

# THE INVESTOR

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## Thought of the Month – Will Fund of Hedge Funds disappear over time?

Towards the end of last month, two separate institutions started publishing a series of indices tracking the Asian hedge fund market. This is clearly a move in the right direction. However, how is the market going to benefit from using these indices and how easy is it for anyone to interpret them? It seems that the ultimate objective of the index providers was which one will reach the finish line first as the data was released only one day apart. With more thought in constructing these indices, the market (or those who have access to the data) could come up with a number of creative applications that could prove beneficial to both investors and fund managers. However, as they stand, it is hard to find real substance in the numbers nor can users compare one index with the other as different methodologies are used. The intentions were right, i.e. to provide some insight into the overall performance of fund managers, but then again the picture is incomplete (no risk information), with limited use (*perhaps* just to calculate relative performance), and some of the index calculations are dubious at the very least (do median returns reflect better the true average of the industry?). Would anyone want to bet his or her money on these indices, which are being labeled as “benchmarks”?

Now let's assume for a moment that a truly representative index is constructed, for example based on capital weighted average returns (either from a sample of funds or the entire population) – a similar methodology used for most market indices. Once this index is recognized by the market as a true benchmark and is updated at least on a daily basis, it can then be listed on an exchange to be totally transparent to investors, fund managers and regulators. Since the index represents a pool of funds, it is assumed to be well diversified and can act as a proxy for any fund of funds portfolio. It could be traded by investors instead of buying into a fund of funds (bypassing all the management fees), used by individual fund managers to hedge or diversify their portfolios, and exchange traded derivatives such as futures and options could be created based on this index. If this idea materializes, will the market still need fund of hedge fund managers and would this mean the eventual disappearance of fund of funds?

## Why is the Sky Blue? – Why do so many people buy insurance?

Insurance of all sorts became so popular because the average individual does not like to take risk. Although the fundamental notion behind insurance is the same as a lottery, the main difference is that the potential loss can be significantly large. Individuals are not concerned if they lose the cost of a ticket in case they don't win however they are not prepared to incur a huge loss. They are willing to pay the premium in case something happens such as their house burns down, someone dies, or more recently with the introduction of options, if someone incurs a financial loss. Even with all the modern statistical and financial models, insurance premiums and options prices cannot be calculated with certainty, hence margins are added to account for errors and profits. Yet individuals still buy these products for the peace of mind even though they are paying more than what is considered to be a 'fair price'. The same evidence was recently witnessed with the popularity of capital guaranteed products.

## Nourishment – Risk Averse versus Risk Takers

It is a known fact that the majority of the population is risk-averse, except perhaps for the habitual visitors to Macau, Las Vegas and Atlantic City, or those who are paid for taking risk. We will not go into the details of explaining the full definition or mathematical theory behind what differentiates those who are risk-averse from risk-takers as this would take much more than a page or two. We'll stick with just the concepts and where they fit in the world of finance.

An economic theory was developed that explains the relationship between the level of wealth or amount of capital and the level of 'utility' or satisfaction. This relationship is generally non-linear and asymmetrical (be patient, we'll explain). That is, for a given percentage change in the level of wealth, utility does not change by an equal percentage (non-linear), and for equal positive and negative changes in wealth, the change in utility is not the same (asymmetrical). Let's use an example to explain this. If wealth decreases by 5%, the decrease in utility will not be equal to 5%, but let's say only 3%. On the other hand, if wealth increases by 5%, the increase in utility will not be equal to 3% - it may be lower or higher. This last point is what differentiates between someone being risk-averse and a risk-taker. A risk-averse person is one whose percentage increase in utility declines as wealth increases (it makes a smaller difference to his/her life) while for a risk-taker, the percentage increase in utility rises as wealth increases. Therefore, a risk-taker is highly induced to increase the level of wealth because the proportional increase in utility becomes much higher. To complete this argument, for someone whose percentage increase in utility remains constant as wealth increases is considered to be risk-neutral.

Risk-averse: for each successive 1% increase in wealth, utility increases by 1%, .9%, .8%,....

Risk-taker: for each successive 1% increase in wealth, utility increases by .8%, .9%, 1%,....

Where is this leading? When an individual is offered incentives for earning profits from his/her capital under management but not penalized for loss of capital, the game is definitely lopsided in favour of that player – any interest in preserving investors' capital could be lost. Furthermore, higher profits would only mean higher utility derived from bigger bonuses. This is the typical case with most traders where they are compensated for taking risk and under the current compensation schemes, they are induced to become even higher risk-takers as there is no risk of losing any personal wealth or utility. Taking this argument to the extreme, perhaps the only thing that stops a trader from risking the entire capital is the risk of losing the *potential* to earn further bonuses in the future or perhaps the possibility of seriously damaging their reputation in the market. However we have also witnessed cases where under desperate situations, traders have resorted to improper or extreme measures when trying to recoup losses and ended up losing vast sums of money if not the entire capital of the firm (some cases may still be fresh in our minds). Can this be prevented, and does it stop with traders?

Preventing someone from risking it all may not be easy, perhaps even if a company has tight internal controls. Possible ways of minimizing this biased attitude towards managing other people's money include changing the compensation formula, requiring traders and asset managers to put some of his/her own capital at risk, etc.. New compensation schemes need to be structured based on better performance measures that also take into account losses and risk, and that defer a significant portion of bonuses to partially offset any losses that might be incurred in the future. Traders and fund managers are compensated for their skills and to generate positive returns; however some means of deterrence needs to be introduced to dampen the level of a trader's aggressiveness and cause a trader's interests to become more closely aligned with his/her investors' interests. We don't want to restrict our case to traders and fund managers as other roles fall in the same category, such as stock analysts. It is well known that many stock analysts

are not neutral in their advice to investors but favour the position of their firm because their bonus depends on it. Can an analyst give a sell recommendation (or neutral as they often call it) when the firm has a vested interest in that stock and the analyst's bonus depends on the firm's earnings? This is just another typical case where we find a conflict of interest while the investor is left out in the cold. (One such case is currently under investigation in the US). We are also certain that it doesn't stop here – a number of other cases or examples can be provided which illustrate the same point. The examples mentioned above partially explain the dangers when the rules of the game and the payoffs are not consistent for all the players, i.e. a risk-averse investor against a risk-taking capital manager.

A footnote to the theory outlined above: it was first developed by John Von Neumann and Oskar Morgenstern in 1944, which was only a small part of a bigger field of study known as 'Game Theory'. Some of the restrictions were later relaxed and the theory was further developed by John Nash who was recently portrayed in the movie 'A Beautiful Mind'. This theory actually lends itself to a number of financial models / concepts, including CAPM, the efficient frontier, and the Black-Scholes option pricing model.

### [Feedback](#)

As always, we greatly appreciate your comments and feedback. We realize that our ideas and information might be cutting edge, futuristic kind of stuff or mysterious in some ways. E-mail us anytime at [help@financialcontrollimited.com](mailto:help@financialcontrollimited.com) if you would like a) for us to clarify anything, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services!