

# IAPF DC Seminar



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# Structure

- Disclosures & definitions
- Why most AR is unsuitable for DC Default
- Characteristics of 'optimum' DC Default
- Could any AR funds deliver?
- Experience
- The trustees' perspective

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# Disclosures

## Managed/Consensus as Default ?

- *not diversified enough*
- *risk profile too high*
- *lack of performance....."managed"?*

➡ other Default options badly needed

## Have written articles justifying AR within portfolios if:

- *well-managed*
- *properly-priced*

## Like GARS !



# Definitions-1

**Question:** What is Absolute Return?

**Answer:** A massive array of wildly different things

One well-accepted definition:

*“funds which employ different strategies in order to produce a positive return regardless of the direction and fluctuations of capital markets”*



# Definitions-2

- ❑ Official Definition– *European Securities and Markets Authority*

## Absolute Return

*“managed...under the constraint of a pre-determined risk limit”*

## Total Return

*“managed according to investment policies and/or strategies that pursue certain reward objectives”*

# Definitions-3

□ Clarus definition:

➤ *a fund/strategy operated to a volatility target*

AND

➤ *which has the capacity to take “short” positions*

□ What the market calls AR is a very broad church

➔ *Most of it not remotely suited for DC Default*

- Sub-‘institutional’ Managers
- Naïve gearing
- Risk parameters
- Charges
- Liquidity
- Focus on Alpha



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# Sources of Performance?

## □ Alpha

- *Logic suggests that adds to zero (gross)*
- *Hard to identify ex ante...little or no persistence*
- *Generally expensive*

## □ Beta

- *Lot of it out there.....will always be there*
- *Major sources are real in nature*
- *Can be harvested cheaply*

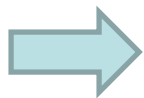
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# Profile of an Ideal DC Default?

1. Acceptable REAL return
2. Modest charges
3. Tolerable drawdowns
4. Does not expose trustees too much
5. Understandable to members



Very challenging for AR funds

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Equity-like returns with much lower volatility ?



Cash + 4/5% annualised over 3-5 years with low volatility ?



Absolutely would suit DC Default

**BUT**

**How likely??**

**These are very demanding objectives**

## Dow Jones Credit Suisse All Hedge Index

(Oct 2004 - Jan 2012)

	All	Global Macro	L/S Equity
Annualised return	2.5	1.6	-2.6
Standard Deviation	7.5	9.4	10.4
Correlation with WI	0.8	0.4	0.6
Worst month	-10.5	-14.0	-18.0

Note: This is an asset-weighted index – period shown is from inception (USD)

## HFRI Index Data-*to 31/1/12*

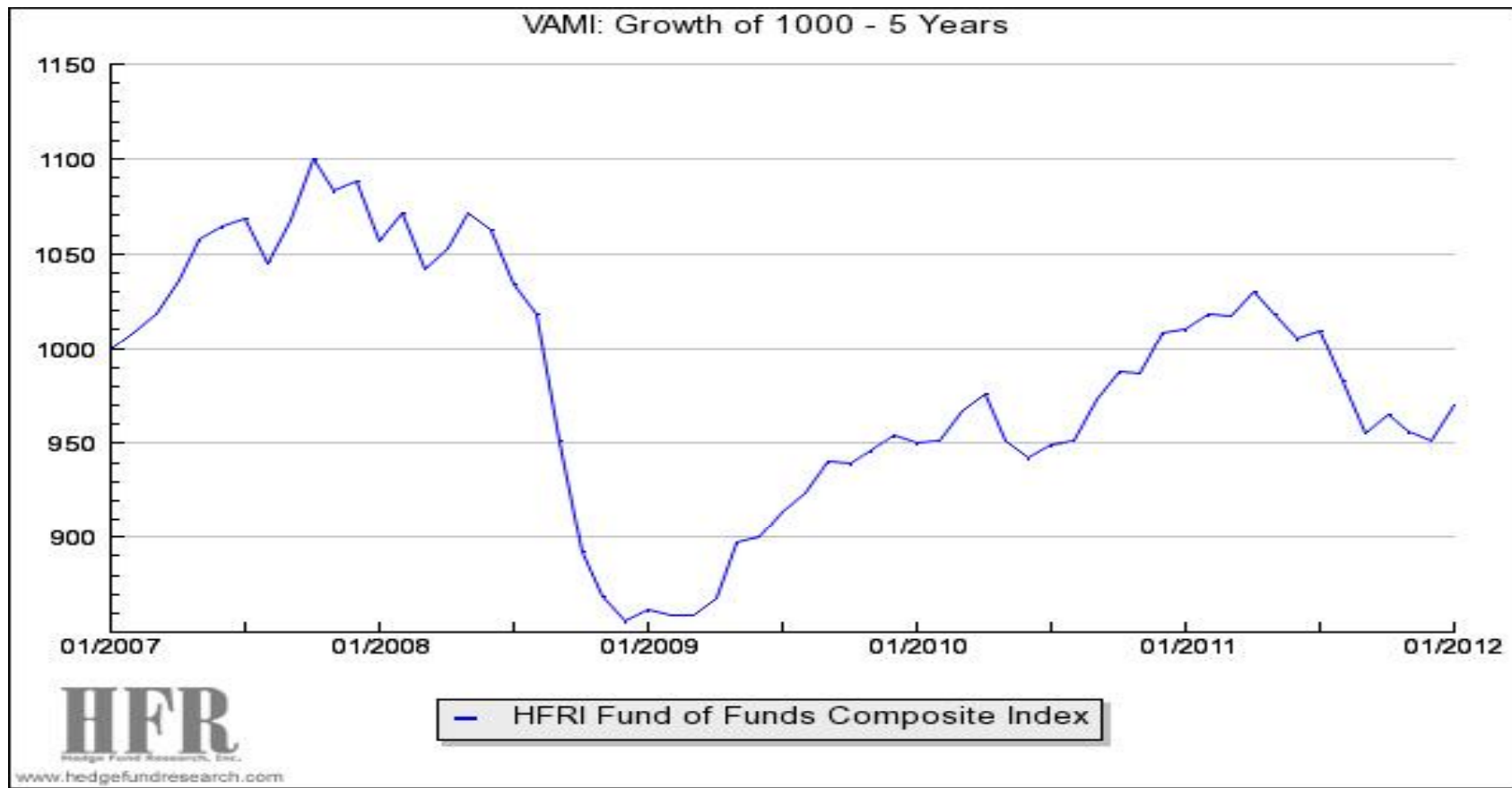
(% p.a.)

	3 Years	5 years
<b>Composite</b>	8.8	2.5
<b>Macro</b>	3.1	4.9
<b>Equity Market Neutral</b>	1.2	0.4
<b>Fund of Funds Composite</b>	4.0	-0.6

*Source: [www.hedgefundresearch.com](http://www.hedgefundresearch.com)*



- HFRI Fund of Funds Composite Index





# Reported Hedge Fund Returns

Major Issues are BACK-FILLING and SURVIVORSHIP bias:

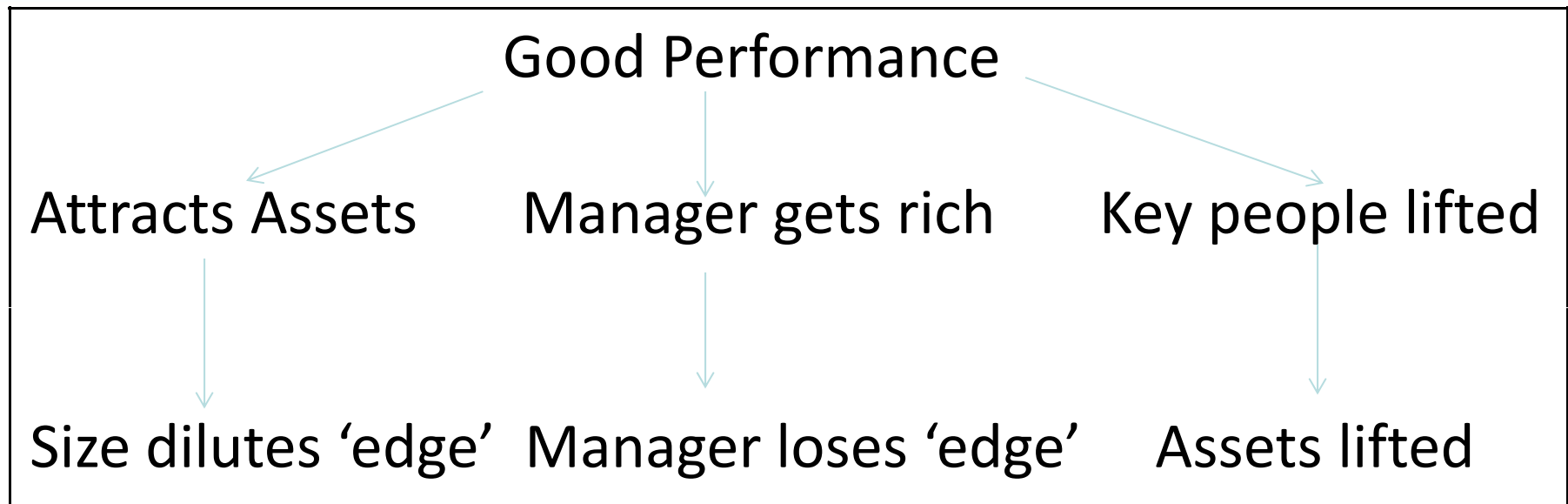
- ❑ Ibbotson, Chen & Zhu\* found that adjusting for above reduced reported returns by 6.6% PER ANNUM over 1995-2009
- ❑ Aiken, Clifford and Ellis\*\* found that
  - *“..the self selection bias in commercial databases is severe”*
  - *“...much of the previously documented skill of hedge fund managers can be explained by the upwardly biased returns data employed by researchers”*

\*"The ABCs of Hedge Fund Investing: Alpha Betas and Costs”(2010)

\*\*"Out of the dark: Hedge Fund reporting biases and commercial databases”(2011)



# Hedge Funds - Risks



- ❑ Large amounts of derivatives and high turnover present significant operational risks
- ❑ Quant processes meet the 'Fat Tail' event....(LTCM)

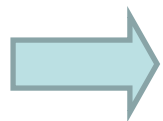


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# Trustee Perspective on AR as Default

❑ One actively-managed fund of any kind as Default  
quite high risk for Trustees

❑ For that to be a hedge fund even more challenging



Only a well-informed and very confident set of Trustees  
could even contemplate



# If Not AR What is Optimum Default ?

- ❑ What orthodoxy says one Default (bigger schemes) ?
  - *self assess/guide towards risk-graduated options*
  
- ❑ Guiding principles:
  - *properly diversified*
  - *emphasis on Beta*
  - *re-balanced*
  - *monitored*
  - *minimise cost*
  
- ❑ Until providers present suitable options, bigger funds should strongly consider “White Labelling” solutions



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# Conclusion

- Most AR funds hopelessly unsuitable as Default
- Some AR funds are candidates
- Performance objectives very demanding
- A very big 'ask' for trustees
- Might fit the bill but certainly **NOT** the optimum solution

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