

The absolute returns revolution

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Zurich 8 May 2013



Introduction

Ineichen Research & Management AG (“IR&M”)

- **IR&M** is an independent research firm domiciled in Switzerland
- Two research products:
 - **Absolute returns research** (advisory mandates)
 - **Risk management research** (subscription based)
- www.ineichen-rm.com

The image displays two screenshots of the Ineichen Research & Management website. The top screenshot shows a page titled "Absolute returns and risk management" with a sub-section "Diversification? What diversification?". The bottom screenshot shows a page titled "Risk management research" with a sub-section "Repressionomics".

Absolute returns and risk management

Ineichen Research and Management (“IR&M”) is a research firm focusing on investment themes related to absolute returns and risk management.

Diversification? What diversification?

Risk management research

Repressionomics

Feature

- The great manipulation continues. The most important variable for savers, producers, and investors to allocate capital and risk continues to be manipulated in a fashion that is arguably unprecedented and dangerous.
- The current political regimes do not trust the markets. It is fair to say that the distrust is mutual.
- More and more investors want real assets. They want out. They want something outside of the whole financial system where the authorities are becoming more and more repressive. Trust has been lost. Sadly, not all investors have the flexibility to take their funds and park them outside of the financial system; they're stuck.
- Bonds are expensive. If an asset class is priced cheaply and something goes wrong, the asset class gets even cheaper and potentially becomes an opportunity for value and distressed investors and bottom fishers. If an asset class is priced expensively and something goes wrong, hell breaks loose.

Macro update

- Global economy remains at an inflection point.
- The average PMI are below 50 and stabilising. So the economic trend, on average, is towards slight contraction and slow deterioration of economic circumstances. This would be more or less consistent with a falling average GDP growth rate and falling average industrial production. All the monetary easing and fiscal stimuli have stabilised the whole situation. Economically it's not great, but it's not a global depression either.

Risk update

- Risk is on. Risk seeking behaviour remains elevated, currently in the 4th highest percentile since 1997.
- The easing of sovereign credit spreads is partially a function of Draghi and partly a function of regulatory-induced short covering.

June 2

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10 January 2013

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“Species govern entities; dynamic evolve c understand inherent”
—Paul O

“My true adversary does not have a name, a face, or a party. He never puts forward his candidacy but nevertheless he governs. My true adversary is the world of Finance.”
—Francis Hollande, Financial Times, 22 January 2012

Outline

- **Absolute returns** is the investment philosophy
- **Asymmetric returns** is the implementation
- **Active risk management** is the key

Do hedge funds generate alpha?

Yes

Fung and Hsieh
(1997)

Yes

Liang (1999)

Yes

Edwards and Caglayan
(2001)

Yes

Kosowski et al.
(2007)

Yes

McCarthy
and Spurgin
(1998)

Yes

Ackermann et al.
(1999)

No

Amin and Kat
(2001)

No

Malkiel and Saha
(2004)

No

Aragon (2007)

No

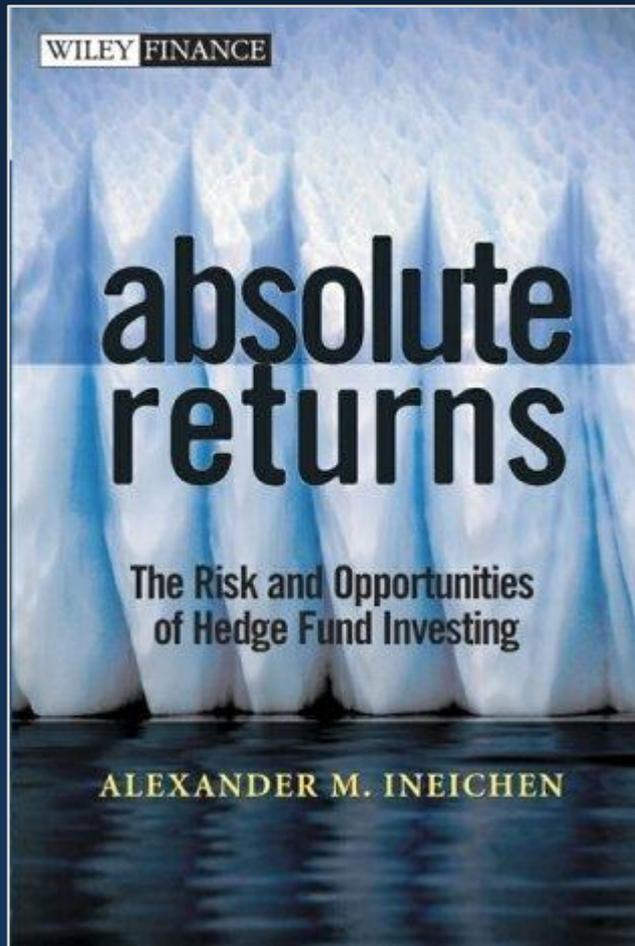
Getmansky et al.
(2004)



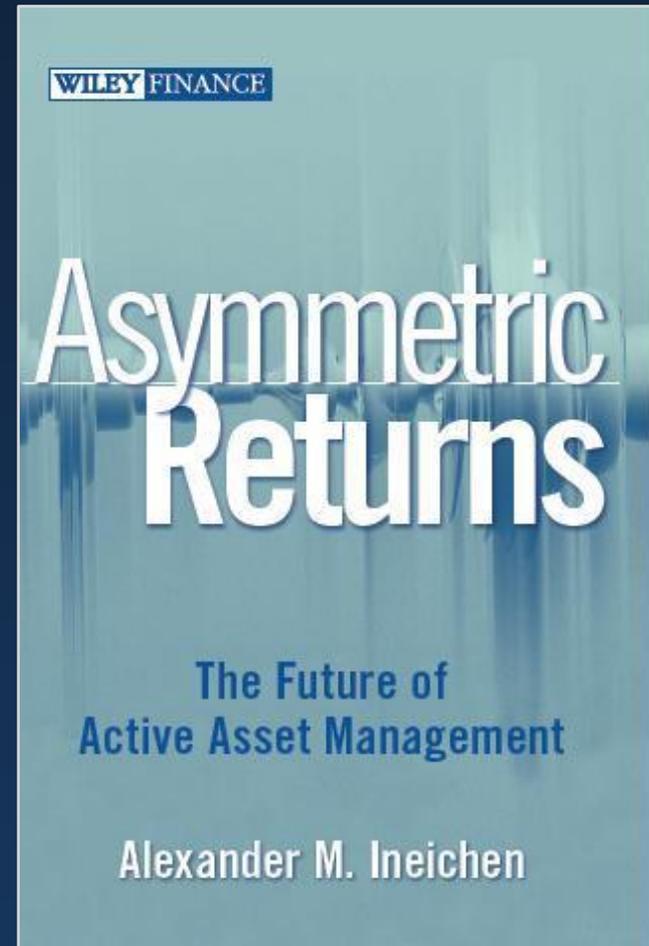
Active risk management manifesto

Alpha moniker doesn't explain what hedge funds are about and do

Investment philosophy



Implementation



Absolute returns in a nutshell

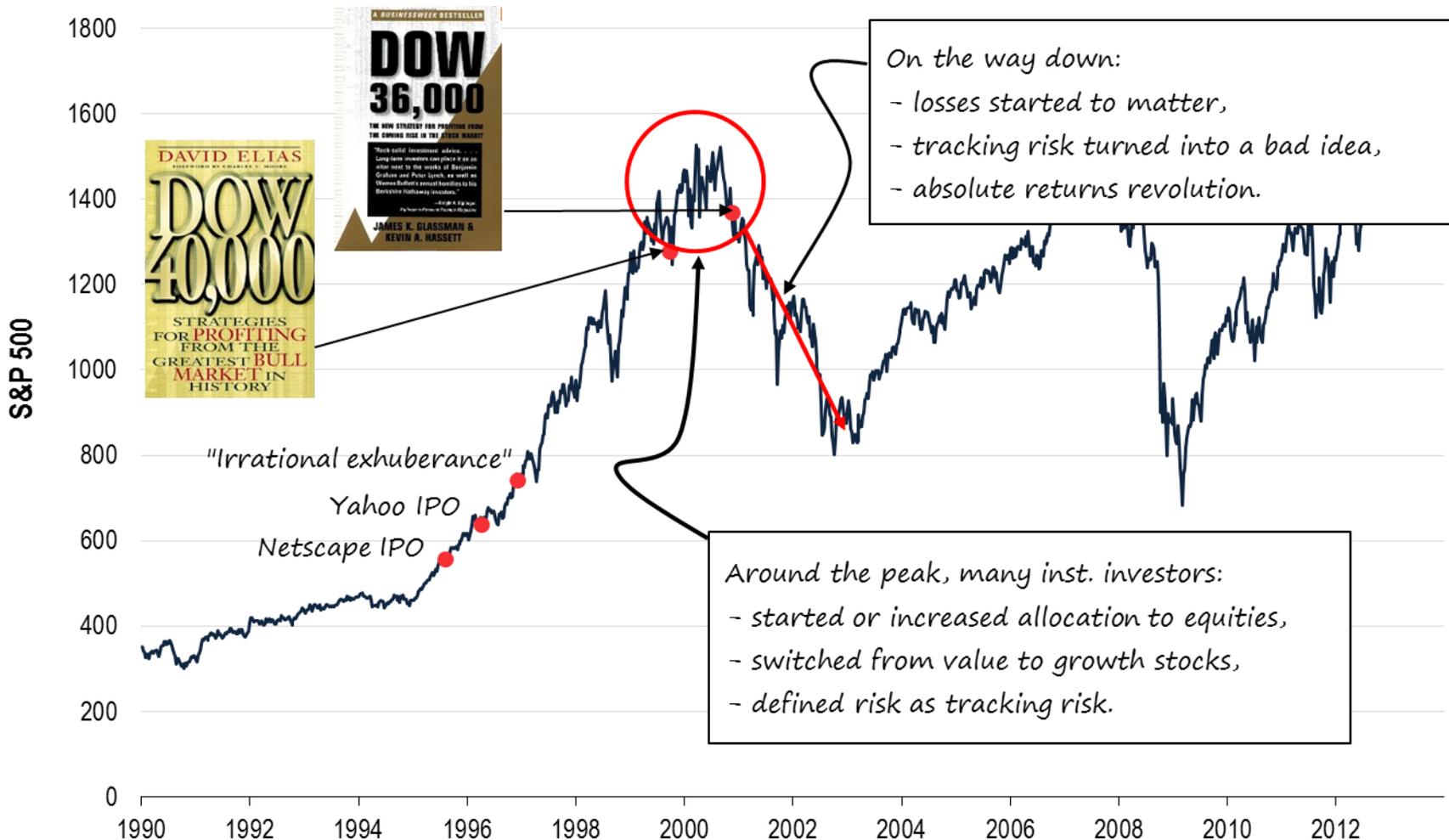
Absolute returns investment philosophy seeks asymmetry between profit and loss

	Relative-return model (Indexing and benchmarking)	Absolute-return model
Return objective <i>General idea is to</i>	Relative returns <i>Replicate or beat benchmark</i>	Absolute returns <i>Exploit investment opportunity</i>
Risk management <i>General idea is to</i>	Tracking risk <i>Replicate or beat benchmark</i>	Total risk <i>Preserve capital</i>

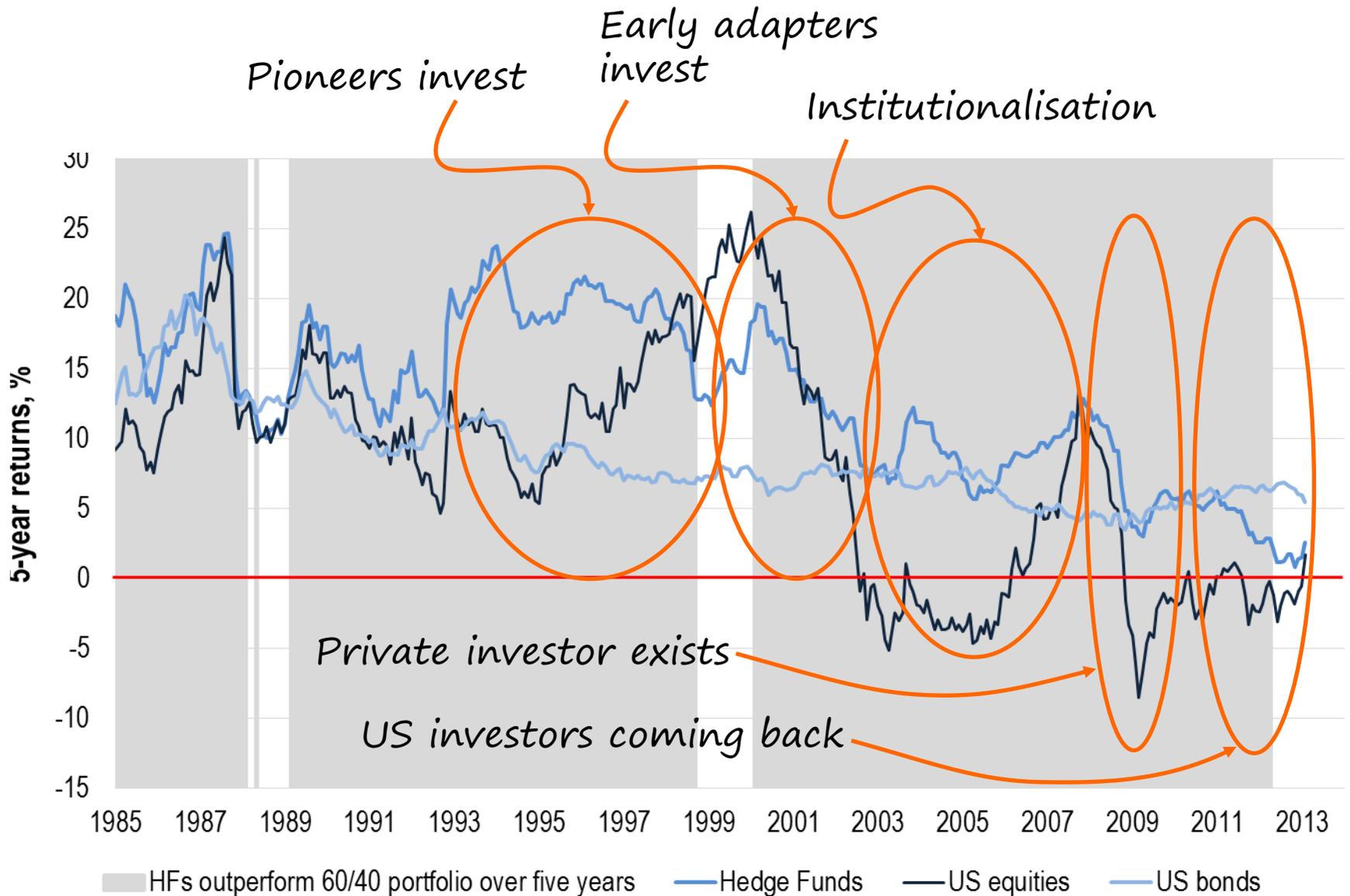
-control accidents
-avoid negative compounding

The absolute returns revolution

Equity-like returns with bond-like volatility?



Hedge fund history

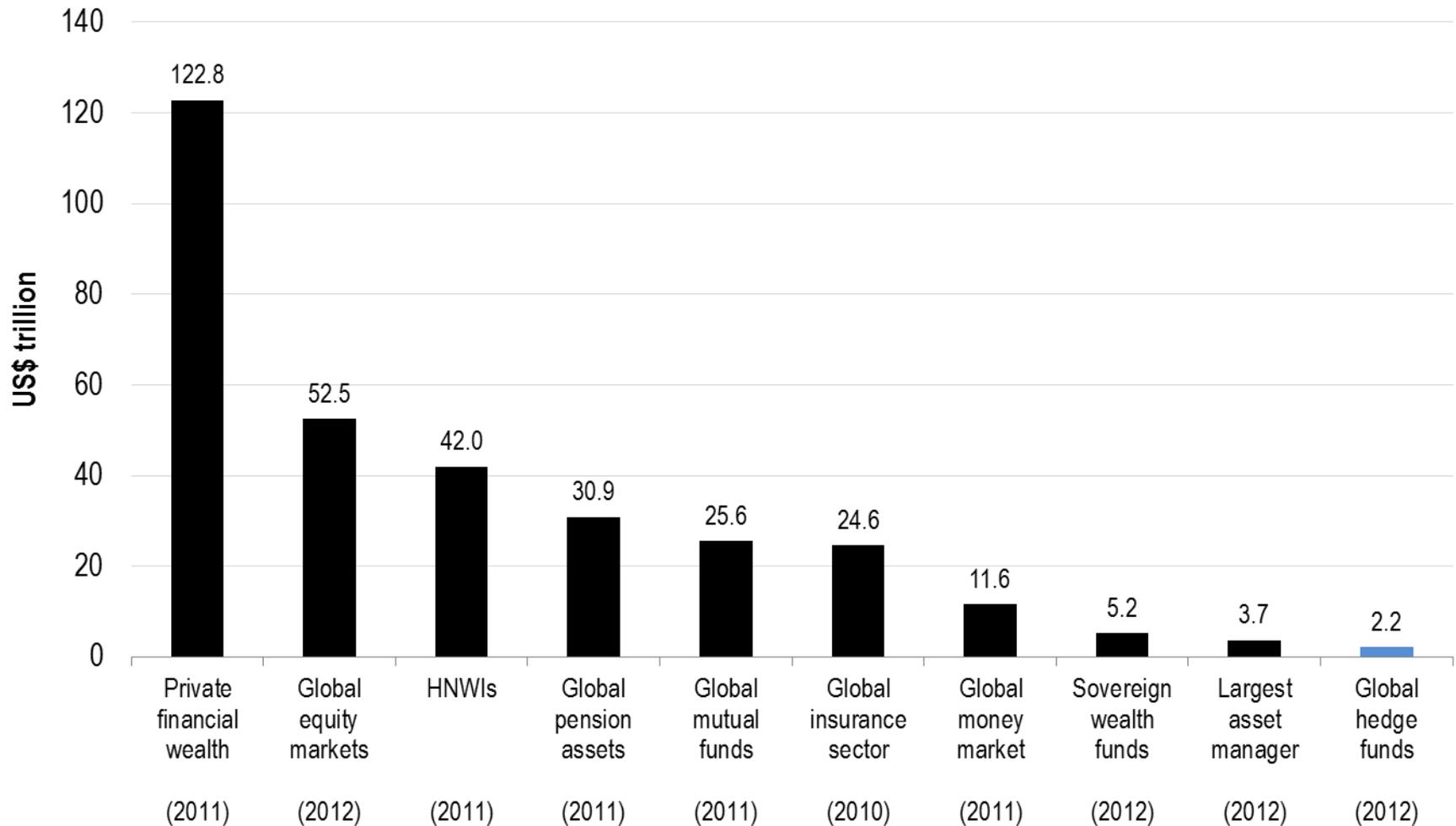


Source: IR&M, Bloomberg

* MSCI Daily TR Gross World USD Index; ** Leveraged Capital Holdings from Banque Privée Edmond de Rothschild to December 1989, then HFRI Fund Weighted Composite Index.

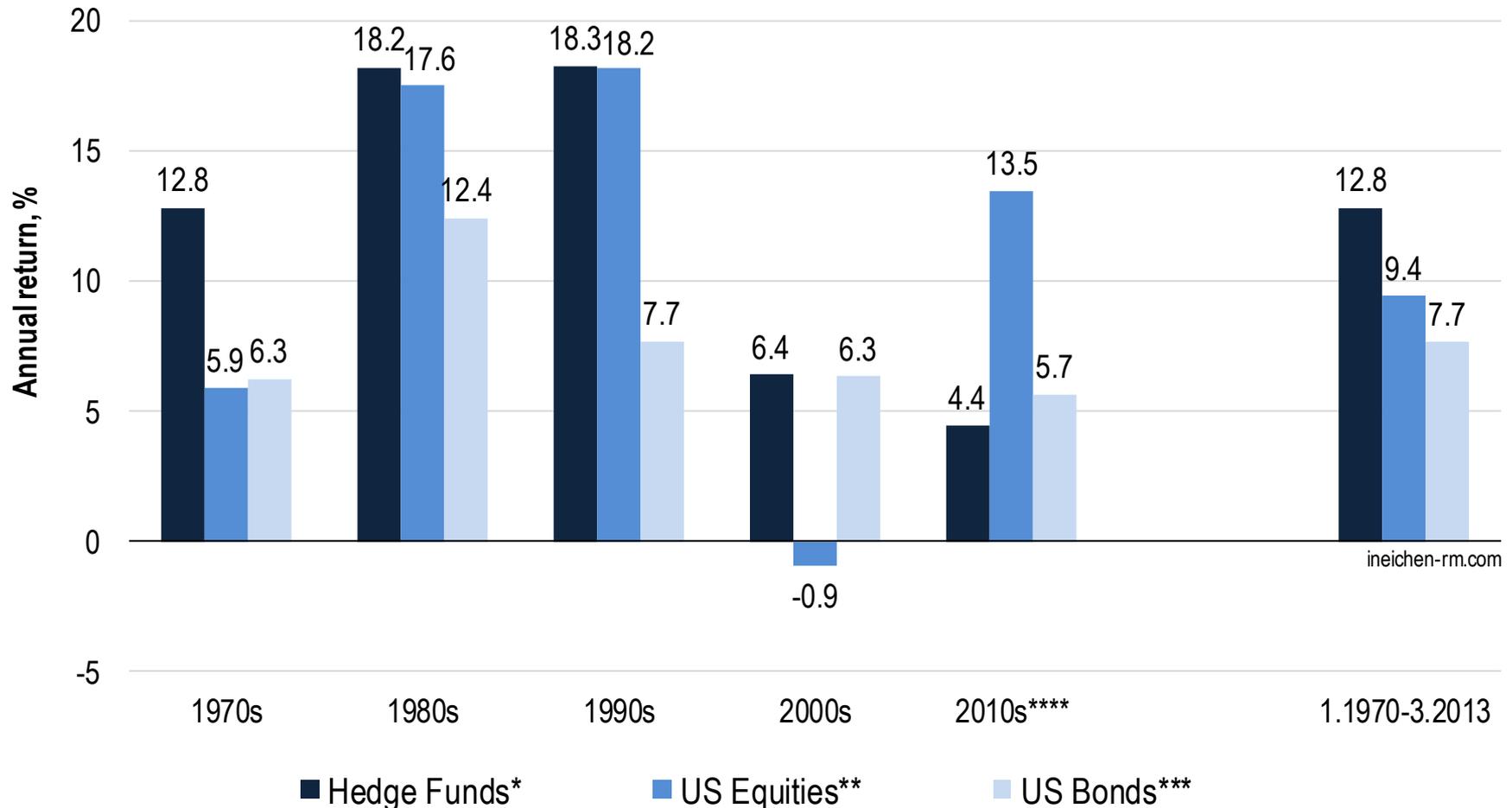
Hedge fund industry still “small”

Global assets under management



Long-term return analysis

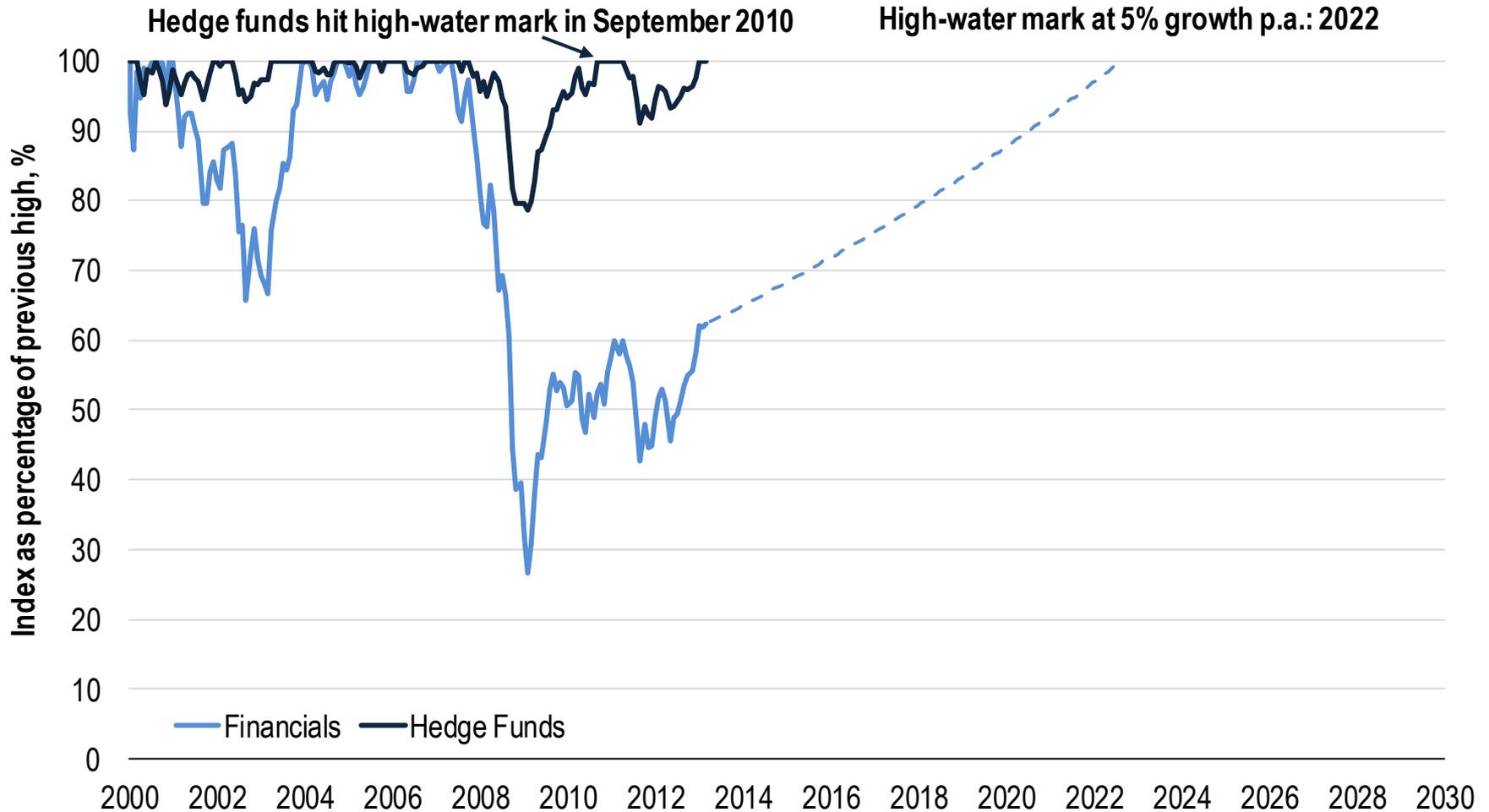
Equity-like returns with bond-like volatility?



All returns are total returns (proceeds reinvested untaxed). * 1970-1989 Leveraged Capital Holdings from Banque Privée Edmond de Rothschild, 1990- HFRI Fund Weighted Composite Index; ** 1970-1989 total return for US equities estimates from GFD, 1990- S&P 500 TR Index via Bloomberg; *** 1970-1979 total return estimates for US Corporate Bonds from GFD, 1980- Barclays US Aggregate TR Index via Bloomberg); **** As of March 2013.

Short-term return analysis

Average hedge fund recaptured high-watermark in September 2010

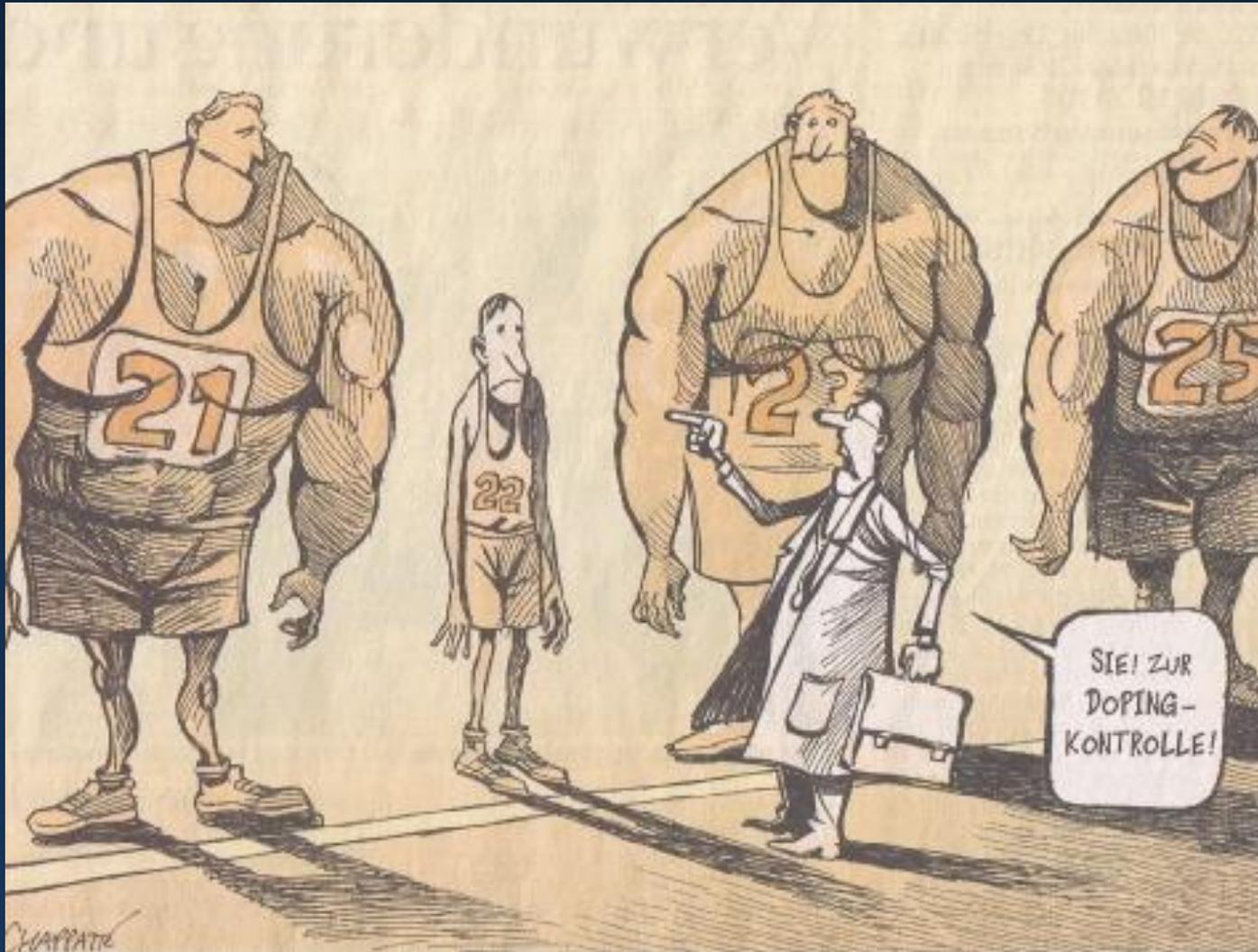


Something to think about

Could hedge funds serve as blue print for a safer financial system?

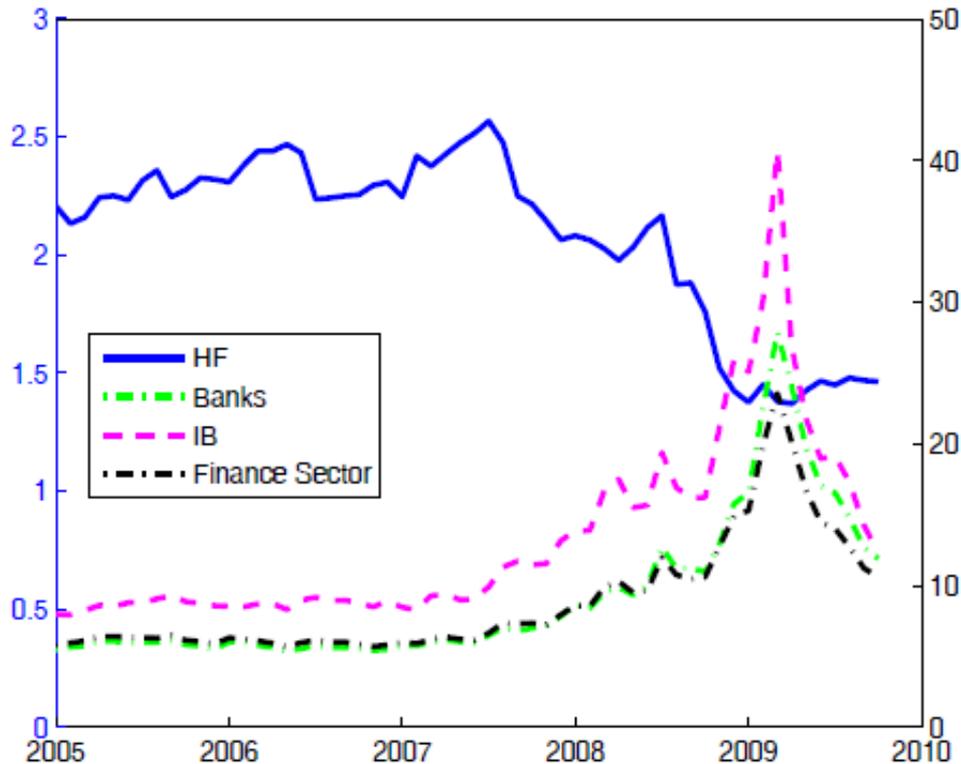
	Hedge funds	Banks
Corporate governance	Capital ownership	Principal-agency conflict
Too-big-to-fail/save	No	Yes
Too-big-to-manage	No	Looks like it
Regulation	Light regulation	Tough regulation
Risk management	Works	Doesn't work, obviously

How the regulator thinks about it



Hedge fund leverage: still a big myth

Hedge funds act counter-cyclically and therefore can reduce systemic risk



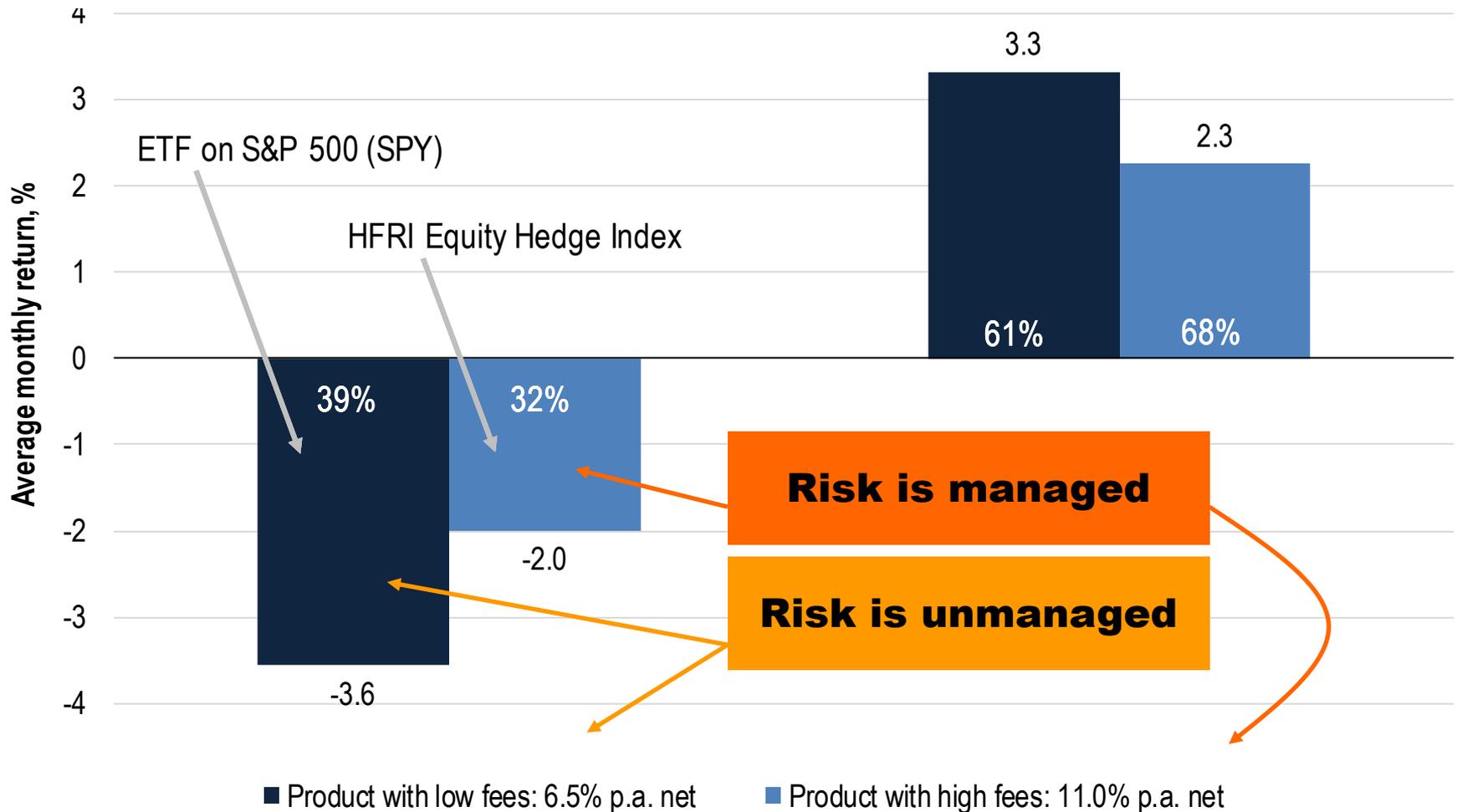
“Hedge funds are presently leveraged 1-3 times, if they’re mad, 5 times, if they’re insane, 10 times. But 15 or 20 times was normal for bank prop desks.”

Michael Hintze, CQS

Financial Times, 30 June 2010

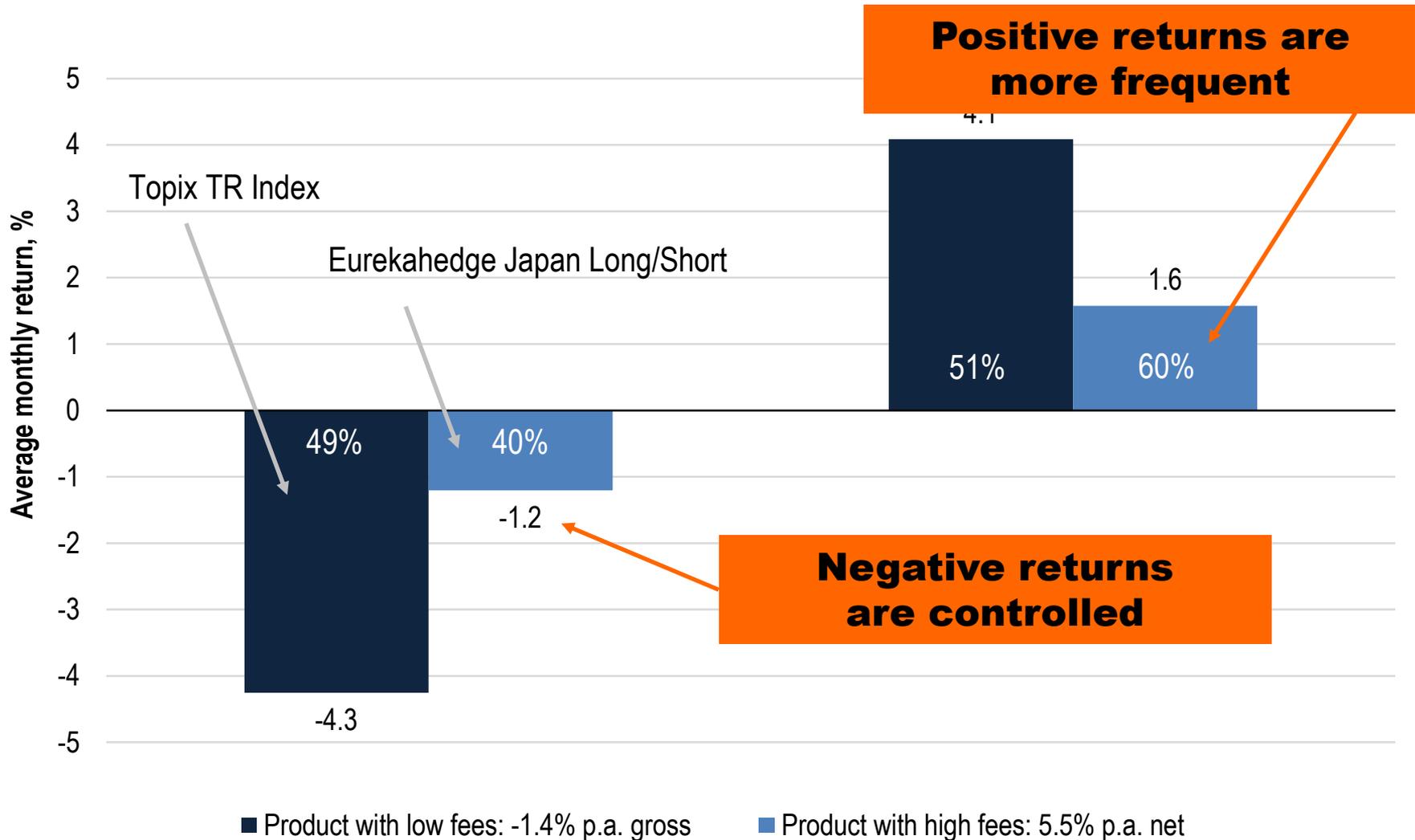
Asymmetric returns in a nutshell

The difference between managed and unmanaged risk can be large



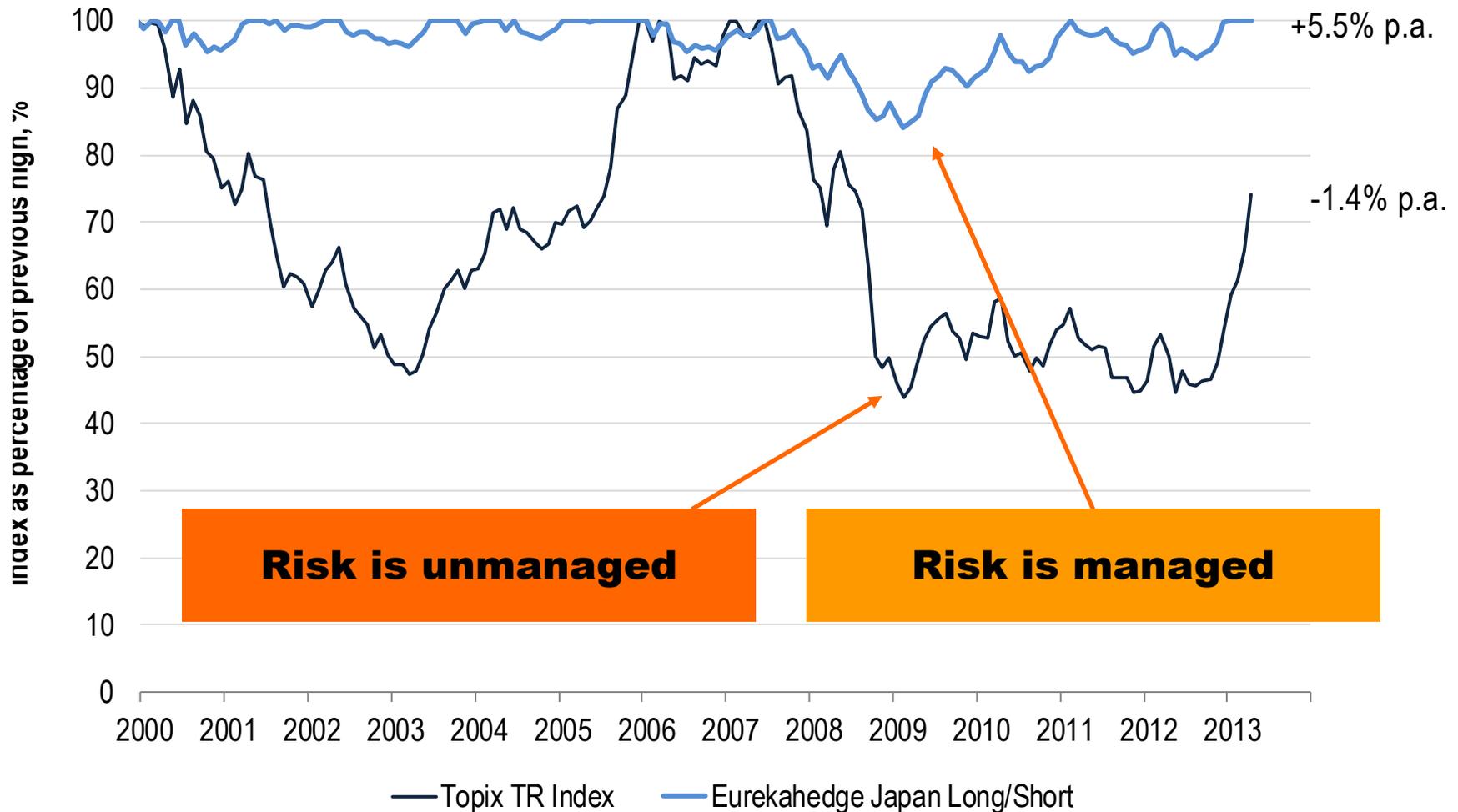
Asymmetric returns in a nutshell, cont.

Negative compounding in Japan: Prologue for other long-only investors?



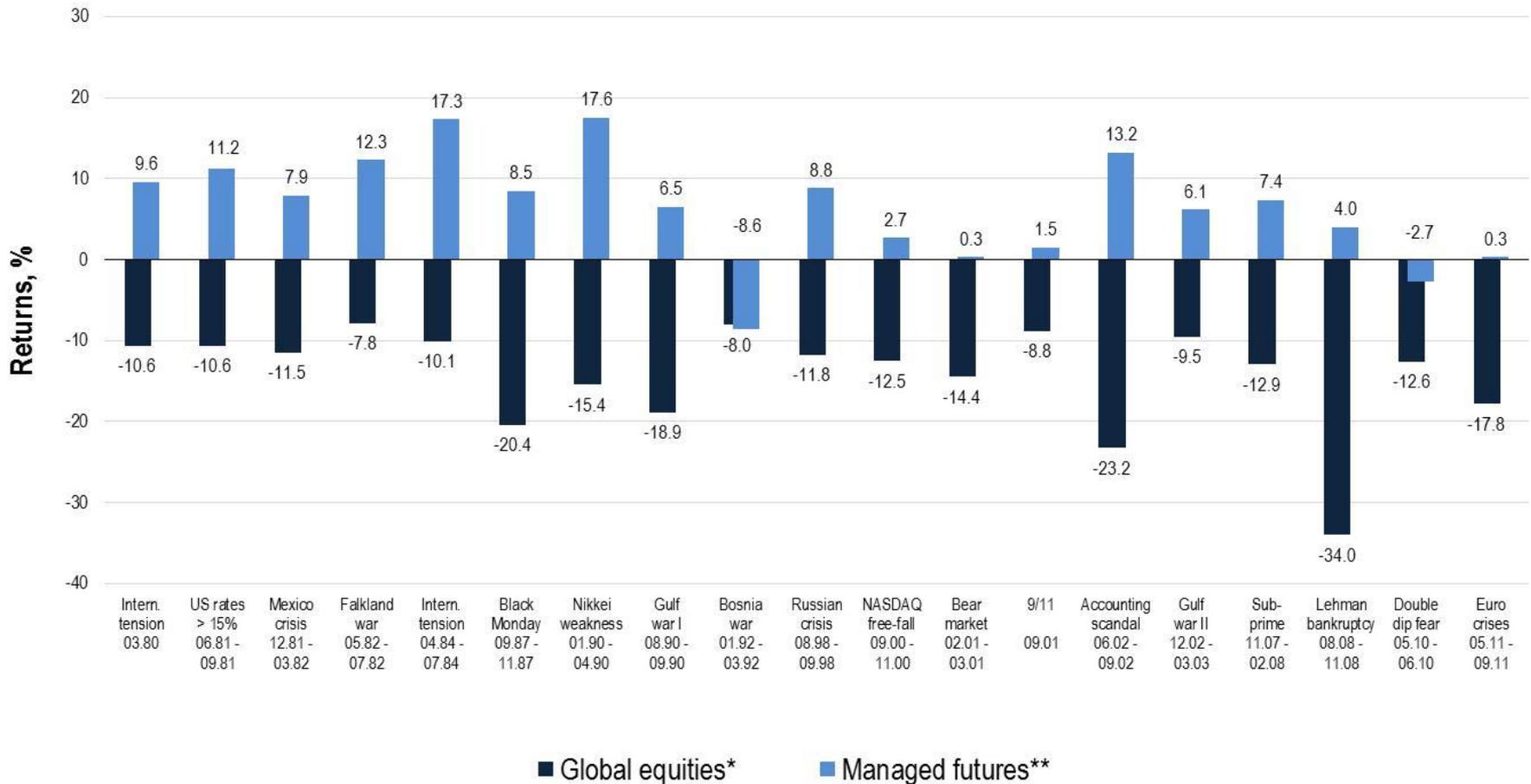
Asymmetric returns in a nutshell, cont.

Negative compounding: not good for your mental and financial health



Correlation

Managed futures: most extreme negative correlation with collapsing equities



17 out of 19

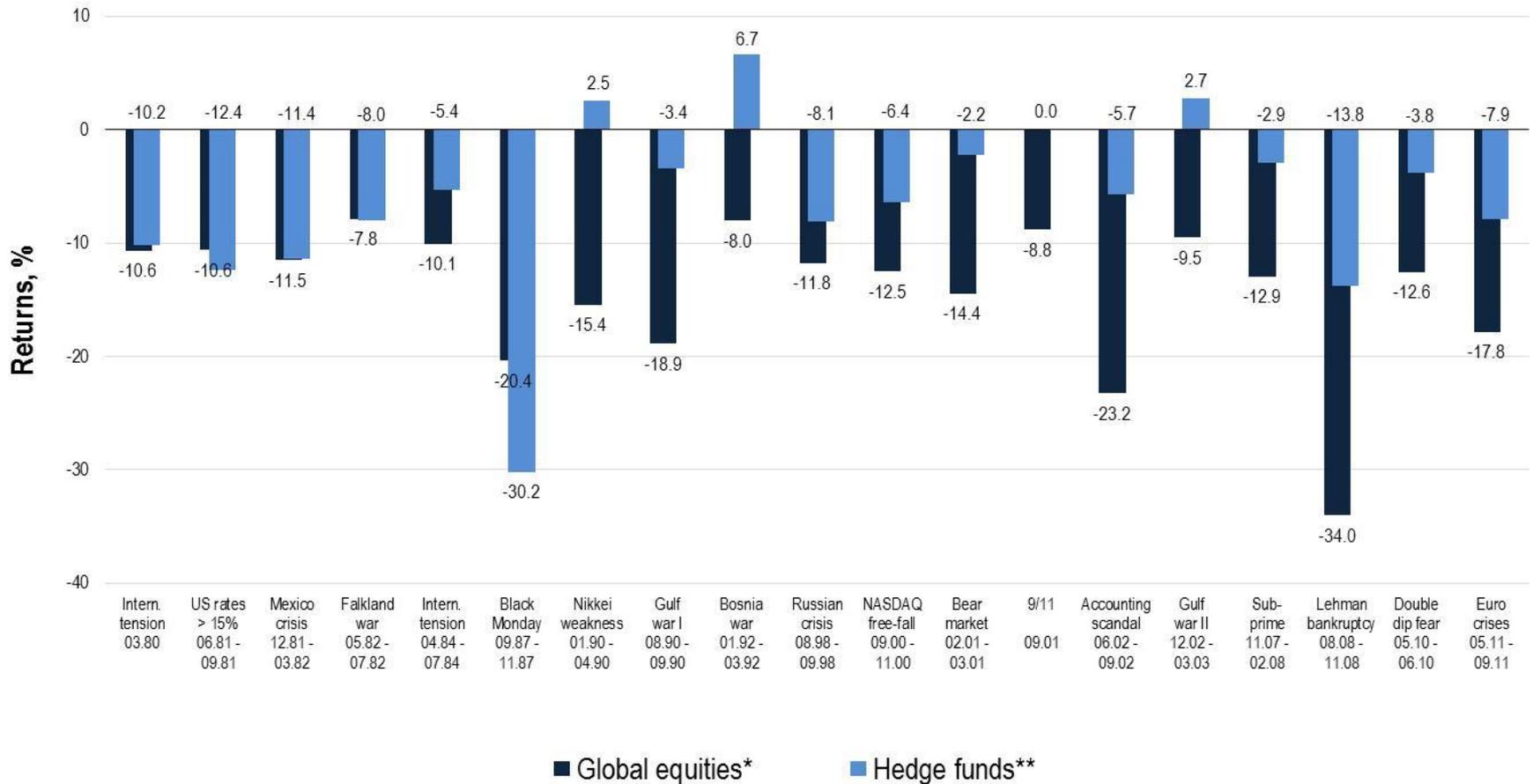
Source: IR&M, Bloomberg

* MSCI Daily TR Gross World USD Index;

** CISDM CTA Asset Weighted Index formerly known as CISDM Trading Advisor Qualified Universe Index until October 2010, then DJ CS Managed Futures Hedge Fund Index.

Correlation, cont.

Hedge funds: A risk management story, not a diversification story



Only 3 out of 19

Source: Ineichen Research & Management, Bloomberg

* MSCI Daily TR Gross World USD Index;

** Leveraged Capital Holdings from Banque Privée Edmond de Rothschild until December 1989, then HFRI Fund Weighted Composite Index.



RISK

John Adam

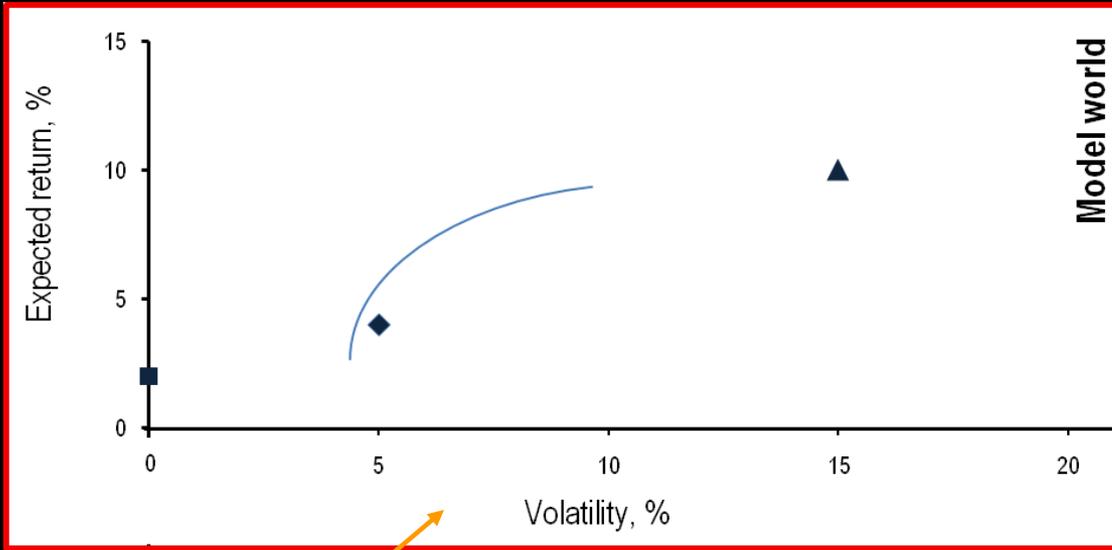


“Real knowledge is to know the extent of one’s ignorance.”

—*Confucius*

“One of the greatest pieces of economic wisdom is to know what you do not know.”

—*John Kenneth Galbraith*



Real world

“Risk“

”Uncertainty“

Beyond volatility

Risk can be defined in various ways

Technocrats define risk as “volatility” ...

- Volatility
- Underperformance
- Bankruptcy
- Accident
- Negative compounding
- etc.



... and generally think
VaR to be a good idea

Risk as accident

San Francisco versus Tokyo



One of the two cities is said to withstand an earthquake of 8.0 on the Richter scale

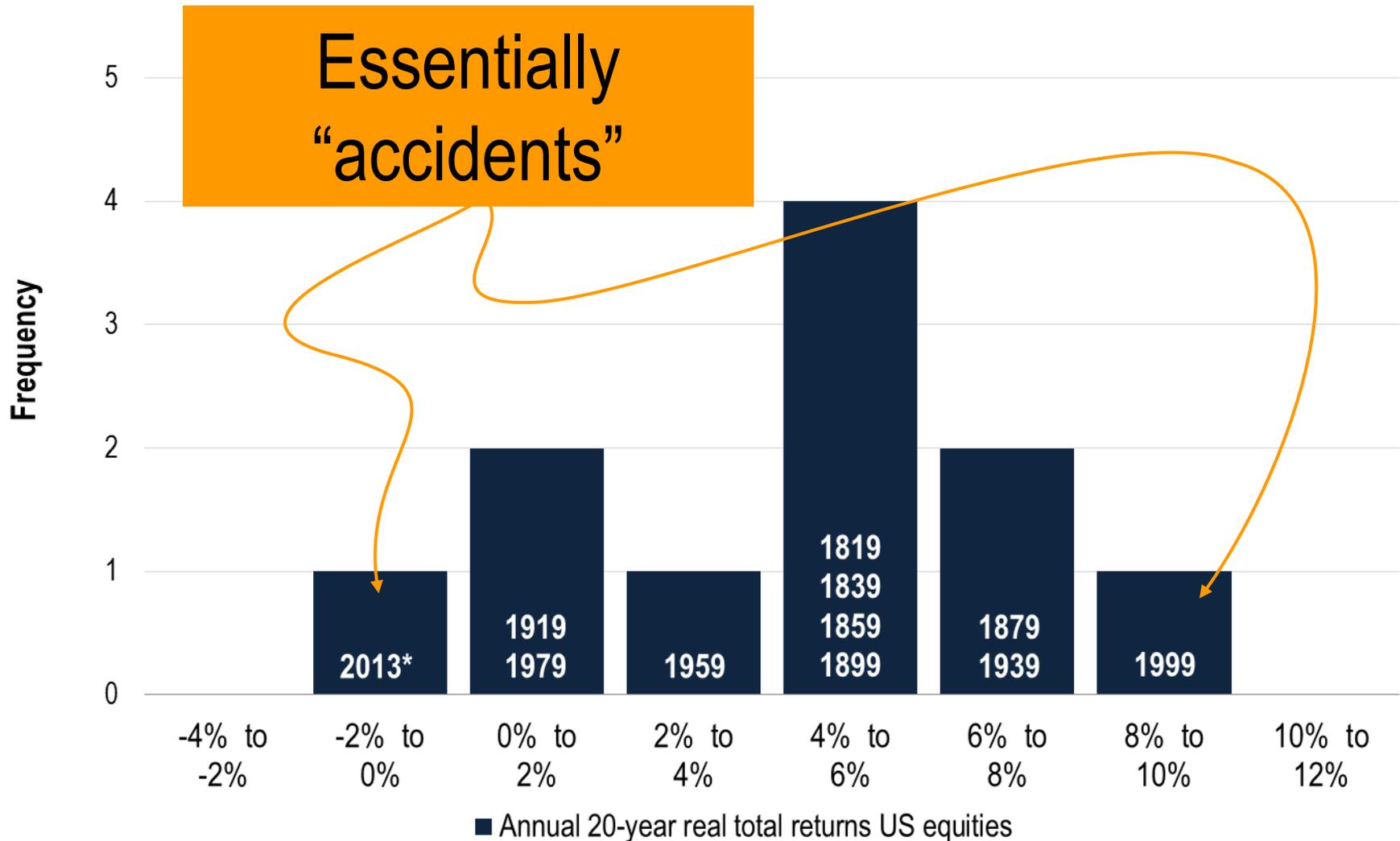
Accidents do not just happen

- In complex systems, accidents are normal and unavoidable
- Attempts to make system safer increases system's **complexity**
- System can become more prone to **accidents**



Equities over the past 200+ years

Annualized 20-year real total returns of US equities

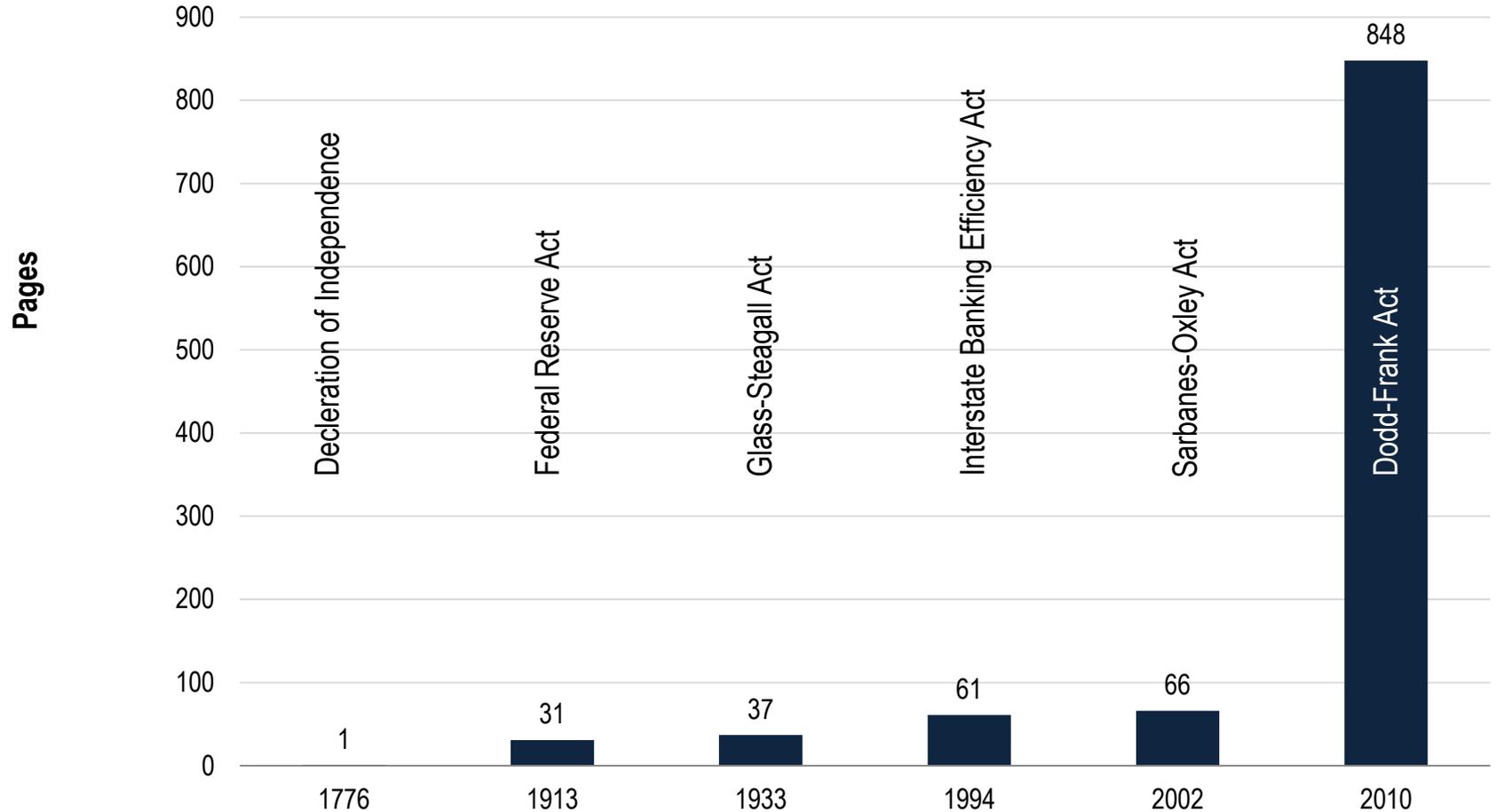


Source: IR&M, Bloomberg, Global Financial Data

* Annualized 13.1-year real total return from January 2000 to January 2013.

Complexity rising

Regulation went “exponential”



Europe falling apart?

Love ...



... and hate



"It's pointless to bet against the euro. It's pointless to go short on the euro. It's pointless because the euro will stay."

—Mario Draghi*

"The European single currency is bound to fail, economically, politically and indeed socially, though the timing, occasion and full consequences are all necessarily still unclear."

—Margaret Thatcher**

*"European Central Bank President Draghi News Conference," Bloomberg, 2 August 2012.

**"Thatcher, Margaret (2002) "Statecraft—Strategies for a changing world," New York: Harper Collins, p. 355.

Something to think about

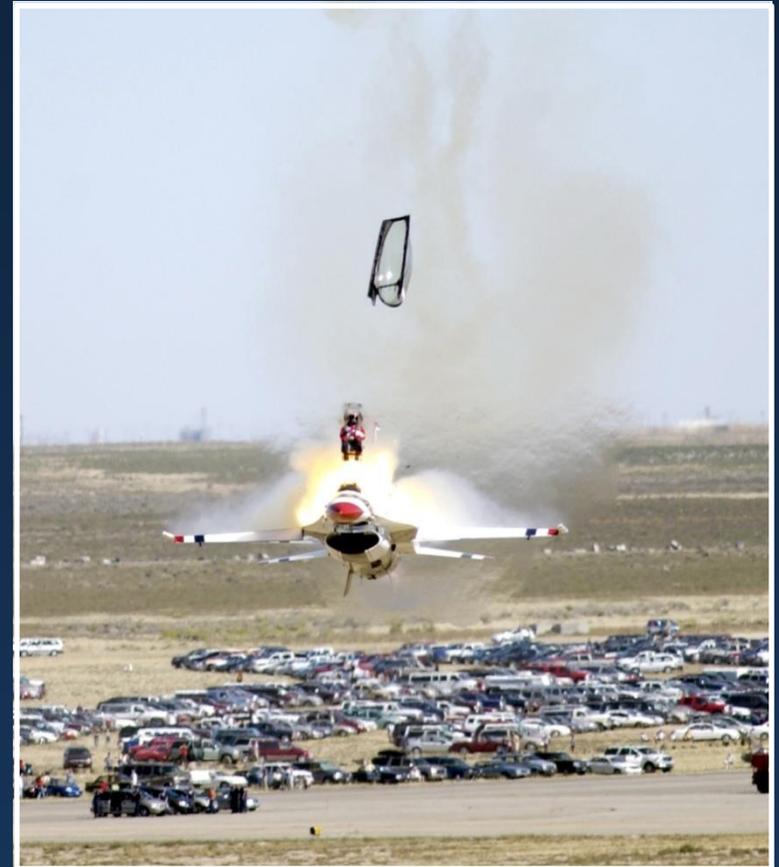
“Risk” could evolve into something unprecedented for current generation

"During my lifetime most of the problems the world has faced have come, in one fashion or other, from mainland Europe, and the solutions from outside it."

—Margaret Thatcher*

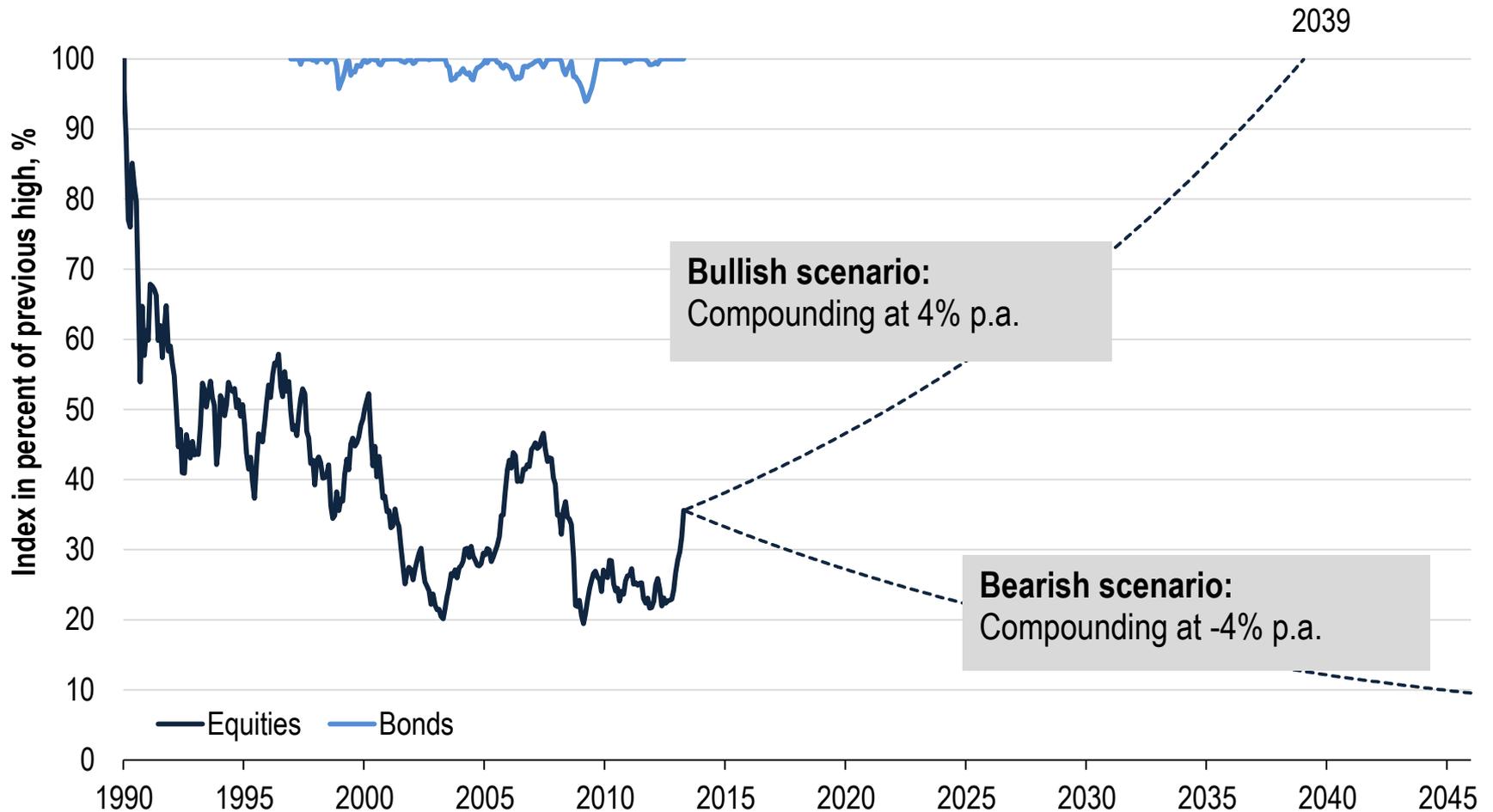
Risk as non-survival

- Accidents are “**known unknowns**”
 - Financial crisis every 10-15 years since Middle Ages
- **Risk management** is discipline, that addresses these “**known unknowns**”



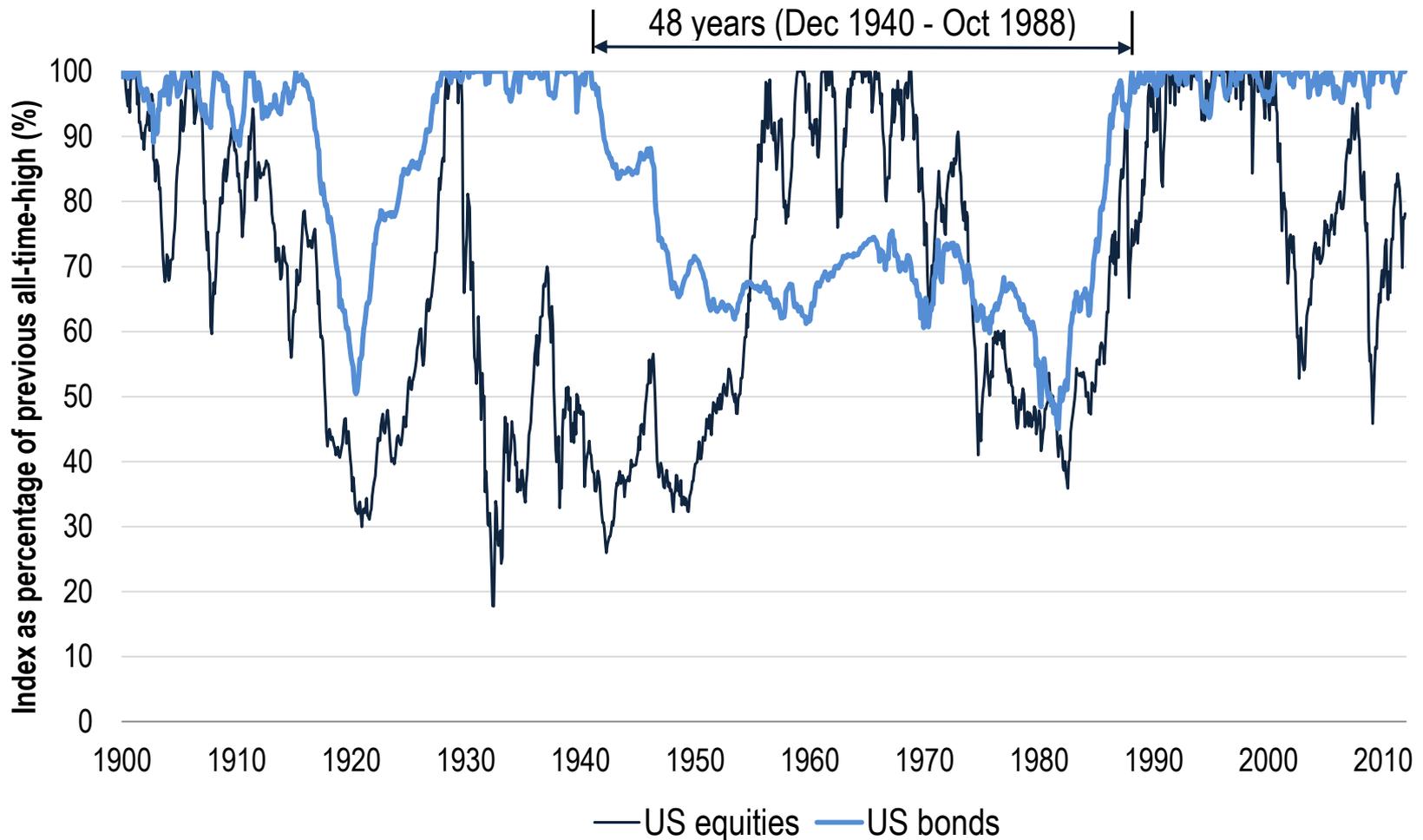
Risk as negative compounding

Nikkei 225: textbook case for negative compounding for decades



Risk as negative compounding, cont.

Bonds more risky than stocks?



Source: IR&M, Global Financial Data, Bloomberg
Equities: S&P 500 TR Index, estimate prior to 1988; bonds: Barclays US Aggregate TR Index, estimate prior to 1976. Indices adjusted with CPI. December 2011 inclusive.

Summary

Current economic environment arguably requires active risk management

“Absolute returns”

is an investment philosophy that seeks

“asymmetric returns”

Implementation requires:

active risk management

- Survive accidents
- Avoid negative compounding

Thank you

Questions?

The absolute returns revolution

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The image shows the cover of a report titled "AIMA'S ROADMAP TO HEDGE FUNDS 2012 EDITION". The cover features a blue-toned world map composed of small dots and lines, with a dark blue background. The text "Absolute returns research" is at the top right, and "Hedge fund performance" is below it. The main title "AIMA'S ROADMAP TO HEDGE FUNDS" and "2012 EDITION" are prominently displayed. On the left side, there is a vertical sidebar with contact information for Alexander Ineichen and James K. Dilly, and a quote from Bret Harter. At the bottom right, it credits Alexander Ineichen as the founder and mentions the support of Deutsche Bank. Logos for IR&M and AIMA are at the bottom.

IR&M

Absolute returns research

Hedge fund performance

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"The only way
that it will d
— Bret Harter
American audit

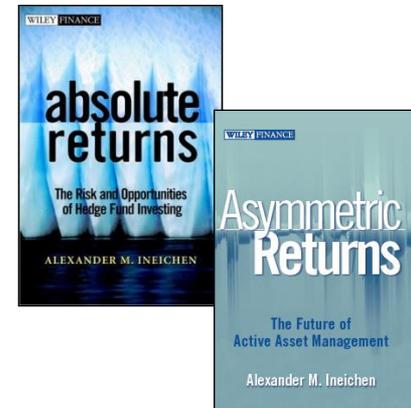
AIMA'S ROADMAP TO HEDGE FUNDS
2012 EDITION

BY ALEXANDER INEICHEN, FOUNDER,
INEICHEN RESEARCH AND MANAGEMENT AG
COMMISSIONED BY AIMA'S INVESTOR STEERING COMMITTEE
PRODUCED WITH THE SUPPORT OF DEUTSCHE BANK

The logo for Ineichen Research and Management (IR&M) features a stylized pyramid with a red top section and blue bottom sections, followed by the text "IR&M" in a serif font.

Selected publications

- ◆ “In Search of Alpha - Investing in Hedge Funds,” UBS Warburg, October 2000.
- ◆ “The Search for Alpha Continues - Do Fund of Hedge Fund Managers Add Value?” UBS Warburg, September 2001.
- ◆ “Asymmetric Returns,” UBS Warburg, 30 September 2002.
- ◆ “Absolute Returns – The Risk and Opportunities of Hedge Fund Investing,” 2003, John Wiley & Sons, New York.
- ◆ “Asymmetric Returns and Sector Specialists,” *Journal of Alternative Investments*, Vol. 5 (2003), No. 4 (Spring), pp. 31-40.
- ◆ “Fireflies Before The Storm,” UBS Warburg, June 2003.
- ◆ “Absolute Returns: The Future in Wealth Management?” *Journal of Wealth Management*, Vol. 7 (2004), No. 1, pp. 64-74.
- ◆ “European Hedge Funds,” *Journal of Portfolio Management*, Vol. 30 (2004), No. 4, pp. 254-267.
- ◆ “The Critique of Pure Alpha,” UBS Investment Research, March 2005.
- ◆ “Asymmetric Returns – The Future of Active Asset Management,” 2007 John Wiley & Sons, New York.
- ◆ “The Iron Law of Failure,” AIS, UBS Global Asset Management, July 2007.
- ◆ AIMA’s Roadmap to Hedge Funds, November 2008. (available in English and Chinese)
- ◆ “Absolute returns revisited,” Ineichen Research and Management, April 2010.
- ◆ “Equity hedge revisited,” Ineichen Research and Management, September 2010.
- ◆ “Regulomics,” Ineichen Research and Management, May 2011.
- ◆ “Europe doubling down,” Ineichen Research and Management, 3 October 2011.
- ◆ AIMA’s Roadmap to Hedge Funds, 2nd edition, November 2012.
- ◆ Hedge fund performance, Ineichen Research and Management, 25 February 2013.



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