

May 31, 2012

“We are what we repeatedly do. Excellence, then, is not an act, but a habit.”

— Aristotle

As with any business, a hedge fund should be able to describe convincingly the source of its edge, why it expects to generate positive returns over time, and how it can consistently harness that edge. While these three elements may seem obvious, many portfolio managers even stumble when directly asked only the first two questions: what is the edge and why should it work?

Among the managers who can successfully describe their strategies and explain why they are a source of alpha, many fail to follow their strategies consistently, particularly during times of market stress. That is, even with a strategy designed to harness a structural edge and generate positive expected returns, many funds simply do not have the experience, discipline, resources and restraint to stay focused and execute profitably within acceptable risk parameters. It is not enough to simply have an edge; it is the combination of an edge and consistent, disciplined execution that produces a compelling investment.

Staying disciplined to an investment strategy is particularly challenging when there are legions of marketing people, financial pundits and research analysts who are compensated by inducing action from investors around the globe. There is endless uncertainty that investors “must” consider when structuring their portfolio. The financial media and marketing engine target both retail and professional investors to take action: “re-think your portfolio, chase the profitable strategies, allocate assets differently, hedge your portfolio... then hedge your hedge.”

While it is easy, and becoming easier with electronic markets and ETPs, to buy or sell any security, the inducement to trade ends up being a destructive force against long-term profits. Investors in index products, for instance, often underperform the index they are benchmarking, not due to fees, but rather because they succumb to emotions that make them second-guess their strategy and abandon it at the worst time. An investor may choose to reduce his exposure during periods of fear and enter back into the investment once things appear to be normal, effectively selling low and buying high and forsaking the discipline that is paramount to having long-term success.

Options Edge

In the options business, participants analyze the difference between investors' expected market returns and how the markets have actually performed over a period of time. Index options provide a representation of the market's expected distribution of returns for a given maturity. This option-implied return distribution changes in response to option prices adjusting to supply

and demand. Monitoring the interplay between the implied and realized distributions is central to identifying ways to make optimal investment decisions using derivative instruments.

Broadly speaking, professionals compare the market's expected return distribution implied by current option prices to the historical realized return distribution to identify relative-value trading opportunities. Here is an example of what these distributions might look like:

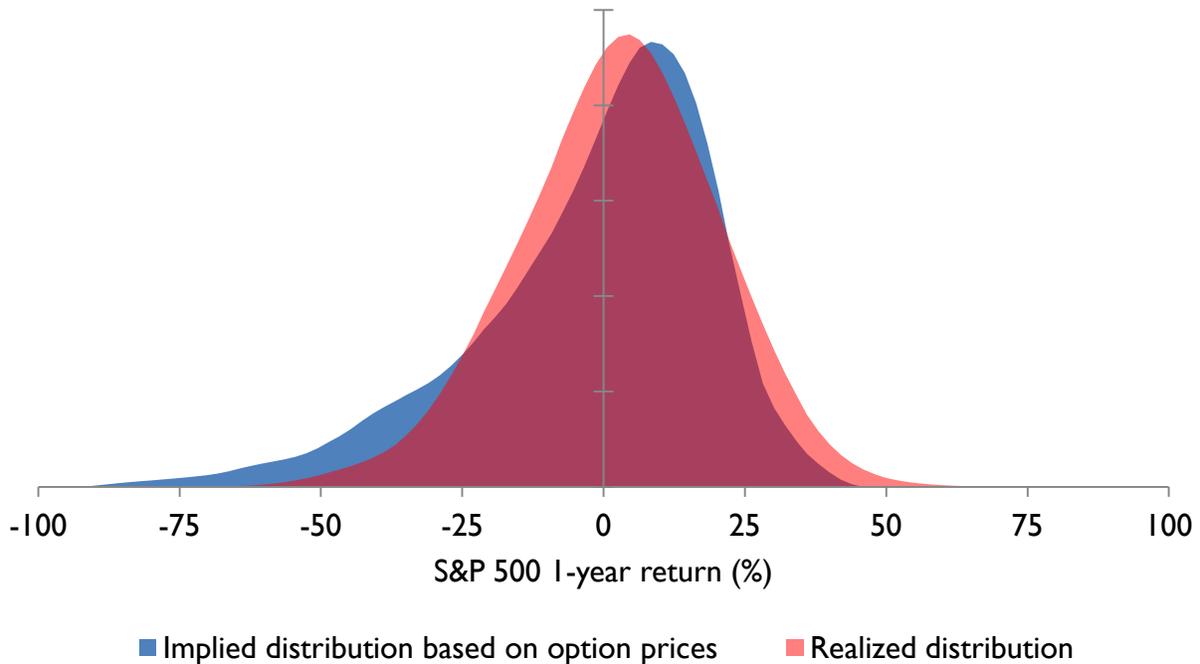


Figure 1: Comparison of S&P 500 1-year return distribution implied by option prices and the historical realized return distribution using data from 1950. Realized distribution is adjusted for dividends, interest rates and normalized to allow for a direct comparison to the options-implied distribution.

Edge can come from taking advantage of differences in the changing shape of the market's implied return distribution and the realized returns. Understanding the fundamental reasons why this edge exists does not ensure success on its own.

Investors must have a disciplined, well-thought-out strategy for implementing and harvesting the edge, and then stick to it, even in the face of uncertainty and chance events. This requires having systems in place designed with predefined risk limits to continuously maximize and maintain the edge. These systems should operate consistently under the same rules in the full spectrum of market environments, ensuring the discipline and not be overcome by human emotion and the pernicious "inducement to trade".

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