



A Bi-Monthly Publication • Vol. 4 • Issue 5 • October - November 2004

A New Paradigm for Portfolio Construction

by Richard C. Kang

The new paradigm for portfolio construction brings the focus back to the decision of asset allocation with reduced emphasis on manager selection.

Over the past few years, since the markets peaked in 2000-2001, there has been much discussion over various issues related to institutional portfolio management. Along with low interest rates, the recent equity market declines caused pension fund shortfalls that have forced both academics and practitioners to re-evaluate certain core concepts such as asset allocation, manager selection, performance measurement and benchmarking, risk management/measurement and the problems related to asset-liability match-

ing. Although institutionally driven, these discussions are appropriate for the retail audience, either because these investors are members of various government/corporate pension funds or simply because the issue also applies to the retail investment portfolio.

This article will discuss some of the changes in philosophy towards matters of portfolio construction, and how these changes may affect the way decisions are implemented in the future, especially for the retail investor.

More specifically, I will compare the traditional model of portfolio construction to a "new paradigm" that attempts to simplify the overall process, and hopefully, reduce inefficiencies and costs. Where the old paradigm focuses on performance relative to a benchmark index (which does not necessarily address the needs of clients but does address the needs of the manager), the new paradigm for portfolio construction brings the focus back to the decision of asset allocation with reduced emphasis on manager selection. The new paradigm argues that once the asset allocation is determined, implementation may be best accomplished through the use of passive instruments such as exchange traded funds ("ETFs") or index funds/derivatives. The next decision is what proportion to invest with active managers. The selection of these managers should seek absolute performance which has a direct and measurable relationship to the needs (liabilities) of clients which are absolute and fixed. Hence, pay for alpha where prudent, get beta cheap.

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Performance Data: CSFB Tremont Hedgeindex

CSFB	August 2004	YTD
CSFB/Tremont Hedge Fund Index	0.14%	2.75%
MSCI World Equity Index	0.48%	0.91%
Dow Jones	0.34%	-2.68%
MSCI EMG MKT	3.93%	-0.68%
NASDAQ	-2.61%	-8.25%
S&P 500	0.23%	-0.69%
S&P TSX	-0.80%	3.07%

Sub Indices

Convertible Arbitrage	0.28%	0.55%
Dedicated Short Bias	1.27%	9.10%
Emerging Markets	1.83%	3.10%
Equity Market Neutral	2.13%	4.71%
Event Driven	0.45%	5.71%
Distressed	0.56%	7.14%
E.D. Multi-Strategy	0.38%	4.78%
Risk Arbitrage	0.18%	0.80%
Fixed Income Arbitrage	-0.41%	4.67%
Global Macro	-0.75%	4.42%
Long/Short Equity	0.09%	1.46%
Managed Futures	-1.53%	-6.99%
Multi-Strategy	0.41%	2.81%

The CSFB/Tremont Hedge Fund Index, the only asset-weighted hedge fund benchmark, was designed to establish a standard for tracking and comparing hedge fund performance against other major asset classes, like the S&P, on a global basis. Its web site provides interactive tools that allow users to manipulate the information and customize their research. www.hedgeindex.com

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Portfolio Construction I. The Traditional Paradigm

The current simplified model for portfolio construction is loosely based on Markowitz's Modern Portfolio Theory whereby the investor's asset mix is derived by optimizing returns of various investments for an acceptable level of risk. Managers are selected for each asset class (stocks, bonds and others) as well as subclasses (US small cap equity, global government bonds, etc.). Then, each manager is allocated an amount to invest based on certain factors such as macroeconomic indicators, portfolio optimization results and allocation constraints based on a risk budgeting system. A periodic review of these factors and their effect on the portfolio is conducted to properly maintain the portfolio's asset mix.

With MPT came a holistic approach to portfolio construction in which the asset mix was based on the historical volatilities and correlations of underlying investments. The positive result of MPT, and still key today, is the importance that should be placed on asset allocation. However, some problems have arisen:

1. For many investors, the focus on asset allocation has shifted significantly towards the task of manager selection. With the advent of portfolio optimizers, among other technologies which many argue to be flawed, less emphasis has been put on the portfolio's asset allocation. In some cases, it seems as if the asset mix decision is run on "auto pilot" often resulting in "fixed" policy allocations. For example, it is common for a pension fund to have a 60% equity/40% fixed income asset mix. The question posed by Peter Bernstein (www.peterlbernsteininc.com) recently is whether policy allocations should be less "fixed" especially considering the outlook for equity markets. The degree to which a portfolio eases its policy constraints (moving from strategic to tactical asset allocation or, in the extreme, market timing) is what is being discussed the most.
2. The next problem is that the use of optimizers and the overall process of portfolio construction have provided an incentive for

a majority of managers in certain asset classes to perform similarly to a benchmark index. Simply put, taking on risk to perform significantly better than an index exposes the manager to the chance of also significantly underperforming the index. This means that managers face "termination risk" (to which investment managers are all undoubtedly averse), and has introduced the concept of "closet indexing". If managers within a particular asset class provide significantly more beta than alpha statistically, then investors should ask themselves whether their manager's performance resulted from keen decision making or merely the movement of the underlying market.

3. The consequence of the "closet indexer" problem has been a lack of specialization by the majority of managers. Granted, there are certain asset classes where there may be some appropriate active manager specialists available for investors (for example, in emerging markets). However, for the majority of asset classes, there are many competing managers, each one often indistinguishable from the other in terms of philosophy, methodology or performance. It is often difficult to determine if managers are truly able to exploit any inefficiencies in the market through their active management. Later, in the "new paradigm" section, we discuss absolute return strategies whose active managers have fewer constraints imposed on them compared to long-only managers and hence are able to be more "absolute" rather than "relative" performers.
4. For investors, both institutional and retail, their feeling after their losses in 2000-2002 was that neither managers, nor any advisors who selected them, were accountable for their poor results. Rightly or wrongly, investors have come to grips with the reality of paying their managers whether markets have gone up or down, and more importantly, whether their portfolios have done better or worse. To this day, many portfolios are still constructed using a system whereby performance is often rewarded based on a function of returns relative to a benchmark index. Although somewhat flawed, this system is understandable since compensation compared to a standard, or index, appears objective. Perhaps a compensation formula based on portfolio size is still valid, but investors are seeking a formula to properly compensate for a manager's performance as well. For example, in many cases, managers are compensated based on assets under management. Suppose a manager had a return of -50%. This would result in a halving of the annual management fee. Most investors would agree that a management fee, even one with a 50% reduction, is difficult to accept in this situation. Although difficult, part of a new paradigm will be to properly deal with the issue of manager compensation.

From the points listed above, we see that the system has created a dichotomy between the managers' objectives and those of their clients. As a result, we are now in a "relative performance game" where manager performance is geared to be very close to that of the benchmark index. The objective has turned to reducing a manager's tracking error versus the benchmark, with comparatively little thought given to asset allocation.



For retail investors in the traditional paradigm, the primary investment vehicles of choice are stocks, bonds and long-only mutual funds. Some consideration has been given recently to uncorrelated asset classes such as commodities, real estate, private equity and hedge funds but generally, only by large institutions and very high-net worth investors. Derivatives are still considered risky but have gained acceptance from sophisticated investors especially as a risk management tool. However, there are still some of the very same problems that we associate with the institutional world in the traditional paradigm as noted above.

As with institutions, the majority of retail investors have had a very distinct focus on manager selection. There is still some awareness on the role of asset allocation, but investors have been focused on choosing managers based on relatively arbitrary allocation factors (i.e. small cap, large cap, value, growth, timing decisions, etc.). In addition to these somewhat “objective” factors, what differentiates retail investors from institutions is their often subjective tendency to make “emotion-based” decisions. It is common for everyday investors to chase the returns of “hot” or “4-star” managers. However, these managers are still relative performers, and simple performance measurements will reveal that the vast majority of retail, long-only mutual funds are “closet indexers.” Style drift is a consideration often ignored by, or even unknown to, many investors. The euphoria of the chase and the mass exodus during panics frequently leads to market timing, often with disastrous results. In addition, although retail investors have become better educated, many are still not fully conscious of the risk and costs of investing.

The traditional paradigm has been revisited by institutions but retail investors are being left behind. Manager selection has its place in the portfolio construction process, but should not occupy too large a role. Furthermore, in its current state, the traditional paradigm does not allow the retail investor’s portfolio to be properly engineered due to the over-emphasis on the manager selection process. Focusing more on asset allocation and limiting the role of manager selection should provide greater assurances of achieving a client’s stated objectives.

II. The New Paradigm

This could be considered as a new era of “Post-Modern Portfolio Theory” where equal consideration is given to *absolute returns* and *relative returns*. In other words, keen investors should seek out “alpha,” while maintaining exposure in other portions of the portfolio to general market movements or “beta.” The search for alpha comes at a higher cost, but is somewhat offset by the prudent (and inexpensive) use of passive instruments. Taken to an extreme, portfolio construction may be managed in such a way that beta and alpha can be separated by applying passive investment management where it is prudent and utilizing active managers elsewhere. This reduces the manager selection problem by putting the attention on choosing active managers within areas where it is deemed that passive instruments are either unavailable or unsuitable.

It has only been due to the poor returns of 2000 to 2002 that the subject of absolute returns has become a priority. As Chris Guthrie mentioned in last month’s CHW newsletter, investors have to go beyond just thinking about return, risk and correlation and consider other factors such as “drawdown” and “time underwater”. Hence, the current interest in absolute return strategies and, primarily, hedge funds.

So, why do we need a “new paradigm”? As discussed in the previous section, there are numerous problems with the current model, especially surrounding the existing role of manager selection. In the “new paradigm”, investors’ philosophies should change to reflect the following preferences:

1. Investors should make “relative performance” decisions at the lowest cost. As discussed earlier, once the asset allocation decision has been made, investment to each asset class and subclass may be implemented through the use of passive instruments such as ETFs or index funds/derivatives as the building blocks of a core portfolio. This eliminates, or at least

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greatly reduces, the role of manager selection. Resources (including management fees and trading costs) saved by the reduced application of “relative performance” active managers can be redirected to focus on manager selection where it is more greatly needed, that is in the search for “absolute performers” such as hedge funds and managed futures funds.

2. Pay for alpha for its own sake, rather than within an asset class to beat a benchmark.

In certain cases, No.1 above may not apply when a low cost option is not the most appropriate or is unavailable. Some may feel that emerging market equities require an active stock picker, while others will prefer investing in EEM (an ETF traded on the Amex). In the new paradigm, absolute returns matter, leading many institutions, and in recent years individual investors, to focus on real return bonds, hedge funds and managed futures. By moving away, in a measured amount, from relative returns to absolute returns, the investor’s portfolio has begun to move towards matching investment returns to liabilities (what the client needs in the future) rather than benchmarks (what the market achieved in the most recent measurement period). Absolute returns do not come cheap, especially when compared to ETFs and index funds, but with investors being more cost conscious, their wallets will decide where they can “get what they pay for”.

Investors should make “relative performance” decisions at the lowest cost.

Reduced “long only” manager selection also allows for greater resources to be allocated to where it is truly required: qualitative and quantitative due diligence for the analysis of absolute return strategies and their managers. It must be stated that these managers certainly require greater investigation than traditional “long only” managers.

3. Greater focus on qualitative and quantitative risk management.

By completing step one, the investor reduces an amount of “active manager” risk related to the deviations (although often slight) between the manager and the benchmark index. Reduced “long only” manager selection also allows for greater resources to be allocated to where it is truly required: qualitative and quantitative due diligence for the analysis of absolute return strategies and their managers. It must be stated that these managers certainly require greater investigation than traditional “long only” managers. However, it is the absolute return strategies that provide greater risk management properties, and in a sense, act as an insurance policy to the core portfolio of stocks and bonds. The absolute return strategies portion of the portfolio may not necessarily perform well in a strong

bull market, and thus one pays a premium, but they should ideally provide the required performance when overall market trends are negative.

The new paradigm has already started for institutions, especially with the larger pension funds who are big followers of both passive investing and the use of absolute return strategies. However, many small to mid-size funds still rely on the traditional paradigm, and thus focus on the selection of “long only” managers as the key function within the portfolio construction process. On the other hand, often one of the managers is selected with an index mandate. Similarly, on the retail side, investors have begun to understand the benefits of ETFs and index funds. Recent trends that will facilitate greater acceptance of the new paradigm in the retail world include:

1. Growth of the exchange traded funds industry and the continued flow of capital into ETFs
2. The introduction of new products and instruments that promote the use of passive investing and “asset class investing”
3. The continued growth of the hedge fund industry and the movement of assets into hedge funds as well as other areas that will continue to require active managers (such as private equity and infrastructure)
4. Increased investor education and awareness of issues related to costs, the “active versus passive” debate, investment tax issues and a more realistic view of retirement savings.

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In the future, we may see the application of “portable alpha” and the combination of asset allocation and strategy allocation (active/passive decision) in fund wrap programs or managed account programs for retail investors.

CONCLUSION

For many institutional readers, there’s really nothing new here. What has been discussed is the use of *asset allocation* as the main driver for portfolio construction decisions, followed by the use of *strategy allocation* (beta providers vs. alpha providers).

In other words, we first decide how much to put in stocks, bonds, and alternative asset classes, then decide what proportion to manage through passive instruments and how much through active managers. Many of the larger public pension funds have stated that their objective is to manage assets in the context of its liabilities. This would suggest the prudent use of absolute return strategies (ARS), and their truly “active” managers.

Is it possible to replicate this model for the retail investor? In a word: yes! Instead of spending time on selecting mutual funds for the majority of one’s portfolio, use ETFs or indexed mutual funds (“beta providers”) as the core. This should afford exposure to most investment classes including, among others, stocks, REITs, Canadian government bonds and various forms of US bonds. The average investor will be surprised at what investments can be made through ETFs these days.

There is still some manager selection required of the savvy investor; however, it is just not as prevalent across all asset classes as it was in the traditional paradigm. It is very prudent risk management to consider limiting manager selection to the absolute return strategies, and focus the relative return portion of your portfolio on passive instruments. For most investors, this means working with an advisor to pick one or two “fund-of-funds” to fulfill the portfolio’s ARS mandate.

This is essentially a “core and explore” portfolio approach to asset class investing. The core is a collection of passive managers that provides exposure to various asset classes. These are augmented by such ARS as hedge funds and managed futures that are not true asset classes, and should thus be selected differently. It’s up to the individual investor to decide whether this system should be augmented through further stock selection or manager selection in an additional attempt to capture alpha (for example, a long-only stock picker in India or China).

In conclusion, the “new paradigm” of investment management seeks to construct portfolios that look to the use of modern market instruments and make prudent strategy choices when implementing asset allocation decisions. There is ample proof that passive management will reward the investor with performance similar to, or better than, that of active managers in most asset classes. The remaining choices related to manager selection (ideally, just in absolute return strategies) are made by the investor and the advisor

in such a way as to create a portfolio that allocates assets to managers with the proven ability to add alpha. In this new paradigm, the advisor and the client have selected management that can most prudently create a portfolio that meets the client’s objectives, and at a reasonable cost.

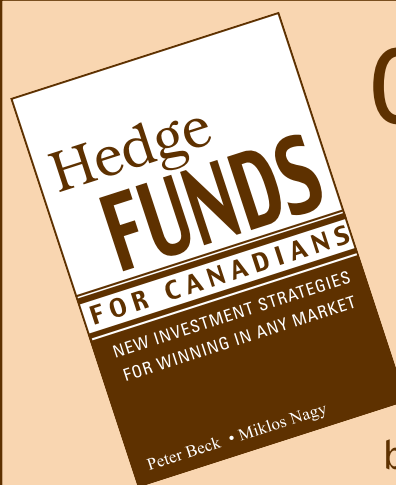
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Consider limiting manager selection to the absolute return strategies

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