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A Skill Based Multi-Strategy Organization

A SKILL BASED MULTI-STRATEGY ORGANIZATION

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Given the advances in financial technology and investment technology, how does one design an investment organization which maximize your chance of investment success (by sustainable enabling the capture of return) and business success (by aligning the interests of the asset owner, asset manager and portfolio manager).

Conventional logic advocates – set up three divisions: equities, fixed income and alternatives; set up region based products in each division – US, International and Emerging Markets, and leave all the exotics and hedge funds to Alternative Investments. But is this really the best way to structure an investment management company, or is it merely an administratively convenient and consultant friendly structure?

We believe that there are three basic frameworks that need to be implemented for asset owners and asset managers to cater for the evolution in asset markets, and to retain an optimal solution for the assets – the design of a business model for the organization, a revised investment structure for the portfolio and an evolved allocation and risk management methodology.

DESIGN OF A BUSINESS MODEL

We argue that the definition of a business model to align the interest of the asset owner and asset manager is critical to maximizing investment returns. Failure in

this process leads to a vicious circle, both for the organization and the investments. Further, we believe that a business model that integrates both internal and external management, is able to optimally combine the benefits of external skilled managers, while minimizing the potential impact due to agency issues. Plan sponsors who completely outsource their asset management to multiple external managers, will suffer from a compounded agency problem, and a tendency to fall into the vicious circle. Plan sponsors who completely in-source the management of their assets, would be insulating themselves from investment skills available commercially. Both lead to sub-optimal solutions for the assets.

We believe that the current business model of hedge funds and asset management organizations will evolve to a structure where the risk and reward is aligned for the asset owner and the asset manager both on the upside and downside.

A REVISED INVESTMENT STRUCTURE

All asset owners without exception, individuals (high net worth or otherwise) or institutions (corporate or public pension funds), have an inherent objective of absolute returns or inflation adjusted absolute returns to meet liabilities, subject to liquidity parameters and risk constraints.

These objectives have traditionally been fulfilled by -

- o an allocation process to asset classes to get beta return, and
- o an active investment process or product selection within each asset class to obtain alpha

We believe that both these processes need to evolve, to cater for a world without demarcations of asset class, geography, product and implementation. While conventional asset allocation was able to cope with a

demarcated asset market where traditional asset classes had low correlation between them, in a multi-asset class world this process has become less relevant. Further, as the product space within traditional asset classes has become crowded and more efficient, active investment processes within an asset class have become less productive. Within the existing framework not all available arbitrage opportunities can be exploited, accountability for new instruments is limited, there is a miscalculation of the actual risk being taken in the portfolio and return attribution to conventional alpha and beta is misrepresented.

We propose that the investment structure of investment management organizations needs to evolve from an asset class demarcated and regional structure, to a global skill based structure, where there are no asset classes and no regions, and only skills. We propose that asset allocation has to evolve to exposure allocation, and the definition of alpha and beta needs to evolve to exposure premium and arbitrage return.

ALLOCATION AND RISK MANAGEMENT

Conventional methods of asset allocation employ a mean variance framework for allocating assets across asset classes, with the assumption of a symmetrical normal distribution of returns. However, in the context of multiple strategies, three main differences arise, which necessitate an alternate allocation framework. First, it is the basic intention of active strategies to achieve non-normal positively skewed return distributions. Second, there is a very specific target return requirement, which needs to be accounted for in the selection and allocation to strategies. Finally, the objective of multi-strategy funds, to achieve excess return in any macro environment, any market environment and be relatively insulated during stress events, needs to be specifically incorporated in a strategy allocation process. These facets necessitate

the development of an alternative allocation framework, which is able to account for all moments of a return distribution, incorporate the return requirement and facilitate the constraints of behavioral risk of the asset owner.

We believe that the framework we propose in this regard, presents a unified approach that also provides a potential solution to the current industry debates of alpha vs. beta, active management vs. passive management and benchmarked vs. absolute return products.

REFERENCES

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