

# Avoid unnecessary risk

## and lacklustre hedge fund returns

One of the best ways to make money is not to lose it!  
Here's how to make it in today's most  
dynamic financial sector ...

One of the fastest growing sectors of the financial services industry is the hedge fund or "alternative investments" sector, currently estimated at over \$1 trillion in assets worldwide. One of the main reasons for such interest is the performance characteristics of hedge funds—often known as "high-octane" investments. Many hedge funds have yielded double-digit returns for their investors and, in many cases, in a fashion that seems uncorrelated with general market swings and with relatively low volatility. Long the province of foundations, family offices and high-net-worth investors, alternative investments are now attracting major institutional investors, such as large state and corporate pension funds, insurance companies and university endowments, and efforts are under way to make hedge fund investments available to individual investors through more traditional mutual fund investment vehicles.

### What is a hedge fund?

Many institutional investors are not yet convinced that "alternative investments" is a distinct asset class but rather a mongrel categorization that encompasses a wide range of different investment objectives, strategies, styles, techniques, assets and markets, offering a wide spectrum of risk/return profiles.

For the sake of this article, we do, however, use this broad definition that a hedge fund is an investment vehicle that is loosely regulated and which follows a strategy free of any restrictions using all types of financial instruments.

### Why invest in a hedge fund?

The principal argument behind hedge fund investing is that great inefficiencies occur—and will continue to occur—and therefore opportunities arise that enable investors to

exploit mispriced securities without incurring excessive levels of risk. A key element is the talent of the manager (ie manager skill or alpha) to identify them and turn them into profits.

A second argument is that the approach of hedge fund managers is different from that of conventional long-term-only managers. Hedge funds aim to minimize directional market risk, while maintaining steady absolute returns, rather than relative performance against a stated benchmark index, typically the goal of traditional buy-and-hold managers.

And lastly, managers have generally significant personal stakes in their funds alongside investors' money, which ideally aligns both interests.

Comparison with traditional investments  
July 1995 – June 2005

	HFR / Hedge Fund Research Index	MSCI World Equity Index	JPMorgan Global Bond Index
Return	11.78%	7.05%	5.84%
Volatility	7.47%	14.55%	6.47%
Sharpe ratio	1.08	0.23	0.33
Maximum drawdown	-11.42%	-46.80%	-8.14%

The above comparison between a broad hedge fund index and the two main traditional asset classes clearly illustrates the superiority of hedge funds. Not only have they generated above average returns in the past, but also in a manner that is less risky than comparable investments (expressed as Sharpe ratio) and therefore make them a very attractive alternative "asset class".

### What are the current trends in the hedge fund industry?

- ✓ Greater institutionalization (convergence to classical asset managers/consolidation)
- ✓ Increased regulation
- ✓ Increased asset flows
- ✓ Sustained periods of low volatility
- ✓ Longer lock-up periods
- ✓ No reduction in fees
- ✓ Active expansion into new trading areas and regions

And why are some of these trends leading to a lower return environment—against what most hedge fund investors have traditionally expected; namely, high returns in exchange for the corresponding risks that they are expected to bear?

It is common knowledge that the most talented managers are drawn first to the hedge fund industry because the absence of regulatory constraints enables them to make the most of their investment acumen. However, there is a gap opening between institutional investors and hedge fund managers due to a different business culture, regulatory oversight, investment mandate, etc, which impedes the exploitation of manager skill. Even though both groups do share the common goal of generating superior investment performance for their clients, the constraints of institutional investors often fall short of this goal and have led to the exact opposite.

Secondly, too much money flowing in the industry has attracted less skilful managers, who are simply lured to the high-income opportunities. Moreover, too much in a fund can make it less agile and unable to get out of positions quickly. In essence, overcapacity, both in the industry and in a fund as a whole, as well as the influx of less qualified managers, can compromise returns that justified an investor's decision to get into hedge funds in the first place.

Finally, increased observations of lacklustre returns are not only due to the low interest rate environment or the manager quality but stem more predominantly from the investors themselves. Due to the institutionalization of the industry the focus has increasingly been put on the volatility of returns and therefore generated an ever growing group of hedge fund managers who are risk averse and investing along these lines. A low volatility is not only a by-product anymore, but has become the principal focus of a hedge fund strategy.

### How can you avoid being trapped with lacklustre returns?

The beauty of such a huge industry is that there is always room for the unique and the non-conformist. So why rely on big institutional names when niche players such as CAYROS can help you to select managers who are unwilling to work under such institutionalized terms, but who are committed to generating attractive absolute returns with a relatively low level of risk?

CAYROS offers its clients a pool of talented, experienced and hungry managers who are passionate for their craftsmanship. We avoid size managers and select the ones where the performance compensation is still the predominant income source and significant own money is invested in their funds to align the interests of the client, the manager and the adviser.



Adrian M Baumann  
CEO of CAYROS capital AG

Contrary to the institutional investor, we believe that because of the complexity and multifaceted nature of investing in hedge funds that it is best done through qualitative judgment and is simply not amenable to quantitative analysis only. Why? Because in a purely quantitative selection process—in which hundreds and hundreds of managers have to be screened according to rigid quantitative requirements such as lowest possible volatility or maximum drawdown, highest possible Sharpe ratio, etc—the non-conformist manager, who is not going with the flow, will simply fail to qualify for being selected.

In essence, CAYROS' job is to stay away from the crowd to avoid the average and to identify the pearls that can be expected to generate attractive absolute returns in the future. Being small and having a wide-ranging personal network in the hedge fund industry is rewarding and offers room and time for independent qualitative judgement. Common sense still leads to the best results in selecting the right manager and having the manager being co-invested in his own fund is still the best risk management guarantee. «««

\* Adrian M Baumann, CFA, is CEO of CAYROS capital AG, a fully independent Swiss asset management company that specializes in alternative investment strategies, so-called "non-traditional investments". CAYROS services are available to everyone who believes that CAYROS can add value to their existing investments and financial setting. For further information, visit their website at [www.cayroscapital.com](http://www.cayroscapital.com) or call AngloPhone on 0900 576 444 (CHF 3.12/min).

## Glossary

**Alpha** – Ratio that expresses the so-called risk-adjusted performance of an investment fund. If the average return on a security or portfolio is larger than its expected return, the alpha is positive. If the average return is smaller than expected, the alpha is negative.

**Beta** – Measure of the sensitivity of an equity or a portfolio to the overall market. A beta of >1 indicates that the relevant share or portfolio is subject to larger earnings fluctuations and thus carries a larger systematic risk than the overall market.

**Correlation** – Statistical measure of the linear relationship between two series of figures (eg, performance of a security and the overall market). A positive correlation means that as one variable increases, the other also increases. A negative correlation means that as one variable increases, the other decreases. By definition, the scale of correlation ranges from +1 (perfectly positive) to -1 (perfectly negative). A correlation of 0 indicates that there is no relationship between the two variables.

**Hedge fund styles** –

**Convertible arbitrage:** Typically the manager attempts to profit from the inefficient pricing of the convertible bond versus the underlying stock by usually buying the bond and shorting the stock.

**Distressed securities:** Typically the manager seeks to profit by buying debt of companies in financial distress or bankruptcy below what he estimates to be the ultimate recovery value during or upon finalization of the reorganization process.

**Equity long/short:** Typically the manager seeks to achieve returns by taking positions in equities on both the long side by buying undervalued shares and the short side by selling overvalued shares that they do not own in anticipation of buying them back at a lower price.

**Equity market neutral:** Typically the manager attempts to remove market risk by going long and short on similar securities simultaneously (resulting in a zero net investment) to exploit the inefficiencies between the pricings of pairs of stocks.

**Fixed income arbitrage:** Typically the manager seeks to exploit pricing inefficiencies in fixed income securities and their derivative instruments.

**Global macro:** Typically the manager invests in broad reaching macro economic trends in markets around the globe by carrying long and short positions.

**Hedge fund of funds:** Typically the manager invests in a diversified portfolio of other hedge fund strategies.

**Managed futures/CTAs:** Typically the manager applies a systematic (technical) or discretionary (judgmental) trading discipline operating exclusively in listed financial and commodity futures markets and is usually referred to as Commodity Trading Advisor or CTA.

**Merger/risk arbitrage:** Typically the manager attempts to profit from pricing discrepancies resulting from corporate events such as mergers, acquisitions and hostile takeovers by being long in the stock of the company to be taken over and shorting the stock of the acquirer.

**Short sellers:** Typically the manager may take both long and short equity positions but must constantly be net short.

**Volatility arbitrage:** Typically the manager aims to exploit mispricings in volatility between options or between the relative volatility of the options and their underlying securities.

**Leverage** – Means of enhancing profitability using borrowed money by exploiting the fact that the rate of interest on equity capital is higher than the interest payable on borrowed funds. A leverage effect can also be achieved with derivatives, enabling market operators to invest in sizeable holdings of an underlying for a relatively modest capital outlay. The upshot of leveraging is that any percentage change in the gains and losses on options and futures contracts will be larger than the corresponding change in the underlying.

**Maximum drawdown** – The worst return period consisting of only consecutive losing months.

**Sharpe Ratio** – Statistic that measures the risk-adjusted performance of a portfolio by expressing the excess returns in relation to the standard deviation of the portfolio's performance. A high Sharpe ratio means that a good performance was achieved at a low risk.

**Volatility** – A measure of the variability of returns of an asset within a specific period; usually stated as a standard deviation, expressed as an annualized value.

Legend/Source: Alexander M Ineichen; Alternative Universe; Andrew W Lo; CFA Institute; Greenwich Associates; Hedge Fund Research (HFR); Hedge World; JP Morgan Alternative Asset Management; Putnam and Lovell; PvB Pernet von Ballmoos; UBS.