UBS Global Asset Management

Asymmetric Returns_The Future of Asset Management

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For his Statue of David in 1501, Michelangelo used a single block of marble. In fact it was a block that had been started upon but abandoned by another, lesser talent, years earlier. At the time, everyone thought that this block of marble was ruined - that its potential had been exhausted, and that nothing further could be extracted from it. But Michelangelo took on this discarded block, and from it he created one of the masterpieces of all time. For Michelangelo, to sculpt meant to take away, not to add, because the "the work of art" already existed inside the stone. The block of marble was just the covering of a work of art; the sculptor only had to take away the part in excess. The sculptor's hand, guided by skill and experience, could only "liberate" what was already there inside the block of marble. One could argue that, similarly, the alpha in capital markets is already there. But special talent is required to hedge ("take away") all the various unwanted risks in order to carve out the gains - the "alpha".

> As markets become more and more efficient, the constrained investor will find it increasingly difficult to generate alpha

As markets become more and more efficient, carving out the alpha will be increasingly difficult without using all financial tools available. Constraining managers in their field of expertise and the use of the tools to execute their craft, therefore, cannot be optimal. In Ineichen [2006] we claim that the key tools required to extract alpha are risk management tools.* In our view, investors cannot manage returns, but they can manage risk. Achieving sustainable positive absolute returns is the result, we believe, of taking and managing risk wisely. The result-when successful-is an asymmetric return profile.

An asymmetric risk/return profile is therefore the result of an active risk management process. By "asymmetric returns" we mean a return profile that is not available through long-only buy-and-hold strategies. Achieving an asymmetric return profile requires a dynamic and flexible risk management process as well as an entrepreneurial and absolute return mindset. In an uncertain world and with financial markets being volatile, being able to respond to change is the sine-qua-non of risk management. John Maynard Keynes was stating the obvious when he said: "When circumstances change, I change my view. What do you do?" In essence, defining risk in absolute terms and controlling downside risk actively is the opposite of the relative return investment philosophy with concepts such as benchmarking and indexing.

We claim that the delivery of these asymmetric return profiles is the goal, and the future, of active asset management. This claim is based on some assumptions about what investors really want. An important one of these is that all investors are loss-averse, that is, they do not perceive volatility on the downside in the same fashion as volatility on the upside. Hence our focus on asymmetry and our use of the term Asymmetric Returns.

> Achieving asymmetric returns requires a dynamic risk management process and an entrepreneurial mindset

The term "hedge fund" is a misnomer because there are no hedge funds that hedge all risks. If all risks were neutralised, so would be the returns. As racing driver Mario Andretti put it: "If everything is under control, you're driving too slow." Or if all risks were hedged, the portfolio would yield the risk-free rate of return. (Which is probably why the risk-free rate of return is called, well, the risk-free rate of return.) Returns are a function of taking risk. Absolute return investing implies that the risk-neutral position is cash (i.e., no risky positions at all).

Generating alpha by definition means to take some risk. However, there are risks that are more likely to carry a reward, and risks that are less likely. This is where the asymmetry comes in. In financial markets there is both, randomness as well as predictability. The process of differentiating the two, the "sculpting", is then a function of intelligence, knowledge, insight, savvy-ness, effort, experience and skill. Luck helps, certainly, but, in the long run, that cannot be the determinant of success.

Controlling downside risk goes beyond managing volatility that can be easily accomplished by including cash

The ultimate goal of an active investment management process is "alpha". In the relative return world, success is typically referred to as outperforming a benchmark. This means that losing 28 percent when the benchmark fell 30 percent is actually quite an astounding achievement because the outperformence was two percentage points. However, in the absolute return world there are no benchmarks. The active risk manager, unlike the relative return manager, has additional objectives that go beyond beating an arbitrary benchmark. We believe this new terminology of "asymmetric returns" goes beyond "the search for alpha". In fact, the term alpha originally stems from a linear model. We believe alpha is non-linear, an option of some sort.

An asymmetric return profile is either achieved through absolute return managers driven by P&L or, more passively, through financial engineering using hedging techniques. What we call a hedge fund today is really part of the risk management business. Given that many investors expect the 2000 to 2020 period to be less investor-friendly than the 1980-2000 period, we could currently be witnessing the convergence between what we referred to as the asset management industry and what we have come to understand to be the risk management business. Taking this line of thought further, we could say there is a convergence between the long-term (as in "equities outperform bonds in the long-term") and the short-term (as in "interim volatility matters"). The synthesis of the two would be, in its active form, managers seeking investment opportunities while managing total risk.

An institutional or private investor allocating money to an active risk manager is essentially outsourcing to that manager the task of managing total risk. This is one of the main differences compared with the relative return approach, where the manager does not have a mandate to manage capital at risk, but has a mandate to manage tracking risk relative to a market or liability benchmark. Confusion arises because risk is sometimes defined in relative terms and sometimes in absolute terms. During the 20-year equity bull market, the traditional asset management industry used a more relative metric, whereas the risk management industry (essentially trading departments of investment banks and hedge funds) focused on an absolute metric to define and manage risk. Among the pivotal objectives of active risk management-unlike with relative return investing-are avoiding absolute financial losses as well as actively managing downside risk.

Controlling downside risk goes beyond managing volatility that can easily be managed by including cash in a risky portfolio. The risk management process of an active risk manager focuses largely on controlling the probability of large losses. It is large losses that kill the rate at which capital compounds over the longer term. The irony of this is that while hedge funds are renowned for short-term trading, the value proposition is designed to appeal to long-term investors. The often referenced short-termism of hedge funds refers to the notion that risk is actively managed. An active risk manager continuously responds to changing market circumstances, that is, constantly adapts to an ever-changing market environment and its risks. Darwin was probably on to something when he said: "It is not the strongest of the species which survive, nor the most intelligent, but those most able to change." Constraining an active manager, therefore, is like giving Michelangelo only a hammer.

Endnote

This article draws on material from Ineichen (2006). The views and opinions expressed in this article are those of the author and are not necessarily those of UBS. UBS accepts no liability over the content of the article. It is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. ■

Biography

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Reference

* See Ineichen, Alexander M. (2006) “Asymmetric Returns-The Future of Active Asset Management,” New York: John Wiley & Sons.

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