The premier meeting place of the risk profession

PRMIA

MEMBERS' UPDATE

October 2004

Volume 3 Issue 10

Board of Director Elections, Member Survey and Annual Campaign Underway—Contribute to Your Association!

Each year at this time, we emphasize the member control of PRMIA in three clear ways.

First, it is the time of year that Regular Members put themselves forward, with the support of endorsing members, for election to the PRMIA Board of Directors. Unlike many associations, including those in the risk and governance arena, we don't pre-select your "choices". To be put in front of the membership requires only that three of your PRMIA-member colleagues think you would do a good job. It's a very pure democracy and we strongly encourage you to participate in it with your vote.

Second, we ask you for your feedback on the work that PRMIA and its volunteers have been doing for you. The Member Survey will shortly be sent to all members. This form gives you a chance to give us your ideas and suggestions.

Responding to these is what it means to be member-driven. In fact, we've implemented many enhancements based on such suggestions. We take compliments and criticisms equally!

Finally, When you joined PRMIA, you showed your commitment to several things:

- To improving your professional skills and knowledge
- To joining a rapidly growing, international community of risk professionals
- To participating fully in the long-term growth of the field of risk management

Whether your contact with PRMIA is through the extensive educational programs and materials available on-line, through participation in the meetings and events of our international network of local chapters, or through your preparation for the PRM exam, PRMIA is there to support you and enhance your career. And the membership is free.

Most professional associations charge for membership. To insure fair access to members around the world, PRMIA does not. We do, however, ask our members for their support in one of three ways:

- By making an annual, voluntary membership contribution;
- By helping PRMIA solicit corporate memberships or sponsorships from their employers; and
- By being active participants in PRMIA chapters and helping build the PRMIA community world-wide.

Members contributions help pay for the lean staff and overhead expenses necessary to build the organization, for the cost of maintaining and enhancing the PRMIA web site, for provisions that bring valuable resources to you like PRMIA Publications, ROSE, the PRMIA Jobs Board, and local chapter meetings. The membership in PRMIA is free, but the services we provide must still be paid-for.

We thank you for your commitment to PRMIA and to enhancing the profession of Risk Management. With your support, PRMIA will continue to serve as the premier meeting place of the risk profession!

The Role of Hedge Funds in Institutional Portfolios: Part II

Contributed by Hilary Till
Principal, Premia Capital Management, LLC
www.premiacap.com
PRMIA Member Since February 2002

In last month's PRMIA Members' Update, we had discussed how the hedge fund industry and

Inside this issue:

Points of Interest

- **PricewaterhouseCoopers** Again Matches Annual Campaign Donations from Members
- Members Now Come from 144 Countries
- Over 1,000 new members last month

FIGURE 1

HOW HEDGE FUNDS SHOULD BE CHARACTERIZED	POTENTIAL IMPLICATIONS FOR MANAGER SELECTION	IMPLICATIONS FOR INSTITUTIONAL ASSET ALLOCATION
1. Equity Proxies	Want managers who capture the premium of asset class but also curtail downside risk	Replace traditional equity managers with hedge fund managers.
2. Unconventional Betas/Non-Standard Performance Characteristics	Could decide to only use style-pure managers once factor exposures are defined; Use investable style tracker funds instead of managers; and/or Be careful to not pay high "alpha" fees for what is actually a type of "beta."	Include unconventional betas in plan's long-term asset allocation modeling. Opens up possibility for tactical style selection. Decide which hedge fund styles are appropriate, given an institution's level of risk and loss aversion.
3. Alpha Generators/Exploiting Inefficiencies	Emphasis on managers whose performance cannot be linked to major risk factors Manager selection is a bottom-up exercise.	Expectation is that return patterns will be unrelated to asset classes in the core portfolio. Cannot use hedge fund style and index data in asset allocation modeling. For every investor that benefits from exploiting an inefficiency, there must be an investor supplying the inefficiency: Strategies are therefore inherently capacity constrained.
4. Traditional Factor Exposures with Additional Returns from Market Segmentation and Liquidity Premia	Manager selection would be part of a top-down approach.	A holistic framework in which all investments are represented in terms of a common set of factors
5. Total Return Provision Through a Fund-of-Funds	Emphasis on fund-of-funds or multi-strategy managers "Style Drift" is acceptable on the part of both managers and the fund-of-funds. Within a fund-of-funds portfolio, rebalancing is not a viable option.	Diversify idiosyncratic operational risk of individual hedge funds. Additional advantage in modeling is as follows: of the hedge fund data that is available, fund-of-fund data have the least biases. Optimal fund-of-fund construction is a responsibility of the fund-of-fund manager, not the plan sponsor.
6. Unstable Factor Exposures	Hedge Funds can't be integrated into an institutional framework.	Don't use hedge funds

institutional fund management arise from different intellectual traditions. This article will introduce the competing conceptual frameworks for incorporating hedge funds into institutional portfolios with future articles covering this area more fully.

Last month's article discussed how hedge funds do not easily fit into the current way institutions go about investing. We believe that much of the recent research on hedge funds has been driven by the following concerns:

- Understanding hedge funds using the tools that are well-established in institutional investment management;
- Noting how hedge funds themselves should change in order to be appealing to institutional investors; and

The Role of Hedge Funds in Institutional Portfolios: Part II

- Creating more flexible ways of analyzing portfolios that would incorporate the unique features of hedge funds along with traditional investments in a holistic fashion.

Surveying the extensive hedge fund literature, it appears that there are six competing conceptual frameworks for considering how hedge funds should be incorporated into institutional portfolios. These frameworks are summarized in Figures 1 and 2.

Figure 2

Six Possible Conceptual Frameworks for Hedge Funds, Part II

HOW HEDGE FUNDS SHOULD BE CHARACTERIZED	BENCHMARK
1. Equity Proxies	Want correlation with S&P but with truncated downside. Equity mutual funds
2. Unconventional Betas/Non-Standard Performance Characteristics	Benchmark is either a linear function of basic factor exposures, or asset-based style factors, or hedge fund styles.
3. Alpha Generators/Exploiting Inefficiencies	A total-return benchmark
4. Traditional Factor Exposures with Additional Returns from Market Segmentation and Liquidity Premia	Derived from the factors assumed to drive each hedge fund strategy's returns.
5. Total Return Provision Through a Fund-of-Funds	Balanced 60/40 Portfolio: But note that this bogey has been difficult to outperform.
6. Unstable Factor Exposures	Not applicable

This article will cover the first conceptual framework: that of hedge funds being used as proxies for traditional asset class allocations.

One possible role for hedge funds is for them to become substitutes for an institution's equity allocation. The goal would be to benefit from the risk premium of the equity markets but with truncated downside risk.

Ineichen (2003) notes that long-short equity sector hedge funds have opportunity sets that are correlated to their respective sectors, resulting in the active sector funds having returns that are correlated to their sector indices. Even so, these hedge funds control their downside risk so that their returns compound at a higher rate than their sector indices.

Fung and Hsieh (1999) examine a global macro fund versus five equity-market environments. They find that this fund is positively correlated with stocks:

However, it underperforms equities in up markets and outperforms equities in down markets, behaving as if it owned collars (short calls and long puts) on U.S. equities.

Before an institution decides to allocate its equity risk to hedge funds, one might consider examining the relative performance of equity hedge funds compared to equity mutual funds. Ackermann et al (1999) examine the performance of hedge funds and mutual funds in the eight-year period up to December 31, 1995. They find when comparing mean and median Sharpe ratios

Over 390 Jobs Posted On the PRMIA Jobs Board: 135 New This Month

The PRMIA Jobs Board is a free resource to PRMIA members. Over 25,000 job searches take place each month on the board and this month, over 390 Jobs in ten countries are listed.

C++ Quant Developer/Financial Engineer Hedge Fund

Salary: US$300,000

New York, USA or London, UK

Each month we randomly feature some of the latest postings, but be sure to search the entire database to see what is available. All job listings can be found by clicking **Jobs Board**.

Manager / Cash Management-Financial Risk International

Salary: US$Competitive

Passaic, NJ USA

If you're looking to hire, you can post your openings for free and can even use the search utility to find a certified PRM to meet your needs.

Audit Manager

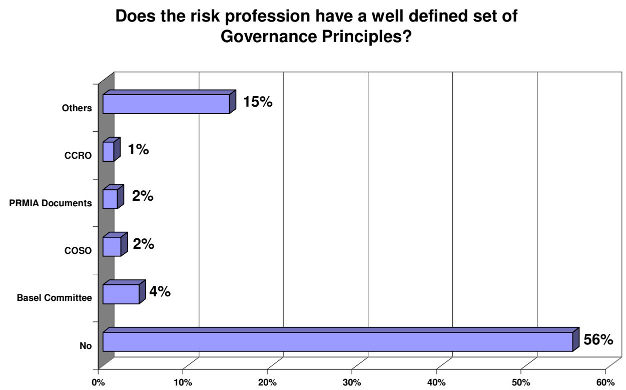
Salary: US$Competitive

Paris, FR

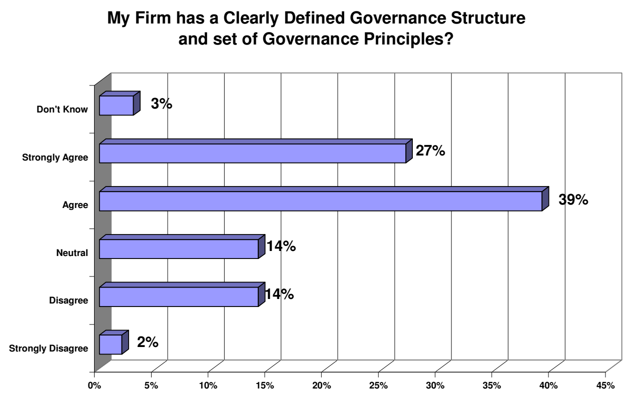
Other PRMIA News and Items of Interest

Less than Half of Survey Respondents Say Risk Industry Has Well-Defined Governance Standard

Over 300 PRMIA members, who had identified themselves as interested in Enterprise Risk Management, recently responded to a survey about the state of Governance Standards in the risk profession. Of those, only 44% said that such a standard exists. Further, of those who said a standard does exist, over 40 different documents were identified as being *the* standard.



Survey respondents identified themselves as being 27% Senior Executives, 38% Mid-Level Managers, 24% Mid-Level Technical and 11% Junior.



The banking sector represented 43% of responses, followed by Insurance and Consulting at 7% each, Energy at 6%, Traditional Asset Management, Alternative Investments and Non-Financial Corporates at 5% each.

Respondents came from Europe (34%), North America (33%), Asia/Pacific (26%), Central and South America (5%) and ME/A (4%).

Approximately 1,800 surveys were distributed electronically during the middle of September, with a total response rate of approximately 17%.

Debasish Ganguly and Girish VS Named First Regional Directors for PRMIA Mumbai

We are pleased to announce that Debasish Ganguly and Girish VS have been named the first Regional Directors for PRMIA Mumbai, our first Indian chapter.

Mr. Ganguly is a Senior Manager, Assistant to the Chief Operating Officer, of Tata Teleservices (Maharashtra) Ltd. He has a BSc with Honors from Ranchi University and an MBA in Finance from The Indian Institute of Social Welfare & Business Management, Calcutta.

Mr. Girish VS is currently Director Marketing at NUCSOFT. He has his *Masters in Financial Management* from University of Mumbai and a B.Sc. Physics from the University of Kerala.

Mr. Ganguly and Mr. Girish were nominated by the PRMIA Mumbai Steering Committee: Ajit Singh Grewal, Erroll D'Souza, DSP Merrill Lynch Ltd, Krishnamurthy K.N, Bankers Training College, Reserve Bank of India, Nirali Shah, Shashvat Systems, Sunando Roy, Reserve Bank of India, Krishnan Sakotai, Zensar Technologies, Mr. Samir Zaveri, Senator Securities, Shammil Roy, Centurion Bank Ltd, Subbia, Chella Software Private Limited, Thakor N. Desai, Puspendra Gupta, Nucsoft Ltd., Ms. Neeta Mukeji, ICICI, Jaideep Sen, National Commodity and Derivatives Exchange.

Top Scores in Third Quarter 2004

PRMIA Professional RISK MANAGER

Congratulations to the Top PRM Candidates

Exam I - Finance Theory, Financial Instruments and Markets

Kit Yee Ng, Hong Kong

Exam II - Mathematical Foundations of Risk Measurement

Michal Goss, Warsaw, Poland
Konrad, Augustynski, Krakow, Poland

Exam III - Financial Risk Management Practices

Viktoria Baklanova, New York, USA
Ka Wai Lo, Hong Kong

Exam IV - Case Studies, Standards of Best Practice, Conduct and Ethics, PRMIA Governance

Christopher Brady, Berkeley, CA, USA
Edward Wright, Rye, NY, USA
Martin Sheerin, Quincy, MA, USA
Donald Meek, Austin, TX, USA
Wei Chung Choi, Hong Kong
Michal Dubrow, New York, USA
Elizabeth Castagna, Hamilton, Bermuda

that: The hedge fund advantage is fairly pervasive across categories ….

The next article in this series will cover two other frameworks for institutional hedge fund investing: as unconventional betas and as alpha generators. The final article in this series will cover three additional competing frameworks for investing in hedge funds.

Ackermann, Carl, McEnally, Richard, and David Ravenscraft, "The Performance of Hedge Funds: Risk, Return, and Incentives, *Journal of Finance*, June 1999, pp. 833-874.

Fung, William and David Hsieh, "A Primer on Hedge Funds," *Journal of Empirical Finance*, September 1999, pp. 309-331.

Ineichen, Alexander, "Asymmetric Returns and Sector Specialists," *Journal of Alternative Investments*, Spring 2003, pp. 31-40.

Green Trading Markets: Will 2005 Be The Breakthrough?

Contributed by Peter Fusaro
PRMIA Member Since June 2004
http://www.global-change.com

Environmental financial risk is rising as an issue in corporate America as well as throughout the world. Environmental financial liabilities and the emergence of climate change risk have made companies extremely nervous on proceeding forward in market development with such near term uncertainty. For the past several years, corporate America has been trying to figure out the business case for GHG reductions. The business case is fairly simple either pay less now or pay more later. So we have companies beginning to analyze their risk and realize that there is a global issue and that they have got to do something about it.

Moreover, another driver behind the GHG market is that we now have institutional shareholders forcing corporations to acknowledge the environmental risk on their books. This has been done by pension funds mostly and is similar to the strategy that was taken in tobacco litigation. In effect, climate risk is rising as corporate financial issue and is becoming a fiduciary responsibility of corporates.

Emissions trading is one mechanism to accomplish much of these goals in a cost effective manner.

Green Trading is the triple convergence of capital markets and the environment and has come into the mainstream as a corporate financial issue. The intent was to capture both the problem and the solution as a financial trading means to ameliorate pollution. Building on the successful almost 10 year program in sulfur dioxide emissions trading in the US, Green Trading is the financial bridge to reduce greenhouse gas (GHG) pollution, increase renewable energy credit trading and the increase the use of energy efficiency (megawatt) trading through the use of financial markets. The long-term impact would be to reduce pollution in a cost effective manner and accelerate the introduction of more environmentally benign technologies. This would cause minimal economic disruption to the capital intensive energy industry as well as other industrial and agricultural sources of pollution.

In the US, we are getting an uplift from the marriage of CO2 injection for enhanced oil recovery and carbon sequestration. And the launch of the Chicago Climate Exchange (CCX) in September 2003 has seen over 60 companies sign up on a voluntary basis with many companies outside of CCX starting to look seriously at self-imposed caps.

In Europe, the EU ETS beginning January 1, 2005 will have close to six thousand facilities in the EU emissions trading system. Transactions have already occurred. represents both the participation of energy companies and banks, the key financial market makers that are needed.

We are witnessing a market transformation as the risk manager in some major corporations is now handling the GHG issue. While only about 200 trades with a notional value of $500 million have taken place globally for carbon trading, we are now positioned for the beginning of a liquid spot market instead of one off trades. Next year will be the breakthrough year with spot trading, high volumes, price indices, and advanced brokerage, similar to the power and gas markets, and we will see a growth in carbon finance.

Renewable energy credits (RECs) are going from promise to reality. The Texas REC market has been extremely active. But we are starting to see real market growth throughout the US, EU and Australia. There is also rising demand for green power among consumers which is driving this market forward.

Green Trading markets are now entering the hockey stick phase of market development with next year promising to accelerate the financial commoditization process. The US is well positioned to lead on environmental financial market development with its entrepreneurial culture, risk capital and knowledge base in trading. Don't count us out yet!

Peter Fusaro is Chairman of Global Change Associates (www.global-change.com), an energy & environmental risk management consultancy based in New York. He holds the annual Green Trading Summit in New York (www.greentradingsummit.com) and has been on the forefront of global environmental issues impacting the energy industry for 30 years.

Regional Chapter Profile: PRMIA Melbourne

Statistics

Membership: 501

Chapter Formed: June, 2003

Members' Areas of Interest:

47.5%	VaR
46.1%	Derivatives
45.3%	Credit Risk
45.1%	Financial
43.5%	RAROC / RAPM
43.1%	Basel II
43.1%	Financial Engineering
42.5%	Trading / Capital Markets
40.9%	ALM
36.7%	Market Risk

Regional Director

Jennifer Moore, ANZ Investment Bank

Steering Committee

Alan Sablich, Melbourne Business School
Chris Rowlands, CDR & Assoc.
David Michell, Finance and Treasury Association
Fiona McNabb, ANZ
Mike Ritchie, KPMG
Richard Oakes, National Australian Bank Ltd
Stuart Norbury, Erskine Consulting

PRMIA Melbourne Regional Director, Jennifer Moore

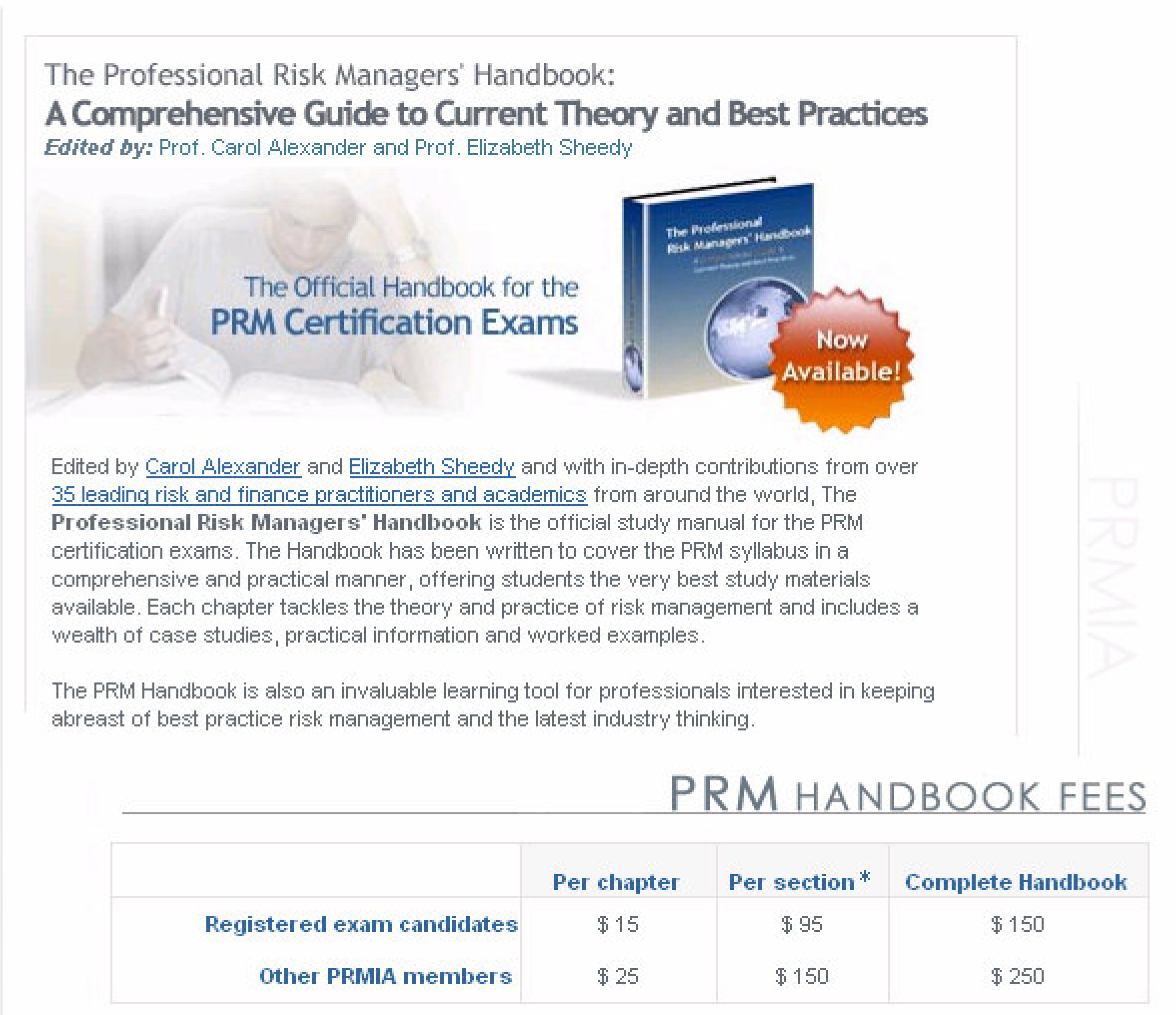
Upcoming Event

Nov. 9, 2004 - Using Value-At-Risk in Agricultural Commodities Markets—Michael Liberman, Market Risk Manager, ANZ

Past Events

Professor John Bilson - University of Melbourne Business School on Modeling Volatility

Fiona McNabb - General Manager, Risk Management and Performance, Treasury Corporation of Victoria, on *Operational Risk* - getting the qualitative components right



Purchase the Professional Risk Managers' Handbook Now