

October 2009 Commentary

“When Amaranth¹ Fades”

“Pirate Investors Abandon Ship”

“Galleon Sinks”



The above headlines represent the fun the media can sometimes have with big hedge fund blow ups. For investors, however, who have invested in these and other blown up funds the fun stops with the head line. We have all read the stories about large fund of funds and institutional investors that have invested with the likes of Amaranth and Madoff. For the readers those stories provided some informational, educational and entertainment values. For the FoFs these stories meant embarrassment , redemptions and , in some cases, total demise.

How does the firm avoid having its name appear in Wall Street Journal, Financial Times or Hedge Fund Alert? Careful due diligence, strong and independent risk management, independent valuation are the most common suggestions. No matter, how diligent an investor may be there will always remain a potential Headline Risk.

Looking at our clients’ portfolios in the past few months we have noticed that same high profile names were present in many of them. Some portfolios had high concentration in the “big” managers. While we often recommend our clients to reduce such exposure we have not before looked to compare the head line risk exposure among portfolios.

To some degree the headline risk for individual manager depends on how famous the fund is. One way to measure fame in twenty first century is to count the number of hits produced by the web search of one’s name. The search on Microsoft’s Bing engine for the name of yours truly produces mere 35 results. The search for Michael Jackson produces 152 million results.

We have decided to apply the same logic to hedge funds and ran Bing² queries on the universe of over five thousand hedge fund management companies (both dead and alive). Figure 1 shows distribution of funds by

¹ Amaranth means “unfading” in Greek

² While Google may be a more the most popular search engine it does not permit running automated search queries required for this study.

popularity (number of hits). (Please note that since it's impossible to exactly calculate the total number of hits for each search we set the maximum number of hits to be 1000).

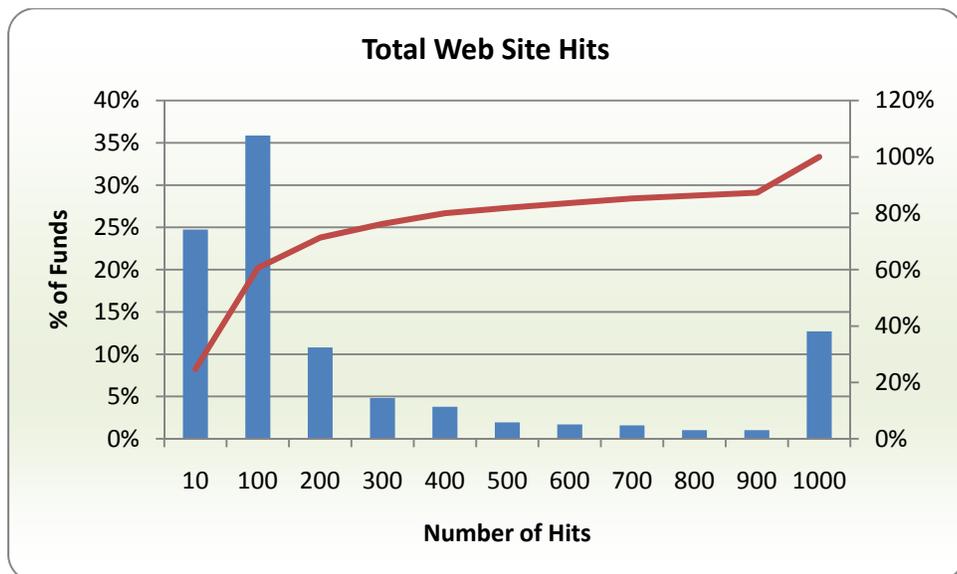


Figure 1

The above chart confirms the notion that most hedge fund managers tend to keep low profile. A quarter of the funds scored less than 10 hits. Over seventy percent of the funds have less than 200 hits. On the other side about 12% of the managers scored 1000 or more hits. Such managers included Cerberus Capital, Paulson & Co, Elliot Associates and others.

The information presented above may be mildly interesting, but is not necessarily useful in portfolio construction. With this data at hand grouped the managers by their corresponding number of web hits we then assigned each manager a Headline Coefficient (HC) that corresponded to a rank on a scale of 1 to 10. To determine the value of the Headline Coefficient we performed the following analysis.

To ensure the maximum number of funds in the analysis while keeping analysis statistically significant we limited the time series for all funds to thirty six months ending August 31, 2009.

First we created two groups of funds – The funds with HC of 1 and the funds with HC of 10. To determine whether fame corresponds to uniqueness or vice versa with calculated average correlation among the funds in two groups. The results suggested that the lower profile funds were more unique based on lower average correlation among them (0.21) vs. the higher profile fund (0.35).

We then simulated two sets of random portfolios corresponding to funds with either rank 1 or rank 10. For each set we generated one thousand portfolios with 20 funds in each. We then studied risk profile properties of these portfolios.

First we calculated some basic risk / return measures for the two sets of portfolios. (Table 1).

| Basic Statistics | Rank 1 | Rank 10 |
|------------------|---------|---------|
| Average Return | 5.52% | 2.50% |
| Average Vol | 7.89% | 8.73% |
| Average Max DD | -15.07% | -21.18% |
| Worst Max DD | -32.95% | -37.06% |

Table 2

The results suggest that the lower profile portfolios provide both better returns and lower volatility than the high profile portfolios.

We then estimated relationships between these portfolios and Barclay Fund of Funds Index. Results in Table 2 suggest that the lower profile portfolios have less correlation to the overall fund of fund industry and produce higher alpha than high profile portfolios.

| Regression vs. Barclay Fund of Fund Index | Rank 1 | Rank 10 |
|---|--------|---------|
| Annualized Alpha | 7.20% | 4.70% |
| Beta | 0.85 | 1.03 |
| R-Square | 0.71 | 0.85 |

Table 2

Portfolios with less famous funds had higher Alpha, and lower beta vs. the Fund of Funds Index. The lower profile portfolios also had lower exposure to the overall markets. (Table 3).

| Regression vs. Global Market Model | Rank 1 | Rank 10 |
|------------------------------------|--------|---------|
| Annualized Alpha | 8.94% | 6.41% |
| Credit | (0.10) | (0.04) |
| Equities | 0.16 | 0.22 |
| Volatility | (0.02) | (0.02) |
| Interest Rates | 2.55 | 2.59 |
| FX | (0.38) | (0.29) |
| R-Square | 0.66 | 0.78 |

Table 3

A few months ago we wrote about our view on the future of the Fund of Fund (FoF) industry. In that article we argued that for the industry to redeem itself the FoFs have to provide investors with more unique investment opportunities and that providing access to high profile managers is no longer sufficient. The study we have just presented seems to confirm our earlier hypothesis.

While the methodology to calculate Headline Coefficient (HC) may still need to be refined, we propose using HC as an additional metric in evaluating the merits of investing in any single manager. We also propose using asset weighted average HC to evaluate overall headline risk of the fund of funds portfolio.

To help our readers evaluate HC for individual managers our website will now provide weekly list of the funds most mentioned in the business news with links to the related news stories.

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