

# Achieving Performance Sustainability in Hedge Fund Products

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## Speakers



**Etienne Rouzeau**

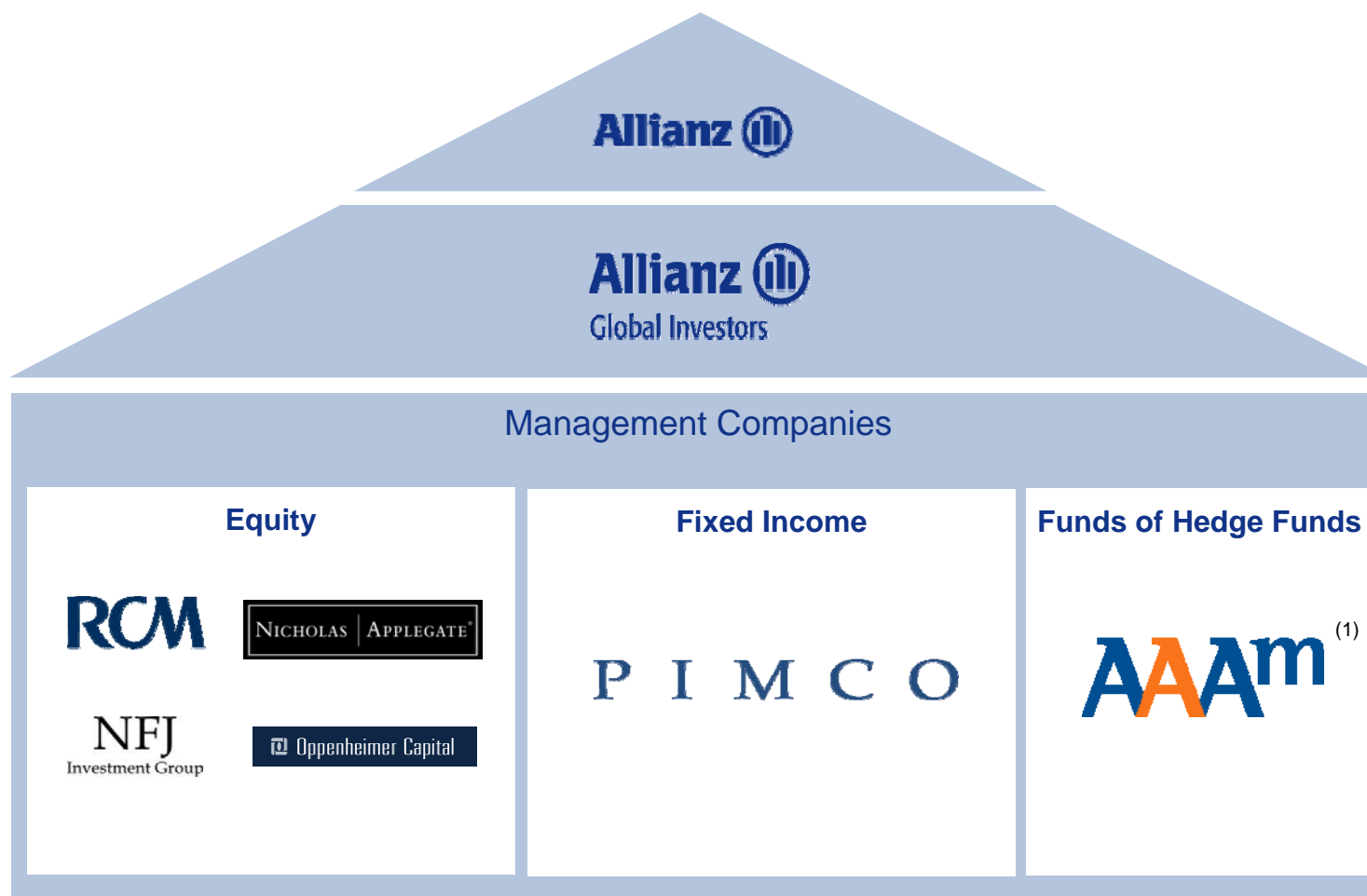
Head of Asset Allocation and Risks  
AAAM



**Oliver Bilal**

Head of institutional Business  
Development & Consultant Relations  
Europe

## Complementary Asset Management Expertise



<sup>(1)</sup> Logo refers to two legal entities :

1. AAAM S.A., a French portfolio management company registered with the "Autorité des Marchés Financiers" (AMF);
2. AAAM U.S. L.P. , an investment advisor registered with the U.S. Securities and Exchange Commission (SEC).

## Allianz Group Ranks among the Largest Asset Managers Worldwide

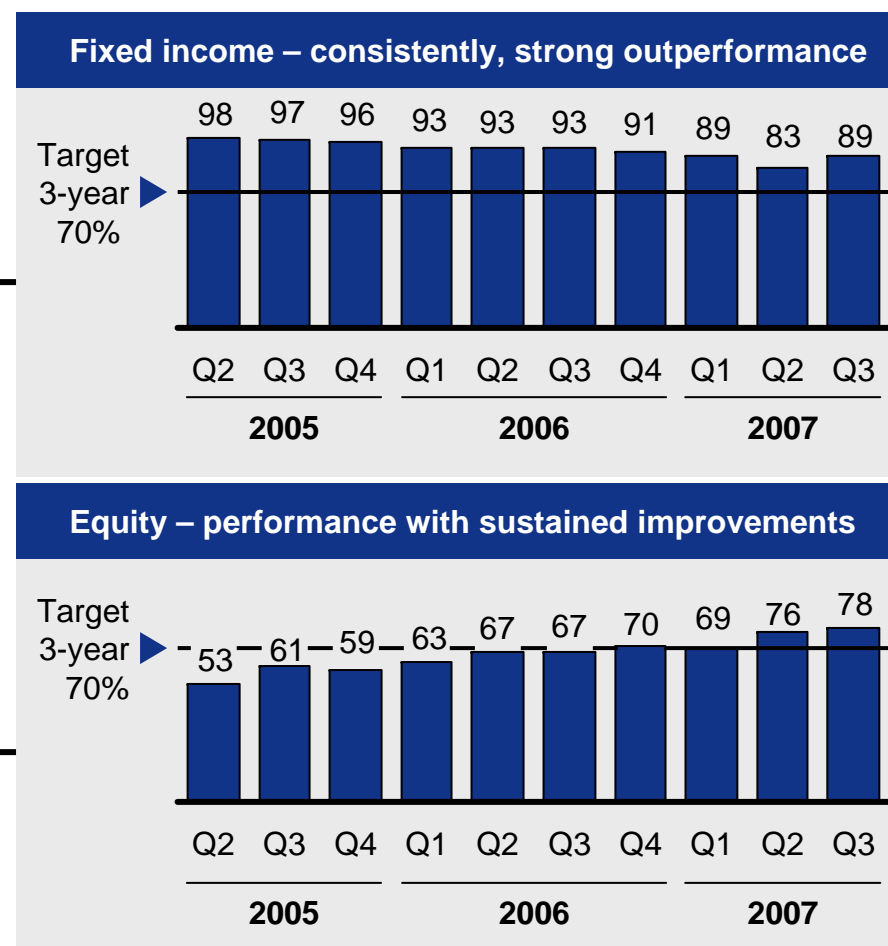
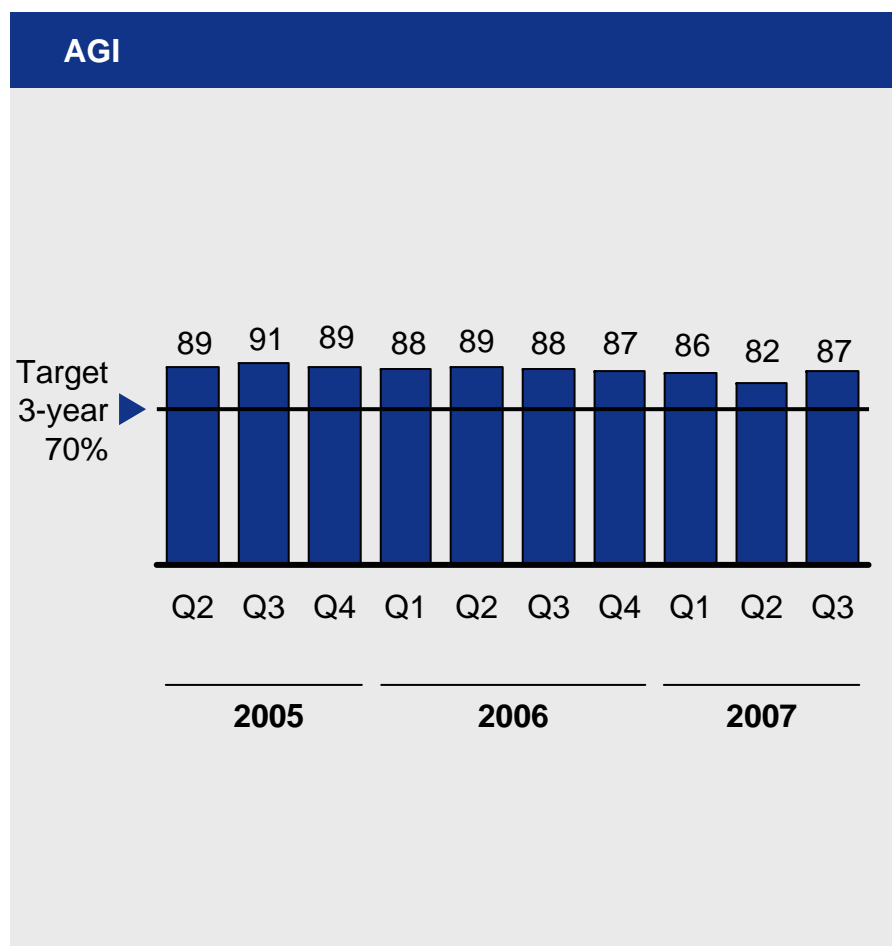


Source: 2007 Company Reports

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## In a 3-year view, consistently strong investment performance – Equity performance with turnaround

**3-YEAR ACCOUNT-BASED ASSET-WEIGHTED OUTPERFORMANCE\* OF TOTAL 3P ASSETS\*\*,  
PERCENT**



\* Institutional: mandates outperforming benchmark, gross of fees; retail: funds in 1st and 2nd quartile, net of fees

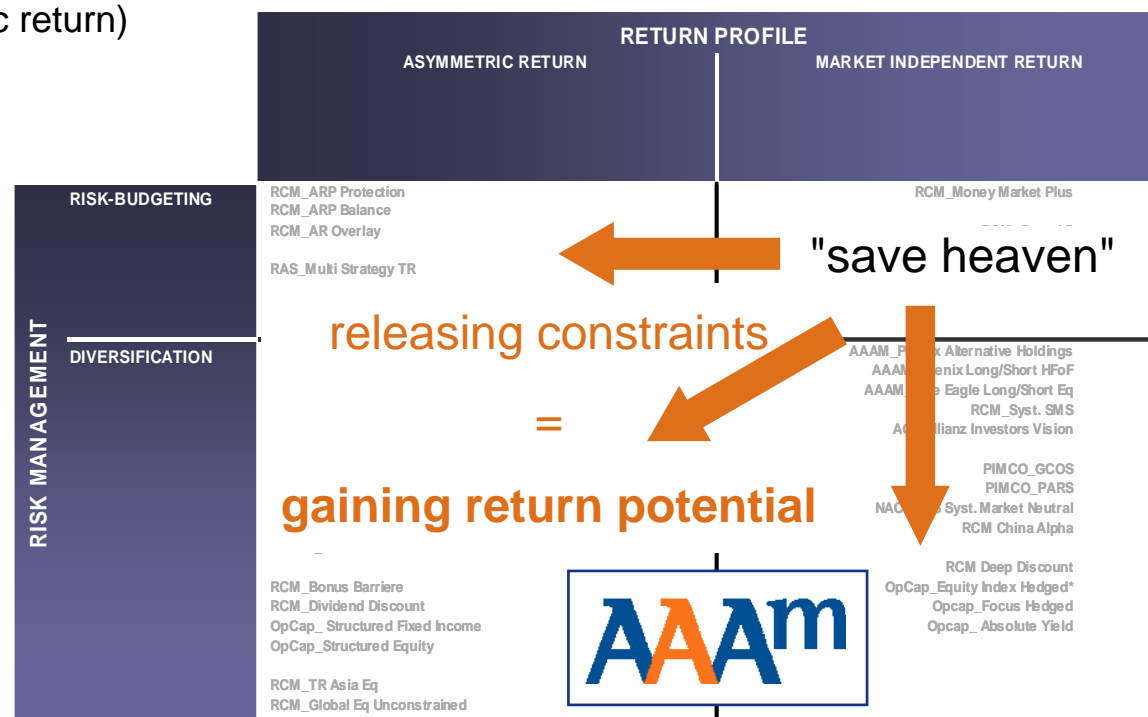
\*\* Excluding RAS AM, AGF AM and Cadence

Source: Internal, Q3 2007 figures are preliminary

## Maneuvering within the Absolute Return Universe

### Return characteristics

- ▶ **reduced** draw-down
- ▶ **lower** probability of **negative** events
- ▶ lower average negative returns
- ▶ **higher upside potential than shortfall risk**  
(omega / asymmetric return)



## AAAM - Company Profile

- Fund-of-hedge funds manager
- CEO has 30 years experience in the industry
- Assets under management: €8.5 bn (based on 31<sup>st</sup> October 2007 figures)
- 38 employees worldwide focusing purely on fund-of-hedge funds business
- Globally integrated research platform located in Paris and New York (including AAAM S.A. and AAAM U.S. L.P.)



## Agenda



### **Recent Patterns in Hedge Fund Returns**

Alpha Is not Dead

Implications for a Fund-of-Hedge Funds Manager

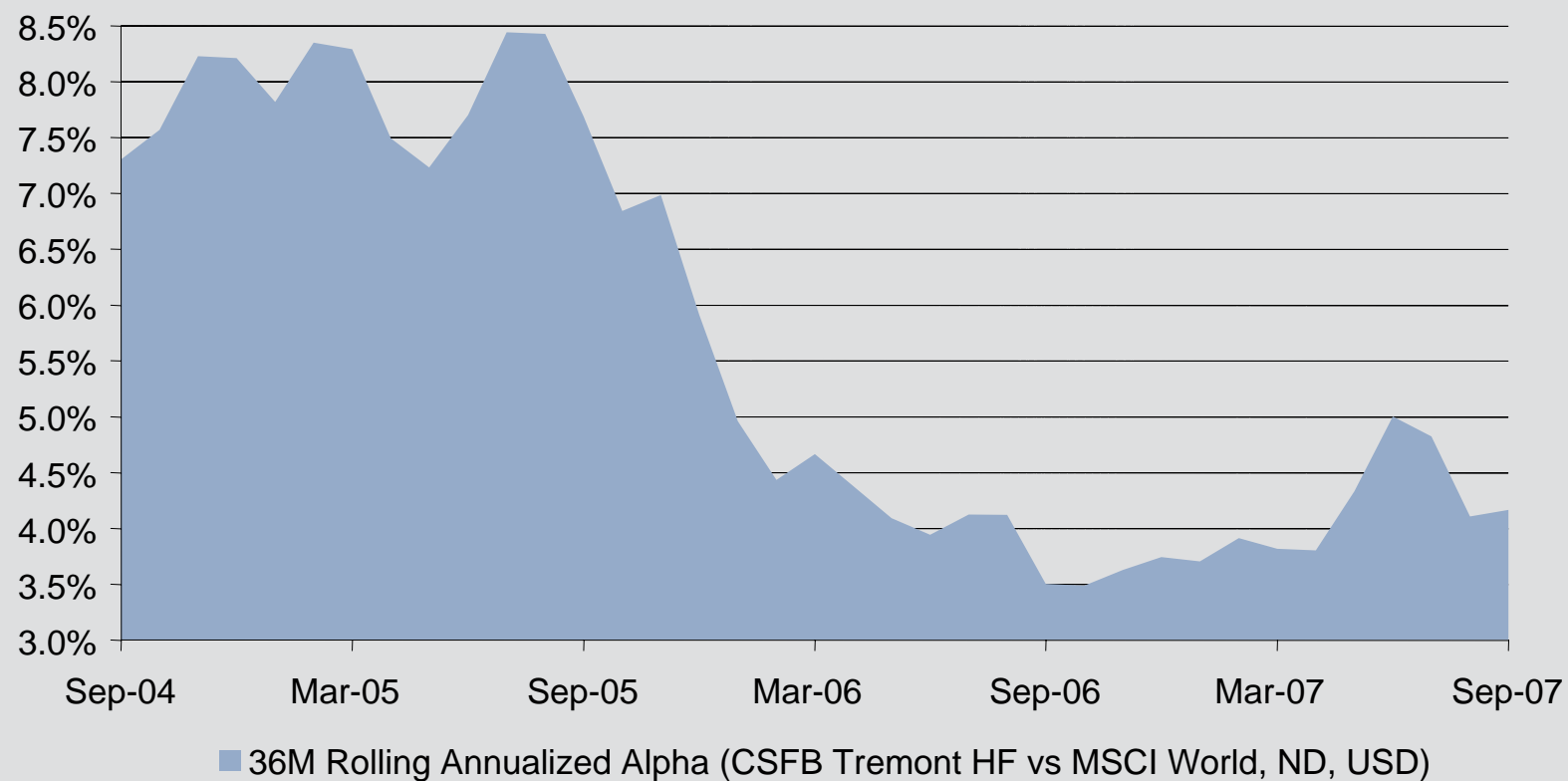
## Outline

- Recent performances show that hedge funds may not have met investor's expectations:
  - The 'easy-liquidity' environment has been a key driver for a crowded hedge fund arena
  - Beta or "smart beta" driven returns
  
- The death of alpha?
  
- Where are the diversification benefits?
  
- Should investors continue to accept the 2/20 scheme?
  
- What are the implications for fund-of-hedge funds managers?
  - Manager selection
  - Portfolio construction & risk management

## Recent Patterns in Hedge Fund Returns

### Is alpha vanishing?

CSFB-Tremont Hedge Fund Index: 36-month annualized alpha versus MSCI World

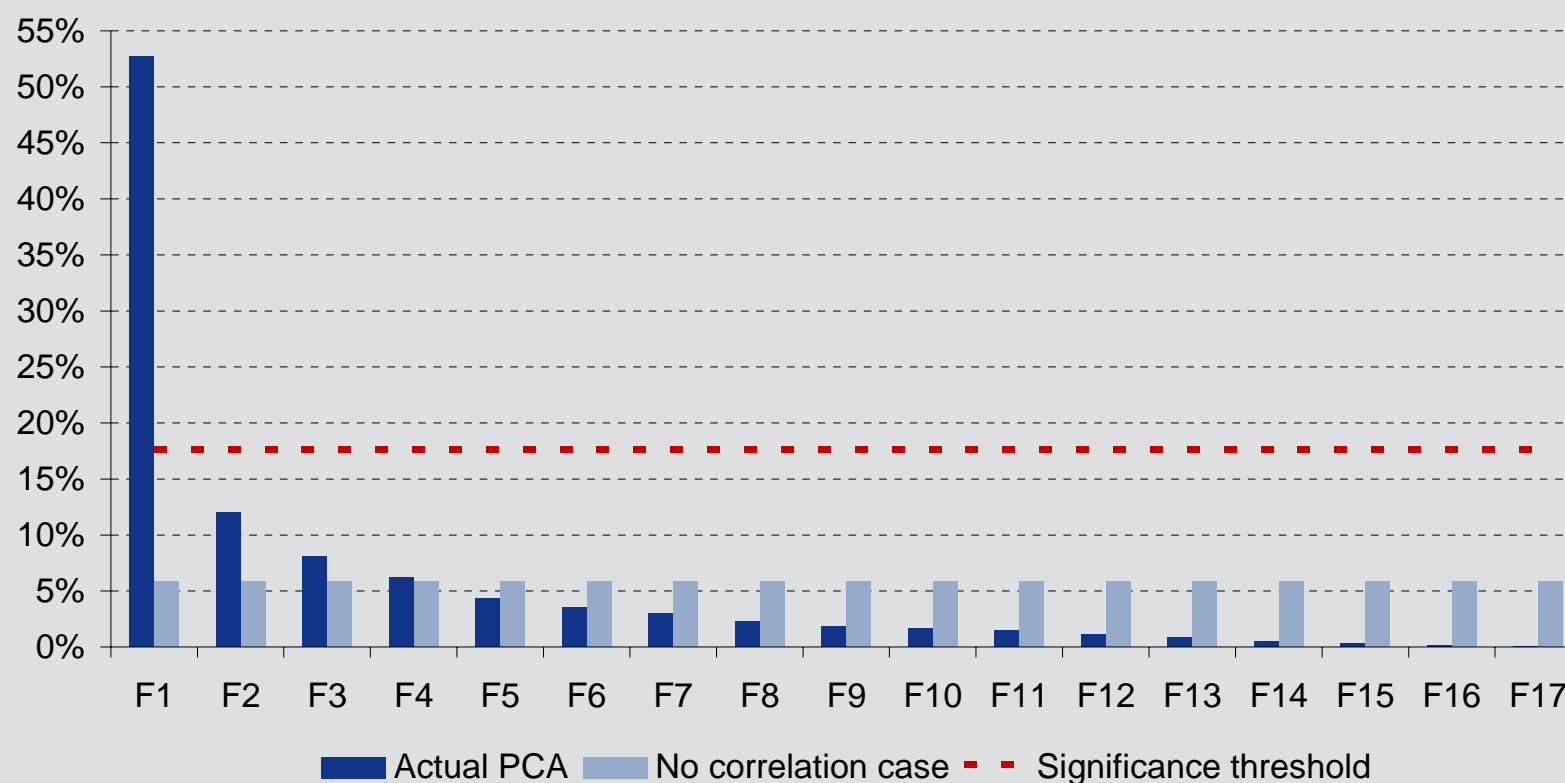


Source: Bloomberg. MSCI World in USD terms with net dividends re-invested  
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## Recent Patterns in Hedge Fund Returns

A common factor explains recent hedge fund returns...

17 top tier multi-strategy funds: PCA analysis of monthly returns [Sep 04 – Sep 07]



## Recent Patterns in Hedge Fund Returns

### Explanatory factors: market betas with negative optionality?

- Identification of the first PCA factors run through a non-linear factor analysis:

| FACTORS                  | STATISTICAL RELEVANCE | BETA     | GAMMA    |
|--------------------------|-----------------------|----------|----------|
| EQUITY MARKETS           | Very High             | Positive | Negative |
| EQUITY VOLATILITY        | Very High             | Negative | Negative |
| EQUITY MOMENTUM          | High                  | Positive | Negative |
| HIGH YIELD (PRICE INDEX) | High                  | Positive | Negative |

Source: AAAM. Factor analysis derived using AAAM's Risk Management and Profiling tools (Fofix - Riskdata©)

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## Recent Patterns in Hedge Fund Returns

### Strategy optionality and return distribution

- Basics of option theory:
  - Positive optionality (i.e. positive gamma) = Structural negative carry (negative theta or time decay)
  - Negative optionality (i.e. negative gamma) = Structural positive carry (positive theta)
  
- Implications in terms of return distribution:

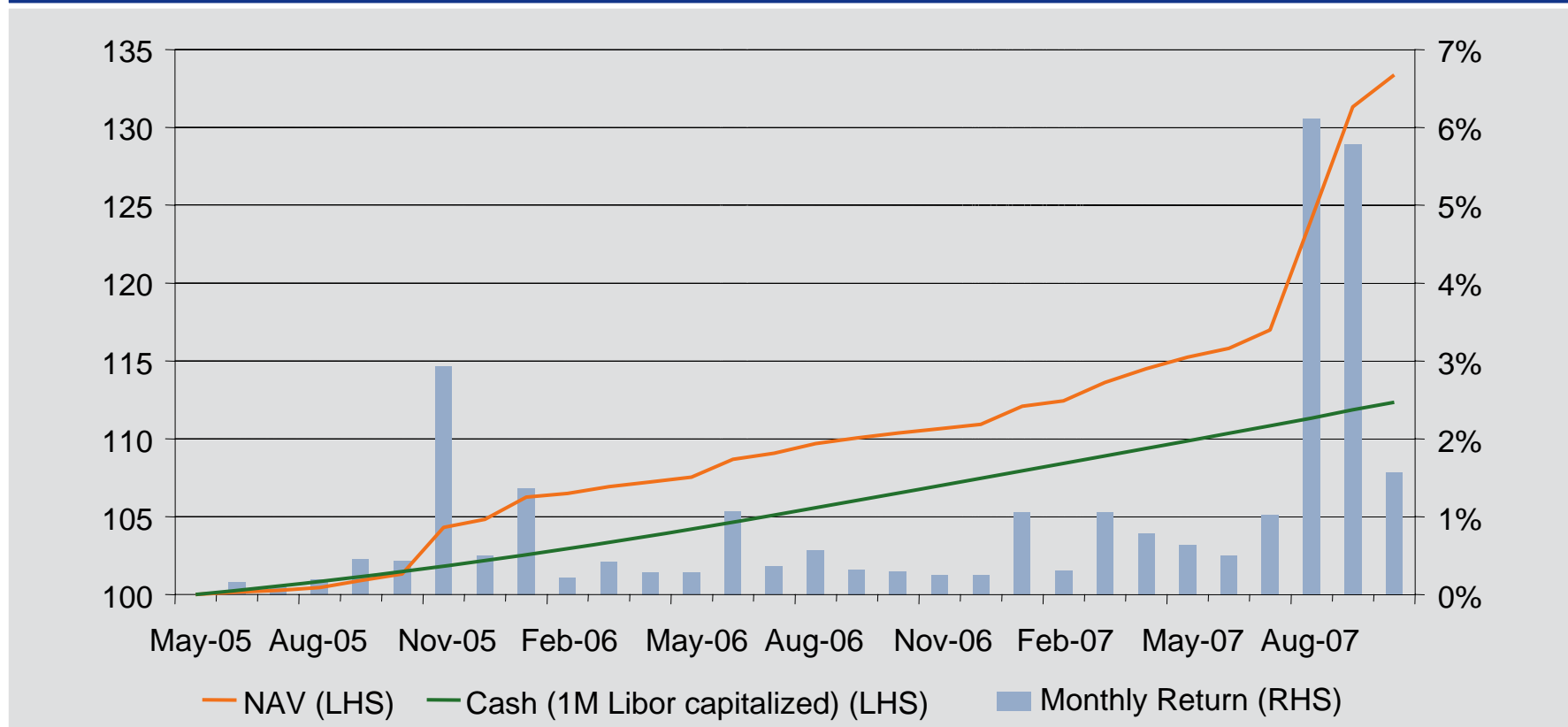
|                         | <b>POSITIVE<br/>OPTIONALITY</b> | <b>NEGATIVE<br/>OPTIONALITY</b> |
|-------------------------|---------------------------------|---------------------------------|
| <b>Gain probability</b> | <50%                            | >50%                            |
| <b>Loss probability</b> | >50%                            | <50%                            |
| <b>Expected loss</b>    | Low                             | High                            |
| <b>Expected gain</b>    | High                            | Low                             |
| <b>Skewness</b>         | Positive                        | Negative                        |

Source: AAAM. Factor analysis derived using AAAM's Risk Management and Profiling tools (Fofix - Riskdata©)

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## Recent Patterns in Hedge Fund Returns Don't mistake theta for alpha!

A trivial example of a "High theta / No alpha" strategy



Source: Bloomberg, AAAM. May 2005 – October 2007. Simulated results for illustration purposes only.  
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## Recent Patterns in Hedge Fund Returns

### Don't mistake theta for alpha!

- Impressive risk-return figures:

|                                   |        |
|-----------------------------------|--------|
| <b>Net annualized return</b>      | 12.6%  |
| <b>Volatility</b>                 | 5.1%   |
| <b>Sharpe Ratio</b>               | 1.50   |
| <b>% of positive months</b>       | 100.0% |
| <b>Skewness</b>                   | 2.84   |
| <b>Kurtosis</b>                   | 7.68   |
| <b>Correlation to S&amp;P 500</b> | 0.28   |

- These figures were derived from a trivial (yet risky!) passive strategy:
  - Shorting 90% moneyness put options on S&P 500 with a 30:1 leverage
  - 2/20 fee scheme with High Water Mark
  - The portfolio blows-up as soon as there is a 10% loss on the S&P 500
  - 11.5% intra-month draw-down reached in August 2007

## Recent Patterns in Hedge Fund Returns Conclusion: is the party over?

- Has the hedge fund industry turned into a crowded playground with no alpha?
  
- Beta driven returns
  
- Danger of short volatility strategies:
  - Invisible risk
  - Structural positive carry (theta) which can be mistaken for alpha generation

## Agenda



Recent Patterns in Hedge Fund Returns

**Alpha Is not Dead**

Implications for a Fund-of-Hedge Funds Manager

## Alpha Is not Dead!

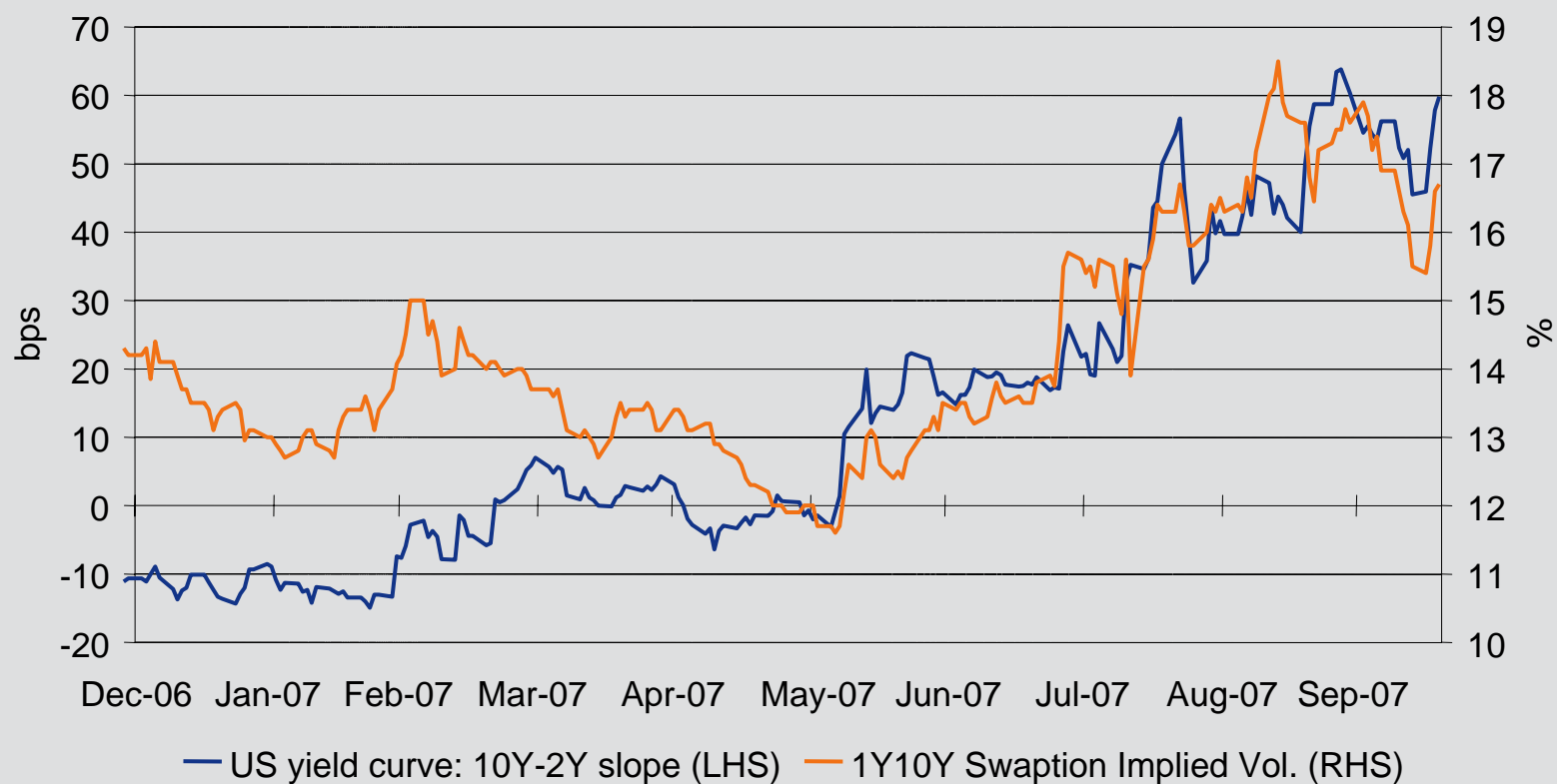
### Absolute return is NOT de-correlation!

- Absolute return investments:
  - Take investment opportunities where they are...
  - Even if they come from beta exposures
  
- Where have been the opportunities for Hedge Funds in the last 3 years?
  - Market momentum
  - Cash financed corporate activity
  - Emerging markets
  
- These opportunities are all beta related and event driven strategies have structurally short volatility.
  
- On the opposite side, non-directional opportunities have so far been scarce:
  - Flat curves
  - Low volatility environment
  
- **But this is about to change...**

# Alpha Is not Dead!

## Possible future non-directional opportunities (I)

Yield curve opportunities: 10 years-2 years slope and interest rates volatility



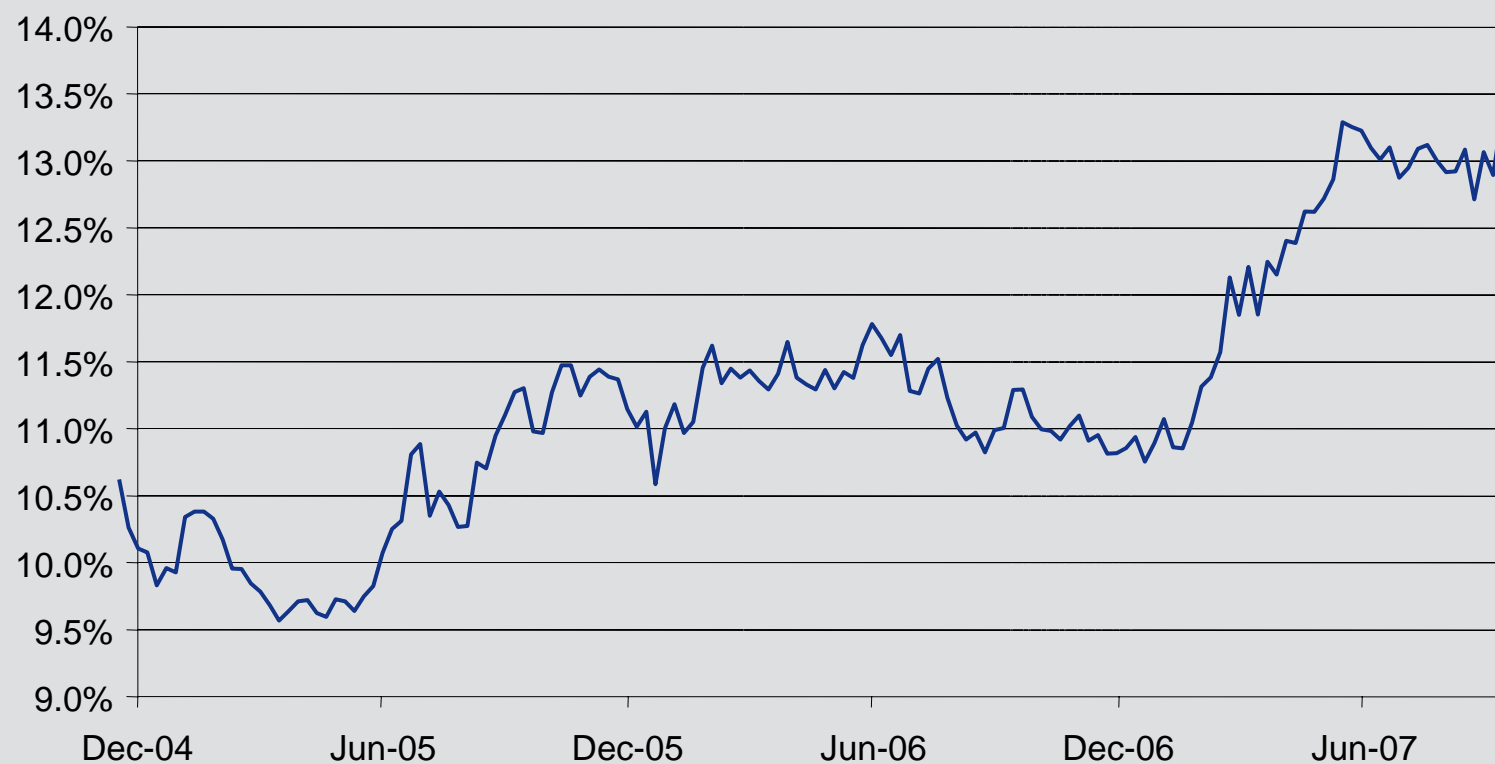
Source: Bloomberg. December 2006 – October 2007

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## Alpha Is not Dead!

### Possible future non-directional opportunities (II)

Weekly dispersion on DJ EuroStoxx 50: 26-week moving average

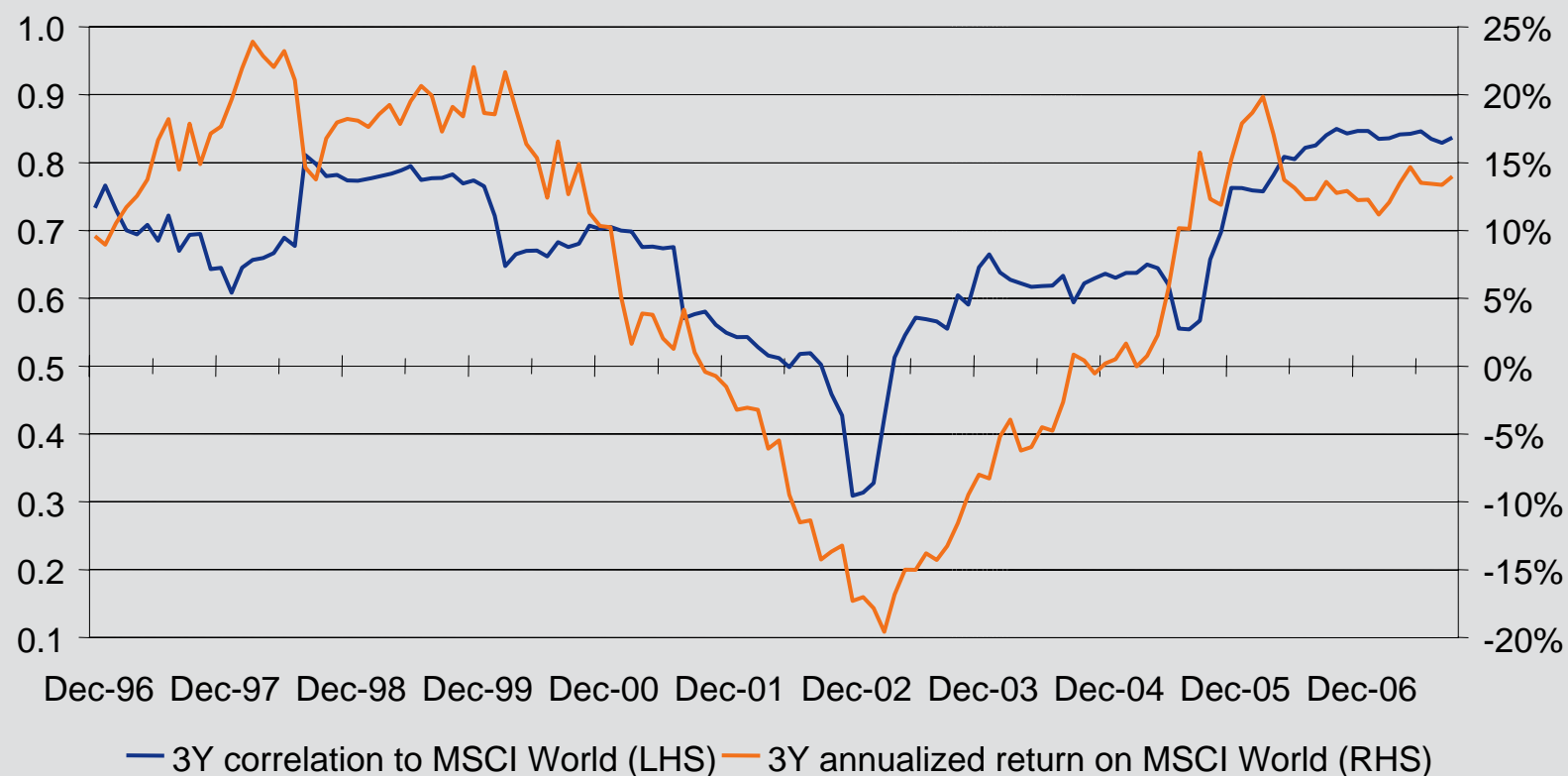


Source: Bloomberg. Weekly dispersion: spread between the best and the worst weekly performers  
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## Alpha Is not Dead!

Hedge funds have demonstrated their ability to monitor their exposures

CSFB Tremont Long/Short Equity Index: 36-months rolling correlation to MSCI World (Large Cap)



Source: Bloomberg, AAAM

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## Alpha Is not Dead!

There are structural sources of over-performance

- Alpha will remain as long as some players exhibit a competitive advantage.
- Two structural sources of competitive advantage in investment management:
  - **Capacity to quickly take advantage of financial innovation:** new markets, new asset classes...
  - **Superior capacity in accessing and processing information:** barriers to entry.
- Alpha fundamentally depends on financial innovation and competition distortions.
- Conclusion: alpha is not dead!
  
- **These two sources of alpha are shaping the hedge fund industry into two distinct business models.**

## Alpha Is not Dead!

### Riding on innovation: multi-strategy funds

- Key competitive advantages:
  - Asset size
  - Profitability
  - Capacity to attract and retain talented individuals in a wide spectrum of expertise areas
  - Strong operational infrastructure
  
- Implication on investment style:
  - Taking advantages of inefficiencies: bias toward self-destructive strategies (Relative Value, Event)
  - Must evolve according to financial innovation (credit, local emerging debt...)
  
- Population is mainly concentrated on historical industry leaders
  
  
- Example: the top of the food chain...

## Alpha Is not Dead!

### Preserving competitive edge: focused funds

- Key competitive advantages:
  - Strong research capacity or structural barriers to entry (niche markets)
  - Low staff turnover and capacity to attract talented individuals
  
- Implication on investment style:
  - Non self-destructive strategies: Long/Short Equity, Macro, CTAs...
  - No style drift
  - Capacity may be scarce in the case of niche players
  
- Industry leaders as well as emerging managers

## Alpha Is not Dead! Conclusion

- Beta driven returns induced by market environment
- Beta does not exclude alpha
- Alpha will remain as long as some players exhibit a competitive advantage
- The recent crisis will clean up the industry from pure beta or theta players

## Agenda

# 3

Recent Patterns in Hedge Fund Returns

Alpha Is not Dead

**Implications for a Fund-of-Hedge Funds Manager**

## Implications for a Fund-of-Hedge Funds Manager

### Sourcing and due diligence

- A successful fund-of-hedge funds program must be able to source its investments within the two alpha generating business models
  
- Key success factors to identify managers with real competitive advantages:
  - Asset size
  - Reputation
  - Sourcing capacities: networking, research, etc.
  
- Capacity to make distinction between true alpha from alternative beta requires:
  - Strong due diligence process
  - Real quantitative capacities

## Implications for a Fund-of-Hedge Funds Manager Portfolio construction and risk management

- Be aware, measure and control implied market exposures at the portfolio level
- Identify positive or negative optionalities at the portfolio level
- Maximize the number of performance drivers and achieve efficient diversification across strategies and managers

## Implications for a Fund-of-Hedge Funds Manager

### Manage diversification consistently

| Styles                 | Weights      | Risk Budget   | Marginal VaR (bps) | Undivers. VaR (bps) | Divers. ratio |
|------------------------|--------------|---------------|--------------------|---------------------|---------------|
| Directional Trading    | 8.0%         | 8.3%          | 22                 | 41                  | 44.8%         |
| Equity Long/ Short     | 28.8%        | 43.9%         | 118                | 166                 | 28.5%         |
| Event Driven           | 17.0%        | 18.3%         | 49                 | 66                  | 25.7%         |
| Multi Style            | 16.9%        | 18.0%         | 49                 | 66                  | 26.1%         |
| Relative Value         | 19.0%        | 11.5%         | 31                 | 71                  | 56.4%         |
| <b>Total portfolio</b> | <b>89.8%</b> | <b>100.0%</b> | <b>270</b>         | <b>409</b>          | <b>34,1%</b>  |

Allocation and risk figures for Phénix Alternative Holdings as at 31/08/2007. Figures produced using AAAM's Risk Management and Profiling tools (Fofix - Riskdata©) and provided for indicative purposes only. Methodologies may significantly change without prior notice.

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## Implications for a Fund-of-Hedge Funds Manager

### Measure and control implied market exposures

| Factor            | Stress | Loss   | Implied Beta |
|-------------------|--------|--------|--------------|
| Equity USA        | -20%   | -2.89% | 0.14         |
| Equity EUR        | -20%   | -2.91% | 0.15         |
| Equity JPN        | -20%   | -2.13% | 0.11         |
| Equity Emerging   | -30%   | -6.19% | 0.21         |
| Large - Small USA | 10%    | -1.25% | -0.13        |
| Large - Small EUR | 10%    | NS     | NS           |
| Large - Small JPN | 10%    | NS     | NS           |
| 10Y Swap USD      | +30bp  | NS     | NS           |
| 10Y Swap EUR      | +30bp  | NS     | NS           |
| 10Y - 1Y USD      | +100bp | NS     | NS           |
| 10Y - 1Y EUR      | +100bp | NS     | NS           |
| HY USA            | -8%    | NS     | NS           |

Estimated stress scenarios for Phénix Alternative Holdings as at 30/09/2007. Figures produced using AAAM's Risk Management and Profiling tools (Fofix - Riskdata©) and provided for indicative purposes only. Methodologies may significantly change without prior notice.

## Key Take-Aways

- Recent beta-driven returns result from market environment
  - Beta and alpha are not incompatible
  - Significant future non-directional opportunities in the hedge fund arena
  
- Alpha is not dead
  - Competitive edge issue
  - Recent crisis will refocus the industry on sound business models for alpha generation
  
- A successful fund-of-hedge funds' operation requires:
  - Proven sourcing and due diligence capacities
  - Strong risk infrastructure to measure and identify asymmetric risks at the portfolio level

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- There is no secondary market for the investors interests in the funds and none is expected to develop;
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