Hedge fund investing

Luis A. Seco

President and CEO, Sigma Analysis & Management

Sigma Analysis & Management

The Fields Institute

222 College Street

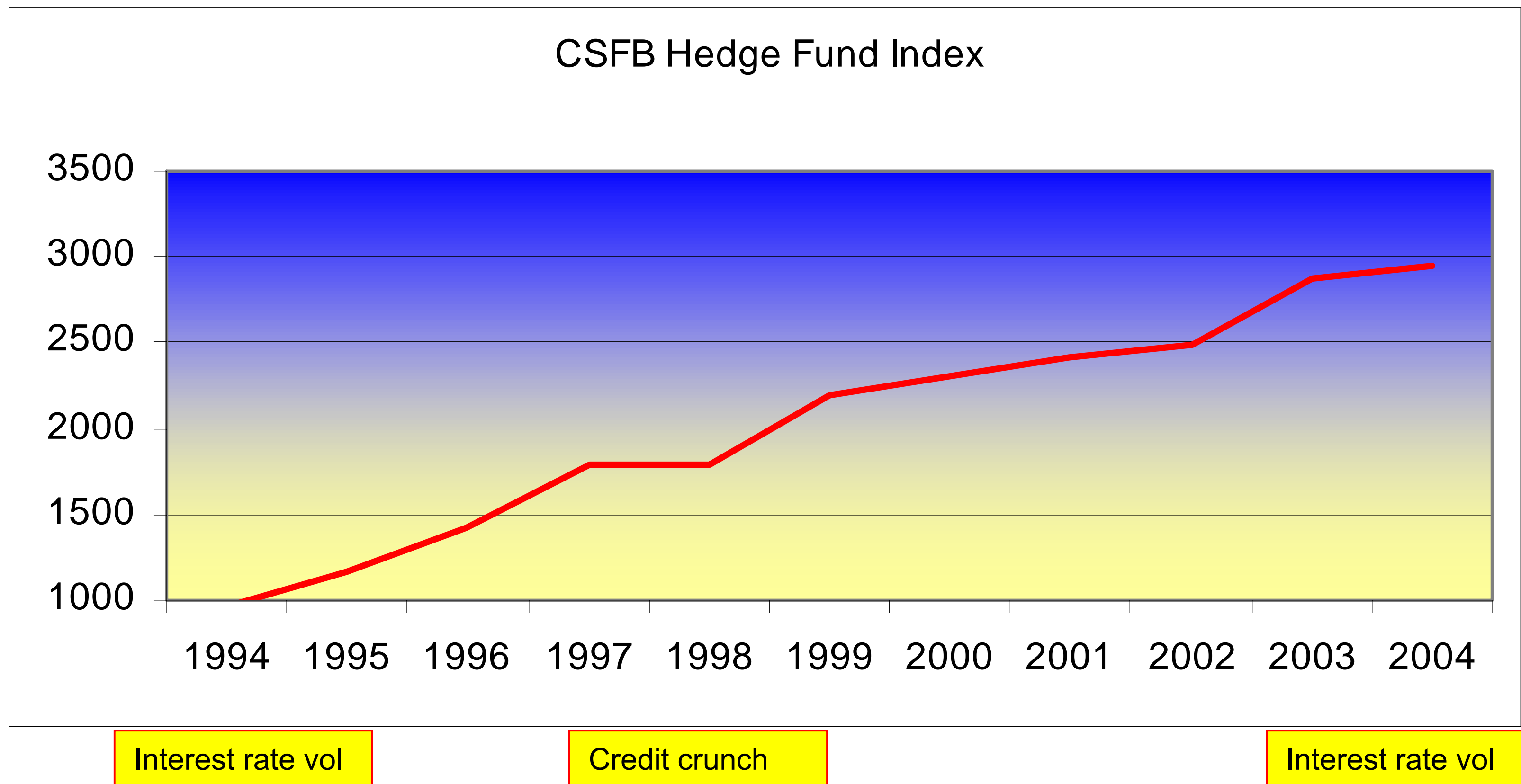
Toronto, Ontario M5T 3J1

Seco@sigmanalysis.com

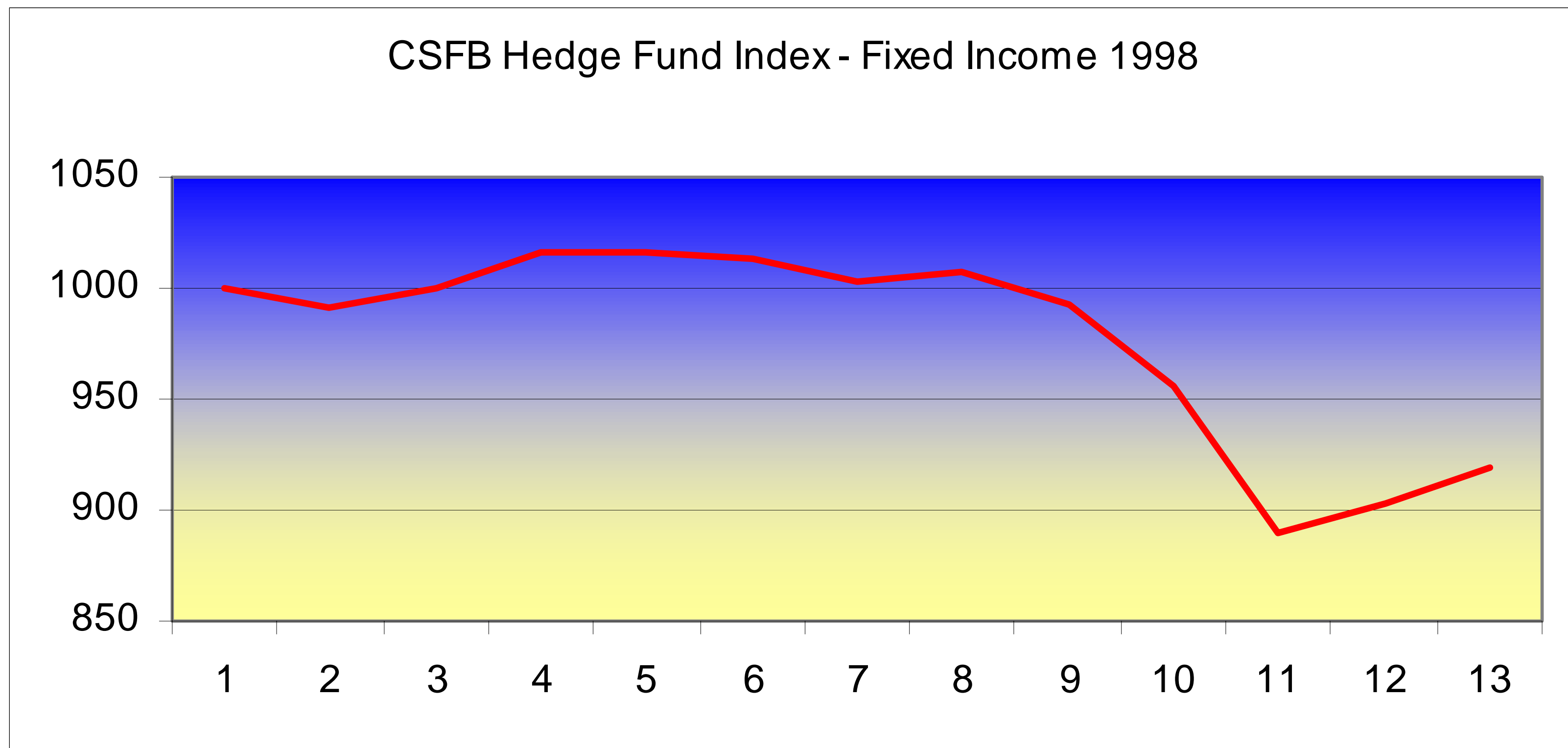
Agenda

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

History of a decade: 1994-2004



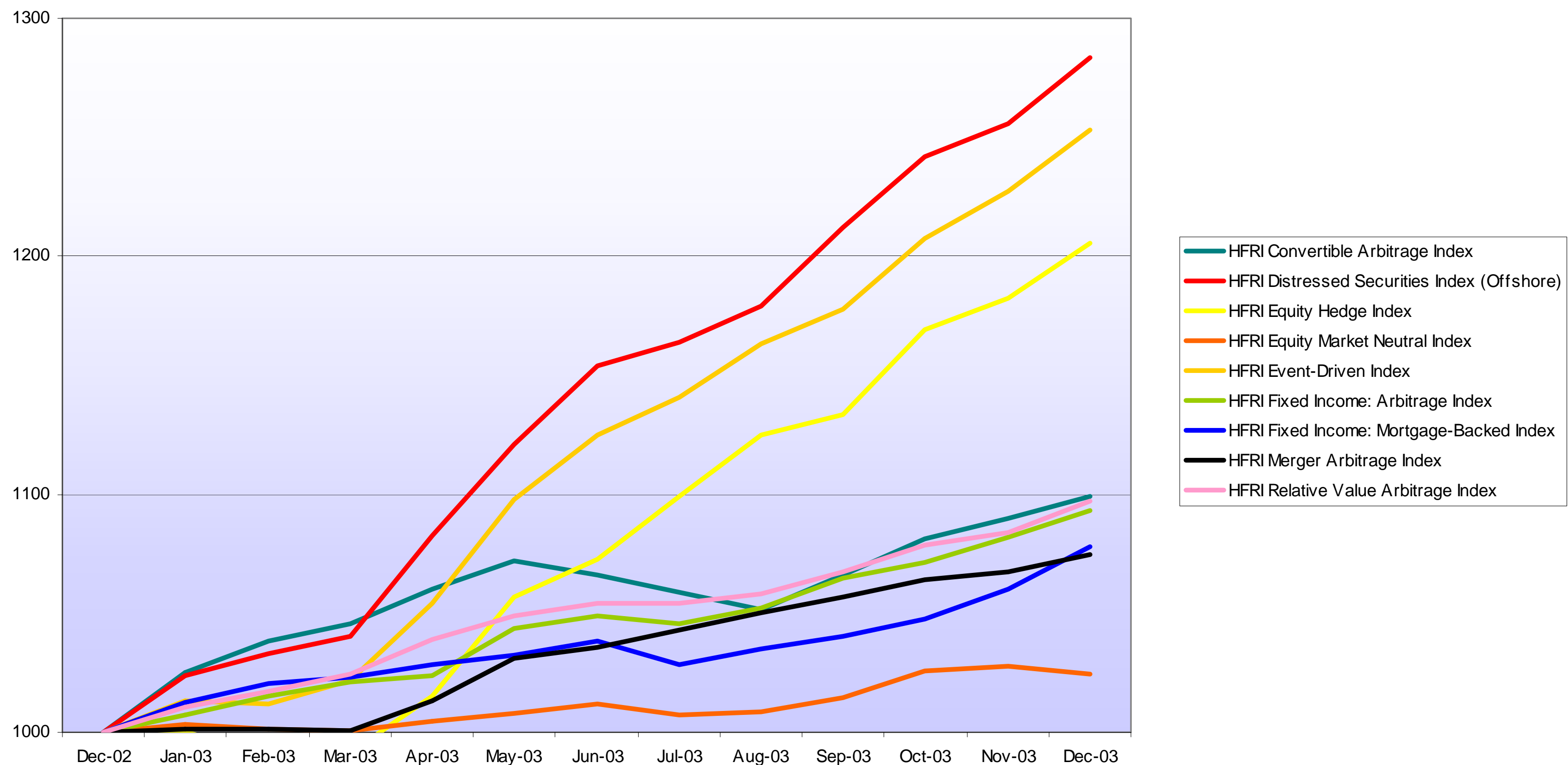
The myth of 1998: Fixed income is bad”



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.

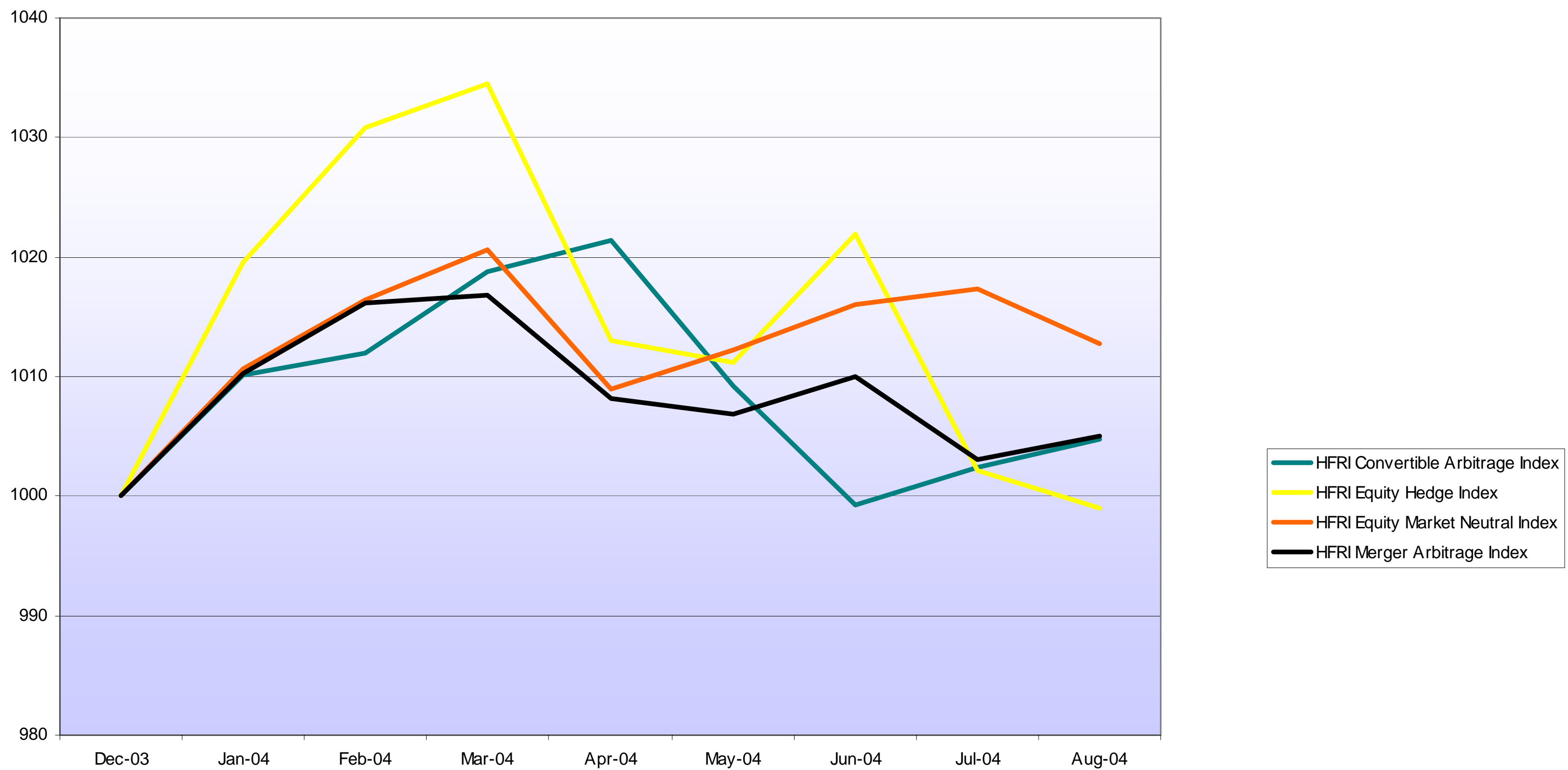
The myth of 2003:
“Hedge funds (equity hedged) are good”



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.

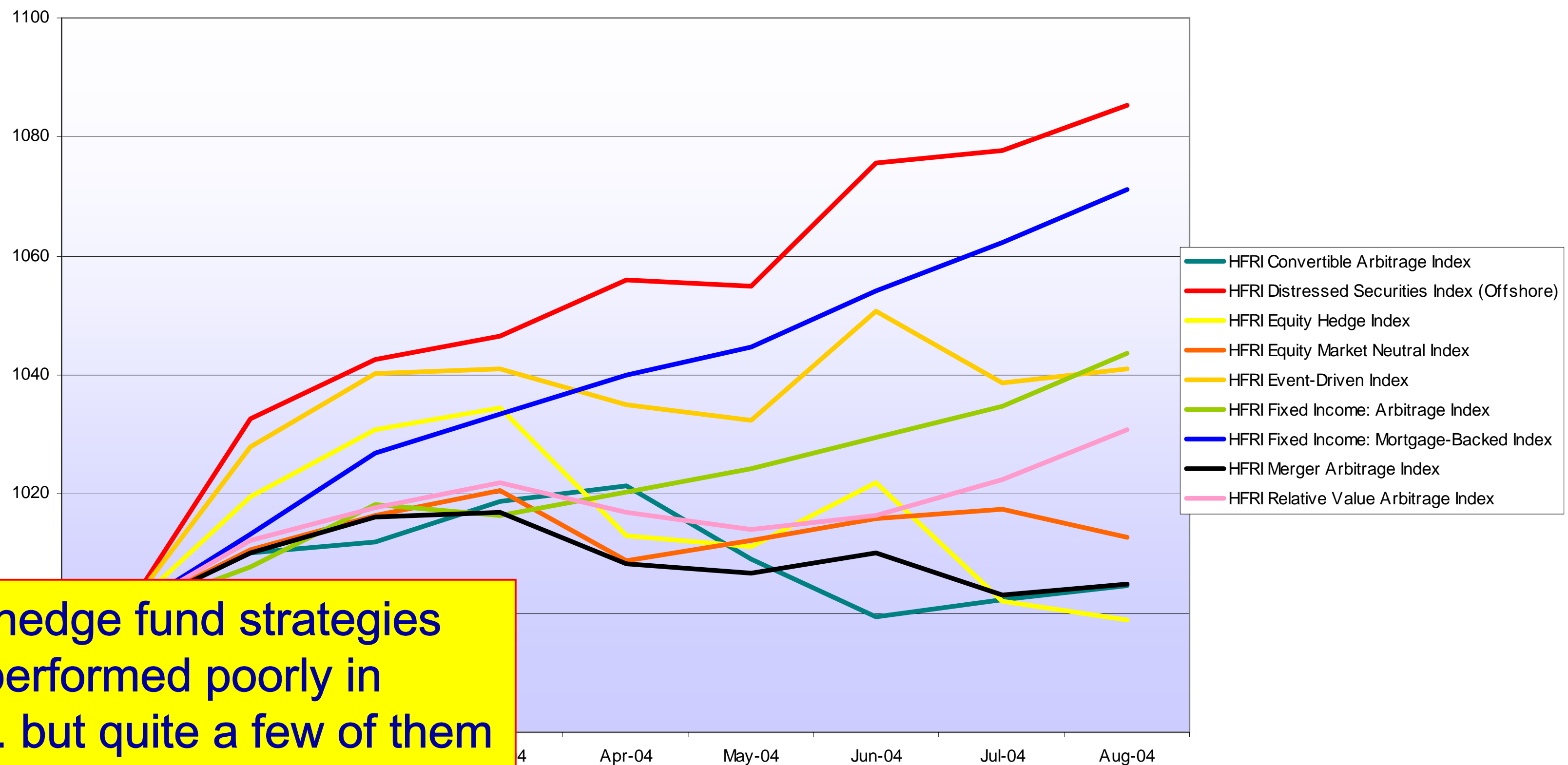
The myth of 2004: “hedge funds are bad”



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 <u>have not been affected</u> 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.

The myth of 2005?

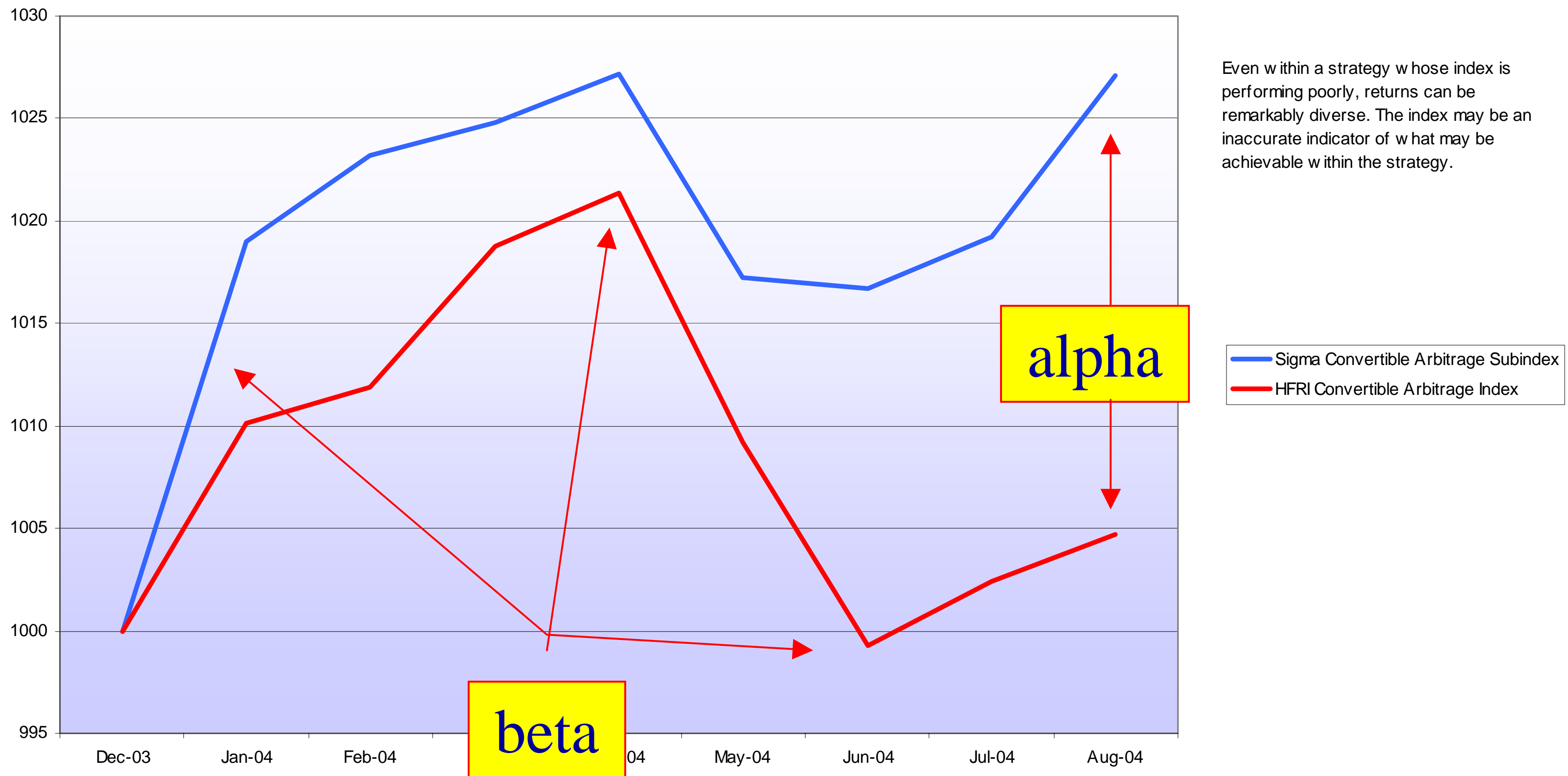
Hedge Funds

- 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

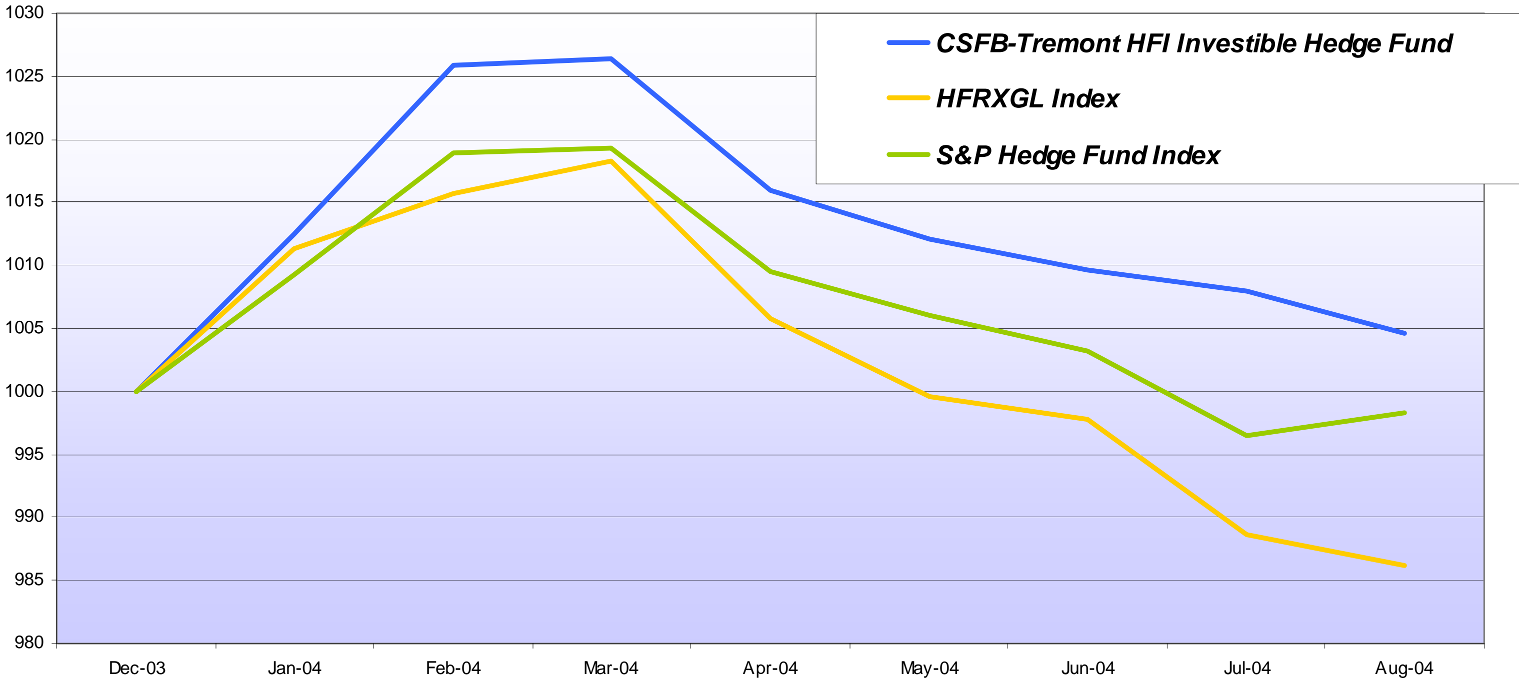
Differences with stock indices

- Index constituence 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



Indices in 2003



Index correlations

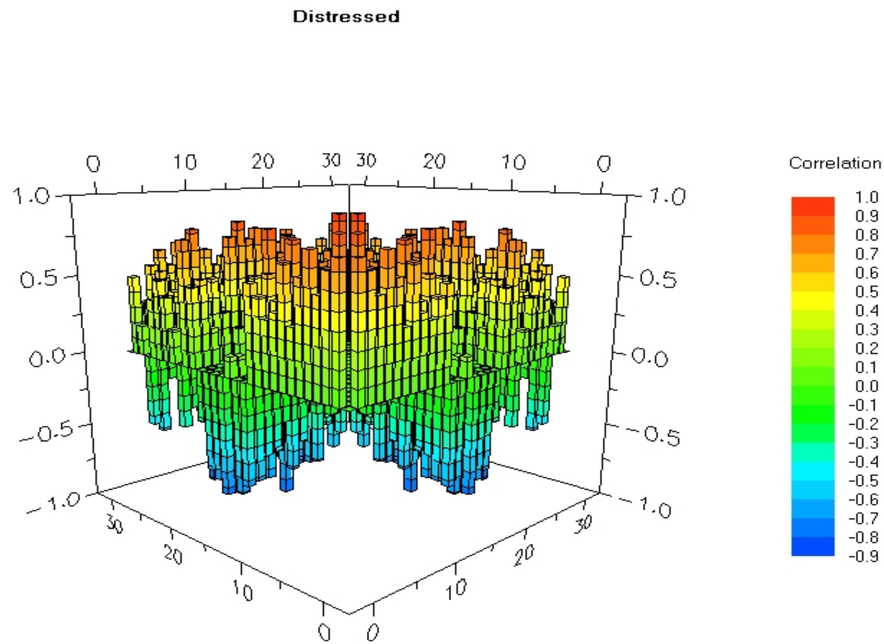
CSFB Hedge Investible Index	**1.00**				
MSCI Composite Equal-Weighed Index	**0.47**	**1.00**			
MSCI Composite Asset-Weighed Index	**0.51**	**0.98**	**1.00**		
S&P Hedge Fund Index	**0.41**	**0.90**	**0.94**	**1.00**	
Van Global Hedge Fund Index	**0.80**	**0.48**	**0.51**	**0.41**	**1.00**

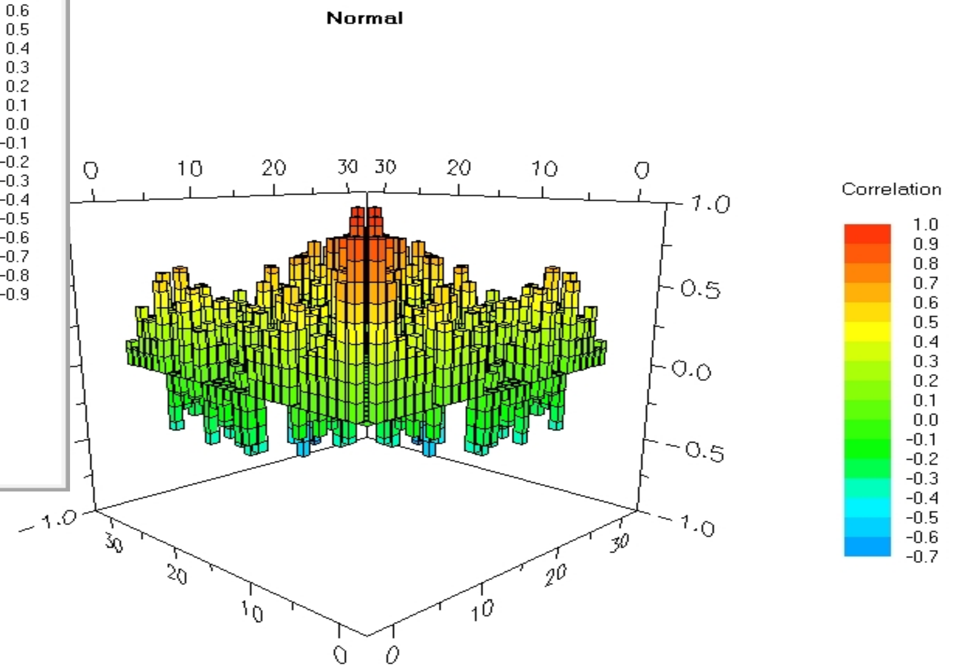
How to invest in Hedge Funds

What investors should keep in mind

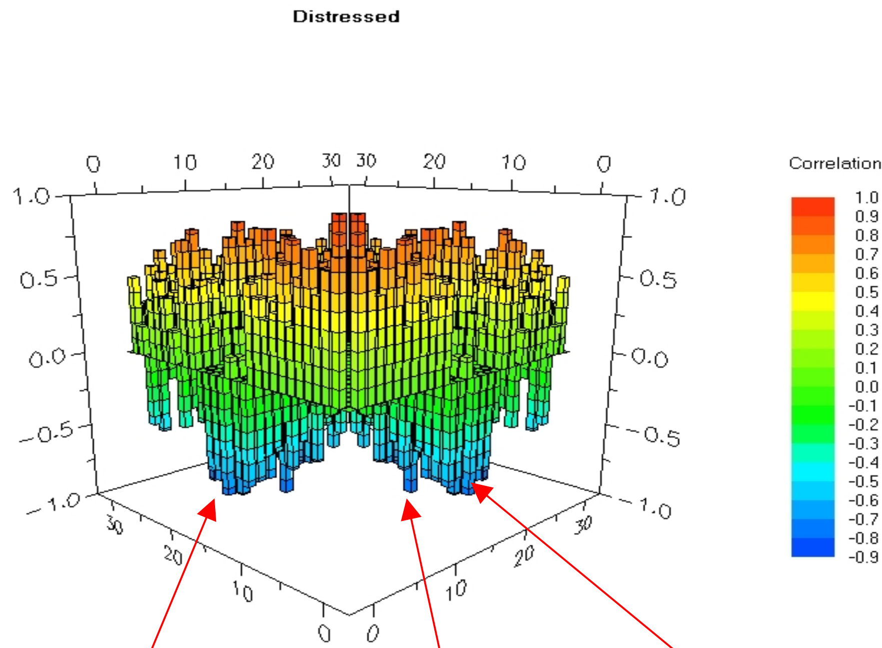
- Absence of correlation continues to be the best aspect of hedge fund investing.
- Correlations change, and an investment should not be left to diversification exposure, which affects the portfolio in the most difficult times.
- There are many mediocre hedge funds, but there are still many which are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

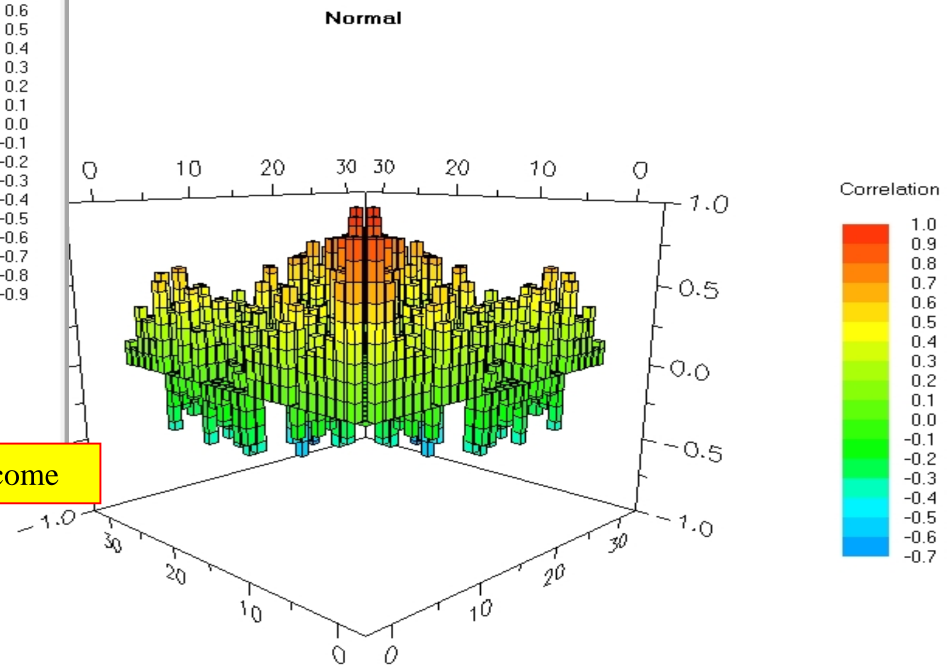
Risks to avoid: distressed alignment





Risks to avoid: distressed alignment



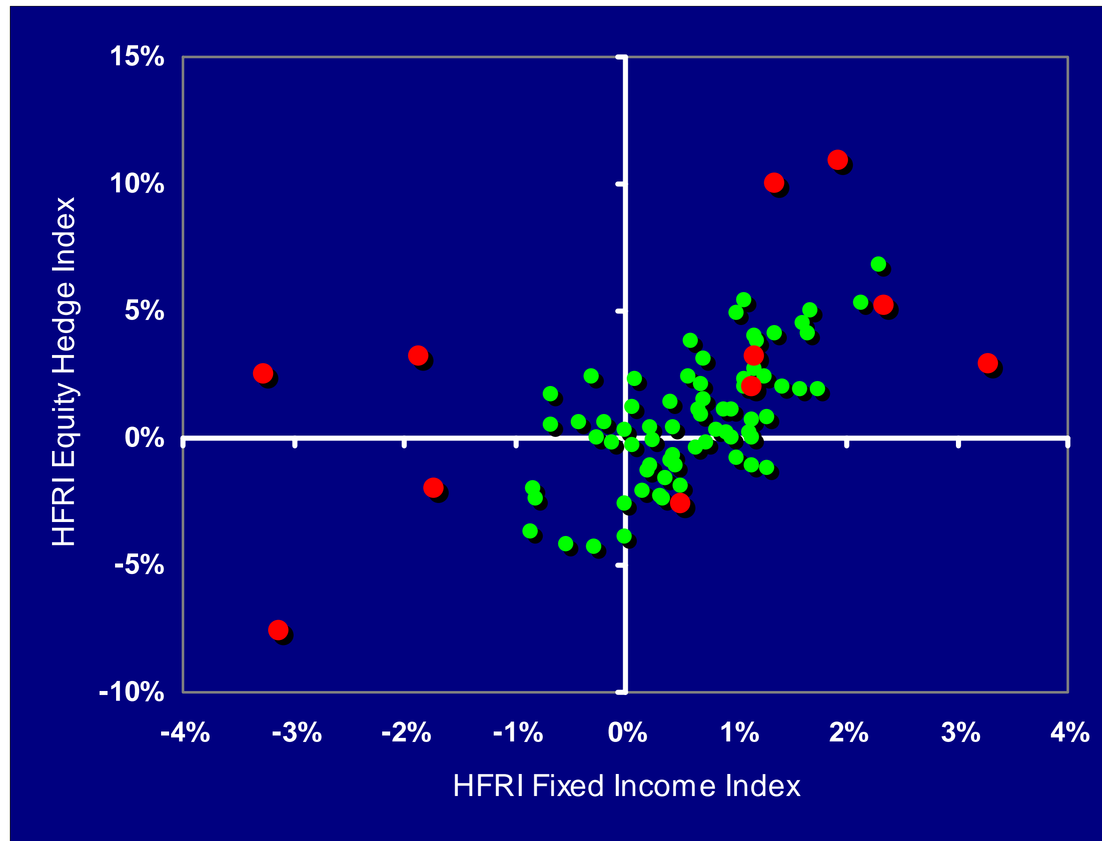


Equity vs Fixed Income

CTA vs Fixed Income

Equity vs Fixed Income

Dependences under distress



Other risks

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

Other risks

Risk	
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 <u>simultaneous</u> 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.