MARKET TRENDS

Hedge fund strategies go mainstream

Quantitative research strategists at investment banks typically spend their time advising hedge fund clients. Monetising this capability and packaging it for retail and institutional clients has become the latest trend in the structured products market. Bhupinder Singh, head of structured rates Europe and Asia at Deutsche Bank, reports

In a search for alpha, investors have poured billions of dollars into hedge funds worldwide. Their intention is straightforward – pay a sophisticated asset manager to outperform the market. With the high returns that hedge funds were able to generate in the early part of this decade, it is little wonder that assets under management have more than doubled in the past three years.

However, proving the power of mainstream retail investors, the billions of dollars invested in hedge funds are dwarfed by the size of the global mutual fund industry. Mutual funds do not have the high minimum investment levels that most hedge funds use to 'filter' high net worth individuals with a risk appetite appropriate to such strategies.

Yet, for many mainstream investors, the techniques employed by hedge funds offer the potential for attractive returns and so the challenge for the mutual fund market is how to capture these techniques in a framework which allows the risk profile to be tailored appropriately to the end investors. Meeting this challenge could trigger the next big regime shift in the investment management space and potentially give investors with a range of risk appetites access to strategies with a range of risk profiles.

Investment banks have moved swiftly to fill this gap by creating customised alpha strategies with the protection features that should increase their appeal to mainstream clients. Investment banks have been able to do this, in part, due to their integration of quantitative specialists with trading and structuring teams.

This has facilitated the monetisation of investment techniques employed day to day by the banks with the incorporation of structuring techniques which provide principal protection and flexible payoffs. The resulting strategies are gaining sufficient momentum to give the product area a real following among investors.

The first alpha strategy to hit the marketplace was appropriately named the Forward Interest Rate Strategy (FIRST), which Deutsche Bank launched in 2004. FIRST is based on the idea that money market forward rates have a large propensity to over-predict future realised rates.

Analysing different money market forward rates from 1990, it emerges that trading the 12x15 forward rate would have been an intelligent way, in terms of risk-adjusted performance, to capture the forward bias. Deutsche has since launched the FIRST strategy in the shape of US dollar and euro-denominated indexes, allowing greater transparency to investors.

MORE COMPLEX STRATEGIES

While the strategy is a relatively simple, static alpha-generating position, it has been wrapped into an array of investment vehicles, delivering alpha in a range of options that are appropriate for retail investors. Combined, FIRST-linked products total a staggering notional of close to €2bn.

However, alpha is more transparently captured by dynamic strategies, and investors wanting to broaden their search for returns now appear to be embracing strategies that are vastly more complex than the simple FIRST. This is evident in the success of other fixed income strategies. Deutsche Bank, for example, has released a new fixed income index, dbSMART. This is the latest in the line of the bank's institutional fixed income research models which seek to extract alpha across the fixed income world. Such strategies are naturally suited to investment banks, as they rely on extensive technical and structuring expertise in alpha-generating products.

The philosophy behind such an index is to capture the direction of term premium, based on the observed behaviour of the yield curve in rate cycles. An intelligent filtering process seeks to time and implement dynamically steepening and flattening positions to capture and maximise alpha for investors.

The index is entirely quantitative and driven by research with no subjectivity involved in the decision-making process. The index is duration-neutral and therefore does not exhibit a strong correlation with the level of interest rates, since the dynamic nature of the long and short positions implemented within the index also leads to low correlation to slope levels.

Investors can access such an index through a variety of products including OTC derivatives, funds, notes, and certificates with many enhanced features such as principle protection which allow investors to tailor their exposure for their risk appetite.

GENERATING ALPHA IN A DIVERSIFIED PORTFOLIO

Alpha can be generated even in more conventional, diversified portfolios. For example, equities, bonds and gold have recently been combined into the db Momentum Index.

A typical balanced portfolio of equities and bonds benefits from diversification – bonds are countercyclical while equities are typically pro-cyclical. However, during periods when there is a flight to quality, such as macroeconomic and geopolitical shocks or bouts of global illiquidity, the correlation between equities and bonds tends to break down. Historically, during such periods of market distress, gold has been the asset of choice. The problem is that gold is typically a very expensive asset with relatively low yields over the long term.

To replicate and manage a physical portfolio of equities, bonds and gold can be extremely inefficient both with respect to the cost incurred and the time involved. However, by investing in this type of benchmark, investors have simple, cost-effective access to a dynamically managed portfolio in a single instrument.

A dynamic portfolio of three assets are represented, which provides the opportunity for optimised risk-adjusted returns. The key to the index is the implementation of a trend allocation mechanism which seeks to optimise the timing and extent of an asset allocation. Knowing when to allocate to gold, for example, can make a considerable difference in terms of performance. The index makes this choice, using gold only judiciously. Its underlying premise is a well-known trading principle – assets which recently performed well are likely to continue to perform well, and assets that underperformed are likely to continue to underperform. Using this momentum-based approach, db Momentum filters out most of the downturns in each asset class, delivering higher returns and improved Sharpe ratios than any of the underlyings over extended holding periods.

In fact, the beauty of such strategies is their remarkable simplicity, which leads many investors to question why they should not replicate the strategy on their own. Given the historical performance of the index, there is certainly a compelling case for such a portfolio concept. However, investment banks can wrap these strategies into tradable mutual funds, thereby offering investors access in a transparent, efficient and liquid manner.

For example, Deutsche Bank is providing value in the investor-friendly packaging of the index. The bank is providing implicit leverage into such alpha strategies by offering call options on the underlying index, wrapped as an outright warrant or a capital-protected note. It also offers Constant Proportion Portfolio Insurance alternatives as a more cost-effective means of managing any position in the index to optimise returns and maintain the capital protection or, possibly, to lock in gains.

In a challenging market environment across the asset class spectrum, some hedge fund managers have felt compelled to take positions that are not in their usual style in order to recover lost ground. For investors this can be a disadvantage of investing in an opaque black box. This is one reason why investors have flocked to alpha products offered by investment banks, in particular those based on transparent and time-tested, rule-based investing.

So, while more savvy investors' confidence in hedge funds is waning, the quantitative strategies used by some of the more disciplined hedge fund managers retain their appeal, due to their fully transparent format.

■ Past performance is not an indication of future performance