

Hedge Funds

**Maximizing Terminal Wealth and
Optimizing Re-investment Policy**

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Serfiex

Introduction: targets of investors

Targets of investors:

Invest his/her money in financial and nonfinancial assets in order to **maintain it, to obtain a return** and **to make it bigger** over time.

Friends: long term, diversification, clear targets, realistic targets.

Enemies: inflation, taxes, costs...

Introduction: Expected return

Important

Real return= Return – inflation

Data

		Ret	Infl	Real
USA	Equity	9,75	3,20	6,55
	Bonds	4,92	3,20	1,70
	Bills	4,60	3,20	1,40
EUROPE	Equity	9,49	4,70	4,79
	Bonds	5,33	4,70	0,66
	Bills	4,80	4,70	0,10

Source: The Millenium Book (London Business School-AMRO)

Introduction: costs

Example

1.000 euros today will be tomorrow... (8,1%)

	Fund 7,8% (8,1%-0,3%)	Fund 6,4% (8,1%-1,7%)
In 1 year	1.078	1.064
In 10 years	2.119	1.860
In 20 years	4.491	3.458
In 30 years	9.518	6.431

In the expensive fund, 1,7% means a **21% of the return.**

In the cheap fund, 0,3% means a **3,7% of the return.**

Introduction: Financial decisions

Strategical Decisions

1. RISK versus NO RISK
2. Asset Allocation

Tactical Decisions:

1. Market Timing
2. Security Selection.

Tactical decisions will never damage strategical decisions. Investment in Hedge Funds is a strategical decision.

Introduction: Asset Allocation and Alternative Investment

Comparison (data for Alternative Investment)

2001

Usa 7,2%

Europe 2,3%

2002

Usa 7,5%

Europe 2,6%

Source: 2002 Goldman Sachs and Co. and Frank Russell

Hedge Funds: Definition

Original Definition

Alternative assets with low correlation with traditional cash, fixed income and equity portfolios.

Nowadays meaning...

Any pooled investment vehicle that is not a conventional investment fund.

Expected return and risk vary enormously among different HF strategies

Market making and proprietary trading are the basis (reserved to financial institutions)

Hedge Funds: Risk

1. Sources of risk

Market risk

Nonlinear market risk

Credit risk

Liquidity risk

Operational risk

2. Concept of risk

Always absolute, Never relative

3. Measures of risk

Volatility is not the best one

Trading measures of risk: % profitability, profit factor, expected loss, maximum draw-down...

4. Risk Control

Risk managers in trading rooms are enterely quantitative (VaR, etc..).

Hedge fund adviors rely on qualitative factors to assess risk due to the lack of available information.

Hedge Funds: Spanish industry

Are they real HF?

Limits of the Spanish law:

- No leverage

- Different commission schemes

- Limited use of derivatives

- Diversification coefficients

- Daily valuation (mark-to-market)

A solution: A Fund of Funds.

A drawback: Lack of professionals.

Hedge Funds on our Mutual Fund Industry

1. Trading, neutral and long-short

Espirito Santo Tesorería Plus

Renta 4 Intradía

Fibanc Global Financial Trading

SCH long-short Europa

BANIF Riesgo Abierto

Madrid Gestión Dinámica

BBVA Opciones 1

FIMA Market Neutral

Hedge Funds on our Mutual Fund Industry

2. Convertibles

Beta Euroconvertibles

Segurfondo convertibles

BBVA Bonos Convertibles

Caixa Catalunya Convertibles, FIMF

3. Emerging

There are a lot...

4. Fund of Funds

BBVA Multifondo alternativo FIMF

SCH Selección alternativa FIMF

Atlántico Multigestión alternativa FIMF

Hedge Funds on our Mutual Fund Industry

5. Real alternatives: the “classics”

Bestinver Mixto

Euroagentes Previsión

In general:

- Small is smart

- Are expensive

- Mainly distribution

- Very few professionals

Hedge Funds: Spanish industry Demand

Use of HF among Spanish Institutionals

1. Fund Management industry
2. Insurance Companies
3. Pension Funds (Pension consultants)
4. Private Banking (Family officers)

Hedge Funds: Strategies

Strategies

Long/Short	40%
Convertible Arbitrage	6%
Event Driven	20%
Market Neutral	6%
Global Macro	10%
Fixed Income Arbitrage	8%
Emerging Markets	5%
Managed Futures	5%

Volatility of Strategies

Long/Short	16,4%
Convertible Arbitrage	6,2%
Event Driven	8,6%
Market Neutral	2,5%
Global Macro	13,8%
Fixed Income Arbitrage	4,8%
Emerging Markets	22,5%
Managed Futures	17,3%

Hedge Funds: Strategy

	Global	Global+HF
EUR BONDS	40	37
USD BONDS	20	20
EUR EQUITY	20	8
US EQUITY	10	10
NASDAQ	10	9
HEDGE FUND	0	15
Volatility	6,3%	5,6%

Hedge Funds: Strategy

	Global+HF	UP
EUR BONDS	37	28
USD BONDS	20	19
EUR EQUITY	8	12
US EQUITY	10	13
NASDAQ	9	13
HEDGE FUND	15	16
Volatility	5,6	6,2

Hedge Funds: Strategy

	Global+HF	DOWN
EUR BONDS	37	56
USD BONDS	20	23
EUR EQUITY	8	1
US EQUITY	10	4
NASDAQ	9	3
HEDGE FUND	15	13
Volatility	5,6	4,4

Hedge Funds: Strategy

	No HF	Yes HF	Relative
CASH	20	17	-3
BONDS	30	26	-4
EQUITY	50	42	-8
HEDGE F.	0	15	15
Volatility	10%	9%	0,8-1,2%

Volatility of Strategies

Long/Short	16,4%
Convertible Arbitrage	6,2%
Event Driven	8,6%
Market Neutral	2,5%
Global Macro	13,8%
Fixed Income Arbitrage	4,8%
Emerging Markets	22,5%
Managed Futures	17,3%

Hedge Funds: Strategies

Strategies	TE (15%)
Long/Short	2-3%
Convertible Arbitrage	0,5-1%
Event Driven	3-4%
Market Neutral	0,5-0,75%
Global Macro	2-4%
Fixed Income Arbitrage	1-2%
Emerging Markets	2-4%
Managed Futures	2-5%

Hedge Funds: Transparency

A word on transparency

If hedge fund managers want to attract institutional investors, transparency must increase.

Performance evaluation doesn't exist.
Ex ante risk control is very complicated.
Performance attribution doesn't exist.

A suggestion: Style analysis (Sharpe 1988)

Thank you

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