MFA Reporter

August 2001

Reporting on issues for investment professionals in futures, hedge funds and other alternative investments

Inside This Issue

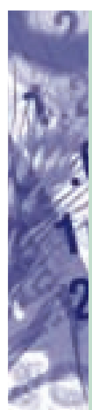
Managed Funds Association

Modern Portfolio Theory and Its Application to Hedge Funds: Part II

By James Park, CEO, PARADIGM Global Advisors, LLC

Part I of this article published last month set forth several observations and assertions about Modern Portfolio Theory (MPT) and hedge funds:

1. The Efficient Market Hypothesis states, among other things, that all available information about securities is already factored into prices. There is little evidence that long-only stock selection outperforms passive buy and hold index strategies in the long run.
2. Active stock picking fees are about 1% per year and, in comparison, hedge fund manager fees of 1-2% per year and 20% of the profits are extremely expensive for any money manager that provides long-only or net-long exposure to stocks and bonds.
3. Diversification lowers risk without diminishing expected returns and 98% of the diversifiable risk of an asset class is eliminated with 50 to 100 investments.



Diversification lowers risk without diminishing expected returns and 98% of the diversifiable risk of an asset class is eliminated with 50 to 100 investments.

4. Hedge funds that are long and short are not portfolios of assets because the asset base of the long securities is cancelled out by the negative asset base of the short securities. Hedge funds behave more like stocks (i.e. companies) than like mutual funds (portfolios of companies) and have a diversification effect similar to stocks. A portfolio of hedge funds, therefore, requires 50 to 100 hedge funds to be 98% or more diversified.

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Modern Portfolio Theory and Its Application

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5. An MPT approach to hedge funds has three parts:
   a. a benchmark revealing the reward/risk profile of the asset class,
   b. a commitment to full diversification to achieve at least the benchmark reward/risk and
   c. an effective manager selection process to achieve (net of fees) a higher return with lower risk than the benchmark.

Part I discussed some of the problems associated with constructing a hedge fund benchmark including survivorship bias, self-selection bias, catastrophe bias and bull-market bias.

Diversifying a Portfolio of Hedge Funds

Hedge fund investors are confronted with a paradox. In addition to the misconception that diversification is at the expense of expected return, it is commonly accepted that hedge funds are already diversified. Indeed, the best managers manage risk by diversifying their portfolios with 50 or more positions. However, this is not portfolio diversification. Consider, for example, the argument that General Electric, by itself, is well diversified. GE has scores of subdivisions, in dozens of countries with thousands of product lines. It is a diversified company. Yet, no one would hold an equity position made up of just GE stock. Why? The fact still remains that GE, as a single company with a single chairman and board of directors, is still exposed to idiosyncratic firm risk. Similarly, hedge fund managers with dozens of market positions or even dozens of sub-portfolio managers are commonly directed by a single person. A single decision to favor value stocks or technology stocks, for example, can and often does result in dramatic losses. Mutual funds and funds of hedge funds, on the other hand, do not directly control their portfolio investments and, therefore, benefit from the non-correlation of idiosyncratic firm manager risk.

Active Manager Selection to Achieve Benchmark Out-Performance

Adopting a new asset class by studying its reward/risk profile using an accurate benchmark and then achieving this reward/risk profile by fully diversifying the portfolio is the MPT approach to passively indexing a benchmark. More than half of the money invested in the U.S. stock market passively buys and holds an index. Index or benchmark returns belong to the investor for free. Case in point, the Vanguard S&P500 Index Fund charges less than 10 basis points.

The goal of an active manager, according to MPT, is to produce a superior return with less risk than the relevant index net of his or her fees. Funds of funds have promised superior manager selection but the empirical evidence shows that funds of funds as a group have produced mostly hedge fund index like returns and risk before fees. Funds of funds charge a management fee of 30 to 200 basis points often with a performance fee of 5% to 10% of profits on top of all hedge fund manager fees and expenses. After such fees, funds of funds do not seem to be providing any value in the area of manager selection and, therefore, according to MPT, fees should be closer to 10 basis points like an index fund. These types of fees can only be justified if a fund of funds' performance net of these fees out-performs a passive hedge fund benchmark.

A study of funds of funds shows that they have failed to outperform the hedge fund benchmarks on a risk-adjusted

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MANAGED FUNDS ASSOCIATION

The *MFA Reporter* is the monthly newsletter of the Managed Funds Association. Its purpose is to publish the most useful and timely news and ideas from the most knowledgeable industry professionals.

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Legislative Action Heats Up

By Patrick J. McCarty, MFA General Counsel,
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Summer in Washington is hot and humid. Congress has just adjourned for the traditional August recess with a flurry of legislative activity involving Appropriation bills, legislative hearings and the Senate's confirming Administration appointments to various regulatory agencies. Much of the first seven months of the year generally is spent on the annual Budget and Appropriations process, and this year was no exception. In addition, certain high profile issues – the tax cut, education reform, energy policy, campaign finance reform and the patients' bill of rights – were addressed in either the House or Senate or both. Congress returns in September and will work until late November on finishing the Appropriations bills as well as the other important issues. Since each Congress is two years in duration, legislators have the year of 2002 to complete work on any legislation introduced in 2001. This is the big picture.

Now, here is a mid-year scorecard on MFA legislative and regulatory issues. There was significant progress on several fronts, but some disappointments. Let's start with disappointments. As a general matter, the Bush Administration was slow in filling spots at the Treasury Department and financial regulatory agencies. The lack of appointees has, in some instances, resulted in delays in regulatory actions. At Treasury several of the high level positions requiring Senate confirmation were not filled until the first week of August. To be fair, Sen. Jesse Helms (R. NC) had a "hold" on four top Treasury appointees – including Peter Fisher, of New York Fed and LTCM fame, who has now become the Under Secretary for Domestic Finance. There was a similar delay over at the SEC where Harvey Pitt was finally confirmed as SEC Chairman on August 1. Pitt, who previously served as SEC general counsel, will most likely take several months to put his staff in place. In addition, I'd note that two of the five SEC Commissioner spots remain open with no candidates' being announced, which could hamper SEC action on revising the short sale uptick rule and the NASD hot issue proposal. Jim Newsome remains the Acting CFTC Chairman, but appears to be in very good position to be named permanent CFTC Chair in September. MFA strongly supports the Bush Administration's nominating Newsome as the CFTC Chairman. We believe that once Newsome is confirmed he will move forward aggressively with a clear regulatory agenda. The banking agencies are a similar story of partially filled spots. Of course, Alan Greenspan remains the Chairman of the Federal Reserve Board due to his reappointment to a new six-year term last year.

Legislative and Regulatory Action

There was significant progress on both the legislative and regulatory fronts for MFA. There are seven "legislative" priorities and 10 "regulatory" priorities on MFA's agenda. (See ***www.mfainfo.org/washington*** for MFA's agenda, related documents, and other projects.) There was significant progress on three of MFA's seven legislative priorities. The SEC Fee Reduction bill is very close to being signed into law. To complete this the Senate needs to take up and pass the House passed bill – H.R. 1088. This bill, which would reduce statutory fees charged by the SEC on securities transactions, is the financial services industry's biggest priority. The Senate is expected to take up H.R. 1088 this fall.

Another MFA priority is the Financial Contract Netting legislation. This bill, which would harmonize banking and tax law for financial contracts in a failure, is part of the large consumer bankruptcy legislation. This bill will provide legal certainty for cross product netting even outside of ISDA master agreements. This bankruptcy legislation is very close to becoming law. The Senate and House conferees are to begin their "conference committee" to resolve differences in September.

The EU single market initiative is proceeding nicely. MFA's EU Task Force, chaired by Steven Olgin of Merrill Lynch, met with EC Director General for the Internal Market, John Mogg, in June to discuss MFA's participation. This meeting was very open and productive. MFA will work with European financial trade associations to comment on the recently released revisions to the Investment Services Directive. MFA will encourage the EC to adopt a reasonable, uniform "professional investor" definition for all of Europe which would be similar to the "accredited investor" definition. In addition, the MFA will push the EC to provide a clear, private securities placement exemption for European wide offerings. MFA will work with EC to clarify that such a private placement exemption would be available to hedge funds.

On the regulatory front, MFA is extremely busy. With the passage of the Commodity Futures Modernization Act of 2000 in December, the industry's attention now turns to the rulemaking front. The SEC and CFTC are working on draft-

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basis. This is evidence that manager selection and due diligence efforts have not provided value. This has also created a perception that any family office or institution with significant assets can easily build its own fund of funds capability. Why have funds of funds not out-performed? The answer may be that early funds of funds were focused on different objectives and used quantitative tools that did not add value towards benchmark out-performance. Funds of funds offer process and experience in the screening, interviewing and due diligence of managers. Background employment and education checks, prime broker checks, reference checks and a good understanding of the underlying strategies acquired from years of experience are all necessary, but far from sufficient, to obtaining the goal of benchmark out-performance. The common image that fund of funds consultants are tough with hedge fund managers misses the point completely. Indeed, the recent declaration by several funds of funds of hiring private investigators to follow hedge fund managers into their private lives is not only a waste of time but also distasteful and unnecessarily intrusive. The objective is not to avoid bad managers. The objective is to identify skill and highly skilled managers. These managers will simply not subject themselves to fund of funds managers who unnecessarily invade their privacy.

Does Past Performance Indicate Future Performance?

Does past performance indicate future performance? The answer is no for mutual funds. Mutual fund managers are highly educated and trained finance professionals. There is no evidence of skill, however, because of the nature of the mutual fund game. Mutual funds are portfolios of assets with clear, identifiable benchmarks. These managers work to generate alpha but, as portfolio managers, they cannot afford to stray too far from their benchmark. Moreover, stock market efficiency creates an environment where the volatility due to systematic risk is much larger than the alpha managers generate and so even if performance persistence many exist it is overwhelmed by the beta of the portfolio.

Hedge funds, on the other hand, are not portfolio managers trying to outperform a benchmark. They are skill-based entrepreneurs who process information in real time and use financial instruments to express their opinions about their information set without market exposure. They have no market benchmark. As a purely skill-based activity, it warrants a 20% performance fee. Skill, by definition, must persist over time, otherwise, it would not be skill, it would be luck. Unfortunately, the quantitative tools commonly used to evaluate hedge fund managers, namely, annualized returns and Sharpe ratio, show no evidence of predicting future performance.

Relying on annualized returns without taking risk into consideration is naïve. Historical annualized returns are more of a distraction than they are helpful. MPT requires an analysis of both risk and reward. Sharpe Ratio is risk adjusted (by standard deviation) and is widely used to evaluate managers. Sharpe ratio is the annualized return minus the risk-free rate divided by standard deviation. It is a comparison statistic and answers the question: "Which is better?" This, however, is the wrong question. The objective of a portfolio of hedge funds is not to find the "best" managers but to construct a portfolio of managers that out-performs an index of managers. Using Sharpe ratio completely ignores the inter-relationships between these managers and further assumes that this ratio has some predictive power or is indicative of future returns. Unfortunately, Sharpe ratio appears to have no statistically significant evidence of predicting the future performance of hedge fund managers. Do equity portfolio managers buy Microsoft because it has an excellent Sharpe ratio? Of course not. The question is not which are better but which stocks (hedge fund managers) help build an optimal portfolio that will outperform the passive stock (hedge fund) index. This is a portfolio question and Sharpe ratio simply does not address this question.

Sharpe ratio does not address the inter-relationships between managers and so many have turned to correlation analysis of hedge fund manager returns as they attempt to build hedge fund manager portfolios. Again, unfortunately, this analysis does not add value. The problem goes beyond the fact that manager correlations are unstable and that seemingly uncorrelated managers lose money at the same time during global information shock scenarios that cause sharp stock market volatility. Correlation analysis simply has no optimal portfolio solution. For N managers, there are (N2-N)/2 cross correlations. For 1000 managers there are 499,500 cross manager correlations. The problem gets worse. As candidate managers are selected into the portfolio, the question arises whether the next manager should have a low correlation with each of the currently selected

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Overview of Commodity Funds in Japan in 2000 vs. 1999

By Mike Kuroda, Japan Commodities Fund Association

Editor's Note: *This article revisits the same topic the author first addressed in the December 1999 issue of* MFA Reporter.

The Climate in 1999

After growing smoothly, commodity fund sales in Japan experienced a decline in 1998 from the prior year. Then, sales value fell sharply in 1999, by nearly one-third from the preceding year. Seventeen funds were newly established with a total sales value of 30 billion yen. This sales figure was the smallest since 1990, when the Japan Commodities Fund Association ("JCFA") first started collecting statistical data. During 1999, thirty-five commodities funds matured with the total redemption principal of 67 billion yen. For the first time in three years (since 1996) the sales value fell below the redemption amount. Consequently, the outstanding principal at the end of 1999 dropped to 285.3 billion yen, or by 371 billion yen from the end of 1998. The sales value per fund remained slightly below 19 billion yen, the smallest since 1996.

As for open-end-type funds, while the total number outstanding was not so small compared with the number of funds newly established, sales remained slow. The annual sales value per fund held at 250 million yen. As for the minimum sales unit, a million yen was the most popular amount and was adopted by eleven funds. Six open-end type funds were also marketed at a minimum unit of a million yen. Evidently, the most popular minimum sales unit during 1999 was one million yen.

When we look at the investment vehicle or fund structure, limited partnership-type funds, which require agreements in English, all but disappeared. Most funds were structured as trusts or anonymous partnerships. Owing to lower priced minimum sales units, sales to ordinary investors became easier, but many clients balked at having their agreements in English. In the case of trust-type funds, considering the fees for the work done by trust banks, the funds must had to be quite large in order to be justified. Consequently, the sales value per trust-type fund exceeded that of the anonymous partnership.

In 1999 non-guaranteed-type funds appeared for the first time among unit-type funds. Non-guaranteed-type funds were popular in terms of the number sold. From the viewpoint of sales value, partially guaranteed-type funds, in particular those eighty percent guaranteed, were the largest. But owing to the low interest rates in Japan, in 1999 it was difficult to form yen-denominated guaranteed-type funds, and actually there was only one that year. Regarding the maturity, although five years once was popular for both guaranteed-type and active management funds, three years or so became the mainstream maturity. This reflected the fact that non-guaranteed-type funds increased and, due to uncertainty about future interest rates, investors tended to avoid long-term investments.

Most of the funds established in Japan in 1999 were denominated in yen, and there was only one dollar fund. This may stem from the fact that, in marketing foreign currency funds, it is always difficult to explain the risk factors to individual investors.

Altogether thirty-eight commodity investment dealers took part in sales, their number growing faster than the sales value. Taking into account that there were ninety-four licensed dealers in Japan, though, the figure is not very large. One explanation for this must be that certain companies were eager to sell guaranteed-type funds but not active management-type funds, which involved a higher degree of risk. The number of banks participating in commodity funds sales declined sharply, particularly after April 1999, when the marketing of investment trusts by banks started on a full-scale basis. The number of participating banks actually decreased from twenty-five in 1998 to a mere five after April 1999.

Overview of Commodity Funds in Japan in 2000

Sales of commodity funds, after declining sharply in 1999, made a bad situation worse in 2000. Sales of commodity funds in Japan in 2000 totaled 11 billion yen (U.S. $95million), comprised of but 10 funds, which were about one third of the previous year, which had been the worst on record since commodity funds sales started. Consequently, the outstanding principal at the end of December 2000 dropped to about 255 billion yen (U.S. $2.2 billion), or by about 30 billion yen from the same period of previous year.

Those knowledgeable in Japan consider the sharp decline in sales in 2000 was mainly due to the following factors:

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Matching Engines and Prime Brokerage Enter Center Stage in E-FOREX Crusade

By Doug York, Campbell & Company, Inc.

E-trading in the FOREX sector faces substantial resistance from high volume traders. The bank-led FXALL and Atriax solutions are based around a RFQ (request for quote) or RFS (request for streaming) methodology that is viewed as predatory by the banks when used by large volume dealers trading on the telephone. The reason the RFQ approach would not work for Campbell & Company is known as the *winner's curse*. If we ask two banks for a price on 75,000,000 Pounds and one bank reads us as a buyer and we pass and pay the other bank, the winning bank faces the prospect that the losing bank will buy Pounds in the market in anticipation that the other bank is about to (this is called front running). This ruins the existing liquidity pool and hence "winners curse". The RFQ methodology is highly undesirable for the high volume trader. FXALL and Atriax would counter that we could simply ask one bank for the quote. Our reply is that this eliminates well-oiled telephone dealing channels and increases the specter of dual data input - their platform and our platform.

> *Once the banks realize that the information arbitrage realm they dominate and it's attendant mystery only decreases FOREX participation, they will embrace new technology such as FX prime brokerage and matching engines.*

The hook to engage high volume players with e-trading is not STP (straight through processing) or the ability to RFQ. Instead, e-FOREX becomes worthwhile when you introduce an enhanced form of liquidity in the form of matching engine technology and greater anonymity. This technology already exists for the banks (EBS and Reuters Dealing) but has never been offered to non-banks for fear that bank's will be displaced in the role of market maker. The matching engine allows banks to bid or offer anonymously until the moment a deal is executed at which point the buyer and the seller are connected.

Non-bank players with substantial volume envision utilizing a matching engine for a certain percentage of their trades but not for all because the role of the bank in risk transference is unparalleled and it will be many years before anyone really thinks this bank risk-warehousing function will be diminished. The problem with a matching engine is that in order to release it to large volume players, the same prerequisites which exist for the bank environment must persists - i.e. everybody must accept everybody else's credit (to some degree), and physical delivery by the banks (or net settlement and delivery on the balance) must occur. The credit algorithm component of this is tricky although it has been solved. EBS and Reuters Dealing, the two bank matching FOREX platforms share ownership in a proprietary code that facilitates the credit component. Unfortunately, unlike Mercedes and air bag technology, the banks have not rolled this out for the greater good of the investment community. They are protecting their market share by hoarding matching technology and, in reality, the lack of transparency to the end user actually substantially decreases total volume. This is one of the greatest ironies of the current bank approach.

However, the credit-matching component is actually a business process and ultimately can be recreated, in one form or another. Once this happens, and ultimately FXALL, Currenex and Atriax will probably give it a go, then a matching engine is just a matter of time. Certain sites such as HotSpotFX offer this now. However, they still operate along exchange lines with no delivery and central clearing. Centralized collateral housing renders a matching engine a very difficult proposition.

However, one major challenge remains, and this is at the crux of the revolution. Once you solve the credit algorithm, how do you know hedge fund A can deal with real money fund B? The answer in the minds of many following this closely may lie in the widespread introduction of FX prime brokerage to large volume players. This allows the trading entity to trade in the name of a bank while leasing lines through their FX prime brokerage facility. ABN AMRO, Barclays, Deutsche Bank and Bank of America are four of the larger FX prime brokers. The way FXPB works is that the

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Matching Engines and Prime Brokerage

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trading entity pays a transaction fee, which allows them to trade with leading FX banks in the name of the prime brokerage bank, within prescribed limits. This methodology holds the key to the matching engine enigma. How do you know that the entity you are dealing with will accept you as a counterpart or vice versa? The bank dealing community has such tremendous credit quality as to allow superior trade matching via the EBS or Reuters platform. Through a FXPB, this could be transferred to the matching engine technology. With the prospect (still pending) of decreased settlement risk via the CLS (continuous linked settlement) and PVP (payment versus payment) initiatives now being finalized by the banks, ubiquitous prime brokerage utilization by high volume traders could be one path for the future of the industry. The problem, and herein lies the revolution bit, is getting high quality corporates that have always been granted huge FX dealing lines from the banks to embrace a FX PB and it's fee structure (broad ranges of fees are between $5 and $25 per million of executed volume). It boils down to the sophisticated corporate treasurer economically justifying the prime brokerage fee (1/4 to 1/2 a pip, for arguments sake) for the greater savings of 2 or 4 pips gained, overtime, from a matching engine approach.

If the analysis is done over the course of hundreds or thousands of trades, the impact is significant. Clearly a matching engine is not a panacea for price slippage reduction. There are certain trades (fast markets, high volatility and momentum) where bidding or offering against the market is not a clever approach. It would be far superior to simply phone your banker and pay the toll rather than risk the market running many pips to save a few. Also, the size of the trade is a key determinant as to whether you work closely with your banker in a risk transference approach or use matching technology.

This battle will rage for some time to come and will undoubtedly take some unexpected turns. The willingness of the high volume trading community (say $1 billion per month or more) to unify and help the banks move in this direction is an unknown component but the movement is strengthening. Start-ups such as CURRENEX have made strong inroads that may lead in this direction by working closely with the traditional corporate community and rolling out anonymous FXPB.

Global bank profitability from FOREX trading ranks as one the largest sectors in the world so technology that may initially decrease bank income will be rolled out slowly. Once the banks realize that the information arbitrage realm they dominate and it's attendant mystery only decreases FOREX participation, they will embrace new technology such as FX prime brokerage and matching engines. When you look at the successful models elsewhere in the world such as BUNDS on the EUREX where market depth and matching are transparent, it is hard to argue any other case.

Campbell & Company, Inc. is a 30-year-old investment management firm in Baltimore, MD with $2.4 billion in assets under management. Doug York is a SVP co-managing the trading department. ***Visit www.campbell.com***

Forum 2001 Wrap-Up

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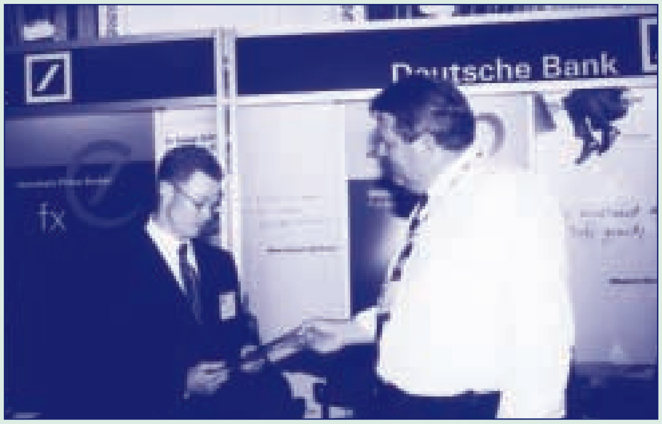
(From Left) Gregory Zuckerman, The Wall Street Journal; Hunt Taylor, Stern Investment Holdings; Matthew Bishop, The Economist; Ron Insana, CNBC's Business Center; Joshua Chaffin, Financial Times; and Katherine Burton, Bloomberg News, participate in "Media Perception of the Alternative Investment Industry."

(From Left) Ron S. Geffner, Sadis & Goldberg LLC; Moderator Samuel Weiser; and Frank J. Carr, A.T. Kearney Executive Search, participate in "Creating a Powerful Organization: Building the Right Infrastructure."

(From Left) Moderator Bruce N. Terry, Marathon Capital Growth Partners LLC; Arthur F. Bell, Jr., Arthur F. Bell, Jr. & Associates, L.L.C.; Esther E. Goodman, Kenmar Asset Allocation; Wesley G. Nissen, Katten Muchin Zavis; and Thomas L. Corwin, Metron Management Company, discuss "The Economics of Running a Money Management Business."

MFA Chairman, Jeffrey D. Izenman, Rabar Market Research, Inc., delivers his conference welcome to Forum 2001 *delegates.*



(Right) Ron Peterson, Deutsche Banc Alex. Brown, showcases his firm in the Forum 2001 Exhibit Hall.

(From Left) John G. Gaine, MFA president; Elizabeth Fox, acting deputy general counsel, Commodity Futures Trading Commission; and Patrick J. McCarty, MFA general counsel, discuss "Washington Perspectives – The New Administration and the New Congress."

John W. Henry, Chairman, John W. Henry & Company, Inc., delivers the keynote speech for the conference-closing luncheon.

(From Left) Randy Warsager, CISDM, University of Massachusetts, and AssetSight; Sandra Manzke, Tremont Advisors, Inc.; David K. A. Mordecai, Journal of Risk Finance; Richard Papert, The Lefrak Organization; and Donald Carden, Clifford Chance Roger & Wells LLP, present "How to Structure Tax-Efficient Hedge Fund Products for Family Offices."

(From Left) Wa'el Chehab, Cedar Management; Bruce N. Terry, Marathon Capital Growth Partners LLC; Jacques Lussier, Opvest International; and Albert Hallac, Weston Capital Management.

(From Left) Diane Mix, Horizon Cash Management, LLC; Terri Engelman-Rhoads, The Guggenheim Group, LLC; and David Blair, Custom House Administration, discuss "The Ultimate Risk Control – Detecting and Preventing Fraud."

The Futility of Buying Drawdowns

By Jeremy O'Friel, Appleton Capital Management

Recently, I sat in front of a potential client and asked him whether he felt inclined to grant us a modest allocation for our currency program. He replied in the negative, and when quizzed on the reason, replied that the recent run-up of profits worried him, and that he only bought CTAs on drawdowns. Lacking the time or inclination to argue this further, I let it go, excused myself, and thanked the individual for his time. But the concept rankled with me, as I felt that there was a fundamental flaw in his argument, but could not pinpoint my reasoning. This article reflects my thoughts since then.

In trading parlance, we regularly hear of the dangers of buying at the top, selling at the bottom and getting whipsawed. Generally speaking, selling at the bottom of a market should be guarded against, presumably on the premise that lackluster performance in a stock/bond/CTA represents a temporary mispricing of what is otherwise a valuable commodity, rather than a seismic shift in the underlying value of the security. Similarly, buying at the top is to be avoided, as a recent spurt in the value of a security is surely an overreaction on the part of the investing public, and the inevitable cooling off will lead to a decline in the market value. It all sounds very easy, and makes me think that traders have an easy time of it, as opposed to us toiling marketers, peddling our wares in the corridors of New York, Chicago, Bermuda and elsewhere. Applied to CTAs, a manager who has had a period of shocking performance can surely get no worse, and is therefore worth a buy. After all, he's never lost this much before. Similarly, a guy who has been knocking the cover off the ball is most certainly nearing the end of a streak and is due a fall, therefore should be partially or wholly sold.

My contention is that the level of a CTA's equity curve has very little to do with his future performance, and that the policy, adopted by many, of buying weakness and selling strength adds little to a portfolio of CTAs.

Right? Wrong.

My contention is that the level of a CTA's equity curve has very little to do with his future performance, and that the policy, adopted by many, of buying weakness and selling strength adds little to a portfolio of CTAs. My support for this argument is buttressed by a two approaches – the theoretical and the statistical. The readers can choose for themselves which, if either, they find the more compelling.

First, the theoretical. It has been proven that a CTA's performance is impossible to predict for a given future time period, and can be viewed as having no serial correlation to previous performance. Not only did I find this from several external sources, but also set our research department to task. If it was that easy, more CTAs would aggressively trade their own equity curves. Therefore, the buyer is making a decision about the CTA's ability to add value over the long term. In buying a CTA, he or she is saying that they believe there to be a higher probability of gain than loss. If there is a higher probability of gain than loss over multiple periods, and no serial correlation between periods, then surely there is a higher probability of gain than loss over the next period. Thus, the manager would want to buy the CTA immediately, given that the probability of avoiding a drawdown by staying out is less than the probability of missing positive performance. My argument is steeped in our own approach to trading, namely that whilst risk can be forecast, return cannot. Thus, just as we do not attempt to time risk exposure, preferring to keep volatility constant, so the allocator should not try to time CTA risk, but rather target a fixed level.

For the moment, though, let's see if we can back up the theoretical argument above with some live data.

For the statistical support, I took 35 CTAs and analyzed their live track records since 1995. This was an arbitrary mark governed largely by the need for a sufficiently large sample with feasible assets under management. I took their monthly performance numbers for six years and, allowing for the effect of interest and fees, adjusted all CTAs to a 10% volatility level. At this constant level of volatility, I found the worst drawdown of each. Then I decided to create two sets of portfolios. One would be constructed on the 1st January, 1998 and would be based on the results of 1997. The second would be built on the 1st January, 2000 and would be based on the results of 1999. On each date, portfolios would be made up of the five worst and best CTAs over the preceding 3, 6 and 12 month periods. This gave us 12 portfolios. (In each case, the CTAs were ranked according to the depth of their current drawdown, relative to their

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Security Futures Contracts Update

By Scott Anderson, Arthur F. Bell, Jr. & Associates, LLC

At this time, it is widely known that the Commodities Futures Modernization Act of 2000 authorized the trading of securities futures contracts. The following discussion provides a brief update of certain tax implications related to such contracts.

While the Commodities Futures Modernization Act of 2000 authorized the trading of securities futures contracts, the Community Renewal Tax Relief Act of 2000 (the "Bill") provided the tax treatment of such contracts. In general, the Bill provides that securities futures contracts and options on such contracts are not Internal Revenue Code (the "Code") Section 1256 contracts. The Bill provides, however, that "dealer securities futures contracts" will be treated as Code Section 1256 contracts. The Bill granted the Secretary of the Treasury with the authority to determine which taxpayers should be treated as dealers in securities futures contracts and indicated that the IRS should issue its determination not later than July 1, 2001.

It is our impression that there was a perception among hedge fund operators that if the definition of dealer could be sufficiently expanded to include hedge funds, thereby achieving 60/40 long-term/short-term capital gain treatment on securities futures contracts, the attractiveness of hedge funds to investors would be enhanced. Unfortunately, pursuant to Code Section 1256(f)(4), any gains or losses with respect to a dealer securities futures contract, which should be allocable to limited partners or limited entrepreneurs, shall be treated as short-term capital gains or losses. Code Section 1256(e)(3)(C) provides guidance on who should be considered a limited partner or entrepreneur. Not surprisingly, nonactive investors, which comprise the vast majority of the investors in a hedge fund, would be allocated short-term capital gains or losses from trading in securities futures contracts. Therefore, it appears that the perceived potential for a boon is a bust. That being said, general partners and managing members of hedge funds should be able to benefit from the 60/40 Code Section 1256 treatment if the definition of dealer in securities futures contracts is sufficiently expanded by the IRS.

The IRS published a notice in 66 Federal Register 13836 (March 7, 2001) soliciting comments on the criteria that should be used to determine whether a taxpayer should be considered a dealer in securities futures contracts for Code Section 1256 purposes. Since our firm specializes in providing services to the managed funds industry, we responded to the IRS request for comments. We, of course, lobbied for an expansion of the definition of dealers to include taxpayers other than those that have traditionally been considered dealers. We are aware of other submissions touting both expanded definitions and restricted definitions.

Based on our conversations with the IRS attorneys responsible for drafting the language identifying the parameters to be used in determining which taxpayers should be considered dealers for Code Section 1256 purposes, the comments have not been as numerous as hoped. In addition, at the time this was written, the IRS attorneys indicated that they did not believe they would meet the July 1, 2001 deadline.

How the IRS will ultimately rule is unknown at this time. But, regardless of the outcome, it appears that the potential to achieve long-term capital gain treatment on securities futures contracts for investors in hedge funds seems to remain on the marketer's wish list. We will continue to monitor this issue and provide an update if the ultimate outcome warrants additional comments.

MFA in Washington, *cont'd.*

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ing rules for "security futures." These products can start trading on August 21, 2001 for institutions, and on December 21, 2001 for retail customers. MFA is participating in the numerous rulemaking proceedings. For example, MFA filed a comment letter with the IRS on May 17, 2001 regarding who should qualify as a "dealer in security futures contracts." Dealers receive the favorable 60/40 tax treatment. In addition, MFA filed comments on July 11, 2001 with the SEC and CFTC regarding foreign futures contracts. In this letter, MFA argued that foreign futures contracts on single stocks, as well as stock indexes which are composed solely of foreign securities, should be specifically excluded from being considered "security futures." See the MFA Web site for the text of this letter. MFA is also very active in representing the industry's interests on the CFTC and SEC privacy rules. MFA was successful in getting the CFTC to provide letters clarifying the applicability of the CFTC's privacy rules to hedge funds run by registered CPOs.

Modern Portfolio Theory and Its Application

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managers or a low correlation with the portfolio as it already exists. An endless number of possible manager combinations creates the need for an endless number of cross correlations with no optimal solution. The root of the problem is that correlation analysis is not portfolio analysis. Do equity managers using an MPT approach calculate the cross correlations of stocks? No. Correlation analysis is fundamentally a 1-to-1 analysis that does not lend itself to optimal portfolio construction.

Mean Variance Analysis and Efficient Frontiers

Finally, mean variance analysis used for asset allocation does not provide any help. This analysis uses annualized returns and standard deviations as well as the historical correlations of the managers. Based upon historical performance, it solves for the optimal set of weights among a group of assets. The problem with this analysis is that it assumes that the past is a good indication of the future. It also suffers from the effect of outliers. Those managers with extremely good reward/risk profiles often force an unacceptable solution that they should get a huge allocation of the portfolio. Once a subset of managers have been identified, mean-variance analysis may help in the allocation decision but the question still remains how do we identify a group of managers that will out-perform an index of managers.

MPT and Stocks: Beta and Alpha

It may be obvious by now what an MPT approach to hedge funds requires. Equity managers have long practiced MPT in building portfolios of stocks. These managers need to know what the characteristics of a stock are relative to the benchmark they want to beat. It is not Microsoft's annualized return or Sharpe ratio that is important but Microsoft's beta and alpha to the S&P500. Beta (the correlation between Microsoft and the S&P500 times the ratio of their standard deviations) is a measure of how risky Microsoft has been RELATIVE to the stock index. A positive alpha is the measure of excess return adjusted for risk as measured by beta. If the objective is to beat a relevant benchmark then each candidate investment must be viewed relative to this benchmark.

Alpha is not a new concept. It is an MPT concept that has been around for several decades. Alpha and beta are the coefficients of a single factor regression between a stock and a stock index. This is the Capital Asset Pricing Model pioneered by none other then Dr. William Sharpe! There is, however, an important point to make here. Regressing a hedge fund manager's returns against a long-only stock index is conceptually inappropriate. Hedge funds can make money regardless of market direction and should have a low or zero correlation with the index by definition. A regression of a hedge fund manager's returns against a stock index, therefore, would always yield a positive alpha approximately equal to the average annual return. It is similar to regressing the height of people against the S&P500. Height and stock market returns are unrelated and so both the correlation and beta are zero by definition and alpha is just the average height. Portable alpha, alpha transport or alpha overlay only have meaning when the investment and the index are related as with an active stock picker and a stock index. Portable alpha has no meaning or value in the context of hedge funds and stock indexes.

Hedge Fund Beta, Hedge Fund Alpha and Park Ratio

An MPT approach to hedge funds requires an accurate aggregate benchmark of all hedge funds as well as style and cluster benchmarks and the calculation of each manager's "hedge fund beta" (HF beta) and "hedge fund alpha" (HF alpha). HF beta is the measure of a manager's risk relative to the investor's passive alternative, an index of managers. A HF beta of 1.3 indicates that this manager is running the portfolio a little hotter than his/her peer group. This is usually an indication of leverage, concentration or both. HF alpha is, therefore, a measure of a manager's excess return (skill). A merger arbitrage manager with a three-year average annual return of 13% against an industry average of 10% might appear to be better. If this same manager has a 1.3 HF beta, however, this would indicate that these returns are only average. HF alpha measures manager skill as defined by the manager's ability to outperform his/her peer group, the index, on a risk-adjusted basis. If HF alpha persists year after year then a well diversified portfolio of high HF alpha managers will outperform the hedge fund index. Does HF alpha persist through time? The answer is yes.

Another refinement to HF alpha is the Park ratio, first introduced in 1996. HF alpha is not leverage invariant (neither is Sharpe ratio). HF alpha captures both skill and leverage. To normalize for leverage, alpha is divided by manager

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Overview of Commodity Funds in Japan

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- Owing to the historically low interest rate in Japan, it has grown difficult to form yen-denominated guaranteed-type funds which institutional investors require.
- The performance of commodity funds was not better than that of other financial products; in particular, investment trusts/domestic mutual funds worked much better in the early part of 2000.

As for the investment vehicle or fund structure, unit-trust-type funds were popular in terms of the number sold and also the sales amount. As for the form of investment in 2000, out of 10 newly established funds, 9 were non-guaranteed-type funds and only 1 was guaranteed-type-fund. In view of the above, this trend has been remained unchanged since 1999.

One noteworthy phenomenon in the commodity fund industry in 2000 was that although the total sales amount was insignificant, non-guaranteed open-type funds whose assets were traded in the domestic (Japanese) commodity markets have been growing in 2000 as a result of a fairly good performance throughout the year.

The sponsors of the newly established funds during 2000 were Orix (3 funds), Mitsubishi Corp. (3 funds), Globaly (2 funds), Toyotatsusho (1 fund) and Kanetsu Shoji (1 fund).

We can only hope that the second half of 2001 will reverse the downward trend of the past three years.

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standard deviation because manager standard deviation moves 1-to-1 with leverage, all else being equal. This is not to be mistaken with the Information ratio, a well-known statistic that divides alpha by the standard deviation of the residual error terms of the regression. The Information ratio is a measure of systematic risk-adjusted return per unit of manager idiosyncratic risk as measured by the standard deviation of the residual error terms and is not easily interpreted. Park ratio, on the other hand, uses manager standard deviation specifically as a proxy for leverage to isolate and measure manager skill.

MPT and Hedge Funds

An MPT approach to creating and managing a portfolio of hedge funds has five steps. 1) Collect manager data over a sufficiently long period of time to reduce data biases and carefully construct a reliable benchmark using statistically and conceptually justified rules of construction. 2) Calculate HF alphas and HF betas and Park ratios for all managers against the hedge fund aggregate index, style index and cluster indexes and rank managers by these HF alphas and Park ratios. 3) Interview managers in the order of this ranking to identify and separate skill-based information processors from the hundreds of intelligent and articulate but overpriced "fixed stock market beta exposed" stock pickers. (The traditional alternative of interviewing or claiming to interview all managers is now virtually an impossible task and a tremendous waste of time.) Keep in mind, even if net long stock pickers produce value based upon stock picking skills, a 20% performance fee will extract this value from the investor on behalf of the manager during bull markets and leave the investor with heavy losses after bear market corrections. 4) Diversify the portfolio with at least 50 managers equally weighted by volatility. 5) Rebalance the portfolio by giving assets to managers after underperformance or drawdowns. After searching and finding a group of highly skilled, highly motivated individuals, then, as Warren Buffet would tell you, invest in them for the long run.

Stock mutual funds give exposure to the skill of a portfolio of corporate managers but also exposure to the concomitant risk of the economic business cycle and volatility of the stock market. Similarly, mutual funds of hedge funds give exposure to the skill of a portfolio of (hedge fund) managers (who use their skills to exploit the relative skill of corporate managers) but do so without the exposure to the economic business cycle or volatility of the stock market. The result is equity like returns, bond like volatility (no down years) and no correlation to stocks or bonds.

The Futility of Buying Drawdowns

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largest historical drawdown. Thus a manager who had lost 5% in the six months preceding the selection point had only ever lost 7.5%, then he was assigned a drawdown index number of (0.67). This formed a ranking system).

The results were as follows:

I am not suggesting for a second that my scribblings present a complete response to the question. Rather, I think I have opened the topic for the floor. But, I certainly did not come across any evidence that caused me to rethink my assertion that CTA performance is random, and therefore inhospitable to timing.

Portfolio	Weak-Buyers	Strong-Buyers	Average
1/1/98, based on 3 months data	4.89%	14.65%	8.21%
1/1/98, based on 6 months data	5.12%	8.63%	8.21%
1/1/98, based on 12 months data	8.26%	8.09%	8.21%
1/1/00, based on 3 months data	7.35%	9.17%	5.14%
1/1/00, based on 6 months data	6.54%	6.77%	5.14%
1/1/00, based on 12 months data	10.18%	6.86%	5.14%

This is the tip of the iceberg in terms of the manipulations of the data. I tried in vain, admittedly through blatant data-fitting, to find some permutation that allowed the weakly performing managers to outperform their stronger brethren, but found none. And whilst I fully admit that my methods are primitive, it was and is hard to argue with the results. There does not seem to be statistical significance in any of the figures above, seeming to back my contention.

At this point, I was going to quote various industry allocators, but demurred. This article is not intended to be democratic, but rather proposes one side of the argument. Of those that I called, 50% agreed whilst 50% stood by their assertion that buying drawdowns works. And whilst several worthy points were raised, I found it hard to overcome my initial view. The case of the long-term trend-follower was raised and the point made that a drawdown is inevitable after a period of profitability. Yet to take a view here would be taking a view on the duration of the trend in question, which I find just as hard to take as the duration of a CTAs profit run-up. Also, the question of survivorship bias was raised. When you think about it, this actually supports my argument, given that a weakness-buyer is the one who is going to see historical performance improved by the omission of currently defunct CTAs. Finally, there was the suggestion of allocating to a new trader over several time periods, and here I wholeheartedly agreed, without diluting my stance. I think the point is particularly valid when considered against a backdrop of high market volatility.

Now if you'll excuse me, I have allocators on the other line trying to give me money !

PR News and Reviews

By Meg Bode, MFA PR Consultant

Give me an **M**. Give me an **F**. Give me an **A**. What've you got? **MFA!** Yup, I'm a cheerleader for the MFA and, like it or not, I have the same kind of enthusiasm about this industry as I did when I cheered my heart out for my high school football team. School-girl enthusiasm may be inappropriate for the intellectual, serious-minded business of global money management, but I have a grown-up word for it – it's passion.

Passion is a key-driver if there ever was one and, hey, by the way, I caught YOUR buzz. In fact, in my 20 years in public relations, I've never had a client exude the kind of passion for an industry as I have witnessed through my relationship with MFA. You are true pioneers.

The ardor in and around this industry is perhaps best personified by John W. Henry, who delivered an impassioned keynote address at *Forum 2001*. Now here's an industry icon who is as enamored of investing as he is of baseball, and for whom each endeavor is endlessly captivating. John doesn't love public speaking, but he is dedicated to this industry and to the notion of "giving something back."

John's address sent up a big cheer for managed futures. He holds a strong belief in the value of trend following, and he was compelled to explain why the strategy is a winner, even though it has suffered through a few difficult seasons. His message was vital – a real team-builder – and well-timed. The industry is poised for incredible growth. Newcomers proliferate.

This is an important time for leadership. It's the perfect time for veterans to give something back to the industry – to nurture and to guide. To share expertise and wisdom. To share mistakes as well as successes. To build the fire that lights the path to a winning future.

So, come on. If you've got the passion, get involved. Join a committee. Lend your voice. Don't just let MFA represent you — be a representative and help foster an industry that can meet the challenges of change through the collective voice of your Association. MFA. Rah!

Press Check

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MFA Clarifies Application of CFTC Privacy Rules, *Bridge News*, 6-19-01

CFTC Takes Sides with Hedge Funds Against SEC on Privacy, *Securities Week*, 6-18-01

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MFA Member News

Pierre Boulogne and Gilles Barret, chairman and general manager of Paris-based **BAREP Asset Management (BAREP AM)**, announced that Alain Casiraghi has joined the firm to head its Systematic Hedge Funds Department, known in the hedge fund industry for its Epsilon managed futures program. Publicly launched in 1995, the Epsilon program had $430 million under management as of May 31, 2001.

Beacon Management Corporation (USA) announced the offering of Meka-MV, the second investment program based on Beacon's Meka technology. The new program offers the same trading and portfolio management techniques as Meka, with a modified portfolio composition and volatility for investors with a lower risk tolerance. Beacon Management Corporation is a futures advisor managing client assets in systematic investment programs since 1982.

Peter Mauthe, president of Trendstat Capital Management Inc. of Scottsdale, AZ, was elected secretary of the Society of Asset Allocators and Fund Timers, Inc. (SAAFTI), at the association's May 2001 annual conference in Denver, CO. Mr. Mauthe has worked in the money management business since 1979.

John Wilson became the managing partner of the Bay area officers of **Shearman & Sterling**, effective July 1. Wilson will continue the recent expansion of the global firm's San Francisco and Menlo Park offices, and strengthen their links to the firm's substantial technology practices in Europe and Asia.

Campbell & Company, Inc. launched its first long/short equities hedge fund. Campbell's long/short equities portfolio will be offered through a "Master/Feeder" fund structure, and the initial feeder fund will be the "Campbell Long/Short Equity Fund Limited," a Nassau-based hedge fund available only to non-U.S. investors. Campbell's new strategy contains elements of both statistical arbitrage and relative value strategies.

New York-based **FIMAT USA** closed its Los Angeles office effective June 29. Mary Jun, senior vice president for institutional sales and branch manager in Los Angeles, and her staff will relocate to Salomon Brother's Los Angeles office where she will be senior vice president with essentially the same responsibilities she had at FIMAT.

Parker Global Strategies recently has hired five professionals. Mark Smith, previously with Deutsche Bank Private Bank and SAC Capital, has been appointed vice president risk management. Antonia Xixis, formerly at Arthur Anderson and Putnam Investment Management, has been named vice president director of operations. Thomas Murray joins as vice president research from the alternative investment strategies area of Citigroup. Constance Doyle joins as vice president of marketing from JH Whitney & Co. Brant Nehr comes on board as senior associate of strategic initiatives from Kenmar, where he was involved in hedge fund and trading advisor due diligence.

Paris-based **Systeia Capital Management** hired Guillaume Proost as head of event-driven strategies in preparation for the launch of Systeia Merger Arbitrage Fund at the end of July. Proost was most recently research analyst for a merger arb fund, and before that spent five years as an analyst at Schroder Salomon Smith Barney in London.

Gary Knapp, who helped run a $7 billion derivatives portfolio to hedge one of the nation's largest retirement funds, has joined **Hedge Fund Research** as a managing director and senior portfolio manager. At Chicago-based HFR, Knapp is constructing alternative-investment portfolios for institutional investors. He quit General Motors Asset Management which oversees $120 billion in assets, after commuting from Chicago to New York for more than five years.

Kirk Rostron, one of the founders of HedgeCall.com, has joined **Merrill Lynch** as a vice president of the firm's prime-brokerage operations. Last June, Rostron and several others launched HedgeCall, an online network for alternative-investment marketing and news. At Merrill, Rostron works in the group that introduces hedge-fund clients to investors.

Ellington Management of Greenwich, CT, has named mortgage-backed securities veteran Richard Brounstein to run its client-relations effort. Brounstein worked with Ellington founder Michael Vranos and other Ellington principals on the mortgage-trading desk at the now defunct Kidder Peabody.

Deutsche Bank appointed John Dyment as global head of capital introduction services within its prime brokerage unit. He was most recently senior manager in Goldman Sachs's global securities division.

Dominic Napolitano, a former macro global trader at Graham Capital Management of Stamford, Connecticut, joined **Soros Fund Management** as a researcher of hedge funds. Napolitano will report to Betsy Battle, who heads the New York firm's manager selection group.

SAC Capital has hired Chad Loweth to oversee its allocation of capital to outside fund managers. Loweth had been a global head of marketing for Deutsche Bank's prime-brokerage unit.