

HEDGE FUNDS

Hedge fund strategies go mainstream

Quantitative research strategists at top 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, says Bhupinder Singh

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, testament to the power of mainstream retail investors, these billions of investment dollars 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. Clearly, if this barrier was removed, it 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.

Moving swiftly to fill this gap, and give alpha strategies the packaging and protections that should increase their appeal to mainstream clients, investment banks have rushed to the task. While, traditionally, knowledge of hedge fund strategies has been only the purvey of quant research groups, the bank has now moved the quants out of research and into trading and structuring teams. This takes the concept of research monetisation one step further and



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the resulting alpha strategies are gaining sufficient momentum to give the product area a real following among investors.

The first alpha strategy to hit the market 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 12 x 15 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 indices, allowing greater transparency to investors. While the strategy is a relatively simple, static alpha-generating position, it has

been wrapped into an array of complex derivatives, delivering alpha in a range of options that are eventually offered to retail investors. Combined, First-linked products total a staggering notional of close to €2bn.

COMPLEX STRATEGIES

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. Deutsche Bank's Fixed Income Research Monetisation (Firm) fund searches for potential trades in nine different currencies and exploits mean-reversion tendencies of cross-currency far-forward rates.

Fundamentally, far-forward rates are determined by market fundamentals – expectations of trend growth, expectations of trend inflation and a risk premium. With the growing influence of globalisation, far-forwards are increasingly subjected to the same shocks. Consequently, developed countries' cross-country spreads have become reliable mean-reverting trades as their economies are simultaneously affected by soaring oil prices, the emergence of China and India, the war on terror, global excess liquidity, runs on real assets, and so on.

The Firm trading algorithm benefits from this co-movement by selecting the top two such spread trades once a week. These trades

are chosen based on stringent stability, diversification and ex-ante Sharpe ratio thresholds.

Due to its complex methodology, Firm has an extremely low correlation – either close to zero or significantly negative – to traditional asset classes and to alternative asset classes. This gives it broad appeal as a means of increasing the risk-adjusted returns of almost any portfolio of assets.

GENERATING ALPHA

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 procyclical. However, during periods when there is a flight to quality, such as macroeconomic and geopolitical shocks or bouts of global liquidity, the de-correlation between equities and bonds tends to break down. Historically, during such distress scenarios, gold has been the asset of choice. The problem is that gold is typically a very expensive asset with relatively low yields in the long term.

From a correlation point of view, holding a portfolio of all three assets seems to increase risk-adjusted returns significantly, but at a significant cost. Knowing when to allocate to gold can make a considerable difference in terms of performance. The DB

Momentum index makes this choice, using gold only judiciously. Its underlying premise is a well-known trading principle – assets that 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 strategy is so remarkably simple that many investors have questioned 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 are wrapping these strategies into various different mediums. 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 DB Momentum to optimise returns and maintain the capital protection or, possibly, to lock in gains.

In an environment where hedge fund after hedge fund has posted

poor results in almost every asset class and where managers are compelled to take positions that are not in their usual style in order to recover lost ground, some investors are questioning the merits of an investment strategy that is an opaque black box.

Consequently, in their never-ending search for yield, investors have flocked to alpha products, 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.

In fact, a key component of First, Firm and Momentum has been a Bloomberg published index, with clearly explained index rules governing performance. The mass proliferation of asset managers and their historical track record has failed to take value away from transparent rule-based investing. It is these rule-based investment strategies – strategies that could be replicated by sophisticated fund managers – that are a true alternative, offering historically superlative returns within a better risk profile. Now these strategies can also be offered in a variety of different formats, with leverage, full or partial principal protection and so on, increasing the appeal of alternatives by tailoring their risk profiles specifically to client needs. **Past performance is not an indication of future performance.*

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