

Absolute Returns: *The Future in Wealth Management?*

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The growth in hedge funds for both private and institutional investors could evolve to be more than just a bear market fad. The “absolute return” industry (to use a more descriptive term than hedge fund) has preserved investors’ wealth skillfully and prudently so far this decade. The preservation of capital has been achieved during what is arguably one of the most difficult periods in the history of capital markets.

In Ineichen [2003a] we called the absolute return approach the third paradigm of active asset management. Calling the absolute return approach a “new paradigm” is undoubtedly bold, but given the speed at which (European) insurance companies ran into solvency problems (and their CIOs sent into early retirement) and pension funds have had their surpluses wiped out, it’s clear that the financial community still has some way to go in asset management. It is very unlikely that the huge allocations to long-only equities by U.S. and U.K. pension funds (essentially an extreme concentration of risk) is the pinnacle of investment wisdom.

One could argue that every industry has its own industry life cycle. We believe the asset management industry is about to move from its second stage into its third. The first stage of the asset management industry was a holistic approach. Individuals and institutions sought to generate returns by balancing stocks, bonds, and cash in a single portfolio. This approach was primarily implemented by the trust department

of the neighborhood bank. This paradigm suffered two great weaknesses: mediocre returns due to the lack of specialization and lack of manager accountability. These weaknesses were the seeds that enabled a whole new investment management industry to grow, and a shift to the second paradigm: the relative performance game.

With the relative return approach, clearly measurable passive market indexes provided the benchmark against which performance could be measured and investment managers held accountable. The second paradigm fits nicely with modern portfolio theory (MPT) and seminal academic work on performance evaluation. With a final push from regulatory changes, the ERISA act of 1974 in the U.S. in particular, the second paradigm firmly established its roots in the United States and elsewhere.

However, the introduction of clear and meaningful performance evaluation highlighted one of active management’s greatest weaknesses: poor performance. “Beating the benchmark” became the focus of only a small minority of managers outperforming the benchmark on a consistent basis. Arguably the introduction of a market benchmark can be blamed on further negative phenomena including the focus on asset growth (as opposed to performance), and the following of investment trends and fads rather than the pursuit of contrarian strategies and sticking to a disciplined investment approach. Above all it can result in the deliberate seeking of “the average mean” (that is, mediocrity) as opposed to meritocracy, and a

EXHIBIT 1

Different Business Models in the Asset Management Industry

	Relative-return model (market-based)	Absolute-return model (skill-based)
Return objective	Relative to benchmark	Absolute, positive return
<i>This means:</i>	<i>Capture asset class premium</i>	<i>Exploit investment opportunity</i>
Risk management	Tracking risk	Total risk
<i>This means:</i>	<i>Capture asset class premium</i>	<i>Preserve capital</i>

Source: Ineichen [2003a].

strong disincentive to use risk management techniques to preserve investors' wealth.

The absolute return approach on the other hand seeks to solve some of the issues of the relative return approach. Investors introduce an absolute yardstick against which managers are measured. This avoids some of the pitfalls of the relative return approach, namely index or peer-group hugging, search for mediocrity, and misalignment of interests between manager and investor. Under the absolute return approach, active asset managers are hired and paid to balance investment opportunities with an absolute measure for risk. Their aim is to increase wealth during a phase of tailwind and preserve wealth when the wind changes and becomes a headwind.

This is a material departure from the relative return approach where risk management is left to the end investor. The difference in the two approaches is manifested most clearly through the differing definitions of risk (see Exhibit 1). Relative return managers define risk as tracking risk, whereas absolute return managers define risk as total risk. Risk management of the former is driven by market benchmark, while risk management of the latter by a P&L (profit and loss account).

Defining risk as "total risk" means that it is the manager that determines the investor's risk, and not the market (or the benchmark). Put simply, it means capital appreciation is welcome while capital depreciation is not. Unlike with relative return managers, the paramount objectives of absolute return managers are avoiding absolute financial losses, preservation of principal, as well as actively managing portfolio volatility.

Exhibit 2 compares the HFRI Equity Hedge Index

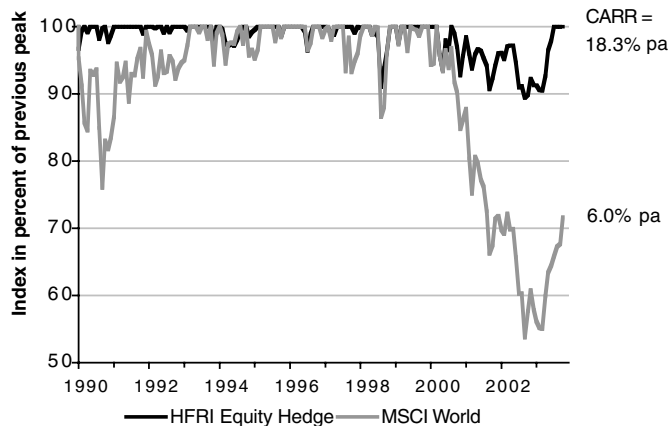
(a basket of long/short equity managers) with the total return index of the MSCI World Total Return index. We call this format "underwater perspective" as it measures an index as a percentage of its previous all-time high. Swimmers and investors alike have an incentive to reach the surface once they are "under water." This format visualizes the drawdown (loss from previous level of wealth). (One could look at it as an esoteric measure for excess kurtosis.) The return figures on the right of Exhibit 2 are the compound annual rate of returns (CARR) for the period from January 1990 to October 2003. The main message this graph is designed to bring across is that large losses kill the investors' compounding rate. Note that compounding matters to all investors but is not a major objective for a money manager benchmarked against a market benchmark. The illustration underlines the notion that the Wall Street witticism "The best way to make money is not to lose it" is not entirely without merit.

RISK MANAGEMENT IS SUPPOSED TO YIELD ASYMMETRIC RETURNS

What today is referred to as active management is really passive, as it uses the same risk management techniques as enhanced indexing (which is considered as a passive money management discipline by most investors) and the same definition of risk (tracking risk) as index funds. The distinction between passive and "active" is merely the magnitude of the tracking error constraint (see Exhibit 1). 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

EXHIBIT 2

Underwater Perspective



Source: Ineichen [2003a] (based on data from Bloomberg and Datastream).

is at 10%, the passive (or the so-called active) portfolio will have a volatility of around 10%, with higher moment risk characteristics similar to the benchmark. If volatility is at 50%, the portfolio volatility will be around that level as risk is defined and managed relative to the market benchmark. In other words, the benchmarked long-only manager does not have a mandate to manage total risk.

In Ineichen [2003a, 2003b] we made the case for actively seeking asymmetric returns. By “asymmetric returns” we mean a return distribution that is different from a normal distribution. In an ideal world, all returns would be positive, that is, the distribution skewed to the right. One assumption behind the concept of asymmetric returns is that all investors prefer asymmetric returns over symmetric returns. This assumption is based on the following three notions which, we believe, are common to all investors. The first two notions are from Markowitz [1952, 1959] and the third from Kahneman and Tversky [1979]:

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 from the list above (more return) is obvious. However, a hedge fund manager, unlike a relative return manager, also manages the second and third of the three notions actively: First, most hedge funds have a target volatility 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.

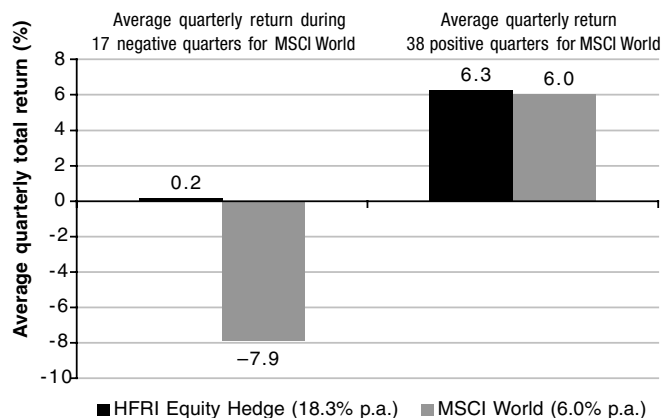
Note that Kahneman and Tversky [1979] were not the first to challenge utility theory: Friedman and Savage [1948] proposed that the coexistence of the human tendency to gamble and risk avoidance might be explained by utility functions that become concave upward in extremely high range. Markowitz [1952, 1959] also pointed out that losses weigh stronger than profits. Whereas Markowitz left it up to the investor to choose where along the efficient set he would invest, Roy [1952] advised choosing the single portfolio in the mean-variance efficient set where a “disaster level” return is determined below which the investor places a high priority not falling below. Savage [1954] showed that the axioms from which expected utility theory is derived are undeniably sensible representations of basic requirements of rationality. Samuelson [1965] explained the violation of expected utility theory. Although this research preceded prospect theory, it illustrates the importance of the kink in the value function from Kahneman and Tversky.

Kahneman and Tversky articulated prospect theory to explain a number of biases and describe how they work. Its most well-known conclusion based on their observations is that the pain of a loss is greater than the pleasure of a gain. The S-shaped function of prospect theory has three features that distinguish it from the concave utility function of classical economic analysis:

1. It is defined in terms of gains and losses rather than in terms of asset position, or wealth. This approach reflects the observation that people think of outcomes in terms of gains and losses relative to some reference point, such as the status quo, rather than

EXHIBIT 3

Asymmetrical Versus Symmetrical Return Profile



Source: UBS [2000] (based on data from Bloomberg and Datastream).

in terms of final asset position. Because people cannot lose what they do not have, classical economic theory does not address losses. The language of losses presupposes that people evaluate things relative to some reference point.

2. The second feature is that the value function is concave above the reference point and convex below it, which results in the characteristic S shape. This feature means that people are maximally sensitive to changes near the reference point. It also means that people are actually risk-seeking on the downside.
3. The third feature of the value function in prospect theory is that it is asymmetrical. The loss appears larger to most people than a gain of equal size. This characteristic is called loss aversion.

If a manager defines risk relative to a benchmark, the portfolio will mimic the return distribution of the underlying market benchmark. However, hedge fund managers are not driven by market benchmark but by P&L (profit and loss). 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.

Car Without Brakes

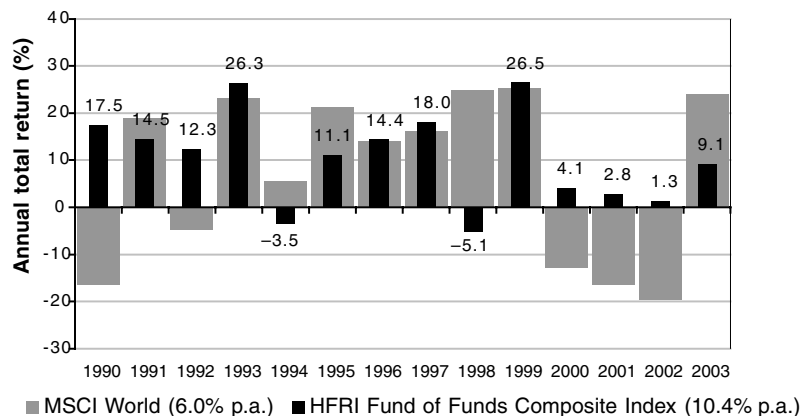
The most comparable strategy to long-only equity is long/short equity. The HFRI Equity Hedge Index (equity long/short managers) outperformed most equity market indices on an absolute as well as risk-adjusted basis by a wide margin. However, most long/short managers

should underperform long-only managers in momentum-driven bull markets where all stocks increase rapidly. The long/short manager should underperform because the short positions are a drag on performance (for example, in liquidity-driven momentum markets as in the late 1990s). However, when markets have only slightly positive or negative returns, long/short managers have outperformed the long-only managers, at least in the past. In other words, long/short hedge funds underperform in strong bull markets and outperform in bear markets. This means that if the returns of the benchmark index are fairly normally distributed, the return profile of absolute return managers is nonlinear, that is, asymmetrical to the market. Exhibit 3 shows the symmetrical returns of an equity index and compares it with the asymmetrical return profile of a hedge fund index. Exhibit 3 shows the average quarterly returns of the HFRI Equity Hedge Index when the MSCI World was positive and negative, respectively. The average of the 38 positive quarterly returns between 1990 and 2003 was 6.0%. The corresponding return for the HFRI Equity Hedge Index was 6.3%. The average of the 17 negative quarters was -7.9% and 0.2%, respectively.

The main reason why traditional funds do more poorly in downside markets is that they usually need to have a certain weight in equities according to their mandate, and therefore are often compared to a car without brakes.¹ The freedom of operation is limited with traditional asset managers and more flexible with absolute return managers. Another reason why hedge fund managers may do better in down markets is that they often have a large portion of their personal wealth at risk in their funds. Arguably, their interests are more aligned with those

EXHIBIT 4

HFRI Fund of Funds Index Versus MSCI World Total Return Index (1990-2003)



Source: UBS [2002a] (based on data from Bloomberg and Datastream).

of their investors. This alignment, together with the lack of a relative measure for risk, increases the incentive to preserve wealth and avoid losses. That is not to say the relative fund managers are any less committed; it's just that they have to work from a slightly different perspective.

One could argue that the absolute return approach is the entrepreneurial approach to investing. The absolute return manager, as does the entrepreneur, balances opportunities with risk where risk is defined as capital at risk or capital depreciation. Exhibit 4 compares annual total US\$ returns of the HFRI Fund of Funds Index with the MSCI World from 1990 to October 2003. The annual rate of return is shown in brackets in the legend of the graph. Whether there is 200–300 basis points survivorship bias in annual hedge fund returns is not relevant for this illustration.

Exhibit 4 demonstrates the difference between volatility on the upside (positive returns) and downside (negative returns). (Whether zero or the risk free rate is taken as the separation point of “upside” and “downside” is not important for explaining the concept of asymmetric returns.) The magnitude of the dark bars in Exhibit 4 is roughly the same as the magnitude of the light grey bars. In other words, volatility on the upside (above zero or above the risk-free rate) is similar. However, the big difference is on the downside. The magnitude of the dark bars on the downside is of a completely different dimension than the magnitude of light grey bars (MSCI World). The volatility of negative returns is much lower for diversified hedge funds portfolios than it is for diversified equity portfolios. Another way of explaining this is with the concept of elasticity: Hedge fund returns should be elastic on the upside but inelastic (or, and this is important, less

elastic) on the downside. Inelasticity on the downside is the ideal world. We believe it makes a lot of sense that managers control exposure to upside volatility differently from downside volatility. The absolute return approach simply implies that the end investor (private investor, insurance company, pension fund, etc.) is not indifferent to swings on the downside (negative volatility).

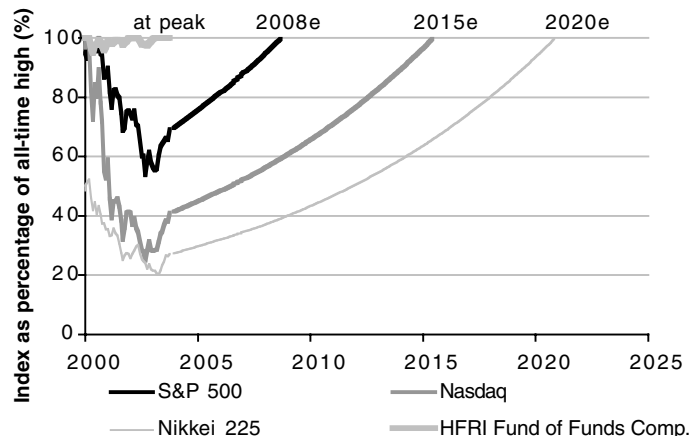
Avoiding Negative Compounding

Downside protection is closely related to avoiding negative compounding. A simple example may help illustrate the importance of wealth preservation: If one loses 50%, as various markets and stocks did during 2000–2003, one needs a 100% return just to get back to break-even. That is, the positive return must be double the negative return. We argue that downside protection from the investors' point of view and avoidance of negative returns from the managers' point of view are different sides of the same coin. By allocating funds to an absolute return manager, the end investor expects the fund manager to manage the funds in an entrepreneurial fashion, that is, balance opportunity with risk.

Exhibit 5 summarizes what we mean by “avoiding negative compounding.” The figure shows the underwater perspective of four indices, that is, the figure shows the index as a percentage of its previous all-time high. We then calculated the potential recovery period assuming the three indices under water recover at an annual rate of 8% per year. In other words, if the Nikkei 225 index starts compounding at 8% per year from October 2003 onwards, it will reach its December 1989 high around 2020.

EXHIBIT 5

Underwater Perspective and Potential Recovery Period at 8%



Source: Ineichen [2003a] (based on data from Bloomberg and Datastream).

The absolute return manager could argue that a long-only strategy has nothing to do with asset management or risk management. Absolute return managers want to make profits not only when the wind is at their backs but also when it changes and becomes a headwind. Absolute return managers will, therefore, use risk management and hedging techniques—this is where the asymmetrical return profile discussed earlier comes from. From the point of view of absolute return managers, relative return managers do not use risk management,² and do not manage assets as they follow benchmarks. They are trend followers by definition.

Both absolute and relative return managers would argue that they were not hired by investors to lose money. The fundamental difference between the two investment philosophies lies in the aversion to absolute financial losses and the definition of risk. Absolute return managers define risk as total risk whereas relative return managers define risk as active or tracking risk.

Orthodox financial theory (or the consensus view in institutional money management) suggests that investors should focus on the long term. It also suggests that investors will generate satisfactory returns if they have a long enough time horizon when they buy equities. This may or may not be true. The problem faced by absolute return managers is that they might not live long enough to experience the long term. Absolute return managers do not care if the probability of equities underperforming bonds over a 25-year period is low. Moreover, absolute return managers are interested in how they get there; that

is, they are interested in end-of-period wealth as well as during-the-period variance.

In other words, the relative return manager is long; hence the term long-only. The relative return manager, again from the point of view of the absolute return manager, has no incentive, no provisions to avoid losses.³ This does not make sense to many absolute return managers and is the reason why some absolute return managers believe relative return managers face obsolescence.

Investor Protection Versus Capital Protection

A further distinction between the relative return and absolute return approaches has to do with the difference between investor protection and wealth protection. Exhibit 6 shows a matrix comparing an investor protection function as well as a wealth or capital protection function for the relative return as well as the absolute return approach.

Based on investor protection (regulation, transparency of investment portfolio, and market benchmark) as well as wealth protection (through risk management techniques utilizing, for example, derivatives, leverage, and/or short selling), the absolute return approach could be viewed as the pure opposite of the relative return approach. Today we, the financial community, know that investor protection is not the same as protecting principal. Regulation, transparency, and a market benchmark protects the investor. However, with the relative return approach, the investor's principal is not entrusted to a

EXHIBIT 6

Investor Protection Versus Wealth Protection

		Long-only	Hedge fund
Investor protection	Regulation	high	low
	Transparency	high	low
	Benchmark	yes	no
Wealth protection	Derivatives	no	yes
	Leverage	no	yes
	Short selling	no	yes

Source: UBS [2003].

fiduciary who tries to preserve it in difficult times but whose mandate implicitly or explicitly dictates that the principal is exposed to the full extent of market volatility—the volatility of the market benchmark. This exposure has been considered acceptable for the past one or two decades because the wealth protection function was held by the end investor and because of some strongly-held beliefs with respect to return expectations and investment processes during the long bull market.

The argument is that the end investor manages absolute levels of risk through asset allocation. If the end investor decides to have an allocation to long-only equities through a benchmarked manager, then obviously the manager needs to be fully invested at all times. This was supported by the beliefs that market timing does not work consistently anyway, that long-term investors (for example pension funds) need to be fully exposed to market volatility to capture the equity risk premium, and that equities outperform bonds in the long term. One of the market benchmark's purposes, therefore, was to reduce uncertainty from a manager deviating too strongly from the market benchmark that was part of the asset allocation process.

We believe that some of these long-held beliefs are currently under pressure. In our opinion, the most obvious erroneous belief is the paradox in constraining a skilled manager. If Grinold [1989] and Grinold and Kahn [2000] are right in arguing that the value added of an active manager is a function of his/her skill and the number of independent decisions he or she can make (breadth), that is, implying some sort of flexibility with respect to investment opportunities, then finding managers with investment skill and then constraining them cannot be efficient. It is unlikely that Warren Buffett or George Soros would have compounded at 25%–30% for so long had they had the S&P 500 Index as their benchmark and a tracking error

constraint of 200 basis points. Constraining a talented manager is like tying a golfer's legs together: He will still be able to play golf, but it won't necessarily improve his swing.

The search for investment talent and the subsequent manager constraint for investor protection purposes is, we believe, sub-optimal at best and highly inefficient at worst. The hypothesis stated earlier, that is, the adoption of an absolute return approach by the active asset management industry, is essentially the synthesis of the investor protection and wealth protection functions in Exhibit 6. This means a skilled manager has the mandate to manage investment opportunity and balance the change in the opportunity set based on his or her individual assessment of total risk. The flexible and benchmark-free mandate is, we believe, superior to a constrained mandate if we assume that it is a manager with an edge close to the investment opportunity who is best suited to judge when the opportunity changes its characteristics.

This paradigm shift is, obviously, only going to happen if the fee-paying end investor buys into it. (That said, we actually believe the shift is already well underway.)

SYSTEMATIC RISK VERSUS NON-SYSTEMATIC RISK

A hedge fund is a business. Businesses, unfortunately, occasionally fail and go bankrupt for various reasons. This is one of the main reasons why investors diversify across businesses (that is, diversify idiosyncratic risk). Although a repeat of a financial disaster such as LTCM is regarded as unlikely, some hedge funds are likely to go bankrupt in the future; they potentially could destroy wealth under management. However, a point can be made that entrepreneurs should have exposure to idiosyncratic risk whereas investors should diversify idiosyncratic risk, that is, be exposed to (and get compensated for) systematic risk. In other words, investors should hold portfolios of hedge funds as opposed to a handful of hedge funds. It is business risk if:

- Key staff leave the firm and the firm's edge walks out the door.
- A fund is inappropriately funded with respect to its market risk.
- The hedge does not work.
- A hedge fund manager departs from her field of expertise without telling investors.
- A hedge fund manager selling Internet stocks reports high positive returns while stocks skyrocket and nobody harbors suspicions.

- Even fraud is not unheard of in the hedge fund industry,⁴ but it is a risk of corporate life (otherwise firms could allocate funds spent for legal advice to productive projects).

From an operational perspective, hedge funds, examined in isolation, are risky—as are technology stocks, or energy trading companies or airline stocks. However, most investors do not hold single-stock portfolios. They diversify stock-specific risk (idiosyncratic or non-systematic risk) by investing in a range of stocks with different characteristics. To most investors, it is regarded as unwise not to diversify idiosyncratic risk. It should be similarly unwise not to diversify risk to a single hedge fund. Note that many critics of hedge funds do not distinguish between systematic and non-systematic risk when demonizing hedge funds.

Schneeweis and Spurgin [1998] and many others have shown that hedge funds offer an attractive opportunity to diversify an investor's portfolio of stocks and bonds. This is true even if the returns earned by hedge funds in the future are merely on a par with those of stocks and bonds. There is no need to see risk-adjusted returns as high as they have been to justify diversification benefits into hedge funds. Any investment with a positive expected return, low volatility, and low correlation to the rest of the portfolio will have a great chance of reducing portfolio volatility.

Hedge funds are risky (as is any other investment when compared with U.S. Government bonds) but they are not speculative. The misunderstanding of hedge funds being speculative comes from the myopic conclusion that an investor using “speculative” instruments must automatically be running speculative portfolios. Many hedge funds use speculative financial instruments (derivatives, CFDs, etc.) or techniques (short selling, leverage, etc.) to manage conservative portfolios. Not everyone understands this. Popular belief is that an investor using, for example, leveraged default derivatives (a financial instrument combining the most cursed three words in finance) must be a speculator. The reason why this is a misconception is that the speculative instrument is most often used as a hedge, that is, as an offsetting position. The incentive to use such an instrument or technique (for example, selling stock short) is to reduce portfolio risk—not to increase it.

This is the reason why most absolute return managers regard themselves as more conservative than their relative return colleagues. The decision of an absolute return manager to hedge is derived from whether principal is at risk or not. To them, preserving wealth is conservative. The protection of principal is not a primary issue for the

relative return manager, as his mandate is outlined and risk defined differently. It is the absolute return manager who will think about all the risks and judge whether to hedge or not to hedge. In other words, it is actually the relative return manager who speculates on many variables that are not subject of the benchmark. In addition, relative return managers, more often than not, manage OPM (other people's money). So do hedge funds. However, hedge fund managers, more often than not, have their own wealth in their fund, that is, their capital, incentives, and interests are aligned with those of their investors. Most people care about the risk of loss of principal—especially when it is their own. As Yale endowment fund manager David Swensen [2000] puts it:

While any level of co-investment encourages fund managers to act like principals, the larger the personal commitment of funds, the greater the focus on generating superior investment returns. . . . The idea that a fund manager believes strongly enough in the investment product to put a substantial personal stake in the fund suggests that the manager shares the investor's orientation.

The reason why it took so long for the hedge fund industry to gain wide institutional acceptance is unclear. Today, however, it seems to be common knowledge that a single hedge fund is risky whereas risky constituents can be formed into a conservative portfolio. The reason for hedge funds being risky is the fact that, to the investor, they are like investing in venture capitalists with fairly large operational risk. The investment strategy of the hedge fund and, therefore, the financial risk to the investor might be directional (volatile, but more often than not less volatile than long-only exposure) or non-directional (less volatile, but leptokurtic return distribution), but that still leaves the investor with exposure to operational risk. In other words, most hedge funds will carry less financial risk than traditional long-only managers but the risk to the operation of the hedge fund manager is higher than with an established multi-billion dollar traditional asset management house. This means that investors need to diversify single manager risk to unlock the value in the hedge fund industry.

The investor should get paid for being exposed to systematic risk. A good summary of the existing literature on performance attribution can be found in Schneeweis, Kazemi, and Martin [2002, 2003]. Systematic risk is important to investors as the flexibility of the hedge fund managers' mandate allows the managers to engage in

strategies that can produce the appearance of return enhancement without necessarily providing any value to the investor. The consequence of underestimating systematic risk can result in an overweight allocation of hedge funds in a quantitative optimization process. Weisman [2002] distinguishes between three sources: short volatility bias, illiquidity bias, and St. Petersburg bias.

The short volatility bias is probably the most important of the three. Some hedge fund strategies (primarily arbitrage strategies) are normally referred to as “short volatility.” This means that the risk/return profile is similar to a traditional portfolio including short option positions. The classic example is risk arbitrage where the strategy has an element of short volatility. When stock markets dislocate (fall erratically), the spreads in risk arbitrage tend to widen all at the same time. In other words, while deal risk is idiosyncratic (diversifiable) the exposure to spread risk is not, or to a much lesser extent. This observation resembles a portfolio that is constantly short a far out-of-the-money index put option: Return is enhanced under normal market conditions but when the market dislocates, the short put becomes in-the-money and large losses can occur. The non-linearity is not captured by the first two moments of the return distribution (mean and variance). Ignoring this non-linearity can result in overestimating the attractiveness of the investment strategy.

The second systematic risk factor is simply a premium for liquidity. Hedge funds do not always hold long positions in the most liquid securities. A good example is convertible arbitrage where the typical strategy involves a long position in the bond and a short position in the stock. Both these positions are exposed to liquidity. In the case of a market dislocation or widening credit spreads, liquidity in the convertible bond market has a tendency to evaporate. The investor needs compensation for the risk of not being able to get out of positions when this becomes desirable.

Weisman [2002] refers to the third systematic risk factor as the St. Petersburg Paradox. The St. Petersburg Paradox is best explained with a simple betting strategy. The strategy involves a bet on the outcome of a binomial process such as a coin toss. If you win, you bet again with the same unit size. If you’re wrong, you “double up” by betting twice the initial investment amount. If you lose again, you double the investment size again. You double up until you eventually win, at which point you return to the starting investment amount.

This strategy has two important premises: First, the strategy has infinite expected value. Second (and here’s

the paradox), you will eventually become bankrupt with absolute certainty. Only in the very special but unrealistic case of infinite capital, can you survive a long enough series of losing bets. Hedge fund managers have a certain incentive to recover from losses as they usually have a high watermark that suggests they can only charge a performance fee from new gains, that is, once losses are recovered. This gives the manager an incentive to “double up” (for example by increasing leverage) as he goes into a drawdown.

CONCLUSION

There is still a lot of mythology with respect to hedge funds, much of it is built on anecdotal evidence, oversimplification, myopia, or simply a misrepresentation of facts. Although hedge funds are often branded as a separate asset class, a point can be made that hedge fund managers are simply asset managers utilizing other strategies than those used by relative return long-only managers. The major difference between the two is the definition of their return objective: Hedge funds aim for absolute returns by balancing investment opportunities and risk of financial loss. Long-only managers, by contrast, define their return objective in relative terms. Long-only managers aim to win what Charles Ellis [1993] calls the loser’s game, that is, to beat the market.

Ellis calls the pursuit of beating a benchmark the loser’s game. In a winner’s game, the outcome is determined by the winning actions of the winner. In a loser’s game, the outcome is determined by the losing behavior of the loser. Ellis makes reference to a book by Simon Ramo: *Extraordinary Tennis for the Ordinary Tennis Player* (New York: Crown Publishers, 1977). Dr. Ramo observed that tennis was not one game, but two: one played by professionals and a very few gifted amateurs; the other played by all the rest of us. Professionals win points; the rest lose points. In expert tennis, the ultimate outcome is determined by the actions of the winner. In amateur tennis, the outcome is determined by unforced errors (that is, the activities of the loser—who defeats himself or herself).

The future path of an economy or stock market is not predictable with any reasonable degree of confidence. Having a year-end target for the S&P 500 in January is similar to having a view in July on what the weather will be on Christmas Eve. Both systems (weather as well as the economy) are complex. Any argument to the contrary must derive from a model with an R-squared of 1.00 (Bernstein [1999]). However, there is no such thing. Deci-

sion making with respect to the future will always involve uncertainty regardless of the approach used. What we know for sure about equity markets and their volatility is uncertainty itself. There will always be uncertainty.

The preceding statement is not as fatuous as it may sound. It raises the question of what a money manager should focus on in the long term: expected return or risk. Looking at the world from the view of a risk manager, it is obvious: risk. A risk manager would argue that one cannot manage expected return, but one can manage risk. Return is the by-product of taking risk. Banks today do not manage portfolios; they manage risk. Their long-term investment strategy is to define the risk they want to be exposed to and manage that exposure accordingly. This implies that banks have an absolute return focus as opposed to a relative return focus. They seek opportunities that are then balanced with capital at risk. Potentially, asset management could be in the process of moving in the direction of banks—and hedge funds (that is, defining risk in absolute terms rather than relative terms). In other words, the asset management industry might be in the process of moving from the second to the third paradigm, as outlined in the introduction. One could also argue that the asset management industry is moving back to an absolute return orientation (first and third paradigm) and that the passion with market benchmarks (second paradigm) was only a brief blip in the industry's evolution. As Peter Bernstein [2003] puts it:

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 people's attention away from the conventional benchmarks. This is a very, very important development.

We believe that one of the main sources of confusion, myth, and misrepresentation comes from the fact that relative return managers have a different definition for risk than absolute return managers. The former define risk as some form of tracking risk (probability of deviating from a market benchmark) while the latter define risk as total risk (probability of losing money). Defining risk as total risk means that it is the manager that determines the investor's risk, and not the market (or the benchmark). Among the pivotal objectives of absolute return investing are, unlike with relative return investing, avoiding abso-

lute financial losses, preservation of principal, as well as actively managing portfolio volatility. One of the major disadvantages of all this is that the absolute return approach does not fit as nicely into the 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 with the relative return approach. We believe that this view is similar to the assessment of individual transport one hundred years ago. Because of the lack of proper roads, there was the belief that “the horse is here to stay.”

ENDNOTES

This article draws on material from UBS [2002b, 2003] and Ineichen [2003a, 2003b]. The views and opinions expressed in this article are those of the author and are not necessarily those of UBS. UBS accepts no liability over the content of the article. It is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments.

¹Note that one does not need brakes when driving uphill. However, when driving downhill, brakes come in quite handy when managing risk.

²Note that, for example, Lo [2001] expresses a diametrically opposing view, arguing that “risk management is not central to the success of hedge funds” whereas “risk management and transparency are essential” for the traditional manager.

³This is not entirely correct: A relative return manager has an incentive to grow funds under management (that is, avoid funds under management falling) because fee income is determined based on the absolute level of funds under management.

⁴Although, compared with investors' losses from corporate fraud uncovered in 2002, the losses from hedge fund fraud are minuscule.

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