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## PRACTITIONER'S DIGEST

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### **HEDGE FUND BETA REPLICATION: A FIVE-YEAR RETROSPECTIVE**

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*Peter A. Lee and Andrew W. Lo*

The concept of “beta” in modern financial economics has its roots in Sharpe’s (1964) Capital Asset Pricing Model (CAPM), and despite the many theoretical and empirical critiques leveled against the CAPM, its fundamental insight—that, in equilibrium, there is a trade-off between systematic risk and reward—is still firmly ensconced in financial theory and practice. This trade-off is captured by the “risk premium”, the excess expected return needed to compensate investors for bearing systematic risk. The best known example of such a risk premium—but not the only example—is the one associated with the aggregate stock market such as the S&P 500. Dynamic and multi-factor generalizations such as Merton’s (1973) Intertemporal CAPM and Ross’s (1976) Arbitrage Pricing Theory provide theoretical support for other risk premia. Credit risk, illiquidity risk, currency risk, macroeconomic risk, and political risk are examples of non-diversifiable risks that have historically generated positive expected returns. Moreover, in measuring the value-added of professional portfolio managers, Sharpe also gave us the means to attribute their performance to component factors, which has come to be known as “style analysis”.

These innovations naturally imply that the returns of highly complex investment strategies may possess multiple sources of systematic risk, each commanding a positive risk premium of its own to reward investors for willingly exposing themselves to such risk. This implication was empirically confirmed by Hasanhodzic and Lo (2006, 2007) using the returns of individual hedge funds. Since then, hedge-fund beta replication strategies have captured these “alternative betas” by measuring the most important risk factors driving hedge-fund returns and garnering their risk premia by investing in liquid futures and forward contracts. However, the recent underperformance of the hedge-fund industry has raised a number of questions about the relevance, performance, and practicality of these strategies.

We present a review of the growing beta replication industry with particular emphasis on the five-year history of the ASG Global Alternatives Fund. We discuss the motivation for its existence and the logic of its absolute and relative performance over time and across different market environments. We also explain why these strategies are complements to, and not substitutes for, direct investments in hedge funds, and provide examples of their value-added in investors' portfolios.

Hedge fund beta replication offers investors a new set of choices that fill a gap between traditional and alternative investments, and may eventually become the de facto investable benchmarks for the hedge-fund industry. As financial markets become broader in scope, deeper in liquidity, and more highly interconnected, we believe that replication techniques can enhance risk-sharing and capital formation while enabling investors to stay invested for the long run.

## **A RULE-BASED COMMODITY INDEX**

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*John M. Mulvey*

Over the past few years, the index domain has expanded to include rule-based investment strategies. These indexes and their underlying funds promise improved performance over traditional, static, cap-weighted indexes and can be employed as benchmarks for selected classes of active managers. It is clear that many active managers conduct their affairs with an eye to capitalizing on longstanding patterns in price movement. The “passive” indexes seek to replicate these patterns by following sets of decision rules.

In this paper, we construct an equal weighted portfolio of four well-established tactics in commodity markets. Rebalancing is conducted monthly for ease of implementation. Commodity markets are characterized by relative independence of returns, high volatility, and the ready ability to go long or short via the futures markets. Two of the core tactics are long only—momentum and term structure, whereas two of the core tactics are long short—trend following and breakout. The former maintains a long tilt so that the portfolio is partially hedged against risks such as a war in the Mideast over oil. The latter cushions the portfolio during crashes and other extreme events.

The commodity conditions are perfect for harvesting rebalancing gains and for achieving excellent overall portfolio performance. Since futures markets are employed for realizing the index in an investment vehicle, the index can be implemented as an overlay strategy. Importantly, the returns of the commodity index are close to additive since the correlation of the index with stock and bond returns is approximately zero. Extensive empirical results show the benefits of the commodity index over varying market conditions.

## **LARGE PRICE CHANGES AND SUBSEQUENT RETURNS**

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*Suresh Govindaraj, Joshua Livnat, Pavel G. Savor and Chen Zhao*

Our study divides large price movements into two groups: those that are induced by new information and those that are not. As our proxy for information releases, we examine whether analysts revise their

earnings forecasts or target prices on the day of the large price change or within the next five days. Validating this approach, we show that large price-change days that are followed by analyst revisions are twice as likely to be associated with newspapers articles, firm press releases, or Form 8-K filings relative to other large price-change days.

The main findings of our study are: (1) When large price movements are not accompanied by immediate analyst revisions, we document reversals for large price increases, and continued downward drift after large price decreases over the next three months. Thus, value managers who wish to exploit price reversals should be wary of large price decreases and possibly delay their purchases. (2) When analysts revise immediately after a large price swing in the same direction as the price change, subsequent excess returns exhibit momentum; and (3) A trading strategy that takes long positions in stocks with large daily price increases and immediate positive analyst revisions and short positions in stocks with large price decreases and immediate negative analyst revisions earns abnormal returns in excess of 100 basis points per month. These returns are larger than a pure reversal strategy (without conditioning on information) that takes long positions in stocks with large price decreases and short positions in stocks with large price increases.

## **DILUTION OF SECTOR EXPOSURES: WHEN DOES UNINTENDED INDEXING HAPPEN?**

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*Michael Stein and Svetlozar T. Rachev*

Exchange-traded funds (ETFs) are now an established part of the asset management industry, and in portfolios are often used to efficiently manage sector, country and asset class exposures. However, it is of highest importance for decision-makers to keep track of their exposures and to monitor the indirect compositions they obtain when selecting ETF investments.

This study shows that investors may include several sectors without too quickly replicating the broad index composition, but that the effect of co-movement by the respective portfolios is understated when only the composition basis is monitored. Thus, unintended indexing dilutes the chosen sector exposures at already low numbers of included sectors, and the study shows that this result is robust over time and market phases.

The results have strong implications for investors, calling for an analysis of portfolio return dependence to the broad market index, rather than focussing on portfolio weights solely.

## **CORPORATE CREDIT LIMITS FOR FIXED INCOME PORTFOLIOS**

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