Understanding Hedge Fund Replication Strategies

Live Webinar
October 26, 2010 2:00 – 3:00 pm EDT
Welcome

Alternative Beta

How hedge funds generate returns

How do “synthetic” approaches work

IndexUniverse.com
Exchange-Traded Funds Report
Journal of Indexes
Panel Discussion

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Liquid Alt. Beta, Credit Suisse

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CoreStates Capital Advisors

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IndexUniverse.com
Alternative Beta Defined

“The common risk exposures shared by hedge fund managers pursuing similar strategies.”

Different. Systematic.

Credit, Volatility, Event-driven Leverage, Shorting, Arbitrage
Why Alternative Beta?

- Diversification to other asset classes: 70%
- Low correlation to other asset classes: 60%
- Absolute returns: 55%
- Long-term outperformance of other asset classes: 50%
- Lower volatility than other asset classes: 40%
- Better Sharpe ratio: 35%
- NA / Prefer not to answer: 20%
- Other: 15%
- Higher volatility than other asset classes: 10%
What’s An Alternative?

- **Traditional Beta**: 87.60%
- **Hedge Funds**: 4.20%
- **Real Estate**: 4.10%
- **Private Equity**: 3.10%
- **Commodities**: 0.70%
- **Infrastructure**: 0.30%
- **Other**: 12.40%

Source: Russell
Alternative beta: Hedge funds

Over last 15+ years, Hedge funds have been the main vehicle:

• Industry AUM has gone from $100 billion in 1995 to $1.5 trillion in 2010 (as estimated by CS and DB)
• Superior risk-adjusted returns (of some strategies) versus traditional markets
Hedge Funds: Not Vanilla

Absolute return
Market Directional
Equity Hedge
Market Neutral
Short Bias
Event Driven
Systematic Diversified
Relative Value
Convertible Arbitrage
Individual Asset Class
Volatility
... and more
The Average hedge fund sure looks pretty ...
... but will you bet on the right horse?

Source: IFSL
What’s Wrong With Hedge Funds

- Accessibility constraints with hedge funds
- Minimum net worth requirements
- Popular funds closed to new investors
- High fees
- Poor liquidity/long lock-up periods
- Limited transparency
Q: Can You Really “Replicate” Active Management?

A: A finite number of “factors” explain the bulk of hedge fund returns.
In other words: Groupthink!
Why hedge fund replication?

What are the most attractive aspects of hedge fund replication products?

Source: AllAboutAlpha
Why hedge fund replication?

Source: Edhec
Some Additional Reasons for Alt-Rookies

- Minimize impact of rising correlation when markets fall
- Avoid Manager-specific/idiosyncratic risk
- Performance attribution
Why hedge fund replication?

Liquidity
Why hedge fund replication?

Transparency
Why hedge fund replication?

Lower costs
What are synthetic hedge funds?
What *are* synthetic hedge funds?

2 main types:

- Factor-based-weights determined via regression models
- Trade replication-rely on formulas to mimic hedge fund trading strategies
What are synthetic hedge funds?

- Over 2 dozen hedge fund replication products on the market
- Investable indices, ETFs, options, equity index futures
- Players: CS, IndexIQ, Goldman, SSGA, DB, JPM, Partners, SGAM

- Just a handful of ETFs emerging
Do They Work?

The Academic View: Yes

Accurate replication of diversified indices

Good explanatory power for some styles (e.g., equity long/short, event-driven)

Source: Man Investments
Replication Caveats

- Unclear definitions
- Depends on strategy being replicated
- Depends on provider

- Can not reproduce returns of certain styles (e.g., market neutral, merger arbitrage, commodities)
Index Specification Dilemma

Representation Problems

Survivorship/Selection Bias
### May not solve correlation issues

<table>
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<tr>
<th>Fund Name</th>
<th>SP500</th>
<th>RSL2000</th>
<th>EAFE</th>
<th>CMDTY</th>
<th>BOND</th>
<th>CS/T</th>
<th>HFRI</th>
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<th>HFRX</th>
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<td>AC-Statistical Value Market Neutral 7 Vol Fund</td>
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<td>DGAM-Synthetic Alternative Investment Fund</td>
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*Source: 2010 Journal of Alt Investments*
## Correlation Revisited

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<th>Fund Name</th>
<th>HFRX Global</th>
<th>S&amp;P 500</th>
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<tr>
<td>JPMorgan Hedge Fund AltBeta Re</td>
<td>0.277</td>
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<td>Credit Suisse Long/Short Equit</td>
<td>-0.265</td>
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<td>Morgan Stanley alt-era hedge f</td>
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<td>BAIF HF MULTI STYLE</td>
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<td>CS Long/Short Liquid Net</td>
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<td>DGAM SYNTHETIC ALTERNATIV LP</td>
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<td>IQ Hedge Composite Beta1 Index</td>
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<td>IQ CPI Inflation Hedged Index</td>
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<td>IQ ARB Merger Arbitrage Index</td>
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<td>RYDEX MULTI-HEDGE STRATEG-H</td>
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<td>SGI Alternative Beta</td>
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Daily Returns, 10/26/08 – 10/26/10
## Correlation Revisited

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<td>Credit Suisse Long/Short Equit</td>
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<td>Morgan Stanley alt-era hedge f</td>
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<td>BAIF HF MULTI STYLE</td>
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<td>CS Long/Short Liquid Net</td>
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<td>DGAM SYNTHETIC ALTERNATIV LP</td>
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<td>SGI Alternative Beta</td>
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Weekly Returns, 10/26/00 – 10/26/10
Performance

Graph showing performance metrics from 2008 to 2010.
The Crowbar Issue: Alpha
Conclusion

Get Informed, Do The Homework
Panel Discussion

Peter Little, CFA
Director, Portfolio Management
Liquid Alt. Beta, Credit Suisse

Dave Nadig
Director of Research
IndexUniverse.com

Ken Coniglio
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Thank You!

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