

Comment

**Complain (ca: 14th Century) - Compliance (ca: 15th and 16th Century) –
Complete (ca: 14th Century)**

Thomas Schneeweis

January, 2005

In short, by requiring increased compliance (as the result in part of increased public complaints) the SEC and other government bodies are simply following the spirit which encouraged the very development of the words ‘Complaint and Compliance.’ Moreover, one need but refer to the entomology of words such as Complain and Compliance to see the basis for increased oversight as well as the entomology of words such as ‘Bow’ to see how those affected by compliance may have to react to the new levels of government oversight.

In a world in which there many uncertainties facing alternative investments, and hedge funds in particular, increased government oversight and regulatory compliance is not one of them. In short, increased government compliance is an increasing fact of life. In fact, it is often difficult to find new ground to cover in this area. Certainly the tradeoffs between government order, market order and moral order have been addressed in many other venues. Numerous articles, books, and dissertations have addressed the basis for government regulations over a particular line of business as well as the secondary and tertiary impacts from such decisions. It is now well known that many of the government regulations of the early 1900’s were due not only to the public’s zeal for controls on business actions but also to the desire by large firms to increase the cost of doing business and to eliminate small firms from competing with them. It should be of no surprise that third world nations often see the Kyoto Accords not as an environmental issue but as an attempt by wealthy nations to deprive them of the ability to become wealthy.

In short, by requiring increased compliance (as the result in part of increased public complaints) the SEC and other government bodies are simply following the spirit which encouraged the very development of the words ‘Complaint and Compliance.’ Moreover, one need but refer to the entomology of words such as Complain and Compliance to see the basis for increased oversight as well as the entomology of words such as ‘Bow’ to see how those affected by compliance may have to react to the new levels of government oversight.

Of course, the source of the required compliance is the complaints of various individuals or bodies. The word Complain is cited as coming to common usage in the 14th and 15th centuries. This may have been encouraged by the rise of the nation state and governmental authorities who depended on servicing the will of the ‘complaining’ public enacted government edicts which attempt to solve the ‘current problem.’ Therefore, it should, of course, come of no surprise that soon after a definition of Complain comes into common usage (e.g., 14th and 15th century) that the development of the word ‘Compliance’ soon follows. Compliance came into common usage in the early 17th century (circa 1630). Compliance is first defined as a) the act or process of complying to a desire, demand, proposal, or regimen or to coercion, b) conformity in fulfilling official requirements; 2) a disposition to yield to others; 3) the ability to yield elastically when a force is applied: flexibility.

To those familiar with English history and Oliver Cromwellⁱ the development of the word Compliance in the mid sixteen hundreds as both an act requiring conformity and the ability to yield to it should be of no surprise. It is also of no surprise that words following Compliance in the dictionary are words such as Complicate, Complicated, and even father on Complicity. One word naturally seems to follow the other.

New compliance regulations are really a demand to conform to an official requirement. For some those actions increase the complexity of doing business to such an extent that the very cost of meeting

such requirements may not enable a firm to be competitive and thus drive that individuals or firm to act in a complicitous manner. They may also cause individuals to simply attempt to evade the regulations. One may wish to consider the impact of regulation and its potential impact on how individuals may react to the fear of new regulations. Fear over government regulation led in part to the Puritans of the early 1600's leaving Europe for the Colonies (note this was before Cromwell and before 'regulation' was on the 'Puritan' side).

Is there a solution? I would recommend that the reader simply concentrate on the last definition of Compliance; that is, the ability to yield elastically when a force is applied. Remember it is better to look good than to feel good or as pointed out in any number of common phrases (Better to run away and live to play than....). In short, most investment managers will find a way to 'Comply' with the inevitable even if it means a restructuring of the typical 'hedge fund organization and product delivery structure.' Others of course, as the Puritans, may simply wish to run to a different venue (Plymouth Rock) where regulation is less capable of enforcement.

For those who wish to stay and live with the new regulations, it should be again of no surprise that the word Complete came into common acceptance in the years in which Complain and Compliance also came into common usage. 'Soon after the rise of compliance it was necessary for many to Complain (13th and 14th century). Unfortunately, if one complains one also often has to 'Bow' to the edicts. Bow (ca 1656) came to mean a bending of the head or body in respect, submission, a show of respect or submission. (The word Bow in this meaning of course came from the curve in a bow). Note the words complaisance (a disposition to comply) came to common usage in 1651 (Back to Cromwell).

So, blame it all on the rise of the nation state (or Charles I and Oliver Cromwell) responding to societal Complaints (ca. 14th) and the power to order Compliance (ca 1630) leading to citizens to Complain and often requiring them to Bow (ca 1656). Both sides (government and industry) should be

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warned when one is bowing neither side knows if the other side is smiling or sneering. Similarly one should remember that while bowing may be a means to show submission it is also opening one's head to be removed (Remember Charles I and Cromwell again). Better to be flexible. By the way flexibility is also circa 15th century. It is defined as compliant, capable of the ability to adapt to new, different, and changing requirements. It should surprise no one.

I look forward to your comments.

Thomas Schneeweis

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Comment

Wednesday Night's TV Lineup

Thomas Schneeweis

February, 2005

8:00 – Investments: The Real Survivor Story; 9:00 Apprentice III; Wall Street; 10:00 Celebrity Investment: The Game Show

It does not surprise me that individuals in most parts of our life are required to show some evidence of ability before being permitted to conduct a particular action. Mind you I said most parts of life. If one wishes to drive one is required to get a driver's permit. One is required to show evidence that one has taken courses which enable one to drive and then one has to show that one can drive. As important, if one drives poorly the right to drive can be taken away. Similarly, in other aspects of one's life, one must show the requisite knowledge, the confirmation that one can apply that knowledge, and the fact that indications of one's inability to continue to act accordingly one can lose the right to apply the knowledge.

Mind you in most parts of life. In many aspects of life there is no requirement to show how one has attained knowledge, no requirement that one's level of knowledge cannot be used to act, nor upon evidence of their failure to act professionally that they lose that right. Perhaps a crude but pointed example is having children. There is no required set of courses by which one is required to learn how to produce children, nor once children are obtained, a set of rules by which we are required to return them except under the most egregious actions. Similarly, one is not required to show that one knows how to

choose food that is good for you, or even if one does, if one chooses badly how one's actions are corrected. Similarly, for individuals there is seemingly little oversight as to how one supposedly Knows Investment Theory, how one applies it, how one's acts, or how one loses that right.

Certainly, individuals have the right to act in ways which hurt themselves, the question do they have the right to act in a way which hurts others. Often, we have rules which attempt to constrain individuals from actions which have wider societal impacts. We ask that individuals wear seat belts, not necessarily because we care about them, but that the cost of having them on a ventilator for the next 20 years impacts us.

In the case of alternative investments or investments in general what controls should be placed on individuals? For many we have already tried to limit the impact of bad choices by not permitting them to make good or bad choices (Government guaranteed bank accounts ... are examples). Of course, by limiting their bad choices we also limit their good choices ensuring that they neither win nor lose). Of course, if they earn less than inflation and end up with insufficient capital to support themselves some of us do loose (see current social security issue as basically a debate as to who pays for ensuring that many individuals have to choose to win or to lose).

This is a long way to getting back to the issue of investing. I am only asking that if one is to make a fool of oneself then the place to do it is on national television. In order to educate one needs a new survivor story or apprentice game based on investments. The truth is that most individuals don't Know Investments, Never Knew Investments and are completely unfamiliar with New Investments. Ask the average individual these questions:

- 1) Bond Theory: What happens to a bond's value when rates rise 20 Is it the same for long term bonds or short-term bonds, 3) is it the same for government bonds and mortgage-backed bonds.

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- 2) Stock Market Theory: 1) If corporate earning risk will stock markets rise, 2) what if interest rates rise, 3) what if earning rise less than expected ...
- 3) Hedge funds: 1) what is a hedge fund? 2) If a hedge fund has long equity exposure does it make money when stock markets fall?
- 4) Risk: 1) What is risk and 2) how would you define it?

I could go on but I would overstay my welcome. I question is this, rather than putting all the blame on those selling products, perhaps some of the requirements are on those who buy them. If you can show some evidence of knowledge, pass tests that indicate that knowledge, and have shown some evidence of the ability to apply that knowledge in a fashion that has not hurt others; feel free to continue if not go back to stock and bonds investment theory 1.

Perhaps we need a good board game, a poker table, a bunch of investors competing against one another on a game show. A series of Investment Apprentices with myself as the moderator. You could imagine the suspense, the drama as the loser is kicked out into Wall Street without a suit or a Blackberry.

Remember I am free Wednesday nights; 1) “Investments – It’s all about the Money: The True Survivor Show”. Followed by Investments: The Apprentices (I again consider myself as the host of an Apprentice show since Martha has other opportunities all locked up – sorry for the choice of words). Lastly, I must be good at board games since my wife says I encourage Boredom. As an academic I am skilled at giving out A’s and F’s. “Your fired” I can see myself there already.

Looking forward to your comments.

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Comment

Overseas Investment and Who Do You Trust

Thomas Schneeweis

March, 2005

This understanding, however, does not hide from me the knowledge that investment opportunities outside the U.S. exist in an entirely different world, a world where most of us have never visited and could never really appreciate. When one individual asked me why I didn't invest in a particular nation I said 'quite seriously' that simply did not have the money to bribe successfully.

With the passing of Johnny Carson, I had time to recall his first job in television. His first program was entitled Who Do You Trust. While it did not refer to investments, I realize that it could have just as simply referred to the increasing number of emails alerting me to new investment opportunities in India, China, Nigeria, Brazil. Herein lays the problem. I remember enough from my investment theory course the return is a function of risk. I know that as markets gain in informational efficiency, market liquidity, ... that the risk premium declines and that real 'excess' returns relative to returns in the U.S. are to be obtained outside the U.S.

This understanding, however, does not hide from me the knowledge that investment opportunities outside the U.S. exist in an entirely different world, a world where most of us have never visited and could never really appreciate. When one individual asked me why I didn't invest into a particular nation I said 'quite seriously' that simply did not have the money to bribe successfully. He was taken aback. He replied that he had just received sound audit financial. When I pointed out that there were only three bookkeepers per 50 firms in the country and that you could take all the paper coming out of that country

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and its value as toilet paper was greater than its value as investment tool, you could see the look of disbelief on his face.

It could not be so. These are modern nations. Certainly, they have qualified accountants, financial officers, and government regulatory bodies all well paid in the service of the investor. When I picked myself off of the floor and when the laughter subsided, I pointed out one country in which they government would not regard bribery as a crime because they did not have any other way of paying policemen. In a country which attempted to open up financial markets by requiring no person to own more than 25% of a firm, individuals simply lent the money to a relative and then had the relative but the differential. In a country which had elected to have suitable ‘outside directors’ and which was so deemed by the US press as an example of corporate democracy the basis for the directorship model was simply a way to pay off friends and relatives.

Here is the offset. I am not necessarily against such actions. I am only against individual believing that what is ‘natural’ in one’s own country reflects actions in another. In teaching ‘International Finance’ in the U.S., I am not permitted to explain the real financial activities in foreign countries for fear of ‘political correctness’ (how dare I indicate that many countries act in ways inferior to the US, don’t I realize that it is simply a cultural difference). But in truth I have no problem in a country having no comparable regulatory, reporting, ... basis relative to the U.S.

If they did, the returns would be lower. I also realize the firms which have spent considerable resources, by which they ferret out good investments from bad. They deserve a return on their investment. Some of them may in fact be hedge funds, for whom informational inefficiencies and ability to work in ‘regulatory ambiguous’ areas is an area of their expertise.

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One could of course attempt to stop all investment into all countries which fail to meet our current level of transparency and regulatory control. Such action is of course the ultimate in U.S. global control. In reading the Newspaper today, the title of an article interested me “America You Got It – We Want it.” One can point out that by requiring the same level of oversight as in the U.S., one is ensuring that that the country would or could never create an environment where such ‘infrastructure’ development would be created.

I have come to accept the ambiguity in it all. I realize that when I invest in the U.S., we have created an environment where know one knows more than anyone else. The Ultimate democracy, we are all equally entitled to equal lack of access. (Mind you some do have greater access (e.g., Goldman Sachs...) but after they pay all their employees, computer costs ... and charge you the required cost of servicing those costs, your return from using their services is about the same as if you bought the index fund). I also realize that in many other countries, individuals who have spent considerable money gaining access expect to be paid for it. They simply do not see the conflict. As a recent Chinese official stated in regard to Chinese Piracy: “you are making good money – why don’t you want to share it with those poorer than you”.

We have a long way to go. It is an interesting path of globalization in nonfinancial and financial markets. But remember, as Dorothy indicated in the Wizard of Oz, when investing overseas one is not in Kansas anymore.

Looking forward to your comments.

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Comment

Efficiency in Markets and Ideas: Gross or Net

Thomas Schneeweis

April, 2005

The common differential descriptor of an academic and a practitioner is the story of the two walking on the street and both seeing a one hundred dollar bill on the sidewalk, the academic steps over it and the practitioner picks it up. When asked why he stepped over it, the academic replied that in a ‘costless’ efficient market it would have been gone by the time he bent over to pick it up.

The common differential descriptor of an academic and a practitioner is the story of the two walking on the street and both seeing a one hundred dollar bill on the sidewalk, the academic steps over it and the practitioner picks it up. When asked why he stepped over it, the academic replied that in a ‘costless’ efficient market it would have been gone by the time he bent over to pick it up.

For the practitioner, the academic is never addressing questions of interest to them but concentrating on complex unanswerable issues. The academic replies that it is a waste of time to work on simple problems since if the problem is simple (and therefore relatively costless), the problem would have already been answered.

Therein lies the common conflict between the two areas. To an academic, the problem lies not in efficiency in markets but in efficiency in ideas. Moreover, that is their market; that is, the market in ideas. For academics to be successful, they must show an alpha (superior excess return to their competing academics) in the idea market. This is not as easy as it seems to the practitioner. As an academic I am constantly amazed at the efficiency in ideas; that is, if I am thinking of it someone else has already think it. This seems reasonable. There are a lot of bright, non money-based utility driven nuts out there who

have nothing better to do but think of solutions to crazy academic problems. Moreover, the state even supports these individuals in a way which makes the cost of the problem-solving process relatively cheap (an academic's salary is really an option on his idea creation ability – which today may even have some monetary reward to the university but that is left for a future monthly letter).

The result is that it should surprise no one that academics believe in efficiency of markets (something they know very little about) but realize the possible openings that exist in the efficiency in idea market they compete in. In contrast, practitioners believe in the efficiency in ideas (CAPM ...) which have little impact on their life, but have little belief in the efficiency in real markets (where their salary is an option on their alpha idea output).

Who is right? Well the answer is both. That is, market or idea efficiency does not mean that new ideas or new products are not created or that we all cannot make a living at it. In short, one may expect 'net efficiency' but not 'gross efficiency;' that is, the academic and practitioner market is fairly good at paying people the price of their option. Once the costs of that option or the cost of implementing the idea are considered it is difficult for someone else to produce the product or the idea more efficiently.

Efficiency thus is a relative concept. Large investment firms have more resources than I. They should have higher gross returns but after costs an investor in their products may not make more than I (I charge considerably less). Similarly, in the business world, when managers leave little happens to the value of their firm since the labor market is efficient (other good managers exist). Likewise, I have yet to see the world tremble when an academic leaves one school for another (the school simply purchases a replacement).

In short, it is not that efficiency does or does not exist. It just exists at different levels in different markets. What for the practitioner market? A short story may suffice. A friend of mine who trades on the CBOT told me that all academics are crazy in saying that the futures market is efficient. Look at the

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money I make (\$1,000,000 per year gross). I asked him the cost of his seat and its expected return elsewhere (\$250,000), I asked the cost of his office, secretary ... (\$250,000), I asked the number of hours he worked (80 hours) and said he had to divide his income by 2 to get to a normal week (\$500,000 left considering investment return and office costs/ $2 = \$250,000$). I asked him about his academic credentials (MBA Chicago) and job opportunities elsewhere (about \$250,000). Result zero net excess return.

Market efficiency (gross or net) – The answer to the practitioner picking up the \$100. Well in time he will throw his back out medical costs, time out of work – It is only a matter of time - the market is efficient.

Looking forward to your comments.

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Comment

The Risk of Risk Management

Thomas Schneeweis

May, 2005

What You See From Here You Don't See From There

At a recent dinner symposium hosted by CISDM/CAIA/AIMA two widely respected individuals from the practitioner and academic sides of the hedge fund world offered their own unique views of hedge fund risk management. Risk management in hedge funds remains a primary topic of such gatherings. I suspect since hedge fund returns are so difficult to quantify or to forecast, individuals hope that there must be some way to handle the risk part of the return/risk part of the equation.

It was an enjoyable evening, not only for the chance to meet old friends, but also since both individuals brought a well thought out approach, although from different perspectives, to the overall subject. And here is the best part, I disagreed with both of them (but only in part I have to admit). The practitioner side pointed out that we simply do not have the quality of data required to provide the ongoing dynamic analysis required for a quantitative driven approach to risk management regardless of the sophistication of our statistical analysis. The academic side accepted the quality of the data but showed that our quantitative or theoretical models are generally not sufficient to capture the underlying dynamics in monitoring these portfolios.

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In the thirty minutes, the two speakers had explained the problem of risk management is the risk part; that is, that there is a lot of 'RISK' in risk management. Different individuals put different spin on it, but one reason for the popularity of books, seminars, meetings, firms. all dedicated to risk management is that there is simply no simple answer to the problem.

The reason for the differing views is that "What You See From Here You Don't See From There." For those individuals involved in the day to day analysis of hedge fund portfolios, data is the problem (since the quantitative models are generally purchased from an outside vender the models are assumed correct). For individuals involved in the day to day analysis of quantitative approaches, it's the models that are the problem (since the data is generally purchased from an outside vender the data are assumed correct).

Given the shortcomings throughout the risk management system are there any solutions? Both individuals pointed out that knowledge of the underlying shortcomings provides a basis, at least, for individuals not to become complacent. Anxiety in a risk manager is a good thing. However, for most investors, anxiety is a bad thing. They want to believe and we therefore have to pretend that we believe that we really do control the plane. It is just that (as an ex-pilot) I never really cared what happened behind me or where I was at present, what mattered most was where I was going (assuming that the plane was mechanically sound).

I believe that experience led me to see risk management as somewhat different from either speaker. Risk management (Part I) is to me is making sure the plane is sound. To some degree informational tools can be used to capture somewhat the current 'soundness' of a firm or a portfolio. Risk management (Part II) is to make sure that I do not take the plane to places it is not supposed to go (again informational based decision rules may help here). Risk management (Part III) is the rough one, that is,

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determining how a fund or portfolio will act in a turbulent storm not of your making, for which you have no idea when or where it will come and for which you have never been prepared.

For this Part III of risk management, the speakers came to a common conclusion. The real solution to ultimate risk management is to hope you have a great, (I repeat), a great risk manager (e.g., pilot) who has a feel for the problem and will get you on the ground or who has a feel for how to evade upcoming storms.

Do I think that approach is really a solution? . I question the existence of the great pilot (I would be happy to have a good one – Note I gave up flying because I was not either great or good). The problem with depending on ‘great/good risk manager’ is that the reality of the issue is that government bodies, firms, and investors want to see a ‘Manual’ for risk management not a ‘Mr. Manual.’ I presume the conclusion to all of this is that there is plenty of room for additional dinner conversations on the subject. Next time at dinner, however, try to sit in a new section where you might see the discussions differently.

Looking forward to your comments.

Tom Schneeweis

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Comment

Absolute Returns Revisited – Absolutely

Thomas Schneeweis

June, 2005

Whenever a student of mine answers a question in the affirmative as, “I am absolutely sure,” or “Don’t worry about it, I have it absolutely covered,” I know I am absolutely in trouble. Alternative investments, and hedge funds in particular, are often described as ‘Absolute Return Vehicles’. For any academic this should immediately raise concern. Finance professors have been raised on the mother’s milk of expected returns based on an asset’s marginal contribution to the risk of a portfolio; that is, relative risk. In short, absolute returns, absolutely not.

Whenever a student of mine answers a question in the affirmative as, “I am absolutely sure,” or “Don’t worry about it, I have it absolutely covered,” I know I am absolutely in trouble. Alternative investments, and hedge funds in particular, are often described as ‘Absolute Return Vehicles’. For any academic this should immediately raise concern. Finance professors have been raised on the mother’s milk of expected returns based on an asset’s marginal contribution to the risk of a portfolio; that is, relative risk. In short, absolute returns, absolutely not.

This is not to say that academics have come up with a suitable answer as to what is the proper measure of an asset’s relative risk return tradeoff. The CAPM is now almost 50 years since its inception (early 1960’s) and almost over 40 years (early 1970’s) since it is commonly known that one can never test the CAPM (no one knows the true market portfolio). Since that time, academics have made a profession out of coming up with new and then newer and now newest theoretical and empirical solution. The result

– today we still do not have an answer. For academics, this is not a problem because uncertainty, especially theoretical uncertainty, is what academics are all about.

However, for practitioners, and even more importantly their customers (read investors), there is one absolute and that is that uncertainty is ‘absolutely’ not acceptable. Therefore, hedge funds have been marketed as to produce absolute returns; that is, positive returns in a wide range of market conditions since a hedge fund portfolio may have a zero beta (See CAPM) and therefore should produce an expected return equal to the risk-free rate plus additional return due to manager skill. The fact that the simple beta model hides a number of risks that hedge funds have and must be compensated for in terms of return and that we do not have a certain model for hedge fund return is often not discussed.

Simply put, the fact that the CAPM has been dead for 40 years has not seemingly deferred individuals from that an investment with zero beta results in one using “a Libor Plus Something” as a benchmark for hedge fund returns, where the something is based on the ‘alpha’ return in a particular strategy. In short, for strategies that may have little alpha (e.g., market neutral or fixed income arbitrage) absolute return is Libor plus 300 basis points. For event strategies it is Libor plus 400 basis points. For equity long short it is Libor plus 600 basis points.

This is not to say that other approaches have not been suggested. Some compare hedge fund returns to returns in other markets (e.g., S&P 500). The basis for this comparison is that hedge funds are often regarded as a replacement asset for the S&P 500 (from the “if can’t beat it, why do I want it theory”). Other individuals suggest the use of a Sharpe ratio adjustment (in short the higher the variance the higher the return with all assets having the same assumed Sharpe ratio). Of course, some point out that using variance to capture risk for hedge funds which by their very nature are supposed to have asymmetrical returns (limit downside and offer upside dynamically) is ‘absolutely’ not correct. (For

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articles on the use of variance in hedge fund risk estimation see a host of articles on www.cisdmm.org).

Similar concerns to the Sharpe ratio been raised on the use of the beta based Treynor Ratio (hedge funds should all have a beta of zero so why use it).

In brief, at this point I am absolutely sure that there are no absolutes in how to measure absolute returns. When facing this level of uncertainty, I have been told to go back to what I learned in kindergarten; that is, if it looks like, act like, feels like, talks like it most likely is (but not absolutely). The same is true for hedge funds. The required returns on hedge funds should be similar to investing in other investment vehicles with similar risk and return characteristics.

Of course, the hedge fund managers answer is that we use “Libor plus Something” since there simply are no comparable products to hedge funds. I disagree with that (see CISDM research on passive index and factor replication) but OK, but in that case, simply look in the mirror. A benchmark return may simply be the return of similar managers in similar strategies. While this approach may not offer you an estimate of a manager’s true alpha (return in excess of a manager free replacement strategy) it will offer you an expected return which is relative to other managers. Of course, this leads us back to our starting point of how to determine the expected return of the strategy. Circular reasoning – ABSOLUTELY.

Looking forward to your comments.

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Comment

The Little Red Book

Thomas Schneeweis

July, 2005

Why a little red book? As a colleague student in the 1960's, the Little Red Book referred to a collection of quotations from Mao Zedong which summarized his teachings. A little later, in my first job as a bond analyst, the little red book (or was it blue – I forget) referred to a book by Homer and Leibowitz called 'Inside the Yield Book' (since then they have changed the color) and offered (pre computer) all possible combinations of yield, price, and maturity. Later on in life, the Little Red Book referred to the pieces of 'golf wisdom' provided by *Harvey Penick's Little Red Book: Lessons and Teachings From a Lifetime in Golf*. In between these readings were a number of additional 'Little Red Books' each of which offering in brief measure the source of the author's experiences. (e.g., *The Little Red Book of Selling:*). I am increasingly concerned that Little Red Books or Books of any color will be replaced by short commentary, reports etc..... I believe the world will be worse for it.

All of us know the importance of color. For all of us, an object's color has many impacts. For many it's green as in one's Green Card – NOTE the Green Card is in fact Yellow but that is a different story for a different time. For me it is red that has all the implications. Whenever I pick up a new piece of electronics, a new computer, a new whatever, I hope that somewhere in the package will be a straightforward pamphlet which will offer me simple clues on how to operate the enclosed and to become a professional in a matter of minutes. In short, a simple little red book which offers the inherent wisdom of the ages.

Why a little red book? As a colleague student in the 1960's, the Little Red Book referred to a collection of quotations from Mao Zedong which summarized his teachings. A little latter, in my first job

as a bond analyst, the little red book (or was it blue – I forget) referred to a book by Homer and Leibowitz called ‘Inside the Yield Book’ (since then they have changed the color) and offered (pre computer) all possible combinations of yield, price, and maturity. Later on in life, the Little Red Book referred to the pieces of ‘golf wisdom’ provided by Harvey Penick's Little Red Book: Lessons and Teachings From a Lifetime in Golf. In between these readings were a number of additional ‘Little Red Books’ each of which offering in brief measure the source of the author’s experiences. (e.g., The Little Red Book of Selling: ..)

I am also told that such books exist in other areas, however, the only alternative investment book with a red cover that I have found is ‘The Handbook of Alternative Investment Strategies’ edited by Schneeweis and Pescatore. This book is a list of readings of other individuals’ ideas than the experiences of the authors themselves. In short, I have not yet found a true ‘Little Red Book of Alternative Investments.’ That is not to say that I haven’t found many ‘Lessons and Teachings from a Lifetime in Alternative Investments’. It seems at times that everyone in the world has had the time (or at least the time between jobs) to offer individuals their personal experiences (e.g., Lessons from the Genius...). Despite these efforts, (or because of them – alternative investment returns have not offered the level of returns expected by many investors.

There are of course recent efforts by various individuals and groups to offer information on the best approach to managing hedge funds. These include:

MFA’s 2005 Sound practices for Hedge Fund Managers

AIMA Guide to Sound Practices for Asian Hedge Fund Managers (Dec 2004)

AIMA Guide to Sound Practices for Hedge Fund Administrators (Sep 2004)

Summary of Existing Documentation on Best Practices for Hedge Funds, Mark A. Pearl (Greenwich Roundtable) available on [www. CISDM.org](http://www.CISDM.org),

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I wish to note a small difference in some of the above titles. Several of them use sound practices while the other cites 'Best Practices.' For the purposes of these comments, I only wish to note that each report is between 50 and 150 pages of single space recommendations as to what one should do, could do, or would do if one wanted to meet a list of assumed industry standards.

Here is the rub, as in golf, politics, or sales there are numerous professionals each offering their own unique approach to excellence. Moreover, while one can read each of the above, one must at some time go out and practice. What works for one alternative manager may not work for another. That being said, there are historical guidelines as to the ways to hold a club, greet a client, or run an empire. I would suggest that each of the above listing of 'How Hedge Funds Should Run Their Business' would be helpful to any industry professional or investor, however, the very nuances of asset management cannot be found in such publications.

For the nuances without the specifics, one must return to books which attempt to offer experiences as a guide. These include books such as:

Fundamentals of Hedge Fund Investing: A Professional Investor's Guide by William J. Crerend and Robert A. Jaeger but it's green. There is Hedge Fund Risk Fundamentals by Richard Horowitz but it is blue.

Now if I could only find that Little Red Book.

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Comment

The Other New Orleans's Disaster: Common Sources of Expected Tragedies

Thomas Schneeweis

August, 2005

Similarly in the case of the Bayou Disaster, the lack of hedge fund oversight at the state or regional level is affected as the lack of resources to oversee the potential problems (e.g. money), changing characteristics of the hedge fund industry (consultants and marketing specialists as primary sources of investor information), as well as the lack of discourse or information transfer between government officials, managers, and investors.

For those of us in the alternative investment area, the name 'Bayou' brings up a picture not only of the area surrounding the current human tragedy in and around New Orleans but also the current tragedy surrounding the collapse of a well known hedge fund. One should always be careful in attempting to bring analogies between two events (Bayou and New Orleans) very different in scale as well as in their human impact. However, both cases seem to have similarities in terms of how various local, regional, government officials and citizens prepared for, relied on or acted before, during and after the events. Similarly, it was the newspapers and other media which brought to the public the reality of both crises and the issues surrounding failure of the existing system and their inability to prepare for or cope with the events.

On the most obvious level, whatever the level of government, those levels failed either to forecast the likelihood of the event or of its severity or to respond quickly to their knowledge of potential problems. This is not to say that knowledge of the probability of such an event did not exist. Recent newspaper stories point out that the Feds' 'Hurricane Pam' exercise predicted possibility of massive

flooding and widespread destruction in the New Orleans but I doubt if local citizens were aware of this. Similarly, Arizona banking officials were aware of potential problems surrounding Bayou but few investors were aware of the legal proceedings.

In the case of the Hurricane Disaster the area itself and the failure of local and regional officials adequately to supervise or to prepare for the event led in part to the enormity of the disaster. Their inability to act was in part due to a lack of resources (e.g., money), a changing environment (the city was sinking), a fear of citizen response (no one really trusted the local officials), and state officials' fear of federal officials as well as lack of leadership (no one wanted to look as if they had done little or was incapable of doing anything).

Similarly in the case of the Bayou Disaster, the lack of hedge fund oversight at the state or regional level is affected as the lack of resources to oversee the potential problems (e.g. money), changing characteristics of the hedge fund industry (consultants and marketing specialists as primary sources of investor information), as well as the lack of discourse or information transfer between government officials, managers, and investors.

Of course, individuals have responsibilities. One could always leave. Certainly there were obstacles but the fact is that in New Orleans some with resources did get out as some of the larger investors left Bayou. In short, some saw the problems but did not share those concerns with others (as long as my family got out ...). But for a moment think of the current uproar from New Orleans citizens if they had been asked (e.g., forced) to leave several weeks before the potential event and nothing happened. Think of the uproar from investors in the Bayou fund had been forced to leave by the government officials only to find nothing was wrong. Think of the indifference of most investors (and therefore their lack of

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willingness to force universal action) if the suffering is localized to those to whom they have no connection.

So, the blame game is in full force. Government officials are quick to disperse the blame (e.g., It was their responsibility to force us to act, we only oversee the brokerage end of the business, registration does not mean oversight.....). Investors are quick to blame the government or other watchdogs (we depended on them to protect us don't we?) instead of doing their own due diligence. Many individuals placed their faith in others without fully understanding the pressures or the incentives of those individuals which led them not fully disclose potential problems (salesmen who represented the seller (the fund managers) not the buyer, consultants who profited from associations to the seller indirectly but not directly). I wonder what the pressure was on the Governor of Louisiana from various business leaders (hotels etc) not to act.

One could go on and on. Whose responsibility was it? To this day, whistle blowers are punished, not rewarded. The individual who tells one's associates that they have failed is not regarded as a 'Team Player.' In short, I feel the failure of New Orleans or Bayou is less the failure of a system than the failure of people to be leaders as well as a failure of people to truly expect or desire leadership (except as a convenient source to blame ex post after they themselves have refused to accept the constraints imposed by a system headed by such a leader).

No system protects. In my own local city, I called the public works to discuss putting speed limit signs on a street not in my area but in another area in which I am familiar with, I was told 1) put in a request, get in line, and in the next four years we will do a 'review'. 2) why are you complaining it is not your area, 3) we have no money to act (I do not even have the money to pay for gas for our trucks); 4) I

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don't care I don't get paid enough to care. In any event the official said, "rules without enforcement fail and we cannot afford enforcement" or our only choice is to 'shut the road down.'

Well, here we are. Rules and systems do not protect without willing enforcement (government and citizens). Lacking that will, only the future will tell if we are 1) simply willing to accept the random tragedy and self insure through future government taxation which pays up for the event or self diversification such as in the case of the Hurricane a house outside of New Orleans or in the case of Bayou a diversified set of investments or 2) simply shut the road down which means in the case of New Orleans all coastal cities or in the case of Bayou all hedge funds. Not a set of very attractive choices. What we do need is greater personal responsibility and knowledge of the consequences of our actions? What we continue to demand is costless protection and unobtrusive leadership. With that dichotomy future tragedies must be expected.

Looking forward to your comments.

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Comment

The Rise and Fall of Alternative Investments

Thomas Schneeweis

September, 2005

In reading any of the above (especially a critic's response) it is interesting to note how quickly individuals can rise to support a 'new approach' or a 'new idea' and just how quickly they can turn on any new idea. In a similar vein, hedge funds were once the 'investment de jour' and alternative investments in general were seen as the 'new asset class.' Over the past year, a series of new articles have come out questioning the 'real benefits of alternatives in general and hedge funds in particular.'

One of the reasons Mapquest is such a popular Website is that many of us desire a form of roadmap for where we are relative to where we wish to go. This is true for a wide range of human activities. Bestsellers often start with: "How To" Other popular books attempt to provide a simple set of rules as to why individuals succeed such as "Eight Simple Rules ..." or fail such as "Why Nations or Civilizations Fail" I believe that my majoring in history in college was in part driven by the desire that an understanding of the knowledge of the success and failure of the past would offer insight into the basis for future successes and failures.

In reading any of the above (especially a critic's response) it is interesting to note how quickly individuals can rise to support a 'new approach' or a 'new idea' and just how quickly they can turn on any new idea. In a similar vein, hedge funds were once the 'investment de jour' and alternative investments in general were seen as the 'new asset class.' Over the past year, a series of new articles have come out questioning the 'real benefits of alternatives in general and hedge funds in particular.'

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Certainly, hedge funds in general and some strategies specifically have performed less than their long term average. This is not to say, however, that they are condemned to have poor performance in the future. This should surprise no one. One of the reasons Mapquest is such a popular website is that it permits 'experts' to update the map frequently. In contrast, the old paper map of the past can become outdated quickly. In short, one should think of the alternative investment area as a form of Mapquest with different cities, different regions all within an evolving pattern of roads, highways Given the dynamic nature of hedge funds one can only expect that yesterday's map may provide little information as to today's guidebook.

For instance, the failure of certain strategies is not that there is not too much capital in hedge funds, but more likely a shortage of current opportunities. It is true that as opportunities begin to return to a market (e.g., foreign distressed debt), financial firms may 'stoke up' their operations in these areas with resulting greater liquidity, information overview ... such that returns (and risk) may decline. However, that pattern is not necessarily evidence of a declining asset class merely, the natural risk and fall of the risk and return of a strategy in response to a changing economic environment.

Others have addressed similar issues on a grander scale. For example, Arnold Toynbee's *Study of History (12 volumes: 1930-1960's)* presents history as the rise and - with one exception - fall of 26 societies, 21 of which are "civilizations", with the remaining 5 defined as "arrested civilizations". The cycle of civilization comprises two major phases: a "universal state", and an "interregnum." The cycle of rise and decline was not inevitable in Toynbee's view: he allowed the possibility that a civilization could continue to respond creatively and successfully to recurring hardships including. 1) A failure of creative power in the creative minority; 2) the withdrawal of allegiance to the ruling minority on the part of the majority; and 3) the consequent loss of social unity.

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Alternative's rise and fall would similarly be due to 1) a failure of new products and ideas, not the performance of current products., 2) the withdrawal of a wide set of investors from the product area (unlikely given the need of investors for investment opportunities) and 3) a lack of unity among current managers who fail to see their common goals as a asset class (reaction to SEC comments).

In brief, alternatives asset in general and hedge funds in particular may just be in a period of "interregnum". In short, there is no reason for alternative investments to be one of the arrested civilizations. I would hate to believe that there is some historian out there ready to write the obituary just yet.

Looking forward to your comments.

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Comment

Historical Returns: Three Years Feast and One Year Famine Traditional Investment and Hedge Fund Strategy Returns

Thomas Schneeweis

October, 2005

Despite our knowledge of the factors that drive hedge fund returns, the natives are restless. It has been at least 5 years since overall hedge fund returns have resulted in returns approaching 15%. Are the good times gone? Will they ever return? The problem is that few of us in the industry remember the period before 2000. Results show that the underlying hedge fund strategies reflected the economic conditions of that time period.

Investment alternatives have often been divided into three asset classes, traditional stock and bond investments, traditional alternatives (private equity, commodities, private real estate) and modern alternatives (e.g., hedge funds). Hedge funds have often been suggested as an alternative to traditional stock and bond investment as well as traditional alternatives due to their ability to invest in certain asset classes not easily investible by the other primary investment media. Over the past fifteen years, hedge funds have grown to an estimated \$1 trillion dollars under management over a broad range of hedge fund strategies. These hedge fund strategies themselves have grown and evolved based on changes in regulation, trading, and economic environments.

As important, academic and practitioner research has conducted extensive analysis of various hedge fund strategies. This analysis has shown that the return to various hedge fund strategies, as traditional investments, is due primarily to their underlying strategy (and thus securities held) and those strategies (e.g., securities) exposure to various economic or market

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factors as well as the unique risk and return attributes of a particular hedge fund strategy (e.g., liquidity) as well as the unique trading abilities of certain firms. In brief, certain hedge fund strategies perform better during various economic conditions (e.g., periods of high merger activity, high yield debt issuance) and market factors (rising equity markets, falling credit spreads).

Feast or Famine:

Despite our knowledge of the factors that drive hedge fund returns, the natives are restless. It has been at least 5 years since overall hedge fund returns have resulted in returns approaching 15%. Are the good times gone? Will they ever return? The problem is that few of us in the industry remember the period before 2000. Results show that the underlying hedge fund strategies reflected the economic conditions of that time period.

■ 1990-1994: While hedge funds in general performed well during the period 1990-1994, the dominant performing strategies were Global Macro and CTAs reflecting the variability in global currency and interest rates during that time period. The unexpected increase in interest rates by the Fed in early February, 1994 ended the three year rebound following the 1990 recession.

■ 1995-2000: During the 1995-2000 period, equity markets in general rebounded quickly from their 1994 performance with equity long/short the dominant performing hedge fund strategy (reflecting the rise in stocks in general and internet stocks in particular). In addition to internet stock rise, the other primary event in the period was the collapse of LTCM. In August and September of 1998 all hedge fund strategies experienced sharp declines. While equity based

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hedge funds rebounded quickly, fixed income arbitrage and global macro (including CTAs) continued to perform relatively poorly. Other equity and volatility sensitive hedge fund strategies (merger arbitrage, event, equity market neutral) also performed well after the August and September 1998 hedge fund crisis with most hedge fund strategies returning to pre August 1998 levels by the end of 1999. Equity markets reached their peak in March 2000 and equity sensitive hedge funds were flat for the rest of the period. Volatility sensitive strategies such as equity market neutral and convertible arbitrage, however, continued to perform well.

■2001-2005: During the most recent five year period, 2001-2005, distressed securities and event driven strategies had the highest relative performance reflecting decreases in interest rates and credit risk. Overall within the past five years the market factors (e.g., low equity volatility) over this period resulted in hedge funds whose volatility was at the lower end of the estimated historical volatility range. Consistent with this lower volatility as well as lower short-term interest rates, hedge Fund strategies in general were at the lower end of the pre 2000 return range. Current economic conditions (increasing market volatility, rising short term rates, and improved equity market conditions) provide a more positive environment for hedge fund strategies in general and equity and event driven strategies in particular. The increasing supply of corporate high yield debt, corporate governance, and restructuring, as well as global market opportunities also provide conditions which are of advantage to particular types of hedge fund strategies. Performance over the past six months are consistent with the ‘semi-credit crisis of April and May’ (reflecting concerns on possible GM default etc) which affected all strategies but credit sensitive strategies in particular (convertible arbitrage). For the past several months most strategies have rebounded to their pre May 2005 levels. However, continued uncertainty in U.S.

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equity markets due to energy and consumer concerns has resulted in equity sensitive hedge funds having flat performance.

The Future:

In short hedge fund strategies, as well as traditional strategies, have been on a three to four year cycle since the early 1990's. Up for three years and down in 1994, up for three years and down in 1998, up for about two years and down in 2001, Up until 2003 and down again. Where is the absolute return in all of this? Three years of feasting and one year of famine. Obviously to some degree the return pattern reflects the underlying risk of providing capital for relatively illiquid credit sensitive investments.

Hedge fund returns are based on expected economic and market conditions in the upcoming period. Strategies which can take advantage of renewed demand for trading credit, corporate restructuring, and corporate events as well as global market opportunities seem to offer the highest return to risk. Lastly, an important component to returns is how quickly the Fed reaches its interest rate goals. A resolution of this uncertainty commensurate with a soft economic landing provides optimal conditions for future one to three year returns across a wide variety of strategies. After the Famine, everyone is certainly looking forward to the Feast.

Looking forward to your comments.

Tom Schneeweis

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Comments

Alternative Investments and the Fourth Estate The Worthy Adversary

Thomas Schneeweis

November, 2005

If the number of emails that I receive each morning is indicative, the only industry outpacing alternative investments in general and hedge funds in particular in terms of growth is the financial press which covers the industry. As an academic, this is generally viewed as good news. First, in an efficient market more information is generally preferred to less. Second, the continued growth of new sources of information is indicative of the continuing demand for knowledge about alternative investments. This demand for knowledge may result in increased demand for courses, articles, and other products that academics themselves may wish to sell. Third, from a market's perspective, there exists a group of individuals (financial writers) with a unique set of talents who now have an additional area to expend those resources. Spreading unique skills over multiple areas reduces the cost per unit of output.

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Of course, there are those who may not agree that the influx (or to some, deluge) of articles on alternative investments is a net positive for industry or the financial markets. First, depending on the

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quality of the information, more information may lead to greater uncertainty and less risk taking. Second, the thirst for knowledge (e.g., information) may not correspond to a thirst for understanding. It is now almost 40 years since the Sharpe Ratio came into common use and after 40 years of pointing out that it fails at the individual investment level to inform one as to the risk/ return in a portfolio setting, it continues to be used as a generic performance benchmark. Third, academics and to a lesser degree the financial press, are not faced with the ‘reality’ of the market. In short, while they dispense knowledge, the quality or accuracy of that knowledge is open to debate. Moreover, unlike the actual alternative investment markets, a bad article unlike a bad investment (in terms of accuracy) often results in a promotion not a demotion.

This is not to decry the value of the Fourth Estate (The term *Fourth Estate* often refers to the [press](#), both in its explicit capacity of advocacy and in its implicit ability to frame political issues. The term goes back at least to [Thomas Carlyle](#) in the first half of the 19th century). The alternative investment area while willing to declare its successes is not in the business of publishing its own failures. A vital external party working in its own self interest (e.g., a successful article often requires ‘news’) is a fundamental requirement for an investment area which by its very nature is not fully transparent.

For purposes of this commentary, the controversy about the value of the Fourth estate goes to the heart of the question as to how information is disseminated and the quality of that information. Personally, my view of the financial press has evolved over time just as the concept of the term Fourth Estate has evolved (The term *Fourth Estate* has more infrequently referred to the [proletariat](#) in opposition to the three recognized estates of the French [Ancien Régime](#)). First, I have learned more from many of the journalists and financial writers I have read than from many of my fellow academic and alternative asset practitioners. Second, academic self interest has led me to see that my value is decreased unless

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there is a dynamic market for services similar to those that I provide. Lastly, as in any area of change, one needs a counterparty to argue, to debate, and to disagree with; in short, the worthy adversary.

Unfortunately, this is where the relationship between practitioner and press, academic and academic, practitioner and academic seems to fail. No one desires their own particular views to be debated. One does not desire a 'worthy adversary.' As a point of illustration, in the 1980's a journal existed in which following an article a brief one page response was given by a practitioner and by an academic on the point of the article and future areas of research related to the topic. The journal soon failed because no author wished to have their research questioned publicly. Similarly, articles to the editor of a newspaper often go unanswered (especially if it questions the work in a recent article).

Perhaps, I should not be concerned. At a recent dinner, my guests pointed out that I could send anything I wanted since they never had the time to read anything I wrote. What they really needed was for me to condense everything into four or five lines. Even better, how about a rating services on articles (Morningstar move over). I could, if I wished, simply put my commentary for transfer to an Ipod so that they could listen to it while driving (the risk of putting one to sleep and being sued as the cause has delayed me in this endeavor).

Not wishing to produce the last buggy whip, I am considering changing how CISDM does provide its own Fourth Estate privileges. We are going to be more confrontational in what we print and how we print. With the full realization that the returns to printing information come with costs (not everyone wishes a worthy adversary), do not fear; we have even permitted our supporters to continue their support without attribution. CISDM will continue to relish its role as the Fourth Estate. We look forward to all the controversy and debate it brings. What is life without a worthy friend or a worthy adversary?

Looking forward to your comments.

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Comment

Those Who Remember the Past Are Plague to Repeat it

Thomas Schneeweis

December, 2005

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