

Absolutely,



Relatively Asymmetrical

By distinguishing between absolute and relative return, according to Alexander Ineichen, CFA, it's possible to construct portfolios that offer asymmetrical performance, with equity-like returns on the upside and bond-like volatility on the downside.

BY CHRISTINA GROTHEER

It's easy to get caught up in chasing the latest investment craze. Even professionals do it. These days, the terms “portable alpha” and “absolute return” come to mind.

Refusing to be swept away by the current, Alexander Ineichen, CFA, a senior investment officer in alternative investment solutions for UBS Global Asset Management in Zurich, has opted instead to find his own solution.

In his mind, alpha is too frequently discussed and not often enough produced. He also is convinced that alpha is too linear a term to fully explain what absolute-return strategies are intended to accomplish.

So Ineichen decided to more accurately define, by way of a soon-to-be-published book, where investing is headed next. And it's not just for alternatives.

Ineichen sees huge potential in the concept of asymmetric returns, explaining, “If you can achieve the asymmetry, you compound capital at a higher rate over time with lower downside volatility...and that is why I believe it's the future of active asset management—to have these long-term, equity-like returns at a fraction of the downside volatility.”

How do you define absolute-return investing?

Absolute-return investing aims to compound capital positively, as well as sustainably, by mitigating downside risk. I think this is a big difference from relative-return investing, where the objective is (by and large) to replicate a market benchmark.

The absolute-return investor defines risk as the probability of losing money, whereas the relative-return investor defines risk as the probability of underperforming a bench-

mark. This has led to the absurd situation where a relative return manager could lose 30 percent of capital but still have met his objective if the benchmark is down 35 percent.

What are asymmetric returns, and how do they go beyond alpha?

I think the past five years have resulted in an industrywide bifurcation of alpha and beta. This is a positive development, as the two are materially different and carry completely different price tags in the market. However, the term “alpha” stems from a linear model, the capital asset pricing model, and I think now is the time to discuss a new framework for what the absolute-return industry really tries to achieve.

The goal of asymmetric returns is to have more positive returns than negative returns or larger positive returns versus smaller, negative returns or a combination thereof. It is similar to a call option, where you have the instrument behaving differently on the upside than on the downside.

The funny bit here is that if you can achieve the asymmetry, you compound capital at a higher rate over time with lower downside volatility. For example, if you compare returns of fund of funds, their compounding rate can be equity like, whereas the volatility of these portfolios is a fraction of equity volatility or is even smaller than the volatility of a bond portfolio.

It sounds wonderful.

Indeed, I think it is; however, it might not be as easy as it sounds. It requires an active risk management process. You can get the S&P 500 return in a passive way through index funds or total-return swaps. You can also get a 60/40 (60 percent equities/40 percent bonds) with monthly rebalancing, fairly passively. You don't really need to pay a manager a fee if that's what you want.

But the asymmetric risk–return profile you cannot get in a passive way. You can buy options, but then you pay for the option premium. In my new book *Asymmetric Returns*, I claim that it is possible through active risk management—by caring about downside volatility and correlations in a



Alexander Ineichen, CFA, is a managing director and senior investment officer in alternative investment solutions for UBS Global Asset Management in Zurich, where he focuses on hedge fund strategies, asset allocation, and research initiatives. He has earned industry-wide recognition for his research in hedge funds.

Having been with UBS since 1988, Ineichen most recently served as global head of alternative investment strategies research for UBS Investment Bank in London. He began his financial career at SBC (Swiss Bank Corporation) in Switzerland.

Ineichen is the author of “In Search of Alpha” and “The Search for Alpha Continues,” which continue to be the most printed research reports in the documented history of UBS. He also authored *Absolute Returns* (Wiley Finance) and several chapters in various multi-author financial books. His latest book, *Asymmetric Returns*, will be available in late 2006.

Ineichen holds a federal diploma in economics and business administration from the School of Economics and Business Administration in Switzerland. He earned his CFA charter in 1998.

portfolio context—to construct portfolios that have this asymmetric return profile (i.e., equity-like returns on the upside and much more bond-like volatility on the downside).

Why aren't more people talking about asymmetric returns?

The two main buzzwords are “hedge funds” and “alpha.” The term “hedge fund,” everyone agrees, is a misnomer. If all risks were hedged, so would be the expected returns. So a hedge fund does not hedge all risks. A hedge fund hedges unwanted risk.

The term alpha stems from a linear model and typically is used for the value added by a manager with a benchmark. Therefore, if a manager's benchmark is down 35 percent and the manager's performance with the same risk profile as the benchmark is only down 30 percent, then the alpha is 500 basis points.

I think the term is not fully applicable to absolute-return investing for two reasons. First, it stems from a linear model, whereas I believe hedge funds and fund of hedge funds try to accomplish something resembling a call option (i.e., an asymmetric payoff). Second, hedge funds have no market benchmark. If a manager has no benchmark, how do you quantify alpha? The financial industry has not yet found an answer to this question.

What trends are you seeing in absolute-return investing?

One trend is the idea of portable alpha. Portable alpha is not necessarily a new concept. What is new is that it is quite widespread these days among institutional investors. We see billions of dollars going into this idea, while 10 years ago, the idea was there but the flow of funds into the idea was miniscule by today's standards.

What is also new is that hedge funds and funds of hedge funds are used for the alpha engine. Instead of giving 100 percent of capital to an active manager—with the idea to outperform, say, the S&P 500 index—it separates alpha and beta. You get the S&P 500 return (the beta) with a total-return swap, which allows you to put the capital at work elsewhere.

The idea of “elsewhere” is that you want the alpha engine being deployed in markets which are less efficient than S&P 500 stocks, because that is where the alpha is. Once you have this alpha return plus the return of the pas-

sive instrument—in this example, the S&P 500—you have the S&P return plus this alpha of 200 or 300 basis points. So you achieve the outperformance in a different way than if you just gave 100 percent of the capital to an active manager.

What absolute-return strategies are available besides hedge funds, which get all of the press?

Well, I might not be all that representative on this, but in my mind, none. I strongly distinguish between absolute returns and relative returns. I think the investment philosophies could not be further apart. Moreover, I think as soon as a benchmark is involved, it becomes a relative-return game, as the objectives and incentives are set by the benchmark. It is like switching risk to autopilot.

So a long-only strategy can only be considered absolute return if the manager has great flexibility to leave a certain asset class in its entirety and go 100 percent to cash if the situation requires it.

In the relative-return world, this is very unlikely to happen. If a pension fund invests in an equity long-only manager, the manager will not be able to hedge the whole equity exposure because that will obviously change the whole asset allocation of the end investor.

That is why in my work I like to distinguish between active and passive. As soon as a benchmark is involved, then I think it is passive, because the risk-management mandate then sits with the end investor. Say, if a pension fund invests in a long-only fund, then the long-only manager will by and large have to deliver the return of the benchmark and the risk management of the whole portfolio will then be done by the pension fund (i.e., the end investor).

If, by contrast, the pension fund invests in a hedge fund, then it outsources the mandate to manage risk to the hedge fund because the hedge fund might or might not be fully invested in equities. This invariably results in lower transparency, which is something that the institutional investment community is starting to learn to live and deal with.

At the end of the day, whether the benefits—in the form of superior risk-adjusted returns—outweigh the costs—in the form of lower transparency—is in the eye of the beholder. In my mind, in the current environment, more and more investors with fiduciary responsibility will opt for superior

risk-adjusted returns and will find ways to deal with the lower transparency by seeking process transparency rather than position transparency.

David Hsieh got some press back in March for saying that there's a finite amount of alpha out there—about US\$30 billion. Are you familiar with his comments?

I am familiar with his work. He is very well respected. If you think of the hedge fund industry as a US\$1 trillion industry, let's say the risk-free rate is 5 percent and funds of funds are generating 8 percent net returns, then you could argue that that 3 percent difference is alpha. Well, 3 percent of US\$1 trillion is roughly David's US\$30 billion, so you could argue that this actually makes intuitive sense.

However, between 2000 and 2002, traditional equity managers lost nearly 50 percent of their investors' money, right? Hedge fund managers that were market neutral in that time period made around 15 percent. Imagine you start with \$100,000 and you end at either \$50,000 or \$115,000. That is a big difference.

Now how do you translate this into alpha? You cannot really. I seriously believe that we need to look beyond the linear term that is alpha. The absolute-return investment philosophy cannot be broken down into one Greek letter. So you could argue that when someone says there is only US\$30 billion worth of alpha, it could be actually quite misleading.

I love your comment that "Not everyone who is talking about alpha will be generating it, and not everyone who is expecting it will be getting it." Can you elaborate?

Thank you. With that statement I wanted to say two things. First, because of the popularity of the term, it has become somewhat of a marketing buzzword. It is quite fashionable, so everyone uses it. But we should not forget that not every manager who uses the term also has the skill set to deliver it.

Second, there is not only positive alpha, there is also zero alpha and negative alpha. This means there is no guarantee that investors investing in hedge funds or funds of funds or anything that is supposed to yield a return that is not fully explained by systematic risk factors—which could be captured more cheaply through passive vehicles—will really get alpha. So, you could argue by investing in hedge funds and funds of funds, you reduce market risk but increase selection risk.

You've voiced an opinion that investors' fees should be correlated to alpha. Assuming an investment manager wanted to do this, how easily could it be done?

I think that investors' fees should be correlated to the value the manager adds, so, yes, there should be a correlation between the two. However, the problem with alpha, as I mentioned before, is that you really need a benchmark to separate the betas from the alpha. And in the absolute-return industry, you do not have benchmarks. This means you cannot really quantify alpha.

That is another reason I felt motivated to put out another book. I think achieving an asymmetric return profile is a

better description of what absolute-return managers are trying to achieve. Achieving this asymmetry requires investment as well as risk management skill. I think it is very unlikely that these asymmetric return profiles will trade at a discount any time soon.

Can you tell me more about your upcoming book?

Thanks for asking. I am trying hard to find a better way to explain what is going on in the absolute-return world. The methodologies of the relative-return world do not perfectly fit the idiosyncrasies of the absolute return world. The term "alpha" does not fully capture the task of the absolute-return manager.

I believe the idea behind absolute-return investing is to take certain risks for a positive return while at the same time controlling certain other, unwanted risks that are unlikely to carry a reward. One of the claims of the new book is that this requires risk management skill.

You have written about the differences between tracking risk and total risk. Is this a fairly new distinction?

Tracking risk is a fairly standard term in the literature. The term total risk is perhaps somewhat less standard. I use the term as an absolute yardstick for risk, essentially measuring the probability of losing money.

I use these two measures to distinguish between the paradigms of relative returns and absolute returns. For example, an index fund, in my mind, is managing tracking risk. It cares about the probability of deviating from the benchmark. I also put active long-only managers with a benchmark in this category, because long-only managers are not indifferent about their deviation from the benchmark.

Hedge funds do not manage tracking risk. They care about the probability of losing money, and I use the term "total risk" for that. I use these two terms to make the point that if you have different definitions for risk, then it is obvious that the whole risk management process is different. It allows me to really distinguish between the two.

So, I put long-only benchmarking and indexing in the relative-return camp and hedge funds in the absolute-return camp. And I argue, as a further claim, that the former is passive from a risk management perspective and the latter is active. A long-only investment is like driving a car without brakes. As long as it goes up, no one complains. If it goes down, there is little you can do to control risk. The term "long-only" essentially means driving without brakes.

You could make a case that the marketplace is actually already pricing this, as I claim it should, because indexing and benchmarking are things the investor pays a couple of basis points for, whereas for hedge funds and funds of funds, at the moment, the pricing structure is entirely different—it's much higher. You could argue the market has already confirmed these claims. In other words, I probably should have spent more time at the beach than writing a book. **///**

Christina Grotheer is a contributing editor and an editorial consultant to CFA Magazine.