Comment

Education, CISDM, CAIA and the Future of Alternative Investments

Thomas Schneeweis

January, 2003

November 2002 was 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 are to 1) enhance investment knowledge and promoting a high level of ethics and professionalism, 2) promote the CAIA designation among alternative investment professionals and academics, 3) encourage contact and communication among alternative investment professionals, and 4) establish 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) - Both AIMA and CISDM have been leading proponents of education in alternative investment management since 1990 and 1995, respectively.

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

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place in February of 2003. Level I and Level II exams will be given the last week of June 2003 and each six-month period thereafter. The exam proctoring centers are capable of offering individuals the opportunity of taking exams throughout a one-week period.

It is not the purpose of this month's director's comments to present the details of the certification 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 hard, for others not difficult enough. Over time, the program will develop. However, with the help of individuals within and outside the alternative investment industry, the program will continually 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's sees little discussion of private equity, commodity investment, commercial real estate, hedge funds or managed futures.

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This is the role that the CAIA hopes, in part, to fill. The CAIA is not a substitute for the CFA or other programs on traditional investments, derivatives, or risk management. The CAIA is a specialist program which offers basic background information and a means to certify individuals who have successfully indicated their efforts to master that material. One would hope and expect that a wide range of individuals with other professional degrees would see this program as an additional means to advance their education in the area of alternative investments.

There are of course a wide number 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

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created the CAIA to separate themselves further from potential conflicts of interest (for example, the CAIA does not offer 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 program's 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 moment (and these are Director's comments), as an educator, 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.

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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.

Looking forward to your comments.

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Comment

Swimming Lesson 101

Thomas Schneeweis

February, 2003

In a recent article posted on Reuters, a reporter lamented that hedge fund indices fail at providing what investors want to know most; that is, do hedge fund's make money? One must worry if the reporter should be writing on hedge funds if he/she knows so little about hedge funds they should not be in the "hedge fund pool" or at least not in the deep end. While the reporter may be correct in his or her assessment of investors' primary concern, hedge fund indices ARE NOT MEANT to provide investors with a simple one size fits all assessment.

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Investors must remember that not even stock indices give a clear indication if a particular stock made money. In fact, the correlation between even large firms such as IBM and the S&P 500 is well below .50. In short, stock indices do not tell you if an individual stock makes money. However, if one holds approximately 8-10 equity issues drawn from the sample of securities that make up an index, an investor is more likely to find that his portfolio at least moves directionally with the related index. As important, the index may tell investors in which market conditions can they expect their portfolio to go up and down. If in the past, the index in question loses value when GNP falls and unemployment rises it is likely that in the future their portfolio will lose value when GNP falls and unemployment rises,

Similarly, for hedge funds, various hedge fund indices are not intended to give an investor knowledge as to the directional movement of a particular fund. In fact, composite hedge fund indices that either equal weighted or asset weighted averages of all reporting hedge funds have little if any thing to offer for an investor interested in how a particular fund performs. And this is important, such a composite index SHOULD NOT offer information about a particular hedge fund strategy since a composite index is the combination of a wide number of differing strategies.

If an investor desires to know if and when an individual hedge fund is going to or is not going to make money, they must test that particular fund against a wide range of market conditions in which that fund should or should not make money. For instance, if a hedge fund manager is a distressed manager, one would expect that fund to reflect other distressed managers' returns and be sensitive to changes in credit spreads. If one's own manager's returns are not related to US credit spread changes then their portfolio may hold primarily foreign debt or hold a concentrated portfolio that does not reflect general economic conditions.

Moreover, if one holds a portfolio of distressed securities, then one would hope that one's portfolio would make money if a 'style pure' index of similar funds makes money. However, even in this case, if your portfolio loses 1 - 2% when the index makes 1-2% that does not mean the index is not similar to your portfolio. Differences between 2 or 3% within a month are relatively small. In short, hedge fund indices, like stock indices, differ. Some reflect certain strategies others reflect other strategies. And no composite index can provide you with evidence of the return of any particular fund or strategy.

Now why the above title of this month's Director's comments? After almost three years of providing articles on how indices differ and academic evidence indicating that various style pure hedge fund indices as stock indices make money when they should and lose money when they should, why must we continue to listen to reporters who continue to contend that hedge funds 'can make money all the time.' As for traditional stock markets, no one believes that hedge funds make money all the time and no one believes that composite hedge fund indices reflect the performance of a single hedge fund. Indices do have value, especially style pure portfolios of hedge funds that reflect the composition of style pure subindices. I hate to be hard but if one cannot see that 'Like moves with Like" but assets that are not alike do not have to move alike, then I can only remark. "If you cannot swim please stay out of the deep end of the pool."

Moreover, let me add one additional comment. Just because you cannot swim do not prevent others who can and wish to use hedge fund style pure indices just as they use style pure stock indices (e.g., sector indices or even growth or value indices) as part of their risk management or asset allocation process. There are many pools to swim in and there are shallow ends and deep ends. Choose the one that best fits your own abilities and move only after you have had the 'education or lessons' which enable you to move to the deep end.

Looking forward to your comments.

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Comment

A Few Rethinks or What Is in A Name?

Thomas Schneeweis

March, 2003

Recent worldwide events have brought into focus, that all of us must take time to rethink how and why we conduct either our personal or business affairs. It amazes me that whatever one's political philosophy that we expect our leaders never to change theirs. Likewise, we often view a change in one's position or view as a sign of weakness or indecision rather than simply a brilliant change in perspective. In short, we continue to storm the barricades simply because we have always stormed the barricades. The purpose of this month's commentary is to offer a few areas in which "Rethink" might be in order.

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1. Alternative Investments: Alternative investments (e.g., private equity, real estate, hedge funds, and commodities) were grouped under that term only in that they are often viewed as something investors consider after traditional stock and bond investments. Considered in this light they are viewed as an afterthought (Seven Up as the alternative to Coke or I could have had a V-8). Why not stocks and bonds as alternatives to real estate, structured hedge funds, … I understand that

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most traditional stocks and bonds form the basis for 'liquid' investments, however, alternatives maybe need another name (Additional 'but a little less liquid' Investments…). Perhaps stocks and bonds should be seen as low correlated investments relative to more traditional investments such as real estate, forwards, commodities, private firm ownership.

2. Absolute Return Investments: Many hedge funds are viewed as absolute return vehicles (managers search for positive returns in contrast to tracking an index even if they think the index will decline). Since research has shown that almost 50-60% of most hedge fund strategy returns are market related, it is obvious that as long as a manager follows a particular strategy, they are to some degree index (asset class) bound. Again, a name change is required. Perhaps something like Alpha investments since traditional stocks and bonds provide so little.

3. Hedge Funds: Of course, we know that hedge funds achieved their name primarily by taking short positions in an effort to offset market risk of long positions (case 1) or in certain cases as an active investment choice (case 2). Therein lies the problem. In many cases a hedge fund may hedge (case 1) but in other cases (case 2) it may be seen as a hedge but is in fact an active investment decision (the manager could be 100% short). Again, a name change may be required maybe Hedge fund Plus for some and Hedge fund minus for others or perhaps the "Almost Hedge Fund" or "the Hedge Fund that Could".

4. Managed Futures: Well, who would not want an investment to be managed as long as one is paying for it, but more importantly, in this investment area most managers use a wide variety of

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investment vehicles (options, currency forwards …). I realize that an attempt has been made to create Managed Funds as an alternative but aren't all funds managed. Again, no solution but the term commodity trading advisors doesn't even come close to what most of these folks do.

5. Hedge Fund Indices: There is something wrong in a man or a woman who doesn't like an index; solid, representative, and a beacon in a world of confusion. However, most of what is known is that what is sold as an index is just a portfolio of something, representing something. Now maybe that is an index, but why couldn't every fund of fund in the world call itself an index (a collection of something representing something), then one could create the Hedge Fund Index or if enough of them the Hedge Fund Index Index.

I, of course, have not exhausted the number of terms that require change if one really wants a term to represent what it is or what it does. But since change again is viewed as a sign of weakness, we must continue to struggle with terms that represent but do not explain. Till next time

Looking forward to your comments.

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Comment

Education – The Cost of Coming out of the Closet?

Thomas Schneeweis

April, 2003

As a research center which exists in the context of a public university, the economics of education is not only an academic discussion but a practical reality. Recent economic realities have forced states and well as private institutions and individuals to drastically reduce their support for public education. What is the cost of such a reversal in support? Academic research has shown that education is considered a prime factor in the ability of a nation to retain comparative or absolute advantages in product production. For financial market supremacy financial education likewise is required for the U.S. to retain financial market leadership.

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The question remains as to who is responsible for financially supporting the infrastructure necessary for financial education. At present, financial education for alternative investments comes in many forms; that is, 1) traditional public and private education, 2) professional associations, 3) private firms … One of the problems that exists in supporting such educational structures, is that in the case of public educational institutions, the result of such financial support is ‘general education’ which in many ways is a public good in which the firms providing such support cannot capture directly the “sole” benefits of such financial support.

Similar issues exist for professional associations, in which, while ‘support does provide direct benefits either to the industry as a whole and in unique cases to one’s own firm, much of the benefit goes to non-paying individuals. This free rider problem lies at the center of state or private support for ‘public good’ education. Other problems, of course, also are evident. The primary one is that the positions taken by academic research centers or professional associations may not fit with the positions taken by individual firms. Given the potential conflict between public and private views, many firms favor direct control over the educational product. This control minimizes potential conflicts between a firm’s message and its educational message. In addition, since education must be built on a foundation, direct firm educational services permit one to control the education delivery.

All of the above issues are well known. Knowledge does not necessarily lead to action. Private firms providing educational support are forced by the marketplace to provide what they believe consumers want to hear rather than what they should hear. Even public education provides sanitized versions of ‘academic truth’ (e.g., It is better to under educate rather than to confuse). What is the result of such a variety of educational forums? Certainly, there is a mix of information on various topics and how much conflicts there are between various reporting bodies (e.g., do hedge funds provide positive skewness). What is the solution? Certainly, the CAIA is one means by which a global certification process can be used to attempt to provide a basic ‘common’ body of knowledge. Even in this regard, much of what is provided may change over time as new markets evolve and markets change. In fact,

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education is about change, that is, revising as well as strengthening viewpoints. Education should not be about hiding behind doors but in opening them.

Are other solutions viable? It is obvious that the level of education differs among various individuals, business units as well as academic institutions. A wide range of conflicting arguments from various competing sources should not be viewed as a negative but as a positive. What is required, however, is a Foundation or Center at which such differing positions are reviewed and if considered important, consolidated, and reviewed. In the upcoming weeks our readers are going to be asked to support such a center; that is, the CAIA foundation, that will have as its primary basis, the collection and review of a wide range of academic and practitioner research and education cites and to monitor the degree to which they review industry questions in a similar or dissimilar light.

Who will pay for this and why? Again, given the low return for each firm, perhaps the large cost of such an operation will be better spread among a wider range of potential benefactors. But on a high level, alternative investments have remained in the closet long enough, now is the time to open up as to what we are, what we do, and why we do it. Despite some individuals' fears, the results will not shock anyone.

Looking forward to your comments.

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Comment

Who Do You Trust - Moral Order, Market Order, Government Order

Thomas Schneeweis

May, 2003

While one can put various spins on the SEC discussions, it was a wonderful back and forth on the relative worth of Government Order, Market Order, and Moral Order. The government expressed the common concern that somehow, someway, someplace, there was someone doing something to somebody. It was the government's duty to find those involved in this process and find ways to stop them. The respondents, a collection of practitioners, academics, and investors, attempted to respond in various ways to the charges. The practitioners, as expected, brought up the specter of a Market Order, in which the actual trading strategies and the traders themselves were forced by the very environment that they trade in to provide an honest product, back by honest people, providing an honest service to honest investors.

Within the past month, the SEC held a series of meetings which addressed the place of hedge funds in the investment landscape. The reason for these discussions was based primarily on the concern that hedge funds as an asset class were growing and that there was an increasing potential that hedge funds might be marketed to a more retail client base. While it is not the purpose of this series of comments to detail all of the issues raised in these discussions, the primary question can be summarized in "Who Do You Trust". While hedge funds have been marketed under various rubrics, several speakers at the SEC meetings pointed out that hedge funds no longer have a 'd' in them. In short, hedge funds may not hedge. In fact, hedge funds were discussed less as an alternative asset class than as an investment vehicle that was created to bypass several Government Statutes (e.g., Security Acts 33, 34, and Investment Act of 1940). In short, hedge funds were created, in part, to avoid government order. One can

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imagine therefore the concern of government regulators that there exists an economic entity which was created to bypass the very laws which they are ordained to enforce.

While one can put various spins on the SEC discussions, it was a wonderful back and forth on the relative worth of Government Order, Market Order, and Moral Order. The government expressed the common concern that somehow, someway, someplace, there was someone doing something to somebody. It was the government's duty to find those involved in this process and find ways to stop them. The respondents, a collection of practitioners, academics, and investors, attempted to respond in various ways to the charges. The practitioners, as expected, brought up the specter of a Market Order, in which the actual trading strategies and the traders themselves were forced by the very environment that they trade in to provide an honest product, back by honest people, providing an honest service to honest investors.

Market order meant, of course, different things to different participants in the process. Those who promoted government order were concerned that government order was required to ensure market order (e.g., systemic risk). Those concerned with market order expressed concerns that the very government regulation that would lead to a government-based system might in fact lessen the probability of market order. Restrictions on short sales, increased transparency, and forced liquidity might all reduce market stability under the guidance of promoting 'government order.' In fact, increased government oversight might result in hedge funds demise and the demise of liquidity in the very markets in which this government order is supposed to promote. If government supervision is a good thing, how much of a good thing can the market withstand? Practitioners pointed out that, as in most cases, when individuals are forced into goodness at an extreme cost, they have a tendency to run away or find a means to reduce that cost. If the government forces a moral order through government order, many hedge funds will simply move to those areas in which 'religion' is less costly or the sun is shining.

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Of course, any action by practitioners to waylay ‘government order’ was seen by the high priests of that religion as a direct attack on their order. Both parties sought refuge in the arms of the investor. Those invoking the market order pointed out that all investors deserve the right to make their own decisions and that the special privilege to invest in hedge funds should not be the right only of the wealthy. Those invoking government order responded that any religion (e.g., government order) has as its primary responsibility the requirement to protect its flock. In short, there is a higher authority than the market. In fact, religion of government order would not even be necessary if the participants in the market simply had some level of personal ‘moral order.’ Hedge funds, it was pointed out, had in the past participated in some fairly immoral acts including false pricing, false marketing, . . . In short, the government order was not about to give the keys to the cash box of small investors to the market order of hedge funds. Nor was the government order willing to bet on the moral order of the hedge fund provider.

Of course, the fundamental question remains that one man’s terrorist is the other man’s freedom fighter. For many investors, the freedom to invest in certain products is their right. The end of the story is still in debate. What continued is a fundamental lack of trust between the purveyors of the various levels of order. Where we are going is found in the most basic of religions texts – where else would one find order -. When faced with the dilemma of what to do when faced with a tricking moral dilemma, the government has chosen to follow the Wisdom of Solomon – that is simply cut the baby in half. If you have money to lose, we do not care and if you have no money to lose, we will not let gain any.

Rest assured that the discussions that have taken place are only the first of many. As the months go one, there will be many sermons in many churches. The scripts may change but the result is the same – take your pick – Government Order, Market Order, or Moral Order – Just chose your religion.

Looking forward to your comments.
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Comment

Alternative Investments – Back to the Basics

Thomas Schneeweis

June, 2003

At a recent research presentation on accounting information and security valuation, the speaker put a rather intimidating chart on the blackboard. He pointed out that from far away, the chart looked benign enough; that is, clean, straight forward … As one walks toward the chart, he pointed out that one sees that the line is not nearly as clean or consistent as from a distance; that is, spaces appear. He walked up and put his face within inches of the graph. "And from here" he pointed out, "This graph looks really ugly." The same could be said for hedge funds. Much of the recent discussion about hedge funds is due in part to how far one is away from hedge funds.

At a recent research presentation on accounting information and security valuation, the speaker put a rather intimidating chart on the blackboard. He pointed out that from far away, the chart looked benign enough; that is, clean, straight forward … As one walks toward the chart, he pointed out that one sees that the line is not nearly as clean or consistent as from a distance; that is, spaces appear. He walked up and put his face within inches of the graph. "And from here" he pointed out, "This graph looks really ugly." The same could be said for hedge funds. Much of the recent discussion about hedge funds is due in part to how far one is away from hedge funds. For academics, hedge funds are just another means of accessing existing return series. Hedge funds are not a separate asset class but perhaps a cleaner more efficient means of laying claim to a particular risk opportunity. Since the market in ideas, personnel, processes etc. is of course efficient, anyone could do it. While many hedge fund managers regard themselves as unique one of a kind skilled professional, many academics would argue that they could easily be replaced if one were willing simply to pay the requisite search costs. As a case in point, they often refer to the many

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academics who have recently joined the hedge fund family. At many academic meetings, they point out that they know ‘him/her.’ If they can do it, anyone can do it.

The hedge fund manager of course points out that from far away anything looks easy, however, up close – well as said before, up close things can get really ugly. In short, the search costs to finding, monitoring, accessing etc. hedge fund returns or firms willing to provide the return pattern are extensive, continuous, and variable. In short, what works at the ‘Macro’ may not work at the “Micro.” Richard Feynman of physics fame (remember the o-ring and the Challenger story) has pointed out that “things on a small scale behave nothing like things on a large scale.”

It is perhaps good to remember the above concern about large versus small on a number of levels, and not only the fact that academics ‘Macro’ gaze may hide the benefits of hedge fund managers ‘Micro’ view. A considerable amount of research has failed to distinguish between the large and the small. For instance, do large hedge funds perform like small hedge funds - the answer may be no. Large hedge funds do not have the same survival problem as small hedge funds. Large hedge funds often trade strategies differently than small hedge funds (greater number of contracts, larger block trades. etc.). Large funds have different administrative issues (prime brokers etc.).

The problem of small versus large exists at many levels. The attempt to find new emerging managers as if their current performance at one size equates with performance at a larger size is just one example of things on a small scale which do not necessarily behave the same at large scales. The SECs concerns may be true for small firms but are they the same at large firms. A friend at a nuclear power conference pointed out that the ‘large problem’ of nuclear disaster had less to do with the underlying process than the fact that small poorly funded plants have a number of $30,000 engineers who could not find a job elsewhere. Do small and large firms pay staff equally?

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There are few answers to the above issues. Does large scale risk management really work or should we really be concerned as to the micro - $30,000 – slave in the firm checking the computer daily? Well Mr. Feynman was right in more ways than we would like to admit– remember "things on a small scale behave nothing like things on a large scale." Have you weighed yourself lately?

Looking forward to your comments.

Tom Schneeweis

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Comment

"Pride must have a fall . . . . (Richard II, Act 5, sc. 5, 1.88.)

Thomas Schneeweis

July, 2003

Hedge funds are big. Hardly a month goes by without a new magazine, front page article, or seminar announcement. Even Germany (the last bastion of anti-derivatives usage) seems on the verge of opening up to hedge fund investment. If one follows one of the fundamental trading models of many hedge fund strategies; that is, sell after a run up then this might be an excellent time to get out of the hedge fund business. All of us in the industry had better read up on our Shakespeare. The Gods first raise a man up before they cast him down. Hubris is the one human frailty that constantly comes back to haunt us.

Hedge funds are big. Hardly a month goes by without a new magazine, front page article, or seminar announcement. Even Germany (the last bastion of anti derivatives usage) seems on the verge of opening up to hedge fund investment. If one follows one of the fundamental trading models of many hedge fund strategies; than is, sell after a run up then this might be an excellent time to get out of the hedge fund business. All of us in the industry had better read up on our Shakespeare. The Gods first raise a man up before they cast him down. Hubris is the one human frailty that constantly comes back to haunt us.

There are among us those who remember the glory days of managed futures and global macro, to be replaced by fixed income arbitrage and other market neutral strategies, only to fall to the new kid on the block, equity hedge and merger arbitrage, just in time for convertible arbitrage and distressed debt to make a comeback until just this month when increases in swap spreads sent those strategies tumbling. Now economic news indicates that the stock market may just be ready to climb, as well as interest rates,

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driving down the value of just those bond funds everyone just got into after the run up in bond prices this spring.

It is hard to imagine but Enron is now over two years old; LTCM is five years in the past. I wonder if all the new seminars being conducted not only in the United States but overseas have taken the time to rethink just how fragile, financial markets and how easily the mighty fall. Only recently, private equity was the king of the hill and now perhaps is ready for a comeback. Where does this leave, hedge funds?

At many conferences, the first chart to appear is the fantastic growth of hedge funds over the past decade. Today, over 6000 hedge funds exist with over $600 billion to $750 billion in assets. Investible daily indices are being created and traditional mutual fund operations are looking for ways to enter the market.

Is this a sign of Armageddon? Well the good news or the bad news? First, hedge funds have made a tremendous move forward to being accepted as a major asset class. It may soon become ‘de rigueur’ to have them in one’s portfolio. Zephyr and other ‘public’ asset management tools are looking to add hedge funds into their analysis packages. However, things may not be as rosy as we think. First, of the 6000 hedge funds over 1/4 are fund of funds (in essence double counting). Well 4500 is pretty large. Of the 4500 almost 1/3 is in a single strategy; that is, hedge equity. Down to 2000 and only 6 other strategies to go; that is, about 300 per strategy (market neutral, convertible arbitrage, fixed income arbitrage, event, merger arbitrage and distressed). If one leaves out those funds with less than $50 million under management, kill off all of duplicate onshore and offshore funds, refuse to invest in any of those with less than a year under management and one sees that the industry is pretty thin at the top.

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Perhaps this is good news, for in truth few of the markets in which we trade could handle the kind of influx of funds that many predict. In fact, the NYSE, one of the most liquid of markets, finds it difficult to trade many of its stocks with any real liquidity. What we have is a kind of Washington lie. I tell everyone how good everything is. I know I am lying; they know I am lying; I know that they know I am lying. But as long as everyone goes on with the lie, all is well. In fact, as long as every keeps their cool it may be possible for all of us to grow up, the markets included, such that we really need to have the maturity, transparency, liquidity necessary for the markets to fulfill what we have promised.

Well perhaps I am being too critical. Puffery is not even regarded as a crime. But sometimes I think, perhaps the God's are just getting ready for another laugh at our expense. Tragedy or Comedy, in some ways it all depends on how we take adversity. I hope we are ready for our next dose of reality when it arrives. In the meantime, perhaps we should take a little more serious look at some of the new regulatory attempts to bring some sanity back into how we trade, where we trade and who we trade with. Perhaps some Good Medicine might be better than wishing for good luck. Me? I am reading up on my English literature, for as Oscar Wilde wrote, "When the gods wish to punish us, they answer our prayers."

Looking forward to your comments.

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Comment

The Mouse That Roared

Thomas Schneeweis

August, 2003

Similarly, despite the traditional markets fear of the hedge fund power, recent research has indicated that hedge funds are less a separate asset class than they are alternative means of obtaining bond like or equity like returns albeit with an 'alpha' premium.

In a classic Peter Seller's film, a 1959 movie based on a novel by Leonard Wibberley, a small country uses a larger countries' fear as to the possible existence of that smaller countries nuclear bomb as a means to place itself at the center of global politics and change. The fear of hedge funds by larger financial institutions or government agencies has many of the same features. First of all, the small country's main export (in this case, wine) was being copied and taken over by the US wine producers. While traditional assets have not completely copied hedge funds, there is a growth in 'retail type hedge funds' products. Second, in order to save their country, the small country attacks the US primarily to fail and have the US take over their country and to reconstruct it. Similarly, some hedge funds have attempted to morph into mutual funds only to find that government and traditional market monitors have assailed them. In the end, the unthinkable happens, the small country stumbles upon a supposed advanced nuclear bomb (perhaps an unknown financial product). The U.S. surrenders even thought the small country bomb failed to perform as promised. Similarly, despite the traditional markets fear of the hedge fund power, recent research has indicated that hedge funds are less a separate asset class than they are alternative means of obtaining bond like or equity like returns albeit with an 'alpha' premium.

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One must remember how small hedge funds are in the scheme of things. It is even more surprising the fear that they have engendered among traditional investment advisors as well as government or market regulators. 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 levels of the mid 1990's. Unfortunately, it is difficult to believe that equity markets are the driving force behind recent market declines or a source of future economic disaster. The hedge fund industry manages only about 2% of the world's liquid assets, and less than 1% is dedicated to short selling. Hedge funds may have the ability to influence the prices of some securities, particularly those that have low volume. However, market crashes do not result from the abrupt decline in the price of a single stock. Rather, market crashes result from a highly correlated drop in the prices of an entire class of stocks.

While the ability to short stocks and the requirement to cover may have some technical impact on market price movement (e.g., prices rise on Friday and fall on Mondays), people forget that a number of investors are involved in such actions. One must also remember that hedge funds are a small part of the active trading industry. Proprietary trading desks (from which many hedge funds evolved), individual traders and the like are generally regarded as a larger part of the active trading market.

People also forget that hedge funds cover a wide range of strategies (relative value, convertible arbitrage, distressed, merger arbitrage etc.). While hedged 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 and use a variety of techniques (options, futures etc.) to hedge positions. In fact, a number of hedge fund players (e.g., market neutral arbitrageurs) act to counter any increase in price or decrease in price not based on fundamentals. Thus, hedge funds, in certain circumstances, are a primary player in bringing asset valuations back into line. It is also the case that mutual funds and other traditional asset managers

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who employ momentum strategies induce the same kinds of volatility that hedge funds are blamed for, as the momentum strategy involves selling stocks whose price is declining and buying stocks whose price is rising.

Even though hedge funds are not the feared aliens from outer space (as believed in the movie) nor holding a strange bomb capable of destroying the financial markets as we know them (also believed in the movie), many US investors regard them as such. At the end of the film, the moral is that the world might be better off if a number of small countries had the bomb rather than just the US. While one can take any story to their illogical extremes (as we often do in these directors' comments), one can wonder if the investment world would be better off if hedge funds too were in the hands of smaller investors. In the movie version, it seems a little strange that only wealthy countries have the right to produce wine, while other countries perfectly capable of managing the process do without. Similarly, it seems a little strange that only wealthy individuals can obtain the rights to hedge funds when the risk reduction benefits of hedge funds may be best suitable for less wealthy more risk adverse individuals.

Well, perhaps in the future, hedge funds and other alternative asset vehicles will have their own movie, now all we have to do is come up with a title, perhaps "The Attack of the Hedge Funds" wait for it to come out in video.

Looking forward to your comments.

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Comment

The SEC and How Hedge Funds Became an Asset Class

Thomas Schneeweis

September, 2003

The recent Staff Report to the United States Securities and Exchange Commission (September, 2003) offers an excellent summary of SEC staff concerns about the implications of hedge fund growth on various aspects of US financial markets. In brief, these concerns include the recent increase in hedge fund enforcement cases, the role that hedge funds play in our financial markets, and the inability of the Commission to obtain basic information about hedge funds. The over 100 pages of discussion explored a number of important hedge fund industry aspects. As pointed out in my Director's Comments, May 2003, the primary question can be summarized as "Who Do You Trust?"

In the first meetings of CISDM, someone asked if hedge funds were an asset class. One of our members pointed out that once the SEC jumps into the game, you know that you have become an asset class. "Moreover, if the industry grows," he said, "there will be so many views on the benefits and risks of alternative investments that whatever position your Center takes it will have its own supporters." In short, hedge funds are now an asset class, and it is good to know that whatever positions research takes at CISDM, some will support our results while others will criticize it. I am sure the SEC feels likewise about its recent efforts.

The recent Staff Report to the United States Securities and Exchange Commission (September, 2003) offers an excellent summary of SEC staff concerns about the implications of hedge fund growth on various aspects of US financial markets. In brief, these concerns include the recent increase in hedge fund enforcement cases, the role that hedge funds play in our financial markets, and the inability of the Commission to obtain basic information about hedge funds. The over 100 pages of discussion explored a

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number of important hedge fund industry aspects. As pointed out in my Director's Comments, May 2003, the primary question can be summarized as "Who Do You Trust?" In fact, hedge funds were discussed as an investment vehicle that was created to bypass several Government Statutes (e.g., Security Acts 33, 34, and Investment Act of 1940). Therefore, one can imagine the concern of government regulators over the existence of an economic entity created to bypass the very laws which they are ordained to enforce.

While one can put various spins on the SEC Hedge Fund Roundtable and the "Implications of the Growth of Hedge Funds Report," the issue remains the relative worth of Government Order, Market Order, and Moral Order. The government expressed the common concern that somehow, someway, someplace, someone was doing something to somebody and, more importantly, nobody knew what somebody was doing. It was the government's duty to find those involved in this process and find ways to stop them from committing direct fraud or indirect 'false practices.'

It is difficult to find fault with the SEC Staff Report's general goals. Who can be in favor of fraud or falsity? Who does not desire more information over less? Given their assumption that the SEC's actions will have little or no affect on the underlying market or its providers while improving the market for its investors, one may have a difficult time disagreeing with the suggested program. Of course, as often occurs when implementing a solution to a potential problem, the devil may be in the details.

In the upcoming months, CISDM and its academic and practitioner associates will provide their own answers to each of the SEC Staff Report's concerns. My principal concern with the document is not its call for governmental review or increased full strategy disclosure and up to date portfolio valuations. These should be the goal of any investment program. In fact, today various products are being created and offered which provide just such daily valuations and strategy consistency. Rather, my principal issues are as follows:

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1) Little evidence was offered of "The Implications of the Growth of Hedge Fund." Nowhere in the document was the 'Economic Rational' for hedge fund extensively discussed. There was a brief mention that the increased use of certain hedge funds strategies may result in increased capital formation, but very little discussion took place on the economic functions provided by various hedge fund strategies or the implications that new governmental rules would have on the growth of the industry and thereby on various parts of the economic landscape. If many hedge fund managers are providing liquidity to traditional sellers or buyers of assets, what are the implications behind restricting the market growth through increased regulation? What is the cost of insuring that no investor is ever defrauded and that only "fully educated" investors can ever invest in risky endeavors? In short, what is the responsibility of individuals to educate themselves as to the underlying risks of a particular investment? One can attempt to simply restrict small investors from risky investments, but by so doing one is simply ensuring that they never obtain high enough returns to achieve long term wealth.

2) While the SEC report emphasized education, it surprised me how often the document contained references to relatively outdated ideas.

A. Myth 1: Hedge funds have extensive risk.

   Risk measurement is an extensive topic. For instance, Sharpe ratios are still used in traditional and alternative investment comparisons although they only provide stand-alone comparisons and offer little information on the relative impact of an asset's risk on one's own portfolio. While it is impossible for a single report to right all wrongs, the SEC may wish to refrain from forwarding the time worn assertion that hedge funds have extensive market risk and get a better handle on the actual distributional stand-alone and portfolio risks of hedge funds. For instance, simple reliance on past historical performance does not indicate low or high risk. Even academics have come to understand that most hedge fund strategies are created to have low market risks. In fact, recent research has shown that funds that increase leverage within a strategy often trade in less volatile securities such that overall strategy risk does not change. While the lack of transparency may lead to greater firm or non-market risks, those risks (as in the traditional mutual fund area) can be reduced through diversification as well as the type of style transparency discussed in the SEC Report.

B. Myth 2: Hedge funds are 'absolute return vehicles' designed to make money in numerous market environments.

   This assumption does little to foster a better understanding of hedge funds or their benefits. The Staff Report briefly mentions that many hedge fund products offer access to more style consistent offerings and in certain cases these strategies are affected by market risks. However, academic research has shown that most hedge fund strategies are better understood by their consistency with traditional market factors. For example, convertible arbitrage may have credit

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and interest rate sensitivity, distressed debt has credit sensitivity, and merger arbitrage has equity sensitivity.

In short, what is unique about alternative assets is not in their pricing problems, their market sensitivity or even the markets they trade. What is unique is that by offering less concentrated portfolios with greater trading flexibility within a market, they do show evidence of increased market risk adjusted returns at the cost of potentially greater non-market firm risks.

The simple question is how to keep the first (alpha based performance) while reducing the second (firm and non-market investor risks) and permitting this dynamic 'experimental market' to constantly evolve. New financial products, new traders, new processes will arise and, by their very nature, will fly in the face of government attempts to place every investor, every investment and every trader into prescribed boxes that can be easily monitored and managed.

It has been pointed out that we always attempt to solve the problems we know about. The real issues are not the fact that we are jointly attempting to solve potential issues resulting from a changing industry and global marketplace, but that we fail to confront issues that may happen in the near future. Since the event has not exposed itself, no one has the interest or the incentive to address them. Those issues are best left future Director's Comments. However, as pointed out in an earlier issue, calling something a leg does not make it a leg. Calling hedge funds absolute return vehicles does not make them absolute return vehicles and calling them risky does not make them risky.

The problem remains how best to educate and enlighten investors in a marketplace where few are willing to pay for that education. While much that was presented in the Hedge Fund Roundtables and SEC Report is consistent with current academic thinking, it is surprising the level of misinformation expressed. Given the important of education discussed in the Report, perhaps the biggest implication of

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the growth of hedge funds is finding a better way to provide education on the market and personal risks of hedge fund growth. Evidence shows that not only does there remain a lot of information to be transmitted to the market, but there also exists a lot of misinformation yet to be corrected.

"Hedge Funds" - wait for it to come out in video.

Looking forward to your comments.

Tom Schneeweis

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Comment

Time Cop

Thomas Schneeweis

October, 2003

The discussion led me to believe that hedge funds, in fact all alternative investments, will remain a minor element of the investment universe until all of us over thirty simply die off and all those who have lived solely in a world of hedge funds (those about twenty to thirty) come to power. It is similar to the fall of Russia, China or any established state. The old revolutionaries have to be removed from the screen before new individuals not burdened with the past, who have lived their entire life in worlds of multiple asset products and multiple risk scenarios, come into power.

In a recent presentation to a number of alternative sales personnel, it was pointed out to me that alternative investments and hedge funds could not possibly compete with traditional assets. The individual suggested that traditional investments have a long history of returns, which gives investors the comfort of knowing that one could use the past to obtain an adequate forecast of the expected returns into the future. In contrast, hedge funds have only been around for ten years. How could one trust anything or anyone under ten years of age? While I understand the sentiment, I teach at a university where no one trusts anyone over the age of thirty.

The discussion led me to believe that hedge funds, in fact all alternative investments, will remain a minor element of the investment universe until all of us over thirty simply die off and all those who have lived solely in a world of hedge funds (those about twenty to thirty) come to power. It is similar to the fall of Russia, China or any established state. The old revolutionaries have to be removed from the screen before new individuals not burdened with the past, who have lived their entire life in worlds of multiple asset products and multiple risk scenarios, come into power. I wish that many of us today could go back and witness the birth of

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the financial products that we regard as normal but at inception were considered risky and disruptive to the financial environment. In the 1970s, the MSCI indices were simply the CIP indices. Few individuals invested internationally. In 1968 an academic article showed the potential diversification advantages to global investment. About fifteen years later, pension plans were just starting to invest outside the US. Fortunately for them, the latter part of the 1980's witnesses a falling US dollar and positive non-US returns. Today, failure to invest internationally is regarded as breaking the investment trust. Similarly, about twenty years ago, a major retirement program attempted to hire me to conduct research on the cost of too many investment products. They hoped my findings would show that increasing the number of investments from S&P linked investments and simple Lehman Aggregate investments into Russell 2000 and high grade and low-grade bonds would hurt the investment climate because investors could not cope with the diversity.

In today's marketplace we have found that the increasing number of alternatives has permitted investors to better meet their own personal investment needs. Today, investments that are regarded as primary parts of investors' portfolios were even twenty years ago regarded with great suspicion. The reasons for the lack of support for products now regarded as commonplace vary from simple ignorance to competitive fears. I suspect that twenty years from now, hedge funds, credit swaps etc. will be regarded as commonplace investments. Unfortunately, I will be attempting to skip rocks across the pool at the retirement home by then. If time travel is possible then, I only hope that someone will give me a ticket so I can go back and do the 'I told you so speech.' I suspect, however, that I will have a lot of competition.

Looking forward to your comments.

Tom Schneeweis

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Comment

One from Column A and One from Column B

Thomas Schneeweis

November, 2003

I suspect that one way of looking at the issue is to consider at a broad range of risk measures for hedge funds and to use that approach which best reflects one's own portfolio. The use of macro or market risk measures came out of a scenario in which we attempted to define a common risk model for all assets. We now know that a "one size fits all" return generation model is not yet available. Hedge funds are not absolute returns because one can find an asset with which they do not correlate. One should not use the S&P 500 just because it is easy to access. A broader perspective is required. Perhaps instead we should choose one from column A and one from column B.

Traditionally, hedge funds have been called absolute return assets. One reason for this classification is that hedge fund managers do not link their performance to any particular index. However, it is important to realize that failure to track a particular index does not mean that traders within a specific hedge fund style do not trade in similar markets that use similar strategies and have, in general, similar returns. In short, while hedge funds may not consciously track a particular index, an index can be created which offers insights as to their common return performance. Despite the fact that many hedge funds have more similarities than differences, most hedge fund managers refuse to report themselves as a part of any common set of managers. Instead, many hedge fund managers provide simple performance reports that offer data relative to S&P 500 or Lehman Aggregate Bond performance. I have often found this extremely confusing, given that hedge fund managers call themselves absolute returns, because, they assert, they have no relationship to the S&P 500. Additionally, confusing, they often trumpet the fact that they may outperform the S&P 500 in many market environments.

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I understand the use of the term absolute returns, as well as the second corollary that as the beta with the S&P is generally close to zero, a risk-free rate is an analogous return comparison. However, the ability to choose one's own benchmark does not make the choice an appropriate one. To begin with, it is difficult to understand the use of risk-free rates as a comparison return for assets that often have standard deviations in the range of 5% to 15%. Moreover, even if one uses the stock market as a performance base, why the S&P 500? Research has shown that the Russell 2000 has a higher correlation with most hedge fund strategies than the S&P 500. Some managers will point out that use of the Russell 2000 does not change a fund's average beta. The reason is simple: beta is the cross product of the correlation times the relative hedge fund/index correlation. Because the Russell 2000 standard deviation is greater than that of the S&P 500, when correlation with the Russell 2000 increases, the relative standard deviation goes down. In short, beta reflects relative sensitivity, but not risk. I suspect that one way of looking at the issue is to consider at a broad range of risk measures for hedge funds and to use that approach which best reflects one's own portfolio. The use of macro or market risk measures came out of a scenario in which we attempted to define a common risk model for all assets. We now know that a "one size fits all" return generation model is not yet available. Hedge funds are not absolute returns because one can find an asset with which they do not correlate. One should not use the S&P 500 just because it is easy to access. A broader perspective is required. Perhaps instead we should choose one from column A and one from column B.

Looking forward to your comments.

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Comment

New Areas of Hedge Fund Research – Market Microstructure

Thomas Schneeweis

December, 2003

During the past decade various hedge fund investments have been shown to offer investors additional means of increasing return or reducing risk through asset diversification. Research has also shown that the sources of the expected return for various equity or credit sensitive hedge fund strategies (e.g., hedged equity or distressed debt) may be similar to those in traditional asset classes such as stocks and bonds, while the returns to certain hedge fund strategies (e.g., market neutral, convertible hedge) often depend on different factors than traditional stocks and bonds (e.g., implied volatility).

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In recent years, additional questions have been raised on the impact of transparency and other microstructure impacts on hedge fund performance. In traditional markets, considerable research has been conducted on the impact of various market microstructure and firm microstructure impacts on price performance and fund operations. Given the extent of this literature, it is not possible in this short review

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to describe all of the issues as they relate to traditional stock and bond markets or to specialized trading markets. Much of this research also extends to markets and fund structure in which hedge funds participate. Hedge funds often trade in the same markets as traditional stock and bond managers. As important, various hedge fund strategies are designed to take advantage of market opportunities created by traditional stock and bond trading and as such, market and fund microstructure have direct impacts on hedge fund performance.

As pointed out previously, considerable research has been conducted on market and fund-based market microstructure impacts on asset and manager performance. It is not the purpose of these comments to review all of this research. The comments in this section are drawn from two sources (Madhaven [2000] and [Harris 2003]).

Madhavan summarized theoretical, empirical, and experimental academic research that has been conducted in the last two decades on market microstructure with a special focus on informational issues relating to: 1) Price formation and price discovery including issues such as determinants of trading costs, 2) Market structure and design including the relation between price formation and trading protocols, 3) Information and disclosure especially as it

relates to market transparency, and 4) The interrelationship between market microstructure and asset as well as corporate finance. The following highlights several of the conclusions Madhaven draws from current research in each of the above areas:

1. ***<u>Price Formation and Price Discovery</u>***: Considerable research exists on the role of dealers in price formation including identification of the factors that cause price movements such as inventory and asymmetric information. This research may also help explain intraday pricing patterns and short-term fluctuations in the market liquidity, which may be of special interest to hedge fund managers.

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2. ***Market Structure and Design***: No uniform view exists on what structures offer the greatest liquidity and least trading costs. Issues in market structure include issues of market type, order forms (e.g., market, basket), protocols (circuit breakers) and systems. For instance, electronic trading may provide reduced trading costs but increases the risk of illiquidity impacts. Moreover, research is still attempting to determine the impact of market structure on the speed of price discovery and thus return behavior. Research, however, has led to the following implications.

3. ***Information and Disclosure***: Market transparency is often defined as the ability of market participants to observe information about the trading process. Information can refer to knowledge about prices, volumes, and identities of traders. Generally, two classes of traders exist, that is, first, informed traders (liquidity based) and second market makers or liquidity providers who adjust prices based on net order imbalance. Pre-trade transparency refers to the information relative to current prices and trade information. Post-trade transparency refers to the public and timely information on past trades. Issues in transparency include post-trade transparency, pre-disclosure, dual-capacity trading (brokers and dealer), front running, upstairs and off-exchange trading etc. Research, however, has led to the conclusion that changes in transparency are likely to benefit one group of traders at the expense of the others. Traders who trade on private information prefer anonymous trading systems. While liquidity traders (e.g., index funds etc.) prefer greater disclosure. No single market structure is best for all parties.

4. ***Other Issues***: Market structure has an impact on other areas of finance including asset pricing and corporate finance, capacity trading (brokers and dealer), front-running, upstairs and off-exchange trading etc.

Of primary interest is that in alternative investment, past research has focused primarily on the market-based factors driving alternative investments. Less research has focused on the structural issues driving developments in the alternative investment markets. While academic research offers a number of theoretical and empirical approaches to determining the impact of market microstructure and fund structure on asset performance, their research is often not decipherable to the layman. Readers who are interested in a more 'practical' approach are directed to Harris [2003]. In future issues of Director's Comments, I plan to discuss many of the issues raised by Harris. It is important to note that Harris is both an academic and Chief Economist at the SEC. His insights as to the impact of market and fund structure on asset trading may have immediate effect on future developments in the hedge fund industry. As important, traders in the alternative investment markets must find a way to work directly with government

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regulators and academics alike (as well as other practitioners) to ensure that changes in market structure provide an improved marketplace for investors and traders alike.

Looking forward to your comments.

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He has more than forty years of experience in asset management including President of a firm (Schneeweis Partners) which specialized in 'bespoke' structured finance and Director of Research at Ursa Capital, LLC which managed an approximately $4 billion hedge fund managed account platform. He has been managing partner of a managed futures fund (White Bear Managed Futures Fund) as well as an equity long short hedge fund (White Bear Equity Long-Short Fund) and President of an approximately $1 billion commodity-based investment firm (Alternative Investment Analytics). For over thirty years, he also was on the Board of Trustees of the AMG Funds (a retail distribution arm of Affiliated Managers Group, Inc., a world's leading provider of boutique investment management expertise to institutional and individual investors).

He is also currently President of Quantitative Investment Technologies, LLC an investment management firm specializing in downside risk management and investment strategy replication programs (Email: thomas@quantinvesttech.com and website: www.quantinvesttech.com) and the founder of TRS Associates (Email: thomas@trs-assoc.com and Website: www.trs-assoc.com), a financial consulting firm. A collection of his other publications, comments and current writings can be found through his personal email: Trschneeweis@gmail.com or at his personal website: www.thomas@tschneeweis.com.

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