public information to make adequate decisions as to the quality of a particular stock. However, by the end of the 1960's various market-based measures of performance (beta etc.) replaced 'corporate ratings' as a more immediate signal of the quality of a particular stock. In short, beta became the alternative 'rating' for a particular issue. A change in a firm's beta reflected a wide range of internal actions resulting in a new estimate of a firm's underlying volatility.

As stock ratings declined in interest, bond ratings gradually underwent a similar fall from grace. In the 1970's NYC's collapse exposed the failure of ratings to keep up with economic reality. Today, we have advanced even further. Beta is no longer regarded as a 'stand alone' measure of a firm's risk or sensitivity to economic events. Bond ratings are held in even lower regard, as duration, convexity and other measures of market sensitivity are used to capture the market's view of firms' changing risk exposure.

This is not to say that markets themselves do not make mistakes. Even if full information existed at no cost, investors' different interpretation of that information may still lead to errors in pricing. As important, in many countries and for many assets, information is limited. Academic studies have shown that in the US, changes in ratings have little impact on pricing, since prices already contain most information. In less developed nations, rating changes have little impact on prices, since prices are determined by 'irrational investors' rather than on actual information. In evolving nations, rating changes may have an impact, since investors believe that the rating change contains information not known in the market.

Given the problems with the use of ratings in traditional markets, why the sudden interest in the creation of ratings in the alternative investment area? Primarily since, as discussed above, investors believe that they lack valuable information as to the quality (default risk, price risk) of hedge funds and other alternative investments. The question then is: will the rating agency have access to more information or enough information to make qualified decisions?

Unfortunately, I fear not. As important, what risk will the rating try to capture (price risk, default risk) and over what period of time (week, month)? In addition, the rating system may result in creating simplicity where complexity naturally exists. What is likely required is a multiple risk review and a market-based assessment of the quality of the asset or fund. In equity markets, investors vote with their money and price reflects their assessments. In hedge funds, for instance, we currently do not have such a marketplace. However, we do have the ability to measure the underlying positions, etc., of many such funds. For those funds which we are willing to offer full transparency, a systematic valuation system can begin to be created.

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For those who refuse, a daily pricing system would enable one to determine at least the relative volatility of competing strategies in various market environments. As for myself, I prefer to walk before I run and would look forward to the creation of a database that contains the reported daily valuations (before fees) from which such price comparisons could be made. Of course, such a system would necessarily be subject to oversight and other controls such that false prices, etc. would not destroy the effort.

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Comment

In Search of Alpha

Thomas Schneeweis

May, 2002

Part of the problem is that the investment landscape has changed "dramatically" over the last 30 years, but the road maps haven't, giving little direction of how to work in unique investment environments. But alternative asset managers must communicate the changed map and the opportunities for finding returns, or alpha.

It is always interesting to hear one's comments interpreted by others. The following is an Abstract of comments made by myself at the recent Alternative Investments Forum in Canada on June 6-7. Thought you might be interested.

"Part of the problem," says Thomas Schneeweis, the Michael and Cheryl Phillip Professor of Finance at the University of Massachusetts and a prominent academic analyst of hedge funds, "is that the investment landscape has changed "dramatically" over the last 30 years, but the road maps haven't, thus giving little direction of how to work in unique investment environments. But alternative asset managers must communicate the changed map and the opportunities for finding returns, or alpha." "If we don't," Schneeweis says, "we'll be out of a job."

The old investment maps deal with traditional asset classes, but "traditional stock and bond markets are not becoming the primary means by which investors can find alpha opportunities." The alpha opportunities aren't all that new, however. Hedge funds use a variety of strategies – and Schneeweis prefers to call hedge funds strategies rather than an asset class. "There's not a single [hedge fund] strategy that has not been traded on the proprietary desks of major banks over the past 15 to 20 years," he said. "Hedge funds are nothing more than the privatization of the proprietary desk." As a result, hedge fund

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strategies can be reasonably predictable in their outcomes. The question becomes "do you make your money where you should" by following the strategy? "I'm looking for hedge funds to make money in exactly those kinds of markets where they're supposed to," Schneeweis said.

Hedge funds, like many other non-traditional investments, come in two forms. Either they enhance returns when applied alongside traditional strategies, or they diversify risk, softening the losses when traditional strategies go south. But the same type of analysis applies to each. "There's nothing we do in the alternative arena that we don't do in the traditional arena," Schneeweis said. "There's nothing on today's map where we don't understand the sources of return." Identifying and then correlating the sources of return is key to adding alternative investment strategies to a portfolio. "But," Schneeweis said, "if hedge funds don't offer you something unique from traditional ones, you shouldn't be there…each one of these strategies has a unique opportunity and unique sources of return."

Some of the returns stem from the fact that hedge fund managers aren't constrained by institutional rules. "Hedge funds provide diversification traditional investments simply don't," he added. But, as against the myth of hedge fund wizards with strategies encased in a black box, Schneeweis pointed out, "It's actually the same world as traditional investments." The repertoire of instruments is bigger, however, with the hedge fund managers able to sell stocks and other securities short. They load on the same factors as traditional strategies; in other words, multi-factor analysis shows that they draw returns from the same sources as traditional investments. As a result, particular strategies will show high correlation with some traditional strategies. Those differing patterns permit a different sort of asset allocation, one where the same level of returns can be achieved but with lesser risk, or where higher returns can be achieved, but with a similar level of risk. Equity hedge funds, which are often a play on tech stocks on the Russell 2000, can produce higher returns when added to a portfolio, but at the same

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volatility. By contrast, relative value strategies, which usually involve arbitrage between similar securities, can provide similar returns at reduced risk."

Given the performance characteristics of hedge fund strategies against the backdrop of flat traditional markets, the real question Schneeweis believes is "what do I take out?" Should the fixed-income component be trimmed to make room for relative value strategies, or should the equity component be split among passive index investments and active hedge fund managers who can generate returns in excess of the benchmark? At the end of the day, Schneeweis said, hedge funds expose themselves to the same risks as traditional investments. The difference is they can provide the alpha, or excess returns that traditional strategies aren't [providing].

The following gives an indication that hedge funds using a variety of benchmark returns show evidence of positive alpha using traditional market factors in describing the return process (1990-2001).

	Historical-Risk Free	Historical-CAPM	Historical-Multi-Factor	Historical-Vol Adjusted
HFRI Convertible Arbitrage Index	6.1%	5.6%	4.8%	3.7%
HFRI Distressed Securities Index	9.3%	7.7%	7.2%	4.3%
HFRI Emerging Markets (Total)	10.0%	2.8%	0.9%	-3.1%
HFRI Emerging Markets: Asia Index	4.8%	-0.3%	-1.6%	-6.7%
HFRI Equity Hedge Index	15.9%	11.7%	9.4%	8.7%
HFRI Equity Market Neutral Index	5.7%	5.5%	4.6%	3.4%
HFRI Equity Non-Hedge Index	13.9%	5.5%	2.2%	2.4%
HFRI Even-Driven Index	10.8%	8.1%	6.8%	5.9%
HFRI Fixed Income (Total)	5.6%	4.8%	4.5%	3.0%
HFRI Fixed Income: Arbitrage Index	3.4%	4.1%	4.4%	-0.2%
HFRI Fixed Income: High Yield Index	4.6%	2.6%	2.5%	-0.7%
HFRI Fun of Funds Index	6.2%	4.5%	3.6%	1.4%
HFRI Fund Weighted Composite Index	11.1%	7.5%	6.0%	5.5%
HFRI Macro Index	12.6%	9.7%	9.4%	5.4%
HFRI Market Timing Index	9.5%	6.2%	4.7%	4.2%
HFRI Merger Arbitrage Index	7.9%	7.0%	5.8%	5.1%
HFRI Relative Value Arbitrage Index	8.1%	7.4%	7.1%	5.2%
HFRI Sector (Total)	18.6%	13.4%	11.6%	7.4%
HFRI Statistical Arbitrage Index	5.8%	4.6%	3.3%	3.1%

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Comment

Issues in Hedge Fund Analysis

Thomas Schneeweis

June, 2002

In the past decade considerable time and effort was expended on developing a better understanding of the actual source of returns to various hedge fund strategies as well as how these strategies fit into the investment portfolios of individuals, endowments, and pension plans. Suffice it to say that hedge funds are no longer regarded as a mystery, or as some exotic investment wrapped in a black box, or solely based in manager skill. However, debate still exists on a number of issues related to hedge funds. In this Director's Comments we discuss some of those issues:

In the past decade considerable time and effort was expended on developing a better understanding of the actual source of returns to various hedge fund strategies as well as how these strategies fit into the investment portfolios of individuals, endowments, and pension plans. Suffice it to say that hedge funds are no longer regarded as a mystery, or as some exotic investment wrapped in a black box, or solely based in manager skill. However, debate still exists on a number of issues related to hedge funds. In this Director's Comments we discuss some of those issues:

Issue: *Hedge Funds' attempts to expand investor base beyond that provided for by enactment of 1996 exemption*.

Concern: Government and professional associations are concerned over the expansion of hedge funds into more retail like products marketed to less sophisticated investors. In fact, a supposed increase in hedge fund bankruptcies, misleading accounting, and unscrupulous sales to less-sophisticated investors have been laid, in part, to hedge funds' attempts to enlarge their potential investor base to include more retail-based clients.

Response: Several professional hedge fund associations (MFA) have agreed that expansion of hedge fund products into retail markets should not be encouraged. However, from an academic perspective it may be difficult to argue that retail investors should not have access to hedge fund investments if properly regulated. Problems with security pricing and accounting are also found in traditional stock markets. Deceitful communications and unscrupulous sales are again common in traditional markets. The question remains why retail investors should not be afforded the same risk diversification and return benefits that hedge funds provide affluent investors as long as legal restrictions on certain actions are followed.

Issue: *The global reach of hedge funds encourages transfers of capital from illegal sources.*

Concern: Money laundering and other illegal fund flow activities may be a larger part of hedge fund investment in contrast to mutual fund investment.

Response: As investment markets become increasingly global, government bodies are increasingly concerned over the use of private investment vehicles being used as a means to circumvent government rules regarding illegal transfers of money. The real questions are how international governing bodies will bring one common set of rules to any investment industry which is by its very design is governed more by local rules and regulations. As important, as one adds increased costs of compliance and monitoring those investment media, investment areas, such as hedge funds which by design have fewer assets under management, may be driven into larger and larger industrial groupings.

Issue: *Should Hedge Funds be viewed as a skill class, a separate asset class or as simply a variant of traditional asset investment classes?*

Concern: Hedge funds have been marketed as providing a variety of investment opportunities in which the source of these opportunities is based on manager skill, market opportunities and the like.

Response: Recent academic results have shown that for mutual funds, the returns to various hedge fund strategies is a combination of natural return/risk tradeoff to holding a particular strategy (e.g., distressed securities' returns is a combination of the risk premia from holding low grade bonds and the liquidity premia from holding less liquid securities) and manager skill. As a result, some hedge fund strategies (e.g., distressed debt) may be regarded as being a variant of traditional asset classes (fixed income) while other strategies (e.g., market neutral) offer return opportunities not generally available in traditional assets. In short, most hedge fund strategies have a fundamental source of return which is sensitive to certain economic factors which form the basis for that strategy. Of course, certain managers may be able to add unique skill-based returns above the 'market' offered return.

Issue: *The Decline in the Stock Market During 2002 is Primarily Due to Hedge Fund Strategies*

Concern*:* Some industry leaders have claimed that hedge funds may be increasing market volatility by selling stocks as the fall and being forced to cover the same when the market rallies thus leading to increased market volatility, market risk, and declines in equity markets.
Response: Many in the investment industry would like to find a single, simple answer to the complex series of events which have driven the equity market to the levels of the mid 1990's. Unfortunately, it is difficult to believe that in equity markets, in which the hedge fund industry comprises such a small part of the total investment dollar, that hedge funds are the driving force behind most market movements. People forget that hedge funds cover a wide range of strategies (relative value, convertible arbitrage, distressed, merger arbitrage etc.). While hedge equity and other equity-based strategies are an important part of the hedge fund industry, for many hedge funds, investments are long term in nature. Lastly, one must remember that hedge funds are a small part of the active 'trading' industry. Proprietary trading desks (from which many hedge funds have evolved), individual traders, mutual funds and the like are generally regarded as a larger part of the active trading market. Lastly, to claim that active trading is harmful to the markets and that one should minimize trading strikes at the very heart of the hedge fund industry and market efficiency. Hedge funds may outperform traditional long only index based mutual fund because they do act on new information. Market efficiency and price movement may come at a price (e.g., increased market movement) but the cost of reducing the ability of skill informed traders to trade has even greater costs (e.g., the average uninformed investor may purchase securities at prices well above their true worth or sell them at prices below their actual value). Those wishing to find a single guilty party for the recent decline in U.S. equity prices will have to look elsewhere.

Looking forward to your comments.

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Comment

Possible Governmental and Hedge Fund Responses to Current Market Concerns

Thomas Schneeweis

July, 2002

It seems unlikely that investors will suddenly overcome the urge to invest in last year's strategy. However, there are several things that can be said about what we've learned about hedge fund strategies and their investors in the past decade, and the likely response of the hedge fund industry, its investors, and its regulators going forward. The following reflects some of the responses.

Investors in hedge funds always seem to be fighting the last war. Capital flowed to macro strategies in the early '90s in response to the volatility in currency, commodity, and interest rates that took place in the late '80s. Lower volatility in these markets and a resulting compression in credit spreads in the early '90s led to a huge increase in market-neutral fund assets in the mid- '90s. The financial crisis of '98 exposed the risks of these strategies in terms of liquidity and transparency. This, along with the bull market in global equities, triggered the current flood of capital into highly liquid, transparent equity-based strategies. The recent decline in has focused investor and government concerns on issues related to hedge fund's use of the equity markets.

It seems unlikely that investors will suddenly overcome the urge to invest in last year's strategy. However, there are several things that can be said about what we've learned about hedge fund strategies and their investors in the past decade, and the likely response of the hedge fund industry, its investors, and its regulators going forward. The following reflects some of the responses.

- Greater emphasis is being made on risk management -- both by financial intermediaries who trade with and lend to hedge fund managers and by the hedge fund managers themselves. Recent discussions among various professional associations (e.g., Global Association of Risk Professional (GARP), Investor Risk Committee (IRC) of the International Association of Financial Engineers)

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has centered on attempting to create a common platform and standard for hedge fund reporting and risk monitoring.

- As in the traditional markets, where mutual fund families dominate the landscape, new organizational structures are being created to group together various hedge funds in a single financial entity, providing for cross-marketing opportunities and more efficient management of back-office functions.

- New means of trading hedge funds are being developed. Internet-based trading platforms can circumvent the sell-side in the same way ECNs (online exchanges) have altered the traditional asset markets. Financial institutions are now acting as market-makers to particular sets of hedge funds and offering them via their own trading platforms, thereby creating a liquid market in the underlying funds.

- Managers are increasingly concerned about capacity constraints within their particular strategies. The need to ratio capacity more efficiently is resulting in new product structures and product designs based on more liquid futures and option markets.

- Improvements in educating investors and intermediaries are taking place and plans are under way to offer a certification program for industry professionals. This education and certification process will define the common body of knowledge that all industry participants should understand.

- Recent events have focused government regulators on the lack of transparency on fund flows to hedge funds. The recent Patriots act is one indication of an increasing effort by government officials to require hedge funds to comply with rules and regulations similar to those which mutual funds are required to fulfill.

- Abnormal returns are based on abnormal access to unique information. These information-based opportunities will increasingly be outside of the U.S. Since the future of hedge funds is in exploiting unique economic imperfections; hedge funds will expand by concentrating on market opportunities outside of the United States

.Looking forward to your comments

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Comment

Hedge Funds: Future Focus

Thomas Schneeweis

August, 2002

Give them a number, give them a date but never ever give them both

Most Probable (75% Chance):

- The creation of an industry wide education standard for professionals in the alternative investment industry. This designation (e.g., Chartered Alternative Investment Analyst) will provide industry participants with a globally recognized certification similar to the Chartered Financial Analyst designation for professionals in the traditional investment area.

- Lower fees overall, with performance fees tied to relative, as opposed to absolute, performance. Fees will be structured to meet capacity demand and not be based on economic 'alpha' determination. In short there are two forms of fee structure: one for the firm with limited capacity and above average demand and those with excess capacity and below average demand. For newer funds which require a consistent and minimum cash flow, a greater amount of fees will be generated by a higher charge on fixed assets.

- The creation of passive index to replicate and benchmark active trading strategies, with compensation increasingly tied to these passive benchmarks or to the performance of other active managers within the style.

- Increased transparency for investors, with daily reporting of returns and VAR becoming the norm.

- Reduction in lockup periods. Many managers will begin offering daily liquidity, and those that cannot offer daily liquidity will need to demonstrate the need for longer lockups.
- More competition with mutual funds. Mutual funds will replicate traditional hedge fund strategies, and hedge funds will mimic the marketing strategies that have made mutual funds so successful in attracting assets.

- Increased dominance of large financial institutions in structuring and delivering hedge fund products. These institutions can charge lower management fees because captive funds offer cash flows to other parts of the firm such as trading, custody, and securities lending.

- Large single-strategy hedge funds will increasingly attempt to wrap non-correlated strategies around their own product and attempt to sell multi-strategy funds.

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Might Happen (50% Chance):

- All hedge funds operate on a 24-hour basis.
- Hedge funds will be listed in a B2B environment.
- All hedge funds offer full transparency to investors, subject to confidential agreements.
- Rating agencies will provide an on-line rating system of hedge funds including price risk, style risk, and manager risk estimates. This will happen as the result of governmental regulation thus ensuring a required payment and cash flow to rating agencies.
- Development of a traded market in secondary interests in hedge funds
- Downstreaming/retailing of hedge fund products - already happening with insurance wraps etc.
- Proliferation of incubators where the seed investors will have first right of refusal on the managers' capacity and where the total assets under management is restricted/predefined or capped contractually.
- Institutionalization of hedge fund industry as some very large funds move away from the general hedge fund model towards becoming investment banks (e.g., creating new pools of risk capital rivaling and eventually replacing some of the current Investment Bank's).

Probably not (25% Chance)

- Hedge funds dominate active investment management, as mutual funds are replaced by index products.
- Emerging markets (e.g., China, India) attract the dominate portion of hedge fund investments.
- Government regulators stop using accounting-based means of regulation (e.g., reporting last quarters, asset positions) and focus on continuous pricing as a means of regulation
- Governments create a reasonable, worldwide system of reporting which permits a measure of systemic risk under a wide range of financial conditions.
- Development of recognized alpha measures rivaling other broadly accepted statistical measures like Sharpe ratios etc. - probably evolving from reclassification of manager styles and focusing on things like credit risk, volatility risk etc.

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Comment

How to Implement Hedge Funds Into An Investor's Portfolio

Thomas Schneeweis

September, 2002

Hedge funds have been described as skill-based investment strategies. Skill-based strategies obtain returns from the unique skill or strategy of the trader. As a result, hedge funds have also been described as *absolute return* strategies, as these returns do not depend on the long-term return in underlying traditional stock and bond markets. Because hedge funds are actively managed, trader skill is certainly important, as are the basic trading strategies behind most hedge fund investments. However, more recently, hedge fund returns have been shown to be driven largely by market factors such as changes in credit spreads or market volatility, so one can think of their returns as a combination of manager skill and an underlying return to the strategy itself. As a result, it is perhaps more proper to think of hedge funds not as a separate asset class but as an additional 'alpha' opportunity within a particular investment strategy with certain factor sensitivity to market factors.

The alternative investment universe consists of a number of investment strategies that offer risk and return opportunities not commonly found in traditional long only stock and bond investment. Hedge funds trade in both cash and derivative markets and can provide returns based not only on market direction but also unique return opportunities available in individual markets and securities. However, for hedge funds to continue to grow as an investment alternative, individuals need to increase their knowledge and comfort level as to their use in investment portfolios. Exactly, what are the benefits of hedge funds as part of an investor's overall asset portfolio? While, it is impossible in a short synopsis to convey all the details of the benefits of hedge funds, hedge funds offer the opportunity to: 1) reduce portfolio volatility risk, 2) enhance portfolio returns in economic environments in which traditional stock and bond investments offer limited opportunities, and 3) participate in a wide variety of new financial products and markets not available in traditional investor products.

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Hedge funds have been described as skill-based investment strategies. Skill-based strategies obtain returns from the unique skill or strategy of the trader. As a result, hedge funds have also been described as *absolute return* strategies, as these returns do not depend on the long-term return in underlying traditional stock and bond markets. Because hedge funds are actively managed, trader skill is certainly important, as are the basic trading strategies behind most hedge fund investments. However, more recently, hedge fund returns have been shown to be driven largely by market factors such as changes in credit spreads or market volatility, so one can think of their returns as a combination of manager skill and an underlying return to the strategy itself. As a result, it is perhaps more proper to think of hedge funds not as a separate asset class but as an additional ‘alpha’ opportunity within a particular investment strategy with certain factor sensitivity to market factors. In fact, it may be more beneficial to view hedge fund strategies as risk reducers, diversifiers, or return enhancers depending on the characteristics of the portfolio to which they are being added. For instance, hedge equity may be a return enhancer to an existing equity portfolio, but a diversifier to an existing bond portfolio. In contrast, market neutral equity may be regarded as a return enhancer to an existing bond portfolio but a risk reducer to an existing equity portfolio.

Other issues of concern in implementing the additional of hedge funds into one’s investment portfolio include the choice of benchmark or index surrogates as well as the use of historical or expected returns. For instance, one often uses hedge funds and stock and bond indices in determining the benefits of hedge funds. Since stock and bond as well as hedge fund indices have changed over time, historical index data may not reflect the future especially if those indices change style over time (e.g., CTA dominated to Hedge Fund Dominated). .If one’s own hedge fund investment differs from the indices used in asset construction, it should not be surprising if results differ from expected. Even if one is using the proper indices, one should also be careful to use return and risk forecast that reflect one’s expectations rather than simply using historical estimates. Portfolio optimization is highly sensitive to return forecast

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errors. In short, one should use a range of return scenarios in one's portfolio construction process in order to educate oneself as to the potential impacts of adding hedge funds onto one's existing portfolio.

Looking forward to your comments

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Comment

CAIA and the Future of Alternative Investments

Thomas Schneeweis

October, 2002

November 5 is the official launch of the Chartered Alternative Investment Analyst (CAIA) Certification Program. On that date CAIA Level I exam registration will commence and exam materials will be available for download at this site. The CAIA designation program is administered by the CAIA Association. The CAIA organization is a non-profit educational association, which focuses on alternative investment education and is the sponsoring organization for the Chartered Alternative Investment Analyst designation.

Objectives of the CAIA Association:

· Enhancing investment knowledge and promoting a high level of ethics and professionalism
· Promoting the CAIA designation among alternative investment professionals and academics
· Encouraging contact and communication among alternative investment professionals
· Establishing an ongoing series of educational events for alternative investment practitioners and academics

The CAIA Association is sponsored by the Alternative Investment Management Association (AIMA) and the Center for International Securities and Derivatives Markets (CISDM) - two organizations providing global leadership for alternative investment professionals by setting the highest standards in alternative investment education, professional conduct and advocacy pr

The CAIA exams cover traditional alternative investments such as real estate, private equity, and commodity investment as well as more modern alternative investment vehicles including hedge funds and managed futures. The exam curriculum has been determined by a separate exam committee. The exams will be administered at proctored testing centers around the world. Information on the testing centers will be made available online at www.caia.org in November 2003. The first sitting of Level I exam will take place in February of 2003. Level I and Level II

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program. Nor is it the purpose of these comments to discuss in detail the why both CISDM and AIMA believed that this was the time to begin a program which hopes to offer both a means by which individuals can obtain a solid background in the area of alternative investments as well as to demonstrate a basic level of understanding. No educational program is perfect. In fact, I am confident that the current program will disappoint in some way both academics and professionals in the area. For some it will be too easy, for others not difficult enough. Over time, the program will improve and develop. However, with time and with the help of individuals within and outside the alternative investment industry, the program continues to improve and offer a standard by which other educational efforts may be judged.

In part, the program was initiated both in the belief that the industry had grown to the point where there was suitable demand for such a professional certification and that traditional avenues of academic education did not provide a suitable means of educating individuals in the area of alternative investments. The financial and academic industry has done and continues to do an excellent job at educating individuals on traditional stock and bond markets. Investment courses at colleges and universities and professional programs offered by a wide range of financial institutions as well as professional certification by organizations such as the CFA provide excellent means by which individuals can become educated on traditional stock, bond, and derivatives markets. However, if one looks at the principal investment books used by many colleges and universities today one sees little discussion of private equity, commodity investment, commercial real estate, hedge funds or managed futures.

There are of course a wide range of current programs to educate oneself in the area of alternatives. In fact, today the wide range of information offered by various professional bodies and educational programs makes it increasingly harder for individuals to determine which courses or information is most valuable. In part, the CAIA was created to attempt to provide a suitable collection of that information. Simply put, one day, two day or even three day seminars may offer the means to introduce one to hedge funds or other alternatives or to provide the basics necessary for various professionals; however, we believe that a more comprehensive approach offered by the CAIA is also important to the industry. In addition, the potential conflicts within any industry of emphasizing the good (yes, alternative investments do provide expanded risk and return opportunities not available only through traditional stock and bond markets) and not the bad (yes, alternative investments may have pricing and liquidity issues beyond that normally occurring in traditional stock and bond markets) requires an independent educational body. In addition, by creating separate curriculum and testing committees as well as separate advisory boards, the CAIA has attempted to bring a level of transparency and objectivity into the process. While both of the sponsoring organizations (AIMA and CISDM) have connections to the industry (as well they should), both associations are non-profit education institutions. Both organizations created the CAIA to separate themselves further from potential conflicts of interest (for example, the CAIA does not directly offer preparation courses for the CAIA certification).

Despite my previous comments, I have obviously just attempted to offer a justification for my participation and CISDM’s participation in the creation of the CAIA. The programs’ success or failure will not however be solely due to AIMA's or CISDM's efforts. This program will only succeed if enough individuals and financial institutions in the investment industry join the efforts of all of those who have already sacrificed their time and efforts. I wish to thank now, as I will in the future, the hundreds of individuals who have given their suggestions and continue to offer their ideas and support. Education is a public good. One's returns cannot be measured in the traditional manner. If I can be personal for a

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moment (and these are Director's comments), as an educator (at least part time), I realize that the satisfaction of providing a means by which individuals can improve themselves though education cannot be equated in terms of traditional internal rates of return.

I look forward to working with all members of CISDM who have already helped in numerous ways to make the CAIA successful. One individual asked how many individuals would have to sign up for the program to be successful. I answered that the number of participants alone is not evidence of its success. If the program offers individuals the incentive to think about the industry critically, to question ideas on benefits of various products, to continue to grow in their knowledge about alternative investment products, the program will have been of value (that having been said, we do need your support with actual individuals signing up for the program). As for myself, if I could go to a meeting on alternative investments in which no one confused beta with correlation (note they are not the same – an asset with a low (high) beta can still have a high (low) correlation with the comparison asset, I would consider the program well on its way.

Again, CISDM wishes to thank its supporters as well as AIMA and its members for their efforts in helping us to initiate the CAIA program. Without your personal involvement and financial support, the program would not have come into existence. Unfortunately, the hard work has only just begun. We at CISDM look forward to continuing our joint efforts. Remember this is the fun part of what we do.

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Comment

Fees, Fees, and More Fees

Thomas Schneeweis

November, 2002

The relationship between managers' fees and performance remains an issue of controversy. In the traditional stock and bond area, academic research continues to show that managed funds fail to outperform similar investible passive investments. To the degree that the returns of active and passive investment strategies in similar investment areas are similar, managers are simply charging an amount equal to their differential return. This is to be expected. If a manager can provide higher return than a similar passive investment vehicle, he or she should be able to charge for that differential return. The question remains as to how much of that differential return he or she should leave to the investor. In fact, it is not the sole responsibility of the investor to make the manager rich, so an investor should receive at least a portion of the manager's differential return.

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Of course, historical returns do not necessarily provide a sole means of measuring potential manager benefits. Even if a manager underperforms a particular investible passive index, he or she may

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offer services (tax, reporting) that an individual would have to undertake if an alternative passive program is used. In addition, managers may also provide an option to manage risks that for whatever reason do not occur during the period of comparison but would be of value in future time periods. One should pay for that option even if it historically is never “in the money.’

Even academics agree that a manager with more costly information, resources etc. should outperform on a net basis other manager with less costly programs. Of course, the difference in return should equal the differences in costs unless the manager can use that information or resources to obtain a marginally higher return after costs. Research has shown that incentive fees may not result in higher rates of return for hedge fund managers (JAI, fall, 2002). In fact, incentive fees in many areas of corporate and asset management have resulted in perverse manager actions that hurt shareholders.

Of course, managers must charge enough to meet costs of managing relative to a passive strategy offer similar return opportunities. As important, managers have the right to charge whatever fees they desire and investors have the right to accept or reject such fees. Recently two leading funds (Caxton and Renaissance Technologies) have raised their fees (Caxton has raised both management and incentive and Renaissance has raised only incentive fees). While various explanations exist for their actions, (various newspapers have maintained that Caxton says it must raise fees to continue to retain senior traders while Renaissance is returning assets to investors and maintains that the increase in fees is necessary to keep income levels for the firm as in the past).

Of course, herein lays the rub. If the increase in fees is required to keep senior traders and if senior traders are not suddenly going to improve their trading skills as the result of their pay increase, net returns to investors must fall. In short, unless traders become more skilled as the result of the new money, I am agreeing to give you more money based on past performance knowing that future performance will most

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likely fall as the result of the fee increase. This is especially troubling since there is very little evidence that Caxton or Renaissance's returns have been (from an academic viewpoint) strictly compared against similar firms trading similar strategies and on this basis their returns to risk are so outstanding. Never mind, the future will win out regardless of the virtue of the choice.

But people do have a choice, at least to provide an honest statement as to the basis for their fee increase. In both cases, the answer is: **Because we can and there are enough investors willing to give it to us**. But please, refrain from the litany of **'we had to do it for our investor's own good.'** If one's senior traders are that good that they require such fees, the question is if the firm will reduce fees when these traders retire and they cannot replace them with similarly talented traders? I think not. And if such replacement traders currently exist, can they not be obtained at a reduced cost than the existing similar talented 'senior traders.' If so, why not use them and not raise fees. In the Renaissance case, if Renaissance truly believes that their investors are better off because they (the investor) can put their return money to work elsewhere while there will be little diminution of total dollars even after fees from Renaissance (the money that is left will make even more because the firm is not 'burdened' with the excess nonproductive money) the implication is that there are only so many deals out their and reducing money chasing them increases the gross return enough to pay the high fees. It is great to believe that Renaissance has such 'pure rental fees' in their area – but give us a break. Renaissance does not have a lock on its trading market or removing similar competitors from entering. If the opportunities are being reduced, return assets, fire personnel, and keep fees the same. Well reason rarely wins out over greed and I wish all managers the greatest success in charging investors more and more fees. A fool and his money are soon parted and the sooner the better.

Looking forward to your comments
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Comment

The ‘Financial’ Miracle of 34th St.

Thomas Schneeweis

December, 2002

For those of us who find themselves seeing ‘Christmas Past’ through the movies of the first half of the 20th century – Miracle on 34th St. remains a movie to be seen (the old one with Ray Milan and Natalie Wood). To put it briefly, old man Nick stays at a mental ward during the off seasons but in Winter he jumps in to help Macys department store (of course which is located on 34th Street when the ‘Store’s Santa celebrates too early’. In so doing, he turns the entire town abuzz by recommending to mothers and children alike that they may have to go to another store to find the product that they wish. Quite extraordinary in that Store Santa’s are supposed to sell only Store products. This is even more astounding in that he does try to control the expectations of each child, reminding them that one should also hope for the best but one should only ask for what is possible.

For those of us who find themselves seeing ‘Christmas Past’ through the movies of the first half of the 20th century – Miracle on 34th St. remains a movie to be seen (the old one with Ray Milan and Natalie Wood). To put it briefly, old man Nick stays at a mental ward during the off seasons but in Winter he jumps in to help Macys department store (of course which is located on 34th Street when the ‘Store’s Santa celebrates too early’. In so doing, he turns the entire town abuzz by recommending to mothers and children alike that the may have to go to another store to find the product that they wish” Quite extraordinary in that Store Santa’s are supposed to sell only Store products” This is even more astounding in that he does try to control the expectations of each child, reminding them that one should also ways hope for the best but one should only ask for what is possible.

Of course, this is about Christmas and this is a movie so one should expect that it takes a little leeway with reality, however, One of course cannot expect miracles - however we continue to present

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alternative investments as if their future performance is simply a mirror of the past, that risk is minimal, and that despite the performance of other assets, alternatives (especially hedge funds) will continue to provide an absolute return across multiple market conditions. That this is done should surprise not one. In fact, by so doing we respond to the wishes of all investors, that the future is like the past and that moreover, even if it is not, if one invests in alternatives that one need not worry since we have the chance of doing well in all possible markets.

Still, investors are not that naïve. In order to indicate one's sincerity, one must also point out that the benefits of alternative investments do not come without risks. There have been occasions that various hedge fund managers have used the cloak of non-transparency to hide their actions. Still, these events are rare and with proper oversight may be reduced. We continue to present alternative investments as providing a high Sharpe ratio that existing traditional assets, some managers continue to use their historical return as a basis for forecasting their absolute or relative (to other managers) performance.

The reason for all this effort is the necessity to KISS. (Keep it Simple Stupid). From academic research, we know that the Sharpe ratio is a standalone measure of risk adjusted return and tells us little on how an asset fits into an existing portfolio and that at the very least; hedge funds with low correlation with the S&P 500 should not use the S&P 500 as a comparison benchmark. . We realize that hedge fund returns are strategy and therefore economic condition dependent such that the recent historical past may not reflect the near future. We understand that benefits of diversification to reduce both business (e.g., strategy risk) and style concentration are limited. We have seen that the relationship between managers' fees and performance remains an issue of controversy as does the use of mean/variance optimization for comparing assets that may, in many cases, be non-normal (at side point, most hedge fund strategies are normal over an investor's normal holding period. The reason some strategies look non-normal is that

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mixing returns over time in which the underlying returns comes from a mixture of normals with changing variance, leads to a strategy appearing non-normal).

In brief, investment in general and hedge funds in particular is complex in that for the average investor, the variability in returns seems due to unexplained factors. We are often asked to depend on the wizardry of the manager to protect us, but wizards are few and often, as in the Wizard of OZ, hide behind a curtain. Better that we come out in the open and confess that often we do not know the future, that certain strategies may or may not perform well depending on those economic conditions, and that depending on one’s current and expected economic profile, that certain alternative investments may fit while others should not be considered. Moreover, the monitoring, manager review and many of the actions involved in product management are complex. If it were simple one could hire a monkey and feed it bananas. At the same time, it is not so complex that an experienced professional cannot understand the sources of return and the potential benefits of including these assets in many investors’ portfolios.

Unfortunately, as in the movie, one is ordinarily paid to sell one’s product and to suggest that another product in another store may better fit the customer is not commonplace in the industry. Maybe that only does happen in the movies, however, while one may not be expected to sell someone else’s product for them, perhaps in the new year we can hope that investment professionals (traditional or alternative, private market or governmental) help to managed investors’ expectations in a manner consistent with their products expectations. During the current holiday seasons, one may do well to consider how correctly presenting the available products ended - the post office, loaded with Santa letters dispatches them to Kris Kringle and leading to the successful ending (the little girl gets the house and father of her dreams and Kris is made the official U.S. Santa). I do not expect the U.S. government to put

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their blessing on alternative investments or hedge funds in particular but I do believe that the real benefits of alternative investments are not in the wrapping but in the true attributes of the strategy.

So, if you have some time over the holiday, take a look at 'Miracle on 34th St.' Who knows Kris could now be working in the alternative investment management business. Have a happy holiday.

Looking forward to your comments.

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