

MFA Reporter

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Reporting on issues for investment professionals in futures, hedge funds and other alternative investments

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MANAGED FUNDS ASSOCIATION

Hot Legal & Business Topics for 2002

By Michael P. Malloy, Partner, Drinker Biddle & Reath LLP

Registered Fund of Funds – A New Frontier for Hedge Funds

Private fund professionals are focusing on balancing marketing objectives against the sometimes opposing legal requirements: that is, how can a private fund maximize the *number* of investors and broaden the *types* of investors who are eligible to participate in the private fund, while at the same time complying with the regulatory limits on the investor universe and the manner of marketing? Recently, a new alternative has become available for making the benefits of private funds accessible to more types of investors.

First, a bit of background. Private hedge funds are usually offered pursuant to an exemption from the Securities Act of 1933, which imposes investor suitability standards and which severely restricts the manner in which the fund may be marketed. Typical private funds are also offered under exemptions from the Investment Company Act of 1940, to avoid much of that Act's costly and complex host of regulations governing issues as varied as portfolio diversification and Board composition. But, these exemptions generally limit the fund to 100 investors or else include even more stringent investor suitability standards than would otherwise apply.

One way that private funds have avoided the 1940 Act limits on the number of investors is through a registered "fund of funds" structure, where the "top-tier" fund registers under the 1940 Act, and invests in a number of underlying private funds. Through this structure, the underlying private funds avoid the complications of 1940 Act registration, and the top-tier fund, by registering under



Private fund professionals are exploring: How can a private fund maximize the number and broaden the types of investors eligible to participate, within regulatory constraints?

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Performance Assessment of Alternative Investment Strategies

By Hilary Till, Principal, Premia Capital Management, LLC

Author's Note: A version of this article originally appeared in the September 2001 issue of Risk & Reward magazine.

If you saw that a well-known Commodity Trading Advisor (CTA) was in a Top 20 CTA table with returns of 44.1% during the year 2000, you would probably think that CTA did a great job for their investors, right? But what if that CTA's Sharpe ratio was also .19? (This is a real example.)

For futures programs, the meaning of rate-of-return numbers can be somewhat ambiguous, given that one does not need to set aside capital in the amount of a program's funding level. Instead, an investor can fractionally fund an account using "notional funding."

For example, a futures program that I am very familiar with requires that the investor only needs to set aside about 20% of equity for futures margin and as a loss reserve. (In other words, one needs to fund the CTA with \$20 for every \$100 made into the investment.) This program's year-over-year returns were 16.3%. If the program's returns were stated on the basis of the actual amount of capital needed to participate in the program, the year-over-year returns could be restated as 81.5% ($= 16.3\% / .20$).

With the ability to leverage, a futures manager can arbitrarily restate their returns to any number of levels. Therefore, in order to get a clearer picture of the liability assumed when investing in a futures program, many investors use the Sharpe ratio to evaluate a manager. This measure provides the risk-adjusted return of an investment and is defined as the excess return of the investment over the risk-free rate divided by its standard deviation.

Given that a hedge fund manager typically aims for a Sharpe ratio of greater than 1.0, the CTA manager with a Sharpe ratio of .19 would do poorly under this criterion. And in fact, this manager's largest draw-down was about 30%, meaning that one had to tolerate a good amount of risk to earn the manager's headline returns.

But even the Sharpe ratio has its own set of difficulties as a performance measure. In September of 1996, after 31 months of operation, Long Term Capital Management (LTCM) reportedly had a Sharpe ratio of 4.35 (after fees).

With the benefit of hindsight, we can say LTCM's realized Sharpe ratio after two and a half years of operation did not give a meaningful indication of how to evaluate this firm's investments.

Let's discuss the quantitative and modeling shortfalls of the Sharpe ratio and other related Capital Asset Pricing Model (CAPM) measures when used to evaluate alternative investments. These shortfalls can best be appreciated when we understand the common nature of how a number of alternative investment strategies earn their returns. And surprisingly, once understood the source of a program's returns, even an investment with a Sharpe ratio of .19 could win a place in an investor's portfolio based on certain return-to-risk considerations.

A number of assumptions are made when accepting the use of various CAPM metrics. Under CAPM:

1. Investors choose portfolios according to a mean-variance framework; and
2. There is only one source of risk for which investors are rewarded, and that is for assuming market risk.

The Sharpe ratio results from accepting the first assumption. The use of the statistic, alpha, results from accepting the second assumption. Alpha is the excess return above and beyond taking on market risk. Under the theory, a manager can only earn a positive alpha if that manager has an ability to identify mispriced securities or to time the market.

First CAPM Assumption: Investors Choose Portfolios According to a Mean-Variance Framework

The first assumption produces difficulties when an investment strategy has highly asymmetric outcomes as with option strategies. By using variance (or standard deviation) around the mean as the risk measure, one is assuming investors are indifferent between upside risk and downside risk. In this case, investors are said to not have "skewness" preference. But investors most certainly do have a preference for upside risk and an aversion to downside risk!

An investor can seem to "outperform" under CAPM by accepting negatively skewed returns in exchange for improving the mean or variance of the investment.

As a matter of fact, Hayne Leland of UC-Berkeley has shown a strategy of selling fairly valued options can produce a positive alpha. Now of course it shouldn't, given a positive alpha should only result from a manager having superior information.

Performance Assessment Strategies

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It's then no surprise that a managed futures article from a year ago noted option sellers scored high Sharpe ratios. The average Sharpe ratio for options traders in the Barclay CTA database was measured at 1.42 while the average Sharpe ratio for all CTAs in this database was .56.

To be fair, professional investment consultants do attempt to correct for the Sharpe ratio's lack of emphasis on downside risk. Another measure used for alternative investment evaluation is the Sortino ratio. This measure is defined as the incremental return over a minimum acceptable return (MAR) divided by the downside deviation below the MAR. In the downside deviation calculation, if an outcome has a value greater than the MAR, it gets a value of zero in this risk calculation. Only outcomes with values of less than the MAR are included in this risk measure.

The Sortino ratio also has its own set of problems, as pointed out by Frank Sortino himself (of the Pension Research Institute.) The main problem is that it is usually calculated based on discrete data over a limited timeframe. Investment statistics calculated over limited time intervals are very unstable, making this ratio (and any other ratio based on discrete data) not very useful in making predictions for the future.

As James Grant has written, Wall Street will take any new money-making strategy and drive it (and its returns) into the ground like a tomato stake. What this means is the very popularity of a strategy can result in the distribution of its returns changing dramatically. This is especially the case with alternative investment strategies since their hallmark is the use of leverage. David Shaw of DE Shaw noted recently the conditions of the fall of 1998, which led to the failure of LTCM and Shaw's own relative-value bond fund, had never happened before and therefore could not have been modeled (that is, if one were solely relying on historical data to build one's models).

Sortino, jointly with other authors, recommends one should calculate downside risk based on estimating the shape of uncertainty for an investment program, including its skewness in returns. He also recommends rescaling a specific investment manager's risk measure based on the riskiness of its investment style, for which longer term data would be available.

I would agree with the direction of Sortino's refinements, but they are very difficult in practice to implement. Basically, one would need to have a very strong theoretical understanding of an investment in order to successfully model its "shape of

uncertainty." Later in this column, it is noted one should approach this task by understanding the source of an investment program's returns (and not by assuming the main source is "manager skill").

Second CAPM Assumption: There is only One Source of Risk for which Investors are Rewarded, and that is for Assuming Market Risk

The second assumption can produce performance metrics that create an illusion of superior manager skill (as in the option sellers example).

Under CAPM, an asset will earn a return greater than T-bills only if it tends to move up and down with the market. Any return unrelated to the market would be due to superior judgment or inside information. This excess return is known as alpha, as discussed previously.

The latest stream of thought by financial economists is there are actually multiple sources of risk besides the market risk factor, which can produce high average returns. If an investor passively bears any of these risks, the investor will earn a return that is not conditioned upon superior information. Frequently, there may be large losses from bearing one of these risk factors, resulting in a short-option-like return distribution, but the returns over time are sufficient to make the activity profitable. These returns are called "risk premia."

In such instances it would be misleading to calculate the excess returns over the market return of such an activity and then call the results of this calculation, "alpha." Calling the excess returns "alpha" implies the returns are due to manager skill in either market timing or in identifying mispriced securities.

Using the Sharpe ratio to evaluate risk-premia strategies will suffer from the same type of problems as with measuring the risk-adjusted performance of short-option sellers. In investment activities where one earns a risk premium, an investor is implicitly short options and is therefore exposed to asymmetric pay-offs. And as noted before, the CAPM measures are inappropriate for investments with highly skewed outcomes. ■

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