

HEDGE FUND APPROACHES

A sound background in derivatives and risk

Arié Assayag, global head of hedge funds at SGAM Alternative Investments, explains how forward-thinking fund management houses can use their belief in the convergence between hedge fund management and traditional asset management to generate business success

Those wealth managers and private clients interested in alternative solutions might be best advised to look at investing with a global provider, which can offer strategies in structured asset management, private equity, real estate and hedge funds, with adequate resourcing in terms of employee numbers and offices in US, European and Asian markets.

Key also to the expansion of a successful alternatives business is derivatives expertise and strong risk management. Forward-looking hedge funds groups should be able to pride themselves on their innovation and leadership in the development of products. At SGAM AI, these have included portable alpha, daily dealing funds, 'premium' funds and Ucits III funds for authorised European distribution.

At the end of the 1990s, when the SGAM AI hedge fund department was created, our vision was that the hedge fund industry was going to become more and more institutionalised, with the fund of hedge funds leading this change.

Some years later, this vision has evolved as expected: if we consider the 10 biggest managers in the fund of hedge fund business in terms of assets, six are banking institutions or asset managers. Besides, the annual flows invested in funds of hedge funds are mainly from institutional sources.

Looking forward, we expect the same trend to take place for the single strategy alpha generation and the top players must be ready to respond to

meet the new challenge.

To build our fund of hedge funds ranges and to ensure a solid foundation, we followed a three step strategic plan:

- construction of a world-class risk management platform
- demonstration of quality, sustainable performance
- innovation through expertise, resources and willingness to learn.

All this should be addressed with the aim of meeting the expectations of customers. Today, these three stages form a strong base for future growth.

WORLD-CLASS RISK MANAGEMENT

Investing in the hedge fund industry and building a suite of successful fund of funds solutions requires the set-up of a sophisticated risk management infrastructure. By nature, hedge funds encompass a large number of investment strategies involving various investment techniques that each come with the risk of blow-ups, volatile performance, and drawdowns.

Sophisticated risk management should be a core competitive advantage inherent in every aspect of the company culture. Our hedge fund group has dedicated specialised resources and rigorous control methods as part of its unmatched risk management infrastructure. These risk systems involve the careful analysis of all potential risks in every hedge fund strategy and the active implementation of thorough due diligence and risk monitoring processes.

Additional independent levels of analysis are also involved, using complex methods of stress-test to ensure worst case scenarios are carefully understood and controlled. About 30 staff are involved in the active monitoring and management of risk within SGAM, of whom three are specialised in hedge fund market risks.

Since its launch in 2000, SGAM AI's fund of funds programme has seen impressive performance results and successfully leveraged its institutional quality risk systems to ensure an unblemished track record. None of the funds selected and invested by the hedge fund group – totalling more than 100 – experienced a major incident during the period.

SUSTAINABLE AND QUALITY PERFORMANCE

For us, the construction of a high-performing and stable product range requires mastering the knowledge and experience involved with the evolution of a hedge fund within the industry. The solution to create and manage a kind of proxy of the overall industry, is not sustainable and adds very little value creation (see figure 1). With factors such as increasing inflows of capital and new hedge fund players, the average performance of the industry is likely to continue to decline, as has been observed in the past couple of years. For these reasons, SGAM AI never considered this option as one worth pursuing for the end investor.

We made this report early in 2002 and then opted rather for the construction of a fund of funds range targeting the high and sustainable sectors of value creation in the industry. The analysis of the lifecycle of a hedge fund, illustrated in figure 2, led the group to launch new products with a specific positioning.

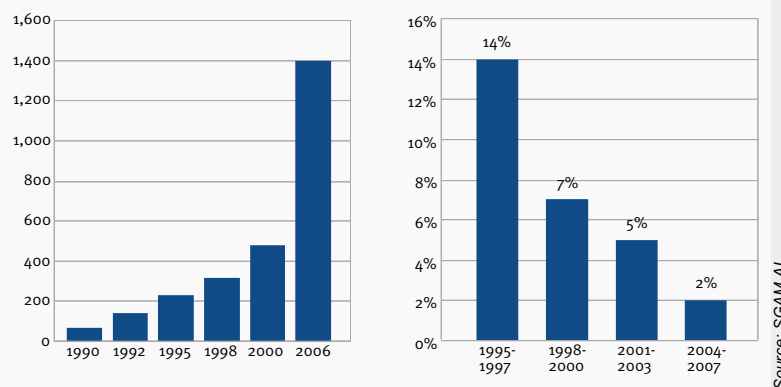
In the year 2003, our hedge fund group developed and launched a strategy targeting the premium bucket. The fundamental element behind this strategy rested on the development of strategic relations and the creation of capacity with the most renowned hedge funds which are for the greater part closed to new investments. This strategy was fruitful and SGAM AI was able to secure about 20 underlying managers, all benefiting in the industry of the status of premium manager.

Thanks to its positioning, the strategy unsurprisingly generated a gross annualised performance since inception of 13.4 per cent (footnote 1), with a Sharpe ratio of 2.33 and a maximum drawdown limited to 2.56 per cent. The strategy – and behind it, the philosophy – was a great success with investors and was closed in the year 2006 with \$2bn under management.

Another area of high and sustainable performance was to develop expertise in the identification and incubation of future ‘premium’ managers. In 2005 we created an innovative private equity investment vehicle with the objective of setting up partnerships with high-quality emerging hedge fund managers with great potential, in exchange for support during their first phases of development.

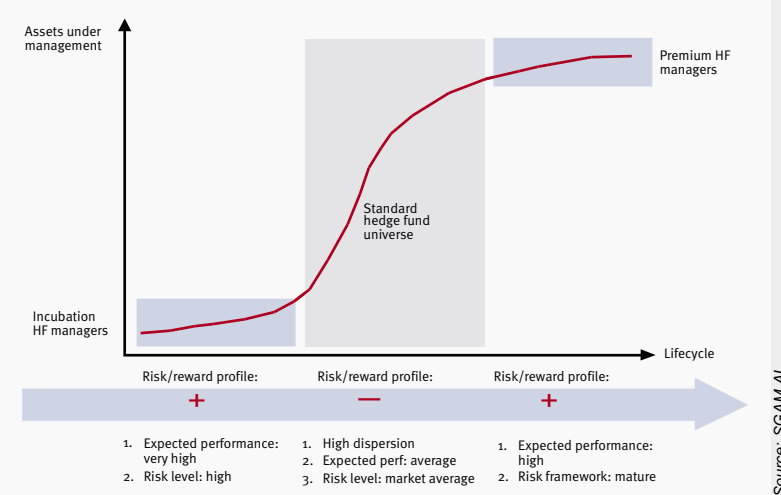
The fundamental theme behind the creation of the fund is partnering and participating in the evolution of a successful emerging manager and eventually to have him or her become an ideal candidate for a range of other group products. Such an incubation programme

Figure 1: Hedge fund market assets Excess return over risk-free rate



Source: SGAM AI

Figure 2: Hedge fund lifecycle analysis



Source: SGAM AI

can be open to investors who are keen to participate in the development and profitability of emerging talent.

INNOVATION FOR NEW INVESTMENT SOLUTIONS

Many investors who are seeking access to the premium hedge fund segment of the market are faced with the problem of lack of extra capacity. Over time, strong strategic relationships with some of the world’s most renowned managers enabled us to participate closely in the discussions leading to the evolution of these managers.

SGAM AI paid particular attention to the launch of new long-only equity strategies during the course of 2004/2005, which created a new silo of capacity giving access to these premium managers. It was at

this time that it was decided to pursue a new strategy focused on the convergence of the hedge fund industry with traditional asset management, with the belief that the hedge fund industry, which up until now had been considered as a standalone asset class, was in fact going to become a ‘regular’ management style within the world of asset management.

The focus would shift into identifying the alpha generated by the hedge fund industry and tailoring it in a package that satisfied investor needs. This focus on convergence logically leads to the development of a product offering, partly based on the concept of portable alpha and the launch of dedicated vehicles.

Such an investment vehicle can typically have an absolute return

objective based on the alpha extraction process, which consists of extracting the alpha generated by the best long-only equity hedge fund managers through the use of hedging instruments.

To generate portable alpha, a series of steps needs to be taken:

- identify the alpha generated by the manager versus the performance resulting from the underlying market
- to extract this alpha
- to combine various sources of alpha to obtain optimal diversification.

Implementing this concept correctly is a challenge that our hedge fund group has managed to overcome by not only being able to identify the sources of strong and stable alpha but also to develop effective 'all weather' extraction techniques.

It is important in this area, not just to manage money, but to act as pioneers in the research of financial theory and in the innovation of portable alpha. Although there are various ways to define alpha, the basic concept of a manager's out-performance relative to a given index is no longer valid.

The portable alpha strategy is managed via an active allocation of the investor beta and the risk beta, an allocation which aims to create an optimal hedging structure level. In addition, and to minimise downside risk in situations of market stress (or increased volatility), we have added additional expertise with the use of a volatility arbitrage technique, which is one of the core building blocks of the single strategy being developed

by our group.

The combination of the core expertise of the SGAM AI hedge fund group has produced very satisfactory results, with the strategy generating a gross annualised performance since inception of 12.3 per cent (footnote 2), with a volatility of 6.3 per cent.

Once the alpha has been extracted from its original strategy, it can easily be transferred to another portfolio to fulfill a specific target. For example, SGAM AI has recently launched a new product to satisfy investor demands including a strategy which is porting the alpha of the long-only equity managers to the Lehman Brothers Inflation UK bond index. More specifically, the strategy's target is to provide 200bps of alpha on top of the Lehman Index with a tracking error of less than 1.5 per cent.

With the strong belief in the convergence between hedge fund management and traditional asset management, we developed and launched long-only products, offering exceptional sources of hedge fund alpha to a large number of investors by using traditional vehicles of investment.

Such a launch at SGAM AI involved the creation of an umbrella unit trust – sicav part 1 – which gives access to three long-only equity strategies managed by Renaissance, Caxton and Highbridge. These unit trusts involved high-quality financial engineering, which allowed adapting the characteristics of the hedge funds to the format of a Ucits III sicav.

Currently three US equity funds

are available and other funds covering regions such as Europe and Japan will follow. These vehicles offer a daily or weekly liquidity to the investors and require a minimum of investment of \$1,000. The creation of these innovative vehicles gives clear and practical evidence of the convergence between hedge funds and the traditional money management.

SGAM AI's hedge fund products have developed themselves successfully since the creation of the department in the late 1990s. Thanks to a strong management strategy based on the main axes of potential in the hedge fund industry, we have now anchored ourselves around strong expertise and can continue to consistently create innovative investment solutions for profitable wealth management.

Footnote 1: This performance corresponds to the gross performance of the premium fund of hedge fund composite which groups together all strategies managed by SGAM AI and pursuing similar investment strategy.

Footnote 2: This performance corresponds to the gross performance of the portable alpha premium composite which groups together all strategies managed by SGAM AI and pursuing similar investment strategy.

SGAM AI is part of the Firm "SGAM" which claims compliance with the GIPS standards (Global Investment Performance Standards) for the period from 1 January 1994 to 31 December 2005. The firm has been verified for this period by Ernst & Young Corporate Finance. Copies of the verification report and of the full premium fund of hedge fund composite report are available upon request to: hedgefunds@sgam.com.



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Alternative Investments



SGAM Alternative Investments (SGAM AI) is a wholly-owned subsidiary of Société Générale Asset Management. SGAM Alternative Investments has developed successfully by combining active asset management processes with a capital market culture that mixes innovation and risk management. With €42.7bn in assets under management at 30 September 2006, 314 employees worldwide and the strategic and financial backing of Société Générale Group, SGAM Alternative Investments has become one of the leading global specialists in alternative investments. SGAM Group as a whole (SGAM AI, TCW and BAREP) manages €55bn in alternative investments assets as at 30 September 2006.