Imagine you’re a frog. You live the good life. You and your comrades, that is, the frog population, live happy and unchallenged lives. Your community prospers and grows. But then, one day, out of the blue and without warning, a frog-eating snake suddenly enters your habitat. What do you do? There are three options: (1) you run; (2) you and your comrades somehow adapt to the change in circumstances; or (3) you end up as snake food. Suddenly, life seems unfair. But you have to act; otherwise, you know it’s going to be option 3 and you’ll be history.

In our recent work (to be referenced later), we highlighted the aggressiveness, and the appetite, of the snake entering the frog’s habitat and also commented on the fear, but also ignorance of large parts of the frog population. Today, things have moved along a bit. The frogs now realize that their environment—and therefore their life—has changed forever. Slowly but surely, the frogs have realized that in order to survive, they must adapt. The snakes, on the other hand, have lost some of their initial edge. They no longer have the advantage of “surprise” that they had when they first entered the habitat of the frogs. With this, they have lost some of their momentum. They, too, have to get smarter. This book is essentially about the coexistence of frogs and snakes.
The asset management industry (essentially the habitat of both relative and absolute-return managers, beta providers and alpha providers, fish and sharks, frogs and snakes—however you want to think about it) started to change around the year 2000. The year 2000 is the turning point at which hedge funds started to seriously compete with the traditional asset management industry for institutional assets. Since then, institutional investors distinguish more carefully between alpha and beta, absolute returns and relative returns, and skill-based and market-based strategies. Quite early on, we referred to this change as a paradigm shift in the asset management industry. Our most serious advice in the early part of the decade was from John Maynard Keynes:

“When circumstances change, I change my view. What do you do?”

Today—roughly half a decade after our initial hypothesis—we continue to believe that the asset management industry is going through structural change. The difference to five years ago is the evidence for this idea’s taking shape in the marketplace, as well as an increasing population of investment professionals who agree that this is indeed a structural change in the asset management industry. We first presented these ideas in Ineichen, “In Search of Alpha” [2000] and continued to refine our thoughts in Ineichen [2001; 2003a, b, c; 2005]. We also believe ourselves to be in good company as we find credible confirmation for at least some of our elaborations in Cliff Asness’s “An Alternative Future”¹ as well as Peter Bernstein’s five inflection points for the asset management industry.²

Change in Risk Perception

Change in the asset management industry is driven by changes in their investors’ change in risk perception. Investor needs are in the process of changing fundamentally, driven on the retail investor front by the looming retirement uncertainty with respect to a huge demographic shift and increased longevity, and on the institutional investor side by a combination of worsening pension deficits and a significant different approach to evaluating and eventually paying for performance. All of this is taking place amid an uncertain market environment that is breeding enormous levels of anxiety among investors of all stripes.

The catalyst that triggered this recent change was the equity bear market starting in 2000. We call this—for want of a better term—the “oops-effect.” Following the sharp decline in equity prices, many investors realized that, “oops,” ignoring short-term portfolio volatility is not in line
with their investment objectives after all. (In cartoons, this is shown by a light bulb popping up above the head of the character with the effect. We are unaware of a formal term in the behavioral sciences that describes an observer’s sudden switch from ignorance to enlightenment of an obvious fact. Nevertheless, an Internet search revealed that this could be called the *light bulb effect.* ) More formally, this means that investors migrated to the belief that volatility matters and time does not reduce risk.

Figure 1.1 illustrates the negative effects of a volatile portfolio and its implications for short-term as well as long-term financial health or solvency. The bear market triggered a change in risk perception among a wide array of investors. Note that nothing at all has changed with respect to the underlying concept of “risk.” A volatile portfolio is still and always has been a volatile portfolio, irrespective of equity markets going up or going down. Nor were there any significant theoretical breakthroughs in finance that brought about the change in perspective. It was the live experience of capital depreciation that was the catalyst for this change in perspective. We believe that what has changed is not risk itself but how investors perceive risk.

Figure 1.1 shows the impact of large drawdowns on compounding capital over time. We have added the potential time it could take for some

**FIGURE 1.1** Underwater Perspective and Potential Time to Recovery

*Note:* December 2005 inclusive. Based on local currencies, HFRI in U.S. dollars (USD). Loss recovery line was based on assumption that indices compound at 8 percent per year.

*Source:* Author’s own calculations; data from Thomson Financial and Bloomberg.
of these indices to recover to their previous peak. The Nikkei 225, for example, reached 38,915.87 in December 1989, fell to 7,607.88 in April 2003, and then recovered to 16,111.43 by year-end 2005. In other words, the index fell by 80.5 percent. In Figure 1.1 this is shown as a line falling to 19.5 percent (of peak value). Assuming the Nikkei 225 recovers from 16,111 at an annual rate of 8 percent, the index will not have recovered from its losses until 2018. It is probably true that equities outperform bonds in the long term. However, what the graph shows is that you might not live long enough to experience the long term. We discuss long-term returns in more detail in Chapter 9.

We call this the “underwater perspective” as it shows an index as a percentage of its previous all-time high; that is, it shows by how much an investment is “under water.” This book advocates an investment approach that is designed to minimize these “underwater” periods, that is, to preserve capital even when market conditions are difficult. The problem with large drawdowns is that they kill the rate at which capital compounds. Any approach that takes an asset or liability benchmark as a risk-neutral base does not give the avoidance of large drawdowns the high priority we believe it deserves. We could argue that investing is like swimming: In both cases the survival-appreciating economic agent—after diving under water—has an incentive to reach the surface level at some stage in the future. As Warren Buffett—arguably an absolute-return investor—puts it:

“\textit{When we can’t find anything exciting in which to invest, our \textquoteleft default\textquoteright{} position is U.S. Treasuries\ldots{} Charlie and I detest taking even small risks unless we feel we are being adequately compensated for doing so. About as far as we will go down that path is to occasionally eat cottage cheese a day after the expiration date on the carton.}”

The idea of what we believe is an absolute-return investment philosophy is to try and stick close to the surface level in Figure 1.1, as digging oneself out of a deep hole can be rather time consuming. In other words, we prefer an asymmetric-return profile, that is, many and large gains versus few and small losses, to a symmetrical profile. More formally, we argue that the post-dot-com bubble period is characterized by a transition from the second into the third stage of asset management. In the preface of \textit{Absolute Returns}\textsuperscript{4} we defined the three stages as follows:

1. Absolute-return approach with low degree of manager specialization.
2. Relative-return approach with high degree of manager specialization.
3. Absolute-return approach with high degree of manager specialization.
We believe it is fair to argue that there was an asset management industry before there were benchmarks. This first stage was characterized by an absolute-return focus and a low degree of specialization on the part of the manager. Managers had “balanced” mandates in which top priority was given to an asset allocation decision rather than security selection. This approach suffered from poor performance in the mid-1970s. More fundamentally, it suffered from what is known in economics as an “agency problem”: The objectives of the manager were not aligned with those of the principal. Managers were incentivized to beat the peer group rather than to invest in an economically sensible fashion based on their individual edge and overall opportunity set.

This first stage was replaced by the second stage: the relative-return game. In this second stage, managers shifted to a relative-return approach. The asset allocation mandate was essentially taken away from the manager and this led, quite naturally, to higher specialization on the part of the manager. Next to poor performance and principal/agent issues, the introduction of the Employee Retirement Income Security Act (ERISA) in the United States in 1974 was yet another catalyst for the industry to move from the first to the second stage. ERISA changed the fiduciary responsibility of the end investor.

The introduction of an index was an improvement of the status quo as it somewhat resolved the agency problem through using a rigid benchmark. Around the same time, the efficient market hypothesis (EMH)* was rising to academic prominence through the work of Samuelson [1965] and Fama [1965, 1970], and the investment community was intellectually gradually moving away from the merits of active asset management in general and the feasibility of stock selection in particular. The main product to emerge from the 1964 to 2000 consensus thinking in the investment community was the index fund. Hedge funds are (or, more precisely, until recently were) somewhat antithetical to the EMH and the consensus view.

We classified active managers exploiting absolute-return strategies as the third stage in asset management. The third stage combines the absolute-return investment philosophy from the first stage with a high degree of manager specialization of the second stage.† The absolute-return approach

*As a matter of priority, investment professionals who read small-printed footnotes of finance books (such as this one), should certainly also read “The Adaptive Markets Hypothesis” (AMH) by MIT professor Andrew Lo [2004]. The AMH can be viewed as a new version of the EMH and is based on an evolutionary approach to economic interactions, taking into account some recent research in the cognitive neurosciences that has been transforming and revitalizing the intersection of psychology and economics.

†One could argue that there is a fourth stage. Hedge funds now have also launched long-only funds alongside their absolute-return products and there are increasingly
seeks to solve some of the issues of the relative-return approach. Investors introduce an absolute yardstick against which managers get measured. This avoids some of the pitfalls of the relative-return approach, namely peer-group hugging, search for mediocrity, and misalignment of interests between manager and investor. However, the absolute-return approach introduces new issues to be resolved. First, the loose mandate of absolute-return managers (i.e., the lack of tracking error constraints) results in a wide dispersion between managers. This means that the costs and risks of manager selection as well as potential benefits are higher with the absolute-return approach than with the relative-return approach. Second, a paradigm shift (i.e., the introduction of something new) reduces transparency and increases costs. This is an advantage for first movers and early adapters, but potentially a disadvantage for latecomers.

Recent consultant survey material adds some credibility to the preceding discussion. Figure 1.2 shows answers to a survey question. The survey was published in fourth quarter (Q4) 2005 and represented $3.5 trillion of global pension assets. The question was phrased as follows: “Which factors have fueled the worldwide growth in hedge funds in the recent past, and which, if any, are likely to do so over the next three years?”

Figure 1.2 confirms that a bear market was the catalyst for pension funds getting interested in hedge funds. The long-only culture came under

![Graph showing reasons by pension fund for investing in hedge funds](image)

**FIGURE 1.2** Reasons by Pension Fund for Investing in Hedge Funds  
*Source:* Create/KPMG [2005].

fewer specialist-focused funds. Many funds, at least within mainstream strategies, now have diversified focus, that is, they keep opportunity set as widely as possible, as some strategies are overcrowded and inefficiencies arbitraged away.
severe scrutiny, as pension funds watched their assets going from surplus to deficit. (Later in this chapter we will argue that “volatility matters,” a notion that was subdued during the 1990s bull market.) However, this is not the main reason mentioned for investing in hedge funds going forward. The main two factors mentioned by the pension funds surveyed were interest in absolute returns and investor appetite for hedge fund risk in a low-return environment. These two factors are driving flows.

**LIVING LEGENDS ON THE FUTURE OF INVESTMENT MANAGEMENT**

**300 YEARS OF COLLECTIVE WISDOM**

The Chartered Financial Analyst (CFA) Institute (formerly Association of Investment Management and Research [AIMR]) issued its inaugural issue of CFA Magazine in January/February in 2003. The cover story was “Words from the Wise”—a conference call from November 2002 that was chaired by Charles D. Ellis (author of Winning the Loser’s Game [1993]). The “wise” were John Neff, Gary Brinson, Peter Bernstein, Jack Bogle, Warren Buffett, Dean LeBaron, and Sir John Templeton. Together, these legends share more than 300 years of collective experience.

One of the questions was the following:

> Looking back over the last 30 years, what are the most important changes in the fundamental nature of our profession? And then looking out over the next 30 years, what do you think will be remembered from today that’s really significant?[^5]

Here are some quotes from some of the participants. The quotes are in chronological order but are taken slightly out of context, as we did not reprint the whole debate. Our first quote is from Jack Bogle, founder and ex-chairman of the Vanguard Group:

> “This business has really changed. It used to be about stewardship, and now it’s about salesmanship. There used to be about 300 broad-based equity funds, and now there are 5,000, many of them narrowly based and speculative specialty funds, often created and sold just when they shouldn’t be bought . . .”
Bogle then pitches for investing in index funds and finishes response to the question:

“... In all, the mutual fund industry has turned from a profession into a business. The challenge for the next 30 years is just as obvious as the smiles on our faces: This industry should return to its roots.”

Bernstein (author of *Against the Gods* [1996]) on the same question listed above:

“One of the problems with this market has been, particularly for professional managers, ‘benchmarkitis’ on the part of the clients. I think there are forces at work that are going to break that down. One is the hedge fund, which you can approve or disapprove of as an animal, but it’s focused peoples’ attention away from the conventional benchmarks. This is a very, very important development.”

Another question posed at the conference call of legends was about corporate governance. Corporate governance could, we believe, be improved through implementation of the absolute-return approach. The main decision for buying a stock under the relative-return approach is balancing outperformance potential with its marginal contribution to tracking error. Most of the relative-return manager’s portfolio is dead weight, that is, long positions held to manage tracking risk. The main reason to buy a stock under the absolute-return approach is balancing potential capital appreciation versus potential capital depreciation. One could argue that corporate executives will pay closer attention to investors who not only can buy or not buy the stock but also sell short the stock.

Here are some soundbites on corporate governance from the legends. Ellis phrases the question as if the U.S. president were calling the panelists on the subject of corporate governance. Some of the responses were:

LeBaron: “Sunshine, sunshine, sunshine, disclosure and more of it. And the president should start with it himself.”

Buffett: “The only real way to get improvement in corporate governance is to have big investors demand it.”
Bogle: “But most important is for institutions to wake up and behave like owners.”

Bernstein: “The president should understand that we run the risk of ending up with corporations run by bean counters instead of risk takers if we push this thing too far. Sunshine is essential. And the tax thing is an interesting idea, but otherwise try to keep the sticky fingers a little off.”

**BOTTOM LINE**

We believe that at least some of these quotes point toward an absolute-return approach. Diverging interests between principal and agent have come a long way. Some of the current problems in the economy in general, and in the financial industry in particular, could be solved (or the status quo improved) by realigning interests between principal and agent. What safer way than principals requesting that agents become at least a little bit principals? For this not to work, capitalism and free enterprise needs to be a flawed idea.

**DEFINING ASYMMETRIC RETURNS**

**Introduction**

What do we mean by “absolute returns”? This question was addressed in your author’s first book: *Absolute Returns: The Risk and Opportunities of Hedge Fund Investing* [Ineichen, 2003a]. The distinguishing feature of an “absolute-return” approach is that it gives priority to capital preservation. This can be contrasted with a “relative-return” approach, which links risk and return to some benchmark; capital preservation is not a major objective in a “relative-return” approach. The argument of this book is that the absolute-return approach is the preferred investment philosophy and that asymmetric returns are the implementation thereof.

What do we mean by “asymmetric returns”? In the first place, we mean a return profile that is not symmetrical, that is, a profile that departs from the so-called normal distribution. The specific “asymmetry” we are concerned with here is between positive outcomes (of which we cannot get enough) and negative outcomes (which we do not like). In an asymmetric-return
profile risk and return depart from linearity. The simplest way to illustrate what we mean is with options.

Think of a strategy whereby $95 is invested in a money market instrument yielding the risk-free rate and $5 is invested in call options. We therefore begin with a portfolio worth $100. Assume for a moment that over a period the value of the options increases threefold, so the $5 investment is now worth $15. During the same period, the $95 investment in money market instruments grows to $100. At the end of the period, the value of the portfolio is therefore $100 + $15 = $115. The return on the portfolio is 15 percent.

Now consider instead of buying options that increase threefold we bought options that expired worthless. In this case the value of the portfolio at the end of the period would be $100 + $0 = $100. So we would still not have made any loss on our portfolio. Our initial capital of $100 was preserved.

In this simple example the relationship between potential gain and potential pain is very asymmetric. Our potential gain was unlimited, whereas the capital base was safe.

The central claim of this book is threefold:

1. **Asymmetric returns** are about finding investment opportunities where the risk/reward relationship is asymmetric, that is, situations in which the potential profit is higher than the potential loss or where the probability of a profit is higher than the probability of a loss of the same magnitude, or a combination thereof.
2. Finding and exploiting these asymmetries requires an active risk management process.
3. The future of active asset management is about finding and exploiting these asymmetries.

We believe this new terminology of “asymmetric returns” goes beyond our previous model of “the search for alpha” [Ineichen, 2000a]. In fact, the term alpha* originally stems from the capital asset pricing model (CAPM), which is a linear model.

*The Economist, in a survey of human evolution, on alpha: “Students of animal behavior refer to the top male in a group as the ‘alpha.’ Such dominant animals keep the others under control and father a large proportion, if not all, of the group’s offspring. One of the curiosities of modern life is that voters tend to elect alpha males to high office, and then affect surprise when they behave like alphas outside politics too.” (“The Proper Study of Mankind: A Survey of Human Evolution,” The Economist, December 24, 2005.)
Background

Traditional asset management has a bias toward long-only investment strategies. Both index funds and long-only managers define risk relative to a market benchmark. Hence, their operation is structured in a fashion wherein replication and access are key elements.

In Ineichen [2001, 2003a, 2004a] and elsewhere, we made the point that what today is referred to as active management is in fact passive, because it uses the same risk management techniques as indexing (which is considered passive money management) and the same definition of risk (tracking risk) as do index funds. The distinction between passive and active long-only investment management is merely the magnitude of the tracking error constraint, that is, the predefined and accepted deviation from a market benchmark. If risk management is passive, the return distribution of the managed portfolio will be similar to that of the underlying market. Putting it crudely: If volatility is at 10 percent, the passive (or the so-called active) portfolio will have a volatility of around 10 percent, with higher moment risk characteristics similar to the benchmark. If volatility is at 50 percent, the portfolio volatility will also be around that level, as risk is defined and managed relative to the market benchmark.

We discuss tracking risk versus total risk and active versus passive risk management in more detail in Chapters 2 and 6, respectively. Table 1.1 gives a foretaste what this discussion entails: controlling downside risk and avoiding losses, especially large ones.

Table 1.1 shows the quarterly performance of the average hedge fund as well as the average U.S. mutual fund in quarters in which the Standard and Poor’s (S&P) 500 index was negative. The sum of all negative quarterly returns for the S&P 500 index was $-111.4$ percent. This compares to $-115.6$ percent for the average mutual fund. This slight underperformance of active long-only asset management is fairly consistent with most of the empirical research suggesting that active long-only underperforms. (Note that index funds underperform, too.) The average hedge fund lost only 8.5 percent in these negative quarters. We believe this a big difference to $-115.6$ percent of the average mutual fund, assuming compounding capital positively and survival is a major objective. (Note that the sum of all negative quarterly returns of the Van U.S. Hedge Fund Index was 26.8 percent, which compares to 111.4 percent in case of the S&P 500.)

One key claim for which we will argue throughout this book is that all investors should prefer asymmetric returns to symmetric returns. This conclusion is based on the following three factors that, we believe, apply to all investors. The first two notions are from Markowitz [1952, 1959] and the third from Kahneman and Tversky [1979]:
### TABLE 1.1  Hedge Funds versus Mutual Funds in Down Quarters

<table>
<thead>
<tr>
<th></th>
<th>S&amp;P 500</th>
<th>Van U.S. Hedge Fund Index</th>
<th>Morningstar Average Equity Mutual Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q 1990</td>
<td>-3.0%</td>
<td>2.2%</td>
<td>-2.8%</td>
</tr>
<tr>
<td>3Q 1990</td>
<td>-13.7%</td>
<td>-3.7%</td>
<td>-15.4%</td>
</tr>
<tr>
<td>2Q 1991</td>
<td>-0.2%</td>
<td>2.3%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>1Q 1992</td>
<td>-2.5%</td>
<td>5.0%</td>
<td>-0.7%</td>
</tr>
<tr>
<td>1Q 1994</td>
<td>-3.8%</td>
<td>-0.8%</td>
<td>-3.2%</td>
</tr>
<tr>
<td>4Q 1994</td>
<td>-0.02%</td>
<td>-1.2%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>3Q 1998</td>
<td>-10.0%</td>
<td>-6.1%</td>
<td>-14.9%</td>
</tr>
<tr>
<td>3Q 1999</td>
<td>-6.2%</td>
<td>2.1%</td>
<td>-3.4%</td>
</tr>
<tr>
<td>2Q 2000</td>
<td>-2.7%</td>
<td>0.3%</td>
<td>-3.2%</td>
</tr>
<tr>
<td>3Q 2000</td>
<td>-1.0%</td>
<td>3.0%</td>
<td>0.6%</td>
</tr>
<tr>
<td>4Q 2000</td>
<td>-7.8%</td>
<td>-2.4%</td>
<td>-8.1%</td>
</tr>
<tr>
<td>1Q 2001</td>
<td>-11.9%</td>
<td>-1.1%</td>
<td>-12.7%</td>
</tr>
<tr>
<td>3Q 2001</td>
<td>-14.7%</td>
<td>-3.8%</td>
<td>-17.2%</td>
</tr>
<tr>
<td>2Q 2002</td>
<td>-13.4%</td>
<td>-1.4%</td>
<td>-10.7%</td>
</tr>
<tr>
<td>3Q 2002</td>
<td>-17.3%</td>
<td>-3.6%</td>
<td>-16.7%</td>
</tr>
<tr>
<td>1Q 2003</td>
<td>-3.2%</td>
<td>0.7%</td>
<td>-3.7%</td>
</tr>
</tbody>
</table>

Sum of returns* | -111.4% | -8.5% | -115.6% |
Cumulative return | -69.4% | -8.8% | -70.9% |

*Author’s own calculations, not in original.

Source: VAN Hedge Fund Advisors, LLC.

1. More return is preferred over less.
2. Certainty is preferred over uncertainty.
3. Losses weigh stronger than profits; that is, disutility from capital depreciation is larger than utility from capital appreciation.

The first factor (more return) is obvious. More is always preferred to less as you can always give away what you do not want, so less is never preferred to more. All investors, everything else being equal, prefer more over less, not only with respect to returns.* An absolute-return manager, unlike a relative-return manager, also actively addresses the second and third of the three factors mentioned above: First, most absolute-return

*For the sake of argument, we ignore here the very special case wherein an increase in wealth can result in negative externalities, tipping marginal utility into negative
managers have some sort of target risk (e.g., volatility or VaR) and control portfolio risk accordingly. Second, capital preservation is crucial; that is, avoiding large drawdowns is a major part of the objectives as well as the investment process. In other words, the difference in market behavior and investment process between relative and absolute-return managers does not manifest itself by examining returns but by examining risk. What we mean by risk will be elaborated in more detail in following chapters. It has many aspects: risk definition, risk control, risk perception, risk management philosophy, corporate risk management culture, and so on. Put simply, if a manager defines risk relative to a benchmark, the portfolio will mimic the return distribution of the underlying market benchmark. However, absolute-return managers are not driven by market benchmark but by profit and loss (P&L). This means risk is defined in absolute terms. We use the term total risk. If risk is defined as total risk and the investment process is driven by P&L, the manager will be taking into account these three factors.

**VOLATILITY MATTERS**

**The Thing about Compounding Capital**

As previously mentioned, one of our claims is that volatility matters. Volatility can kill the rate at which capital compounds. Visualize:

- A 10-year investment of $100 that is flat in the first year and then compounds at 8 percent will end at $200.
- A 10-year investment of $100 that falls by 50% in the first year and then compounds at 8 percent will end at $100.

This, to us, seems to be a big difference. What we find puzzling is that not everyone agrees with our notion that long-term investors cannot be indifferent to short-term volatility. Note that a 10-year investment of $100 that compounds at 8 percent in the first nine years and then falls by 50 percent will end at $100, too. Figure 1.3 shows these three investments graphically. We assume that the three portfolios are diversified portfolios; that is, idiosyncratic risk is diversified. Note that we have added some casual remarks on compounding, survival, and dull financial products to the appendix of this chapter.

territory (e.g., kidnapping, media attention). These negative externalities do not apply to institutional investors, as it can be safely argued that the probability of a trustee of a pension fund being kidnapped or hunted down by a hoard of groupies is minuscule.
Figure 1.3 Effect of compounding
Source: Author’s own calculations.

Note that investment C has outperformed investment A for a long time. We believe the proper response to a presentation of outperformance akin to the one shown in Figure 1.3 is: Who cares? Any form of return examination without a discussion of the risk involved is useless. If we do not know the risk, the next period could be materially different from the past. Examining realized volatility and historical return distribution properties is a start but purely backward looking. We do not see a shortcut for investors that allows intelligent investment decisions without knowing what they are doing, that is, without having as clear as possible an understanding of risk going forward.

While we believe investors’ change in risk perception is largely structural, loss aversion and perception of risk could be cyclical. We possibly have found a simple way to measure investors’ loss aversion. (We discuss loss aversion and prospect theory more formally in Chapter 5.)

Figure 1.4 is a 200-day moving average of the U.S. and Japanese indices. We have normalized the peak to 100 and then synchronized the peaks. We are actually serious in claiming that risk aversion varies a lot. We also feel very strongly about the notion that it was the 2000 to 2002 bear market that put hedge funds, and therefore absolute-return strategies, on the agenda of many institutional investors. Although we equally strongly believe that the asset management industry is fundamentally changing, and that the end
Survival of the Richest—Volatility Matters

FIGURE 1.4 Change in Loss Aversion
Lines in graph show 200-day moving average based on daily returns. All-time highs were indexed to 100 and synchronized. Highs of 200-day moving average were September 2000 (S&P 500) and February 1990, respectively.
Source: Author’s own calculations; data from Thomson Financial.

of this decade will have little resemblance to the previous one, we need to acknowledge that there is a cyclical element in all this. We also believe that, as low interest rates have caused liquidity to swell, by early 2006 equity strategists were falling over themselves with bullish commentary for the year. Flows into hedge funds somewhat slowed in 2005. It is not entirely unthinkable that the flow of institutional funds into absolute-return strategies has slowed because investors are having positive returns in the rest of their portfolio as well. We actually have a mini-theory on this.

In technical analysis there is an oscillator called the Coppock curve. According to investopedia.com, the Coppock curve is “A long-term price momentum indicator used primarily to recognize major bottoms in the stock market. It is calculated as a 10-month weighted moving average of the sum of the 14-month rate of change and the 11-month rate of change for the index.”6 The interesting thing about this curve is that the 14-month and 11-month periods were chosen based on research suggesting that it takes normal, grown-up human beings around 11 to 14 months to recover from the loss of a loved one. This might sound somewhat awkward, but judging from the author’s own experience, this could actually be more or
less correct. If this is true, our theory is that it takes around 11 to 14 months until the pain from a large loss is filed in a different part of the brain, that is, does not influence day-to-day decision making anymore. So we do not think it is pure coincidence that flows into hedge funds started to slow roughly one year after the lows in equity markets, that is, one year into the recovery. Aversion to losses was largest when markets were in freefall. It is not entirely unthinkable that flows into absolute-return space will pick up again as soon as markets start falling again and real losses are experienced.

**Back to Basics** The adoption of the absolute-return approach is to some extent the industry “returning to its roots,” at least for the active part of the asset management industry. The negative effect of large drawdowns on compounding capital was not lost on Benjamin Graham (1894–1976):

>“An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.”

Nor was it lost on Albert Einstein:

>“Compound interest is the eighth natural wonder of the world and the most powerful thing I have ever encountered.”

What we refer to as the third stage of the asset management industry is a combination of the absolute-return approach from the first stage, and the high degree of specialization of the second stage. Combining an absolute-return approach with a high degree of manager specialization results in the manager’s having a mandate to balance investment opportunity with capital at risk. This is a more flexible approach than adding value with respect to a benchmark. It takes into account the fact that market inefficiencies have a tendency to go away when identified by too many investors, as well as the fact that the reward from a certain skill falls over time. Today, we call this

*We believe this to be the case for the asset management industry as a whole. One could argue that within the subspace today called the hedge fund industry, there is a trend toward broader mandates, that is, less specialization as many single-strategy managers seem to be migrating toward multistrategy approaches. We believe this to be related to the scalability (or nonscalability) of an absolute-return venture, as well as the adaptability and flexibility of skill in the marketplace, two issues addressed in more detail later in this book. Another reason is that successful managers migrate to less risk as the downside is perceived as larger (less time to recover from loss, potential kink to reputation and ego, etc.).*
a *hedge fund*. However, the term, essentially a misnomer characterizing a legal construct, might disappear.

A different view from our own is the belief that the absolute-return investment philosophy will somehow be integrated into the status quo—what we call the second stage of asset management, the relative-returns game. After all, the end investors (pension funds, insurers, etc.) have a multiple set of objectives, some of which are defined in relative terms. We do not share that point of view. As a matter of fact, we are inclined to treat the benchmarked long-only and absolute-return approaches as opposites, or, more formally, as passive and active risk management. Why?

Our angle (or bias) comes from looking at the world from what we believe is a risk perspective. The bottom-up stock selection process of a long-only manager and a long/short manager might be identical or very similar. However, there is a big difference in the way risk is defined. If the definition of risk is different, it is obvious that the whole risk management process differs as a result. In a benchmark-driven investment process, risk is defined as some form of *tracking risk*, while, in an absolute investment process, risk is defined as *total risk*. Managing tracking risk means participating in any boom/bust cycle unhedged, whereas managing total risk means reducing risk when the risk/return opportunity set changes to the investor’s disadvantage. The investment philosophy and culture resulting from this differentiation could not be farther apart. Indeed, we believe they could be considered opposites.

We believe, however, that some sort of convergence between “traditional” and “alternative” management has become more apparent over the past two to three years. For instance, it is true that many hedge funds are becoming somewhat more like traditional investment managers, that is, more transparent, regulated, investor friendly. Some hedge fund firms are even launching long-only products. At the same time, the traditional asset management industry is launching what look like absolute-return products or are buying into the absolute-return boom through mergers and acquisitions. But does this trend also reveal any convergence in investment philosophy and risk management culture? We’re not yet convinced.

**Evolution Is Jumpy, Not Smooth**

Generally, progress is not smooth and gradual, but erratic and jumpy due to new discoveries and new ideas. A new development or idea is typically ridiculed first, then it is contested because it does not fit nicely with the current doctrine, then the opposing camp adapts to the changed environment, and then—finally—goes on to argue that “we knew this all along.” With respect to absolute-return investing, we have safely passed the
first phase. There is only a minority of die-hard contemporaries from the popular press and a minority of institutional investors left arguing that the search for alpha, the preference for an asymmetric-return profile over exposure to randomness, the quest for independent return streams (portfolio diversification), and thinking about the extreme impact of large losses to investor survival probability is ridiculous. We believe we are somewhere in the second phase where there is still opposition, as the “new” idea does not fit nicely with “old” beliefs.

Here, the term incommensurability used by Thomas Kuhn (American philosopher and historian of science) in the context of paradigm shifts and scientific change comes to mind.* Kuhn [1962] held that at certain moments in the development of science the abandoned paradigm and the newly embraced one are “incommensurable.” By this he means that the fundamental concepts of one paradigm cannot be rendered by the terms of the other. In other words, according to Kuhn, the old and new paradigms are conceptually so different that a debate is not possible. We find this image extremely apt for the asset management industry, in the sense that the concepts and perceptions of risk between the relative-return paradigm and absolute-return paradigm are so wide as to be incommensurable. A quote from the late Professor Robert Heilbroner, author of *The Worldly Philosophers: The Lives, Times, and Ideas of the Great Economic Thinkers,* potentially also applies to the current regime switch in the asset management industry:

“The high theorizing of the present period [in economics] attains a degree of unreality that can be matched only by medieval scholasticism.”

The theorizing of scholars over abstracted ideas is a common feature of the end of paradigms. The incredibly complex math employed to explain anomalies in Newtonian physics before Einstein posited his comparably simple relativity is a case in point. Comparing the current regime switch in asset management with the move from Newtonian physics to Einstein’s relativity or from the Ptolemaic system to Copernicanism is arguably somewhat over the top. However, risk-uncontrolled exposure to market forces could one day—looking back—be compared to the unsheltered exposure of our ancestors to the whims of natural forces. Most people probably agree

*The term incommensurable derives from a mathematical use, according to which the side and diagonal of a square are incommensurable by virtue of there being no unit that can be used to measure both exactly. Kuhn stressed that incommensurability did not mean noncomparability (just as the side and diagonal of a square are comparable in many respects).
that finding ways to control and shelter life and belongings from the natural elements is considered progress. We believe the same is true for controlling capital at risk. (Nudists might disagree, though.)

**CHAPTER SUMMARY AND CONCLUSIONS**

The asset management industry is often considered a zero-sum game (or even a negative-sum game after fees). A zero-sum game implies the presence of both winners and losers. The gains of the winners are matched by the losses of the losers. If a paradigm shift results in all investors managing risk more aligned to their individual preferences, then all investors win. (Except those who miss the shift, of course.)

We believe that the purpose of risk management and risk management products is to achieve asymmetric returns. By asymmetric returns we mean a risk/return profile that is not available in “nature,” but is artificially controlled to match the end investors’ risk preferences more accurately and more efficiently. Our belief is based on some assumptions, an important one of which is that investors are loss averse; that is, volatility on the downside is not the same as volatility on the upside, hence the key importance of asymmetry.

The asymmetric-return profile is achieved either through absolute-return managers driven by P&L or through financial engineering using hedging techniques. We believe that what we call a hedge fund today is really part of the risk management business. Given that many investors expect the 2000 to 2020 period to be less investor friendly than the 1980 to 2000 period, we could currently be witnessing the merger between what we referred to as the asset management industry and what we have come to understand to be the risk management business. One could view this as a merger between the long term (as in “equities outperform bonds in the long term”) and the short term (as in “interim volatility matters”). The synthesis of the two would be, in its active form, managers seeking investment opportunities while managing total risk. In its more passive form, it would be structured investment products (e.g., capital guarantees or overlays).

We believe that one of the main sources of confusion, myth, and misrepresentation with respect to risk comes from the observation that risk is sometimes defined in relative terms and sometimes in absolute terms. During the 20-year bull market, the asset management industry used a more relative metric, whereas the risk management industry (essentially trading departments of investment banks and hedge funds) focused on absolute metrics to define and manage risk. The pivotal objectives of absolute-return investing are in sharp contrast with those of relative-return
investing. The absolute-return approach aims to avoid absolute financial losses, preserve principal, and actively manage portfolio volatility. One of the major disadvantages of all this is that the absolute-return approach does not fit as nicely into the traditional asset allocation process of the institutional end investor. One could conclude that the absolute-return approach is not fit for survival because there is limited transparency and one cannot budget for risk as well as one can with the relative-return approach. We believe that this view is similar to the assessment of individual transport 100 years ago and the migration to the automobile. Because of the lack of proper roads, there was the belief that “the horse is here to stay.”

**APPENDIX: ON COMPOUNDING, SURVIVAL, AND DULL SWISS**

“It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you’ll do things differently.”

—Warren Buffett

Your author is Swiss. One of the many stereotypes of the Swiss is that they are perceived—by the global non-Swiss community—as dull. One of the reasons the Swiss are so dull—according to an article we came across some years ago—is that the Swiss never had victories on battlefields to speak of, never had colonies, never had social upheavals, never had social disasters. The Swiss, unlike their neighbors, don’t even strike. The article went on to say that periods of stress, such as war, bring out the best in terms of human inventiveness and creativity. The article went on to say that the works of Michelangelo, da Vinci, and the like fell into such stress periods. As a result of the Swiss being so peaceful and dull, the article went on, they are extremely uncreative.* One famous psychiatrist and one partly famous reformist theologian aside, the Swiss have no poets, no composers, no philosophers, hardly any writers, or painters of international acclaim to speak of. So the only creative legacy from the Swiss to the world—according to this article—is the cuckoo clock.

However, Switzerland—by any standard—is also among the world’s richest nations. Has the reader ever thought that there might be a relationship between dullness and riches? Potentially, there is.

*Which is, of course, entirely untrue. According to the United Nations Human Development Report 2001, Switzerland is top-notch when inventiveness is measured by patents per capita. In addition, it does actually require a beautiful mind to come up with the idea of stirring pieces of bread on an oversized fork in a pot of melted cheese for dinner.
We started examining the hedge fund space in 2000. One of the fund of funds marketing one-liners we came across at the time was something along the lines of “We offer dull products.” In finance, there is a measure for the degree of dullness: the standard deviation of returns or—in its annualized form—the volatility. So a fund of funds could argue that if survival and sustainable compounding of capital (two elements that are arguably related) are major objectives, then large erratic swings, especially on the downside, are to be avoided. The bottom line of this analogy is the following: The Swiss—supposedly—are dull but somehow got compensated for their collective loss of sense of humor by creating an environment that allowed a long-term and sustainable creation of prosperity that has been handed over from one generation to the next. Fund of hedge funds—with volatilities in some cases of less than two percentage points these days—are dull, too. But chances are that fund of funds also—when risk is managed diligently—will survive and compound capital sustainably for the foreseeable future.

One way to make the case for the dull is the following: Table 1.2 shows five different investment alternatives whereby we calculated returns over the past ten years. The first row is a simple average of the ten annual returns from 1996 to 2005. The second row shows the compound annual rate of return (CARR). This is the return that shows if one had invested on day one, in this case January 1996, and held on to the investment until the end of the investment period, in this case 2005. However, this is not really a practical assumption for most investors, institutional as well as private. Most investors continuously add new money to old.

The third method in Table 1.2 is more realistic for most investors. It assumes the investor adds an equal amount of capital in regular intervals, in this case ten equal contributions at the beginning of every year. The rate shown is the fixed rate that matches all cash flows. There are some observations we can draw from the table. First, the higher the volatility of the investment, the more the internal rate of return (IRR) differs to the average annual return. In the case of the NASDAQ, the average return was

<table>
<thead>
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<th></th>
<th>S&amp;P 500 Total Return Index</th>
<th>NASDAQ Composite Index</th>
<th>MSCI World Total Return Index</th>
<th>JPM Global Gov. Bond Index</th>
<th>HFRI Fund of Funds Comp. Index</th>
</tr>
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<tbody>
<tr>
<td><strong>Average</strong></td>
<td>10.7</td>
<td>13.8</td>
<td>9.0</td>
<td>5.5</td>
<td>8.8</td>
</tr>
<tr>
<td><strong>CARR</strong></td>
<td>9.1</td>
<td>7.7</td>
<td>7.5</td>
<td>5.2</td>
<td>8.4</td>
</tr>
<tr>
<td><strong>IRR</strong></td>
<td>5.7</td>
<td>4.1</td>
<td>6.3</td>
<td>5.4</td>
<td>7.4</td>
</tr>
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</table>

CARR: compound annual rate of return; IRR: internal rate of return.
Source: Author’s own calculations; data from Thomson Financial and Bloomberg.
13.8 percent. An investor buying the NASDAQ in January 1996 and selling in December 2005 compounded at 7.7 percent. However, had the investor added an equal amount every year, his investments would have compounded at a rate of 4.1 percent. This is probably much closer to many investors’ experience with tech stocks. Second, fund of funds have by far the highest IRR. What is interesting here is that fund of funds have underperformed the S&P 500 Total Return Index. Or have they? We don’t think so. We do not believe that many investors have put money in the S&P 500 in 1996, left the investment untouched throughout all the turbulence, and looked at the performance at the end of 2005. Adding to an existing investment over time is far more realistic. Figure 1.5 shows the two investments whereby $100 was invested at the beginning of every year. The bars measure year-end values.

Going forward, many investors will come to realize that the light-grey bars in Figure 1.5 represent the more attractive investment, that is, portfolios with high risk-adjusted returns are superior to portfolios with lower risk-adjusted returns. That’s why dull is good and volatility matters. Oscar Wilde might have been thinking of the Swiss when he said: “It is better to have a permanent income than to be fascinating.”