

# What Does 2005 Hold?

The 5<sup>th</sup> Annual Alternative Investments  
for Institutional Investors Conference



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# You Cannot Look in the Rearview Mirror to Find the Answers



- Performance reordering – the best strategies change
- Style changes – focused strategies more risk sensitive
- Dynamic industry changes – growth is an issue

# “Human History is a Race Between Education and Catastrophe” — H.G. Wells

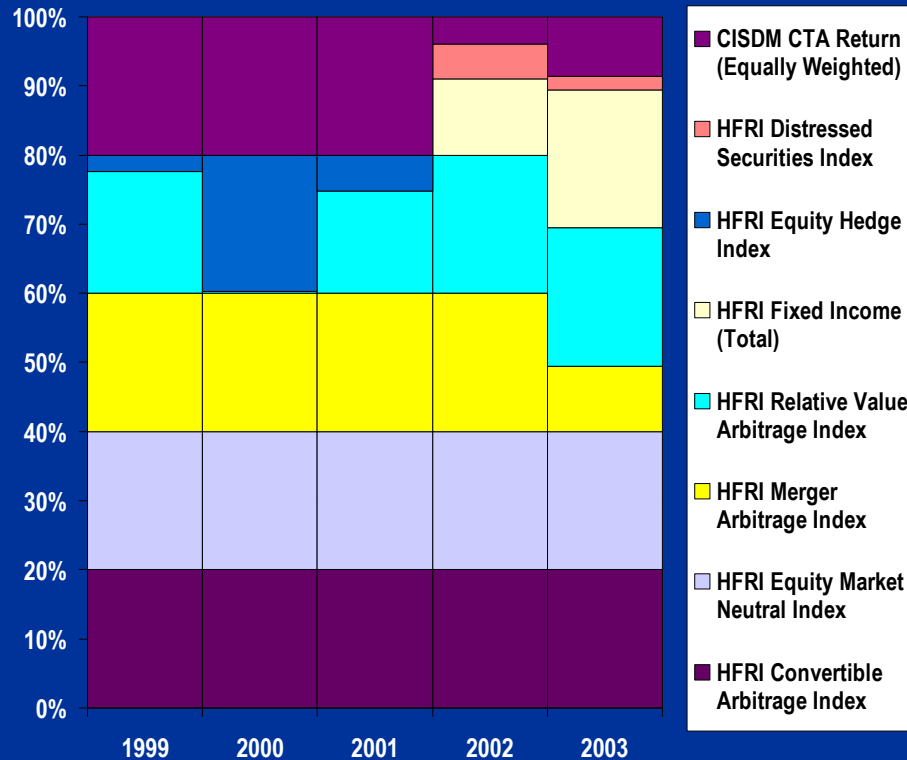
- **What we know:**
  - Performance persistence does not exist
  - Volatility persistence does exist
  - Style alpha high and traditional benchmark tracking error high
- **What we don't know:**
  - Whether recent past is a view of the future
  - Attribution with dynamic strategies
  - Style risks

# Are We “Gambling with Fair Dice”?

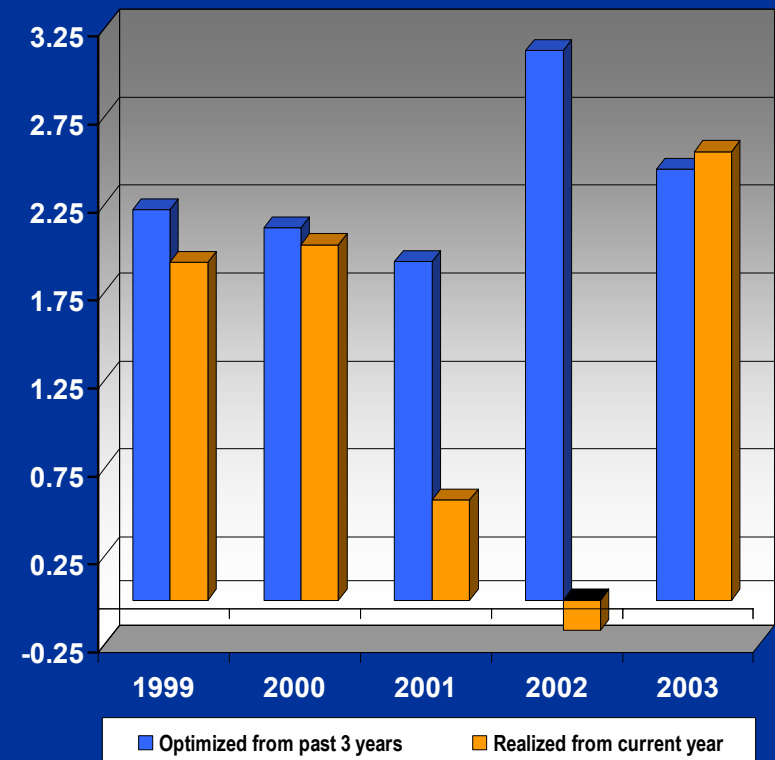
- **Faced with uncertainty as well as risk**
  - Risk ~ countable (measurable with a sample)
  - Uncertainty ~ no sample of events
- **We do not like losses**
  - Desire satisfaction, but suffer from regret – negative skew problem
- **Yet, overconfident of what we know**
  - Law of small numbers

# Optimization Provides Insights

An Optimizer Focuses on Some Familiar Strategies and Changes Others Significantly



The Expected and Actual Sharpe Ratio Can be Very Different for a Hedge Fund Portfolio

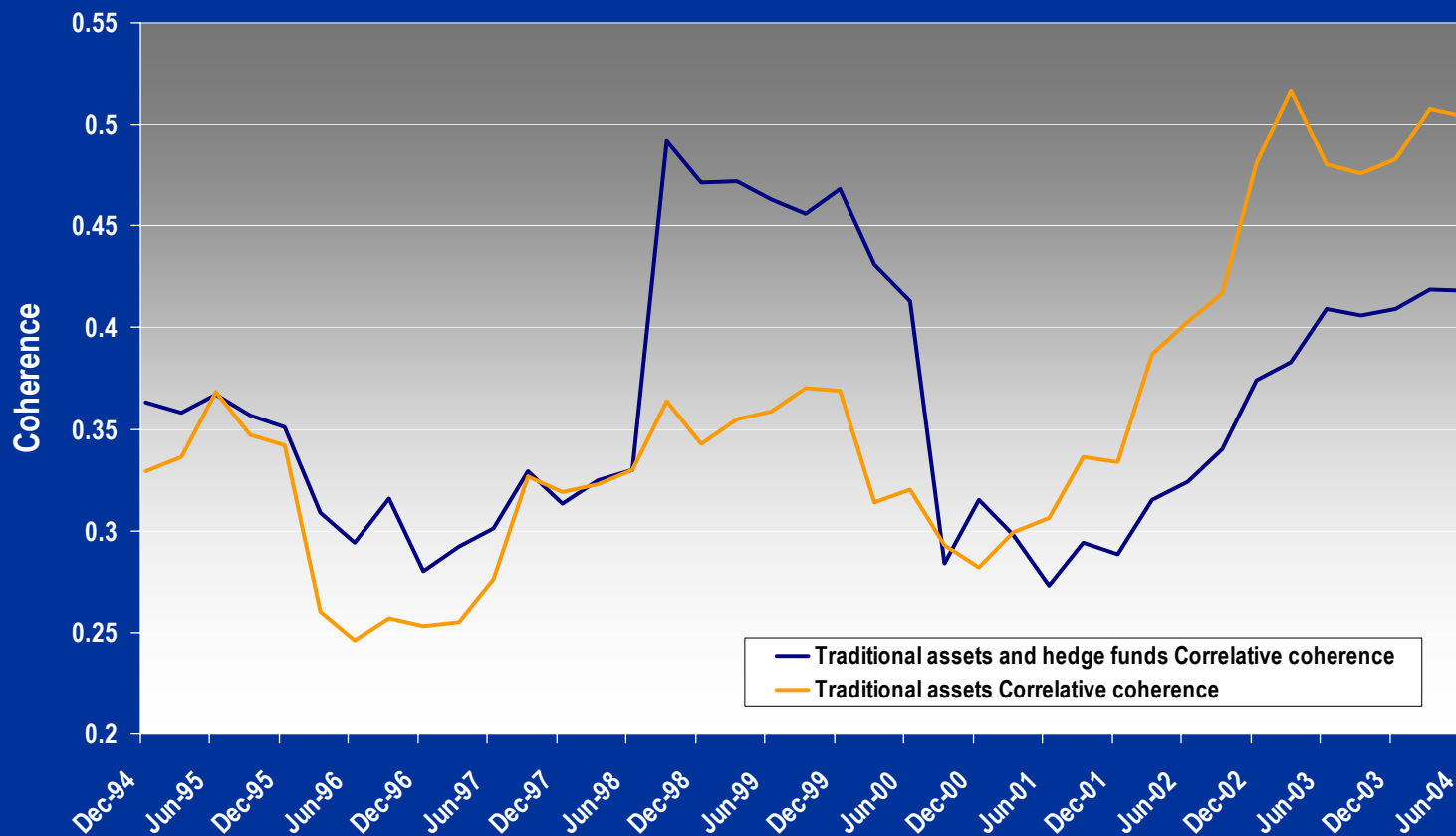


# Coherence is a Big Risk

- **What if hedge funds move together?**
  - **We can measure overall correlation through coherence**
    - ❑ **Coherence measures the amount of order with a set of assets or managers**
    - ❑ **Between zero and one; (zero, no order; one, perfect order)**
  - **Styles driven by limited common factors**
  - **Fads, herding or contagion across managers and investors**

# Coherence Between Traditional Assets and Hedge Funds Has Changed

## Correlative Coherence A Measure of the Order Across Assets Has Increased



Sources: CISDM, Hedge Fund Research, Inc. & Standard & Poor's

# You May Want to be Incoherent!

- **“True” diversification vs. pseudo-diversification**
  - **Diversification by the style not the numbers**
- **Convergence versus Divergence**
  - **View of the world makes a difference**
    - Convergent (mean-reverting view)**
    - Divergent (mean-fleeing view)**
- **What should be the price of skew?**

# Threshold Risk also Important

- **What is your target return?**
- **Downside risk is what we are afraid of**
  - **Originally discussed by Markowitz**
  - **Selling volatility funds actually creates more potential for downside risk**
- **Upside potential also a problem**
  - **Higher Sharpe ratios may lead to a return shortfall**

# Cases or Situations as Stress Analysis

- **Stress behavior has to be tied to events**
  - **Case based reasoning can be applied**
    - ❑ **What are the events you expect and fear?**
    - ❑ **Are they protected with the hedge funds you have?**
- **What can we expect for 2005**
  - **The unknown will happen**
  - **What is hot today will not be tomorrow**
  - **Analysis is important but the beginning point**

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