
PRACTITIONER'S DIGEST

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THE SUPPLY AND DEMAND OF ALPHA

PAGE 4

Harry Markowitz, Robert Snigaroff and David Wroblewski

Based on a large sample of financial products sold to institutional investors we find that, as expected, the demand for any such product increases with its historic alpha, but the ability of the money manager to deliver alpha declines with increasing AUM (Assets Under Management). Specifically, on average for this large sample, the ability to supply alpha goes from positive to negative at about \$300 million, a relatively small product size.

One can use the fitted supply and demand curves to compute an equilibrium excess return and product size, but simulation analysis shows that the model converges to this equilibrium very slowly as compared to a product (or human) lifetime. Also, random repetitions show that the size and past performance of a product after, e.g., a decade is remarkably dependent on the “luck of the draw.”

THE NATIONAL TRANSPORTATION SAFETY BOARD: A MODEL FOR SYSTEMIC RISK MANAGEMENT

PAGE 17

Eric Fielding, Andrew W. Lo and Jian Helen Yang

We propose the National Transportation Safety Board (NTSB) as a model organization for addressing systemic risk in industries and contexts other than transportation. When adopted by regulatory agencies and the transportation industry, the safety recommendations of the NTSB have been remarkably effective in reducing the number of fatalities in various modes of transportation since the NTSB’s inception in 1967 as an independent agency. The NTSB has no regulatory authority and is solely focused on conducting forensic investigations of transportation accidents and proposing safety recommendations. With only 400 full-time employees, the NTSB has a much larger network of experts drawn from other

government agencies and the private sector who are on call to assist in accident investigations on an as-needed basis. By allowing and encouraging the participation in its investigations of all interested parties who can provide technical assistance to the investigations, the NTSB is able to produce definitive analyses of even the most complex accidents and provide genuinely actionable measures for reducing the chances of future accidents. We believe it is possible to create more efficient and effective systemic-risk management processes in many other industries, including the financial services industry, by studying the organizational structure and functions of the NTSB.

By examining the structure and functions of the NTSB, and studying a specific accident investigation in detail, we observe five major factors that seem to characterize the agency's success: (1) the governance structures that give rise to the agency's impartiality and singular focus; (2) the investigative "Go Team" as a cohesive unit; (3) the collective intelligence of the NTSB's "party system"; (4) effective media relations; and (5) employee satisfaction. While some of the NTSB's practices are indeed specific to the transportation industry, we believe that the independence, objectivity, and credibility that this small but powerful agency exemplifies are essential elements that can be adapted to other industries, including financial services.

The complexity of the financial system now rivals that of the most technologically sophisticated industries, and truly systemic "accidents" are an unfortunate consequence. This state of affairs is part of a much broader trend in which technological innovation is a double-edged sword that is responsible for great prosperity, but has also created unintended consequences and systemic vulnerabilities. The most sophisticated technologies often require equally sophisticated coordination among individuals with highly specialized skills, but the institutional and organizational structures needed to support that level of coordination have not always kept pace, especially during periods of rapid growth and innovation. As systems become more complex, the number of points of failure inevitably also increases, and even the most experienced and intelligent individual cannot comprehend all possible failure scenarios with proactive risk analysis. Accordingly, in-depth investigation of failures and collaboration on systemic remedies are essential to reducing the chances of catastrophe. Accidents happen in virtually every technologically advanced endeavor, but we need not compound our mistakes by failing to learn from them. The NTSB's example provides a compelling alternative.

HAS HEDGE FUND ALPHA DISAPPEARED?

PAGE 50

Manuel Ammann, Otto Huber and Markus Schmid

The amount of capital invested in the hedge fund industry increased significantly during the period 1994 to 2008. An expected consequence of this development is a decrease in hedge fund alpha. As new money flows into the hedge fund industry, managers might be forced not only to invest into the most profitable strategies but to opt for less attractive investments or diversify to other strategies, where their knowledge and experience might be limited. There might be only a limited dollar amount of alpha in the market to be shared among more hedge funds. In fact, a recent stream of literature provides empirical evidence consistent with this line of reasoning. Specifically, these studies suggest that hedge fund alpha has been decreasing over time, in particular from 2000 to 2004. Moreover, these studies

document increasing capital inflows into the industry over the same time period and conclude that the declining alpha is due to decreasing returns to scale caused by capacity constraints and/or unscalability of managers' skills.

In this paper, we contribute to the existing literature by investigating hedge fund alpha based on a recent and comprehensive data set compiled from Lipper/TASS covering the time period from January 1994 to September 2008. We employ two alternative factor models to assess hedge fund performance. In the first factor model, we select the risk factors based on a stepwise regression approach procedure attempting to determine the statistically optimal combination of risk factors to be included in the factor model. We compare the results from this stepwise regression approach to those obtained by the widely used seven-factor model proposed by Fung and Hsieh [Fung, W. and Hsieh, D. A., 2004, Hedge fund benchmarks: A risk based approach, *Financial Analysts Journal* 60, 65–80]. In the factor model based on stepwise regression, we account for the possible non-linearity of hedge fund returns by including option-based return factors and lookback straddles in the set of potential risk factors. By estimating the factor exposures based on rolling-window regressions, we apply these factor models as a time-varying benchmark for the returns of equally-weighted and value-weighted hedge fund strategy indices and single hedge funds.

Our results indicate that hedge fund alpha has been positive on average irrespective of the factor model used. In addition, and unlike previous research, we find no systematically decreasing alpha in the hedge fund industry over time. We also find no evidence pointing to capacity constraints in the hedge fund industry over the full time period from 1994 to 2008. While the findings over the time period from 1994 to 2001 are consistent with prior research and suggest capacity constraints at the single fund level, the results for the more recent sub-period from 2002 to 2008 suggest a positive relationship between fund flows and future alpha. Consequently, our results suggest that there are either no capacity constraints at the single hedge fund level or that such capacity constraints are time-varying.

DECENTRALIZED DOWNSIDE RISK MANAGEMENT

PAGE 72

Andrea Reed, Cristian Tiu and Uzi Yoeli

We propose a risk management methodology which simultaneously decomposes the risk of a portfolio across assets as well as across investment decisions, thus separating market risk (which cannot be managed) from the risk generated by the decision to invest (which can be managed). This decomposition methodology is applicable to decentralized investors such as pensions, endowments, mutual funds or multi-strategy hedge funds. We particularize our risk decomposition methodology to downside risk, for which we provide a novel additive decomposition. Finally, we apply our methodology to a sample of U.S. Endowment Funds and find, among other things, that investing in alternatives and active investment management reduce a fund's downside risk from a given payout level, but that the risk reducing capability diminishes when payouts increase.