Preface

"I wish Karl would acquire some capital, instead of just writing about it."

Mother of Karl Marx

For his statue of David in 1501, Michelangelo used a single block of marble. In fact, it was a block that had been started upon but abandoned by another, lesser talent, years earlier. At the time, everyone thought that this block of marble was ruined, that its potential had been exhausted, and that nothing further could be extracted from it. But Michelangelo took on this discarded block, and from it he created one of the masterpieces of all times.

For Michelangelo, to sculpt meant to take away, not to add, because the "work of art" already existed inside the stone. The block of marble was just the covering of a work of art; the sculptor only had to take away the part in excess. The sculptor's hand, guided by skill and experience, could only "liberate" what was already there inside the block of marble. His task was to free the "idea" inside from the superfluous matter surrounding it.

One could argue that, similarly, the alpha in capital markets is already there. But special talent is required to hedge ("take away") all the various unwanted risks in order to carve out the gains—the "alpha."

As markets become more and more efficient, carving out the alpha will be increasingly difficult without using all of the risk management tools available. Constraining managers in their field of expertise and the use of the tools to execute their craft, therefore, cannot be optimal. It's like giving Michelangelo only a hammer. In this book, we argue that the key tools required to extract alpha are risk management tools. In our view, investors cannot manage returns, but they can manage risk. Achieving sustainable positive absolute returns are the result, we believe, of taking and managing risk wisely. The result, when successful, is an asymmetric-return profile.

An asymmetric-risk/return profile is the result of an *active* risk management process. By *asymmetric returns,* we mean a return profile that is not available through long-only buy-and-hold strategies. Achieving an asymmetric-return profile requires a dynamic and flexible risk management process that truly corresponds to the end investors' risk preferences, tolerances, and aims. We claim that the delivery of these asymmetric-return profiles is the goal, and the future, of active asset management. This claim is based on some assumptions about what investors really want. An important one of these is that all investors are loss averse, that is, they do not perceive volatility on the downside in the same fashion as volatility on the upside. Hence our focus on asymmetry and our use of the term *asymmetric returns*.

The term *hedge fund* is a misnomer because there are no hedge funds that hedge all risks. If all risks were neutralized, so would be the returns. As Mario Andretti put it: "If everything is under control, you're driving too slow." Returns are a function of taking risk. Absolute-return investing implies that the risk-neutral position is cash (i.e., no risky positions at all). Generating alpha by definition means to take some risk. However, there are risks that are more likely to carry a reward, and risks that are less likely. This is where the asymmetry comes in. In financial markets there is both—randomness as well as predictability. The process of differentiating the two, the "sculpting," is then a function of intelligence, knowledge, insight, savvy, effort, experience, and skill. Luck helps, certainly, but in the long run, that cannot be the determinant of success.

The ultimate goal of an active investment management process is "alpha." In traditional investment management, success is typically referred to as outperforming a benchmark. This means that losing 28 percent when the benchmark fell 30 percent is actually quite an astounding achievement because the outperformance was two percentage points. However, in the absolute-return world, there are no benchmarks. The active risk manager, unlike the relative-return manager, has additional objectives that go beyond beating an arbitrary benchmark. We believe this new terminology of *asymmetric returns* goes beyond "the search for alpha." In fact, the term *alpha* originally stems from a linear model. We believe alpha is an option.

An asymmetric-return profile is achieved either through absolute-return managers driven by profit and loss or, more passively, through financial engineering using hedging techniques. 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 convergence between what we referred to as the *asset management industry* and what we have come to understand to be the *risk management business*. Taking this line of thought further, we could say there is a convergence 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.

An institutional or private investor allocating money to an active risk manager is essentially outsourcing to that manager the task of managing *total risk*. This is one of the main differences to the relative-return approach, wherein the manager does not have a mandate to manage capital at risk, but has a mandate to manage *tracking risk* relative to a market or liability benchmark. We believe that managing tracking risk is a passive risk management process, not an active one. Confusion arises because risk is sometimes defined in relative terms and sometimes in absolute terms. During the 20-year equity bull market, the traditional asset management industry used a more relative metric, whereas the risk management industry (essentially trading departments of investment banks and hedge funds) focused on an absolute metric to define and manage risk. Among the pivotal objectives of *active* risk management—unlike with relative-return investing—are avoiding absolute financial losses (especially large ones) as well as *actively* managing downside volatility.

The active approach to risk management has many advantages, but it also has some disadvantages. A major advantage for a hedge fund allocator is the substantial diversification benefits that can be achieved by combining many *independently* managed portfolios. (Diversification is the only scalable and repeatable free lunch in financial economics that is available to all investors.) One disadvantage is that the absence of a market benchmark can result in lower transparency.

With respect to transparency, it is important to distinguish between risk *measurement* and risk *management*. Risk measurement is fairly objective. Risk management, however, is subjective. The heterogeneity of the hedge funds industry with respect to the way risk is managed is an indication that this is true. Our main point is that the pure reliance on a process or a few metrics is very dangerous. We therefore believe that an open-minded, dynamic, and flexible approach to risk management is superior to a static (purely rule-based) and dogmatic process. With respect to transparency, this means that investors' demand for transparency should not interfere with the nimbleness and flexible maneuverability of the manager. Successful risk management in an ever-changing environment is like shooting a moving target: It is difficult but improves with practice. We don't think that successful risk management will trade at a discount anytime soon. As Oscar Wilde put it: "Experience is one thing you can't get for nothing."

We believe that in active risk management it is important to apply a skill that carries a reward in the marketplace within an opportunity set where the risk/reward trade-off is skewed in favor of the risk taker. What we herein refer to as *structural change* in the asset management industry is about finding skill (which is difficult enough), as well as the optimal setup for that skill to be operational in a value-added fashion. In terms of applying skill, we believe there is a trade-off between transparency and standardization on the one hand, and entrepreneurial maneuverability on the other. Interestingly, traditional asset managers are becoming somewhat more entrepreneurial by venturing into the absolute-return space, while hedge funds by and large are moving in the opposite direction, that is, they are becoming more transparent (as in self-constrained, disciplined, and process driven) to cater more to high-quality (quite often institutional) investors.

We believe these trends to be consistent with our claim in our first book, *Absolute Returns*—namely, that the hedge fund industry is slowly converging with the traditional asset management industry. In other words, from now on we should be talking about product differentiation in asset management—that is, distinguishing between *active* and *passive* risk management, and not between hedge funds and non-hedge funds. An active risk management process seeks asymmetric returns. We believe this to be the future of *active* asset management.

Some investors argue that the market is currently wrong in the way it prices active risk management services—in other words, that the fees in the hedge fund industry are too high. We believe that absolute-return strategies incorporating active risk management techniques and passive long-only buy-and-hold strategies offer entirely different value propositions and therefore merit entirely different dimensions in pricing, that is, costs to the end investor. In other words, we believe the market is right in the way it distinguishes between the two value propositions through different levels of fees. Searching for bargains when selecting an active risk manager is somewhat akin to searching for the cheapest parachute: By the time you notice the deficiency, it is too late. (Of course this analogy has its limitations, as the parachutist's remorse period is short lived.)

We have designed this book to be readable by all financial professionals, whatever their particular area of expertise. However, at times, we somehow felt the urge to part from the main style. In some instances we have introduced break-out sessions called "Out-of-the-Box." Throughout the book these sections are add-ons that are related to the topic in discussion but are somewhat a digression from the main story line. In Chapter 1, for example, we digress to discuss a conference call with seven luminaries of the financial world. In another vein, we have sometimes added an appendix to a chapter. This is generally where the subject demanded more technical treatment than we gave it in the main body of the text or where we took the liberty to bring across a point more colloquially.

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