

Hedge fund investing

The Sigma Perspective



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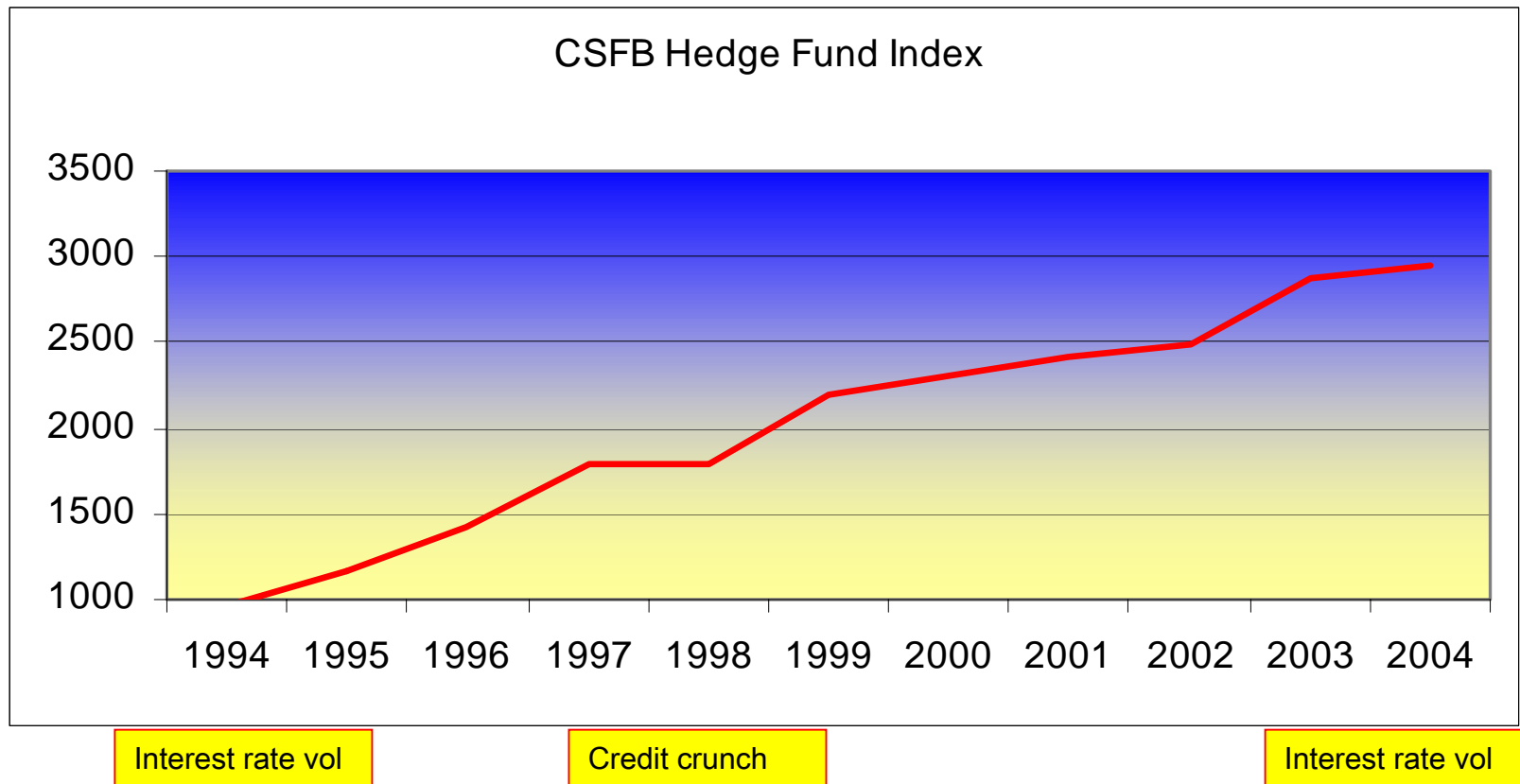
Agenda

- History of a decade (1994–2004): myths and facts
- Hedge Fund Indices: the likely mistake for 2005
- The perspective on hedge fund investments
- Conclusions

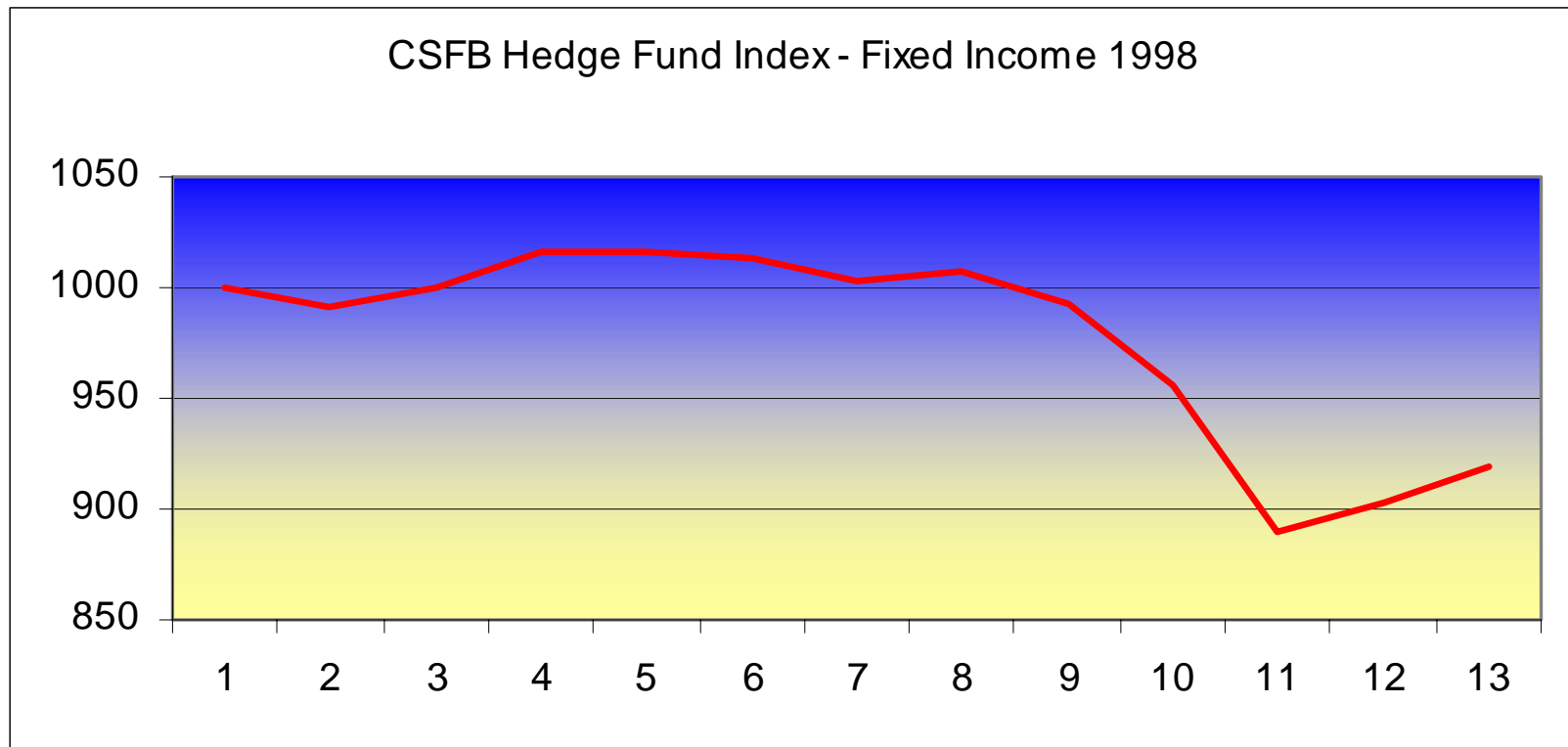
Sigma Analysis & Management

- Marriage between business and academia: the RiskLab
- Risk Management and Asset Management background
- Founded in 1999 as an institutional advisor. In 2002 became manager for family offices. In 2004 it joined Quadrex to bring a risk-controlled product to the retail market.
- 11 employees in Canada, US and UK.
- Clients: Canadian banks and pension plans, US family offices, Insurance Companies and Pensions.

History of a decade: 1994-2004



The myth of 1998: Fixed income is bad”

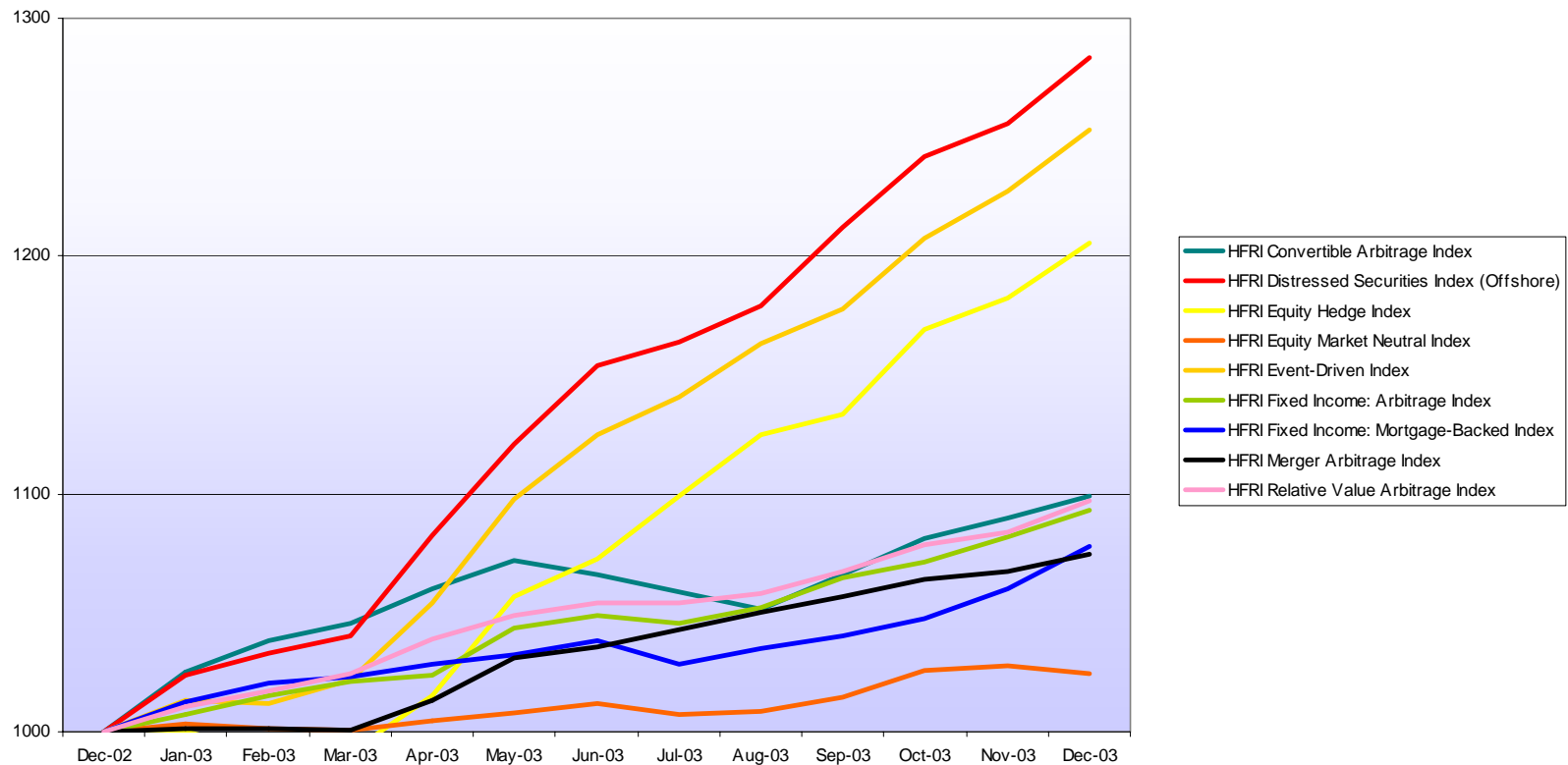


Facts (1998)

- “Fixed Income arbitrage” suffered generalized losses:
-8%
- “equity hedged” obtained generalized *gains*: +13%
(M.F. +20%)
- A balanced hedge fund portfolio would have been OK
in 1998.
- Investors decide to avoid Fixed Income as a style.

The myth of 2003:

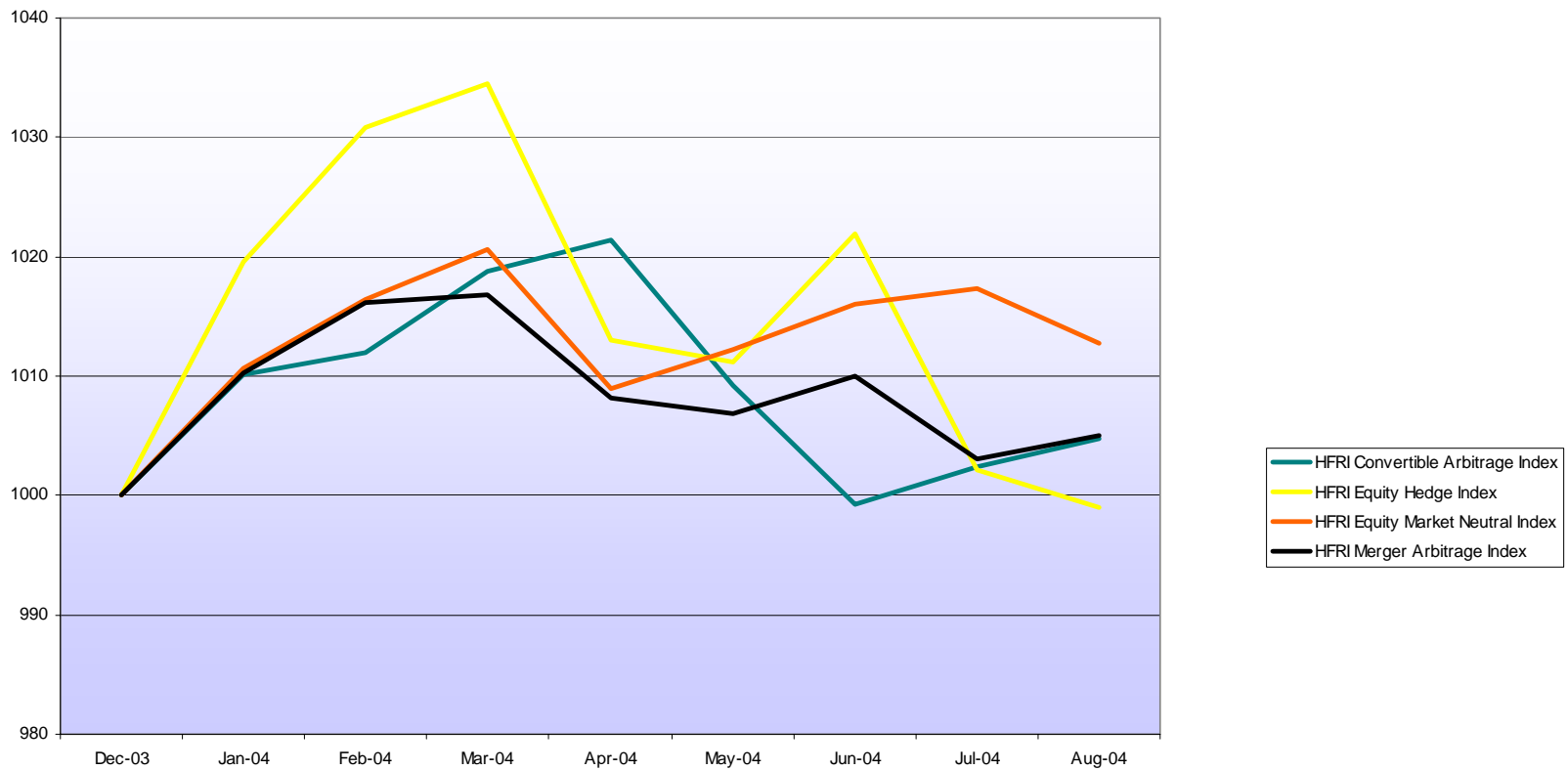
“Hedge funds (equity hedged) are good”



Facts: 2003

- Most hedge fund styles obtained great returns.
- The style “equity hedge” came out on top: +17%.
- Investors moved en-masse to this style for 2004, forgetting all others.

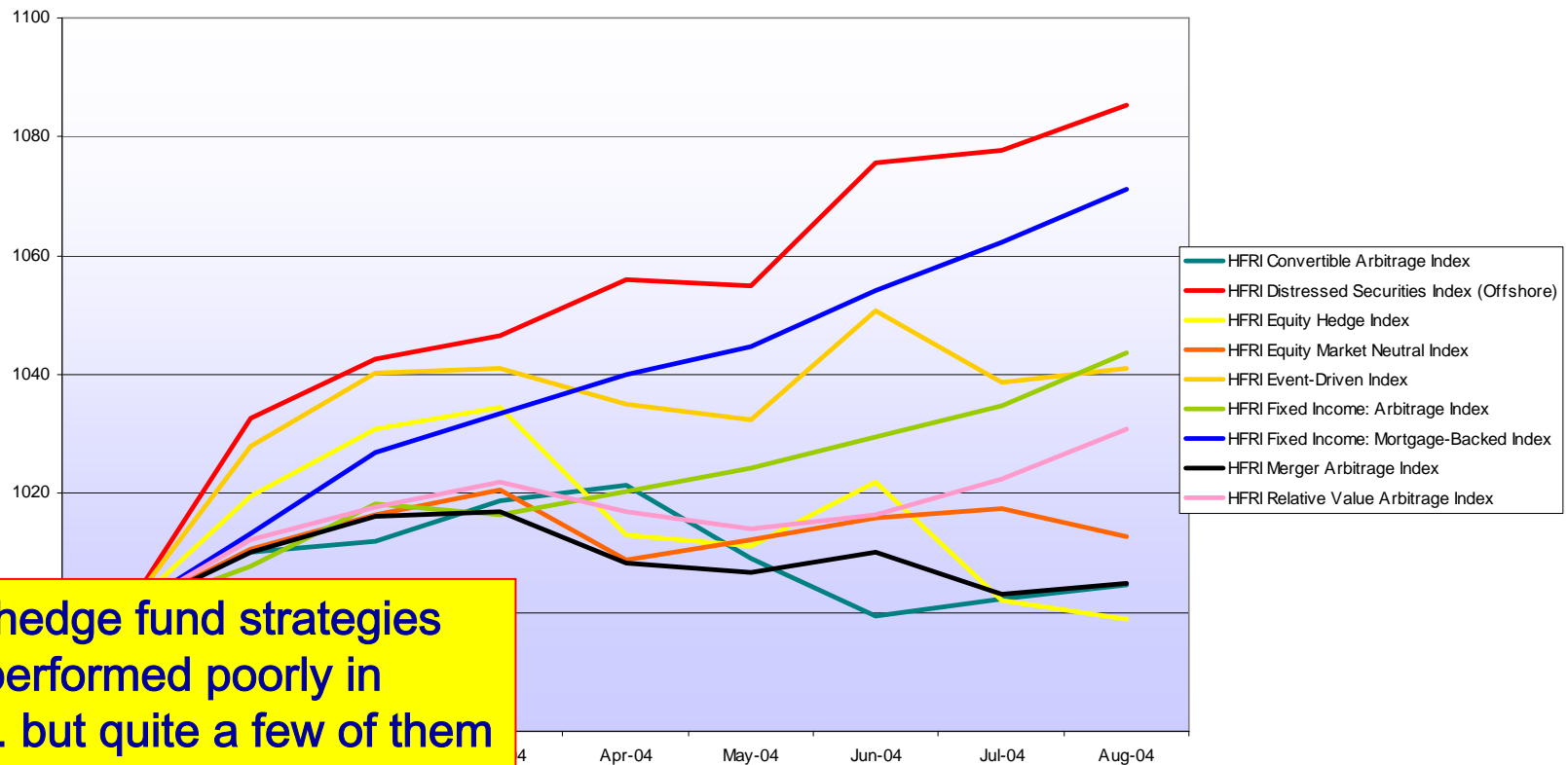
The myth of 2004: “hedge funds are bad”



The facts: 2004

- “Equity hedge” lost, as a style, in 2004.
- Many investors, who trusted this (the most common), lose confidence.
- Speculation arises as to whether hedge funds continue to bring value to investors portfolios.

Myth and science in 2004



Many hedge fund strategies have performed poorly in 2004... but quite a few of them seem to be recovering, and some have not been affected by the "bad times" at all.

Science: lessons from history

- Hedge funds continue to provide diversifying returns.
- One should never favor one style against another based on simplistic rear-looking arguments.
- The main property of hedge funds is their **low correlation**: this should not be destroyed with directional bets or unfounded decisions.



Hedge Funds indices

The myth of 2005?

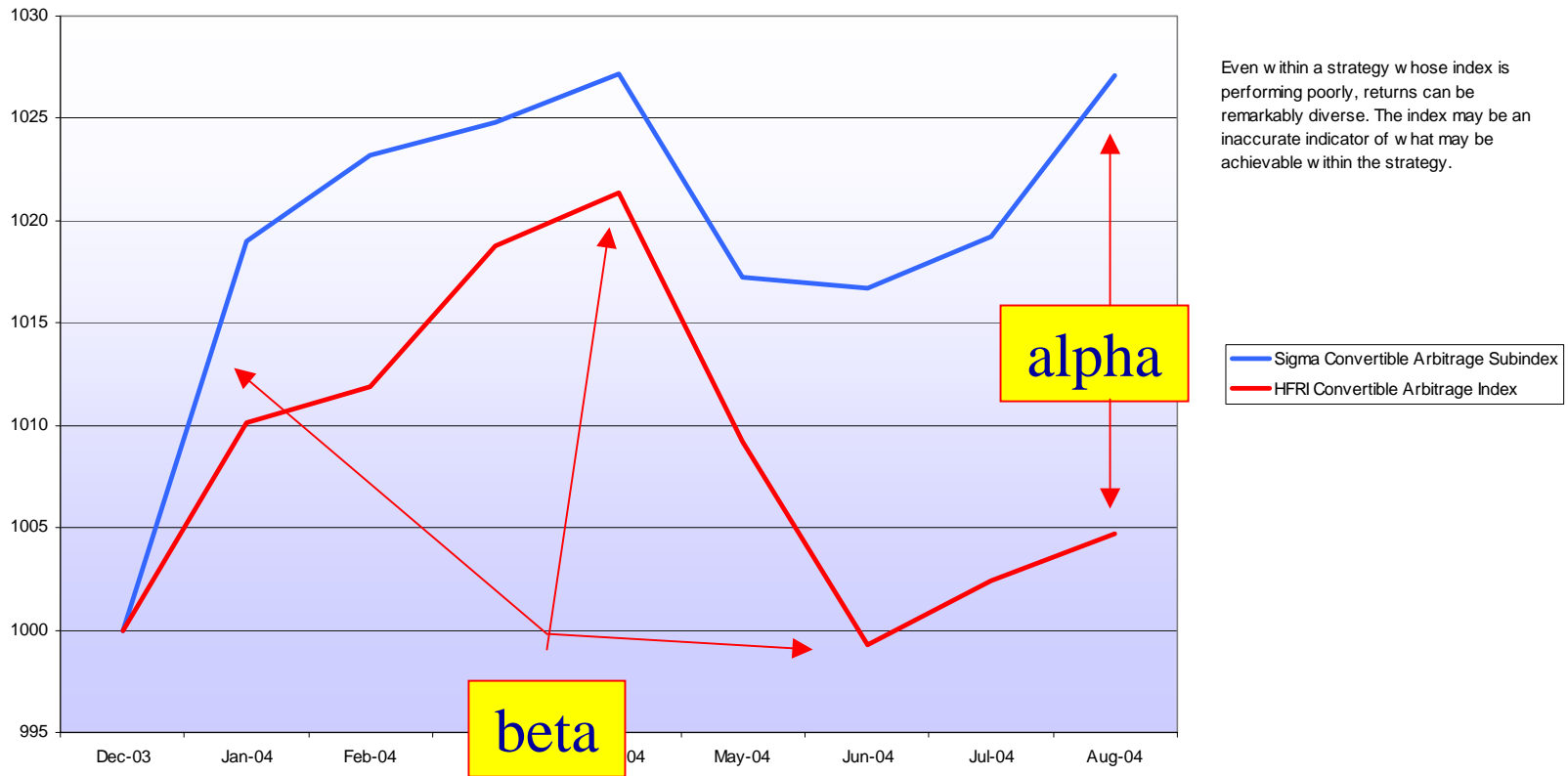
Hedge Funds

- Hedge Funds, unlike traditional investments, show little cohesion.
- This is what makes them attractive: they add diversification.
- Because of hedge fund diversity, a hedge fund index is going to fail to capture anything of interest; they are plain fund-of-funds

Differences with stock indices

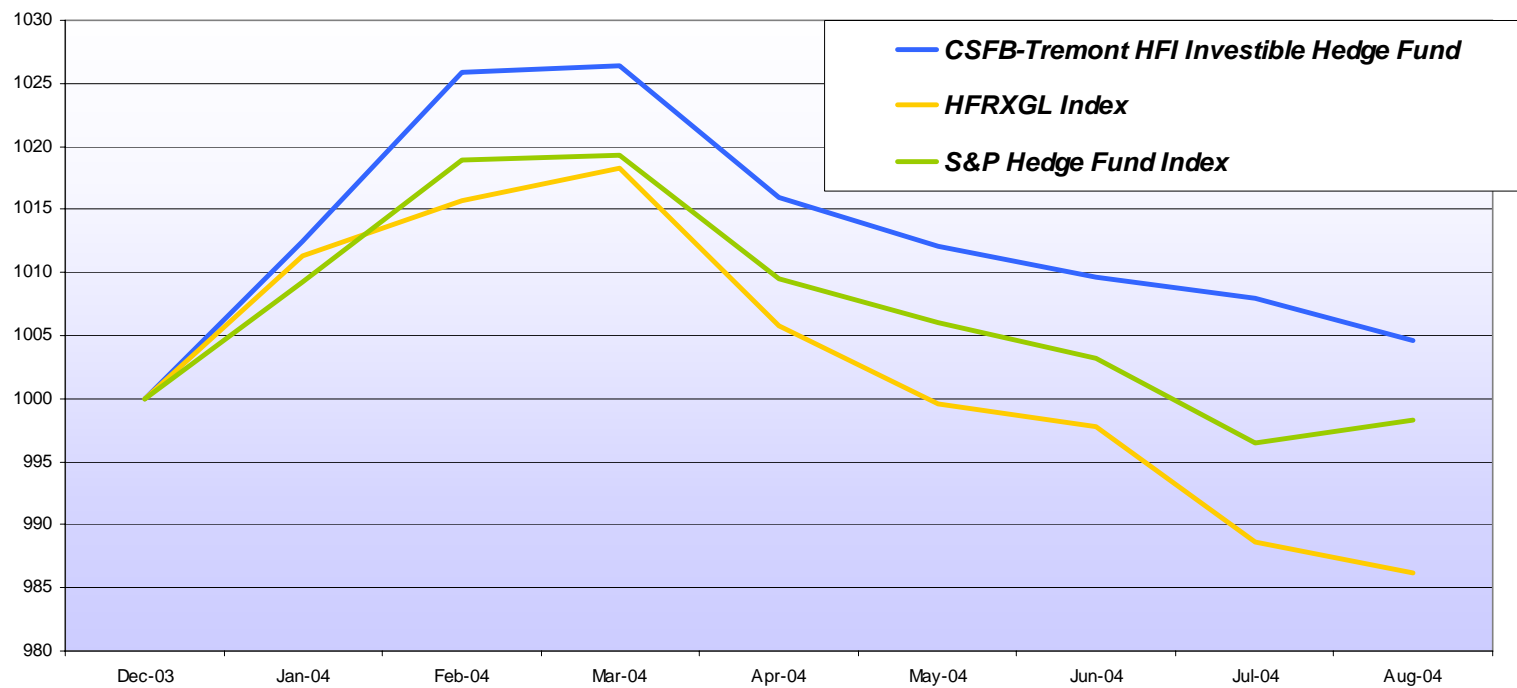
- Index constituency is a function of liquidity, operations, etc. not performance.
- Unlike stock indices, investors don't like their hedge funds to be included in hedge fund investable indices

Alpha and beta



Even within a strategy whose index is performing poorly, returns can be remarkably diverse. The index may be an inaccurate indicator of what may be achievable within the strategy.

Indices in 2003



Index correlations

CSFB Hedge Investible Index	1.00				
MSCI Composite Equal-Weighed Index	0.47	1.00			
MSCI Composite Asset-Weighed Index	0.51	0.98	1.00		
S&P Hedge Fund Index	0.41	0.90	0.94	1.00	
Van Global Hedge Fund Index	0.80	0.48	0.51	0.41	1.00

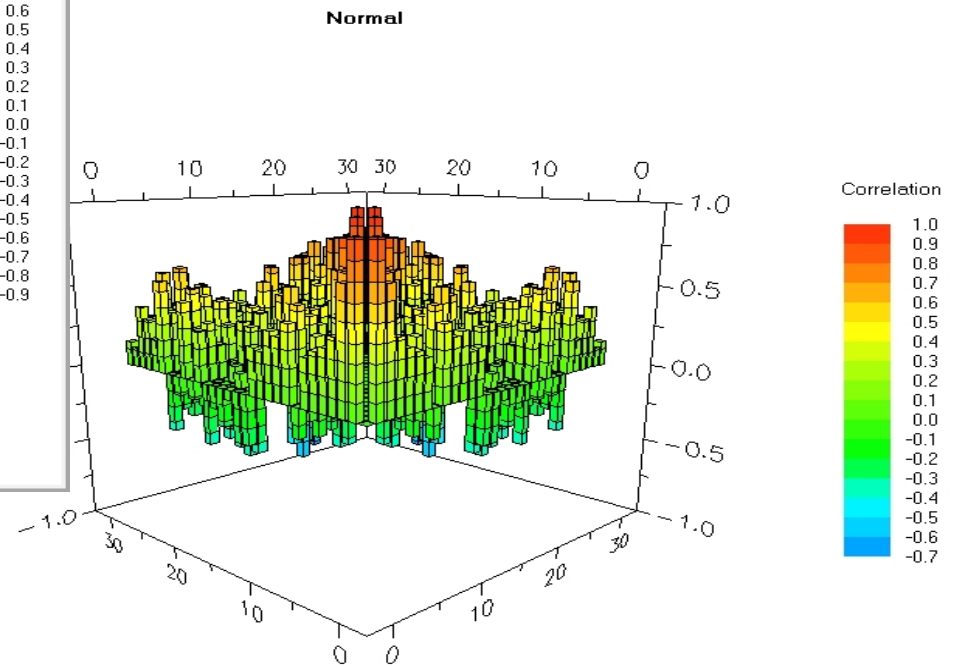
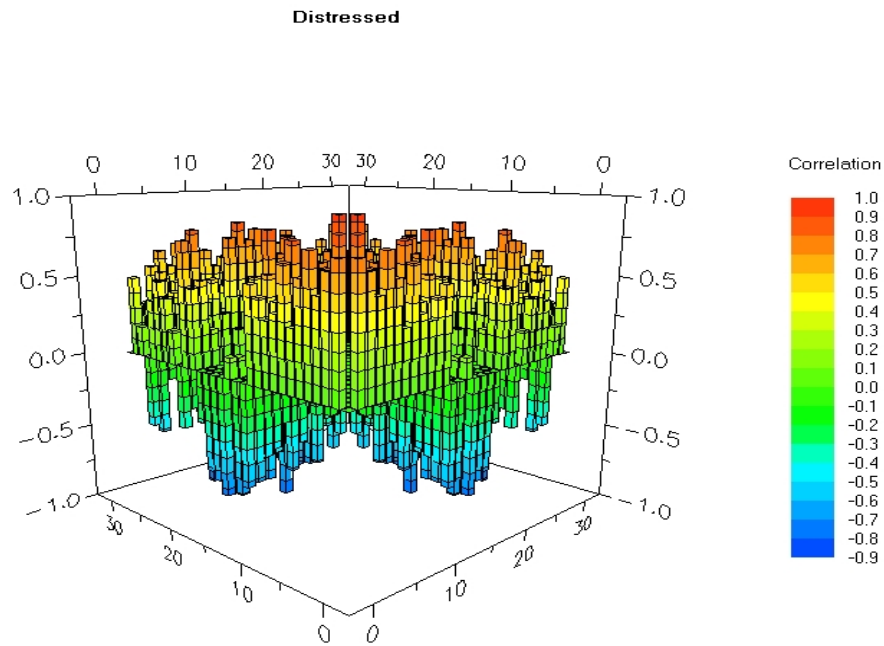


How to invest in Hedge Funds

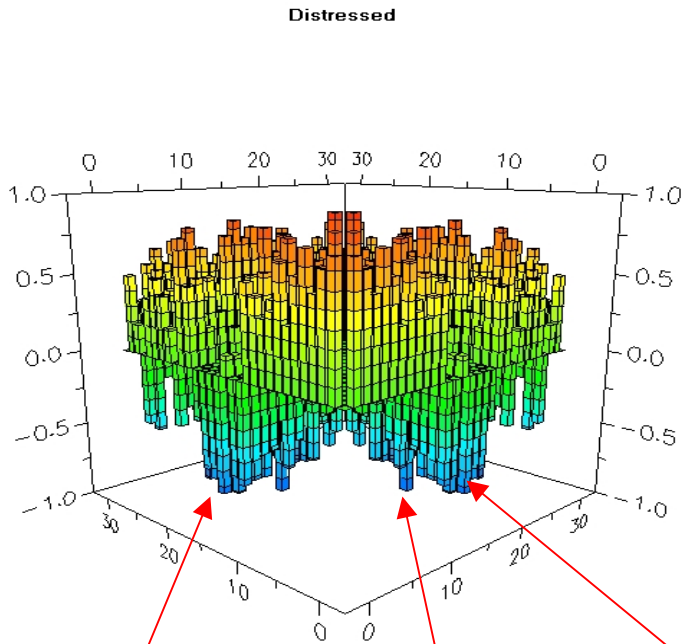
What investors should keep in mind

- Absence of correlation continues to be the best aspect of hedge fund investing.
- Correlations change, and an investment should not be left to diversification exposure, which affects the portfolio in the most difficult times.
- There are many mediocre hedge funds, but there are still many which are excellent.

Risks to avoid: distressed alignment



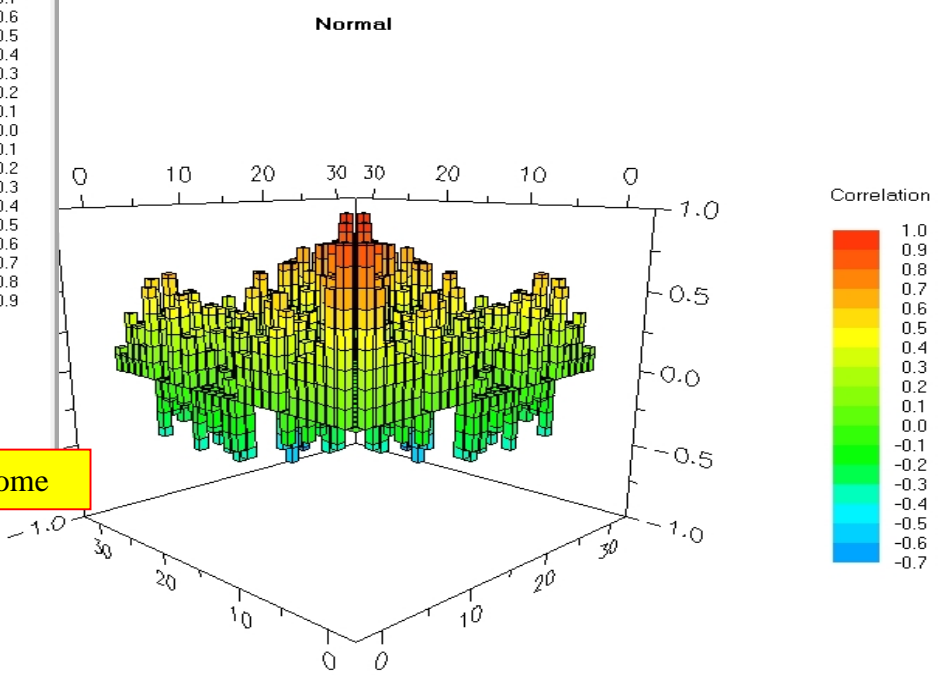
Risks to avoid: distressed alignment



Equity vs Fixed Income

CTA vs Fixed Income

Equity vs Fixed Income



Other risks

- Style risk
- Concentration
- Valuation
- Liquidity
- Operational risk
- Blow-up

Other risks

● Style risk	Non-diversifiable
● Concentration	Non-diversifiable
● Valuation	Non-diversifiable
● Liquidity	diversifiable
● Operational risk	diversifiable
● Blow-up	diversifiable

The Reference Portfolio

- Identify the risks.
- Get a target return.
- Produce a risk tolerance.
- Mathematize the simultaneous risk mitigation problem.
- Do the math

Investment design

- Get a low risk hedge fund foundation: modest return, minimal risk.
- Performance independent of market events
- Get proper liquidity for the underlying hedge funds
- Lever on the low risk levels of the foundation to enhance returns

Conclusions

- Don't buy last year's returns
- Travel with the airline which is aware of the risks.
- Play hockey with good goalies and defense, not just forwards.
- Have a balanced diet.