WILEY FINANCE

Asymmetric Returns

The Future of Active Asset Management

Alexander M. Ineichen

Additional Praise for Asymmetric Returns

"The book is comprehensive and provides a very good overview on issues that many institutional investors are currently facing. The examples used throughout the book are as helpful as they are entertaining."

—Kurt Silberstein, Portfolio Manager, Absolute Return Strategies, California Public Employees' Retirement System

"In Asymmetric Returns, Ineichen advances the practice of active management by distilling the essential elements of the craft from the pedestrian pursuit of index-tracking strategies. Broadly expanding on his seminal work, In Search of Alpha, this treatise is resplendent with assessable facts and reasoning that will recalibrate the focus and attention of thoughtful investors."

—Bryan White, Chief Investment Officer, Quellos Group, LLC

"Once again, Alexander Ineichen is at the forefront of observations about the industry. . . . a must read for investors and asset managers alike!"

—Tanya Styblo Beder, CEO, Tribeca Global Management LLC

Asymmetric Returns

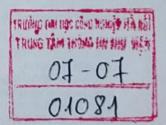
The Future of Active Asset Management

ALEXANDER M. INEICHEN



GIFT OF THE ASIA FOUNDATION NOT FOR RE-SALE

QUÀ TẶNG CỦA QUỸ CHÂU Á KHÔNG ĐƯỢC BÁN LẠI





John Wiley & Sons, Inc.

Copyright © 2007 by Alexander Ineichen. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey. Published simultaneously in Canada.

The documents "Fireflies before the Storm" © 2003, "European Rainmakers" © 2004, and "The Critique of Pure Alpha" © 2005 are © UBS AG, and extracts from these documents are used with the permission of UBS AG.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4470, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030. (201) 748-6011, fax (201) 748-6008, or online at http://www.wiley.com/go/permission.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic formats. For more information about Wiley products, visit our Web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Ineichen, Alexander M.

Asymmetric returns : the future of active asset management / Alexander Ineichen.

p. cm.—(Wiley finance series)

Includes bibliographical references and index.

ISBN-13: 978-0-470-04266-3 (cloth)

ISBN-10: 0-470-04266-4 (cloth)

1. Investment analysis. 2. Investments. 3. Hedge funds.

I. Title.

HG4529.I54 2007

332.6-dc22

2006020137

Printed in the United States of America.

10987654321

Contents

Preface Programme Pr	Xi
Acknowledgments	XV
CHAPTER 1	
Survival of the Richest — Volatility Matters	1
The Future of the Asset Management Industry	2
Change in Risk Perception	2
Living Legends on the Future of Investment Management	7
Defining Asymmetric Returns	2 2 7 9
Introduction	9
Background	11
Volatility Matters	13
The Thing about Compounding Capital	13
Evolution Is Jumpy, Not Smooth	17
Chapter Summary and Conclusions	19
Appendix: On Compounding, Survival, and Dull Swiss	20
CHAPTER 2	
Risk and Transparency	23
Risk Is "Exposure to Change"	23
The Boiling Frog Syndrome	23
Risk versus Knightian Uncertainty	26
Prevention versus Cure	28
Risk Measurement versus Risk Management	31
The Musical Chairs Effect	32
Tracking Risk versus Total Risk	35
Controlled versus Uncontrolled Risk	37
Investor Protection versus Capital Protection	49
Investor Protection	50

viii	CONTENTS
AIII	

Systematic versus Nonsystematic Risk	55
Systematic Risk	56
Nonsystematic Risk	57
Chapter Summary and Conclusions	61
CHAPTER 3	-
The Price of Asymmetric Returns	65
Fees—An Evergreen Issue Revisited	66
Introduction	66
Paying for the Balancing Act	71
Paying the Milkman Thrice	75
To Pay or Not to Pay—That Is the Question	77
Asymmetric Returns through Derivatives	92
Introduction	92
Capital-Guaranteed Structures	93 105
Chapter Summary and Conclusions	
Appendix: Aggregate Fees	106
CHAPTER 4	110
Fireflies before the Storm	
Risk, Returns, and Market Efficiency	111
Active versus Passive Asset Management	111 115
Introducing a Flexible Approach to Managing Money	113
Time Diversification, Risk, and Uncertainty	117
Does Time Increase or Reduce Risk?	117
Tyranny of the Status Quo	121
Chapter Summary and Conclusions	123
Appendix: On Volatility and Fat Tails	123
CHAPTER 5 Alpha is an Option	131
Inefficiency of Financial Markets	131 134
There Is No Free Lunch Plan	
Unorthodox Economics and Voodoo Science Introduction	136 136
	140
Praxeology Reflexivity	142
Behavioral Finance	146
Chapter Summary and Conclusions	153
Appendix: On Alpha, Beta, and Randomness	153
Triplia, Deta, and Kandomness	100

CHAPTER 6 Active Risk Management	164
Applicability and Adaptability of Skill	
Adaptability versus Style Drift	165
The Law of Active Management	166 167
Leverage as a Risk Management Tool	169
Three Ways to Use Leverage	172
The Art of Generating Alpha	174
Asymmetric Returns and Active Risk Management	174
Convertible Arbitrage	175
Equity Market Neutral	180
Distressed Securities	182
Event-Driven Multi-strategy	186
Equity Hedge	191
Sector Specialists	198
Macro	203
Chapter Summary and Conclusions	206
Appendix: The Random Approach to Manager Selection	207
CHAPTER 7	
Asymmetry of Single-Manager Risk	216
Convertible Arbitrage	217
Global Macro	227
Chapter Summary and Conclusions	238
CHAPTER 8	
Asymmetric Returns as a Business	240
Introduction	240
The Best Business Model—Ever	242
Departing from Randomness	244
Positive Compounding as a Major Business Objective	246
Honey, I've Shrunk the Margins	250
Competition Puts Pressure on Margins	250
The Role of Innovation and Marketing	252
Performance Attribution and Fees	254
Alpha? What Alpha?	256
Intellectual Property versus Adaptability of Skill	257
Difference between Generating Alpha and Talking	
about It	260
Are Benchmarking and Financial Innovation	
Opposites?	264

Chapter Summary and Conclusions	266
Appendix: Predicting the Future of the S&P 500	269
CHAPTER 9	070
The Past, the Present, and the Unpredictable	278
Is It a Bubble?	278
Cyclical Versus Structural Change	279
Return Expectations Revisited	284
What Happened to the Long Term?	285
Markets Will Continue to Fluctuate	300
Probabilistic, Dynamic, and Flexible Approach	307
Future Opportunity Set for Active Risk Managers	308
Return Update and Outlook	311
Closing Remarks	314
Notes	318
References	321
About the Author	330
Index	331