

**THE PENSION INVESTMENT ACADEMY
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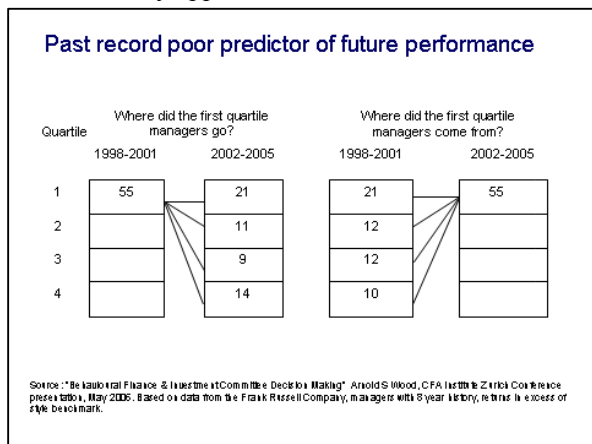
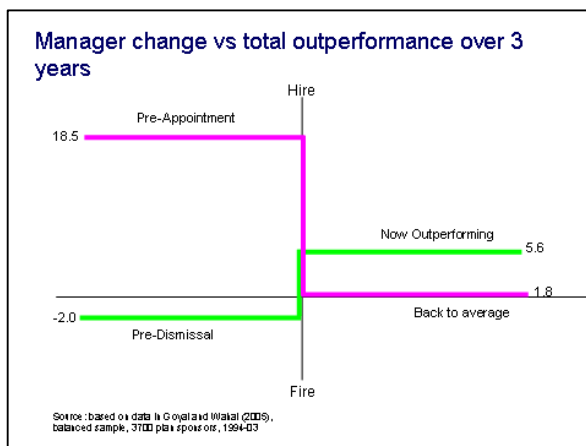
“Capturing Alpha”

Colin McLean, Managing Director, SVM Asset Management

My presentation is on manager selection – focusing particularly in the area of alternatives. I speak both as a selector of managers and other funds, and also as an equity manager myself, both in long and long/short. For more than 17 years I have co-managed SVM Global Fund which is a global fund of funds and hedge funds, and it has a significant portion invested in alternatives, particularly long/short equity funds. It has compounded at 13.4% p.a. In hedge, I have run accounts and funds since 1992, and our flagship fund, SVM Highlander Fund, has compounded over 9.5 years at 14.7% per annum. This experience of our team in hedge, gives us a good understanding of researching and selecting other managers in this area – we own some fund of hedge funds, and macro, but focus mainly on long/short equity, which is closest to what we understand. Indeed long/short has more similarities with conventional long equity management.

My conclusions might surprise you. For, not only will this analysis call into question what you might believe about stock selection and the pattern of returns, but has a direct impact on how managers are selected and monitored. I believe that genuine and consistent alpha is quite rare, whether in conventional or alternative funds, and the best rewards will be gained by using the selection process to get as comfortable as possible with a manager, and then being very focused on ongoing monitoring, so that extraneous information does not lead to ill-advised chopping and changing of managers.

First, though, I would like to look at the existing record of consultants in selecting conventional managers. An excellent study was conducted in this area by Goyal and Wahal. This study looked at US managers who had been fired, usually involving poor performance, although that was not always the main issue. It also reviewed those who had been hired, who usually had a stellar performance in the three years before appointment. It is a very comprehensive piece of research covering 3,700 plan sponsors over a ten year period from 1994 to 2003. The schematic illustrates what happened. Not only did the newly appointed managers quickly revert in the three years’ following appointment, to little better than average performance, but the fired managers started doing rather well. Indeed, markedly better than the newly appointed ones.



This can be seen more clearly in quartile movements on the next slide. In an overall sample of 220 managers, the top quartile had relatively low persistency with 38% of those continuing in the top quartile. A slightly higher percentage delivered below average performances in the subsequent three years. In terms of identifying the next period’s top quartile managers, slightly more came from previously below average performance as carried forward with first quartile persistency. Selecting managers based on top quartile performance illustrates a failure to incorporate the base information about past performance not necessarily

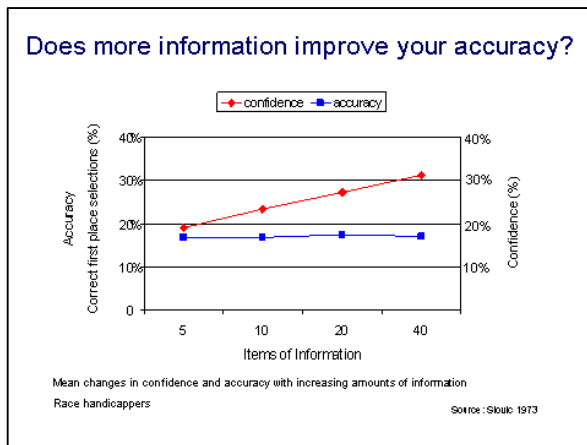
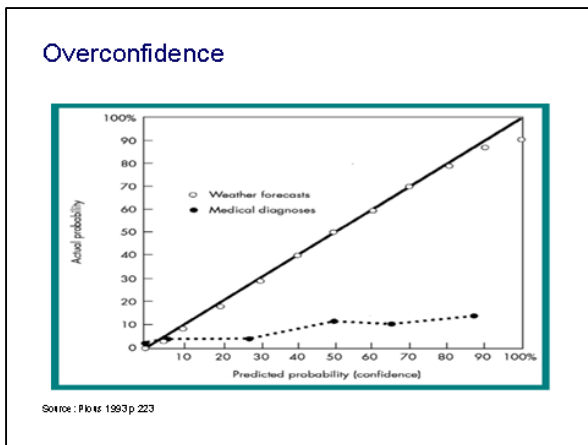
being a guide to the future. Clearly, short lists should include some underperforming managers.

I can personally vouch for experience of this – losing mandates after periods as short as 18 months or after outperformance! It seems that some consultants and trustees do not understand the pattern of returns they should expect, or possibly worry about other things that do not relate to longer term performance and risk. With more unknowns in the areas of hedge and other alternatives, it is natural for trustees to be anxious. However, I do believe that the best returns are achieved from managers by allowing periods of at least four or five years. This is the approach we take at SVM Global Fund, where turnover runs at less than 25% per annum. Some stellar returns have emerged from managers after more than two years of underperformance, and our patience has ultimately been rewarded. Indeed, almost every manager with a strong long term record of success has suffered at least two years of poor performance. Unfortunately, the halo effect means that this is not always recognised.

My overall approach is to identify genuine talent – often exhibited by uncommon insights in a carefully defined universe of expertise that can create true alpha. That is, the returns that cannot be bought cheaply by index investment or other market proxies. I believe that the most successful US endowments and family offices take this approach – spending their research on identifying the skill, as well as the environment in which it might prosper, and the likely pattern of returns. It is for the investor then, with that manager, to structure the right compensation and incentives to share the risks and rewards with the manager. Once that has been done, the right mix of allocations and use of overlays should be able to incorporate that manager into an acceptable overall outcome for the ultimate client. This turns on its head the normal approach of top down asset allocation and determination to put managers into boxes.

But, even more importantly, it highlights that the most useful managers, in terms of lowly correlated returns, will be doing something that is not readily categorised and may not even be easily analysed. But, we should not substitute that analysis with the easy box ticking and form filling that treats all styles in the same way and has little room for the key information about what it is that makes a manager different. I can understand consultants and other selectors believing that what they are creating that is proprietary is defined by the sheer quantity of diligence, but more facts can hinder, rather than help, judgement. By way of explanation, I will step back into behavioural finance and psychology.

Much new research work is being carried out on expert judgement and overconfidence, but I will illustrate this with just two of the classic research papers on this. They make the point very clearly that only in relatively few areas do experts estimate probabilities in line with ultimately observed frequencies. This is a calibration issue, about how sure an expert is about a judgement. What tends to happen, is that anything above six or seven pieces of information, is not reflected in improved judgement, but instead simply reinforces confidence in that judgement. This can be quite counter-productive if flexibility or the possibility of bad judgement must be admitted.



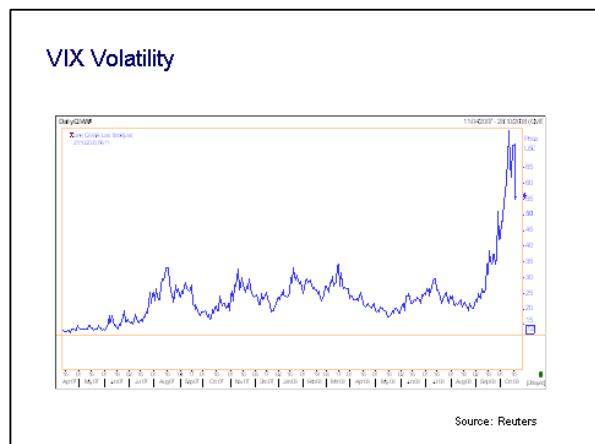
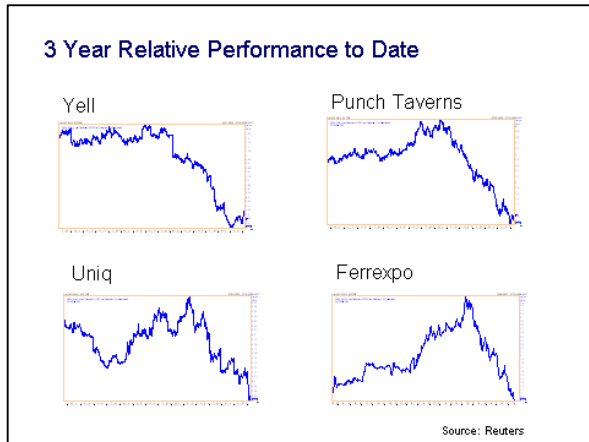
The length of a report may not change the conclusion, but it usually makes us think the writer is smarter. The “thud factor”, as the report lands on the table, seems to matter. It is important that there is a clear scoping of the information to be gathered, that it is limited in number of items (if automation is not involved) and that data is unemotional.

Before analysing hedge managers, or even conventional long only managers, it is necessary to understand first the nature of stock returns. This will go a long way to explain some of the failings of multi-factor analysis and the conventional approach to risk. For example, the slide shows some analysts’ current

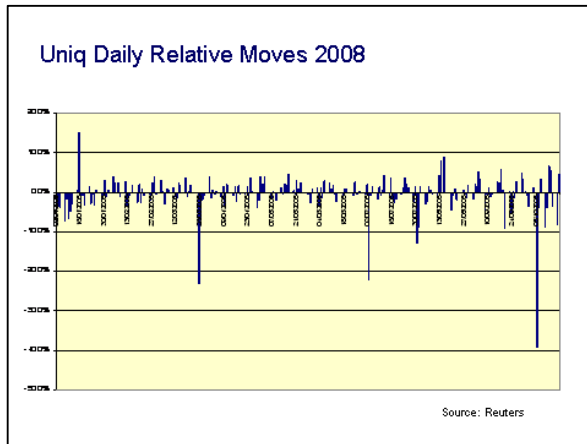
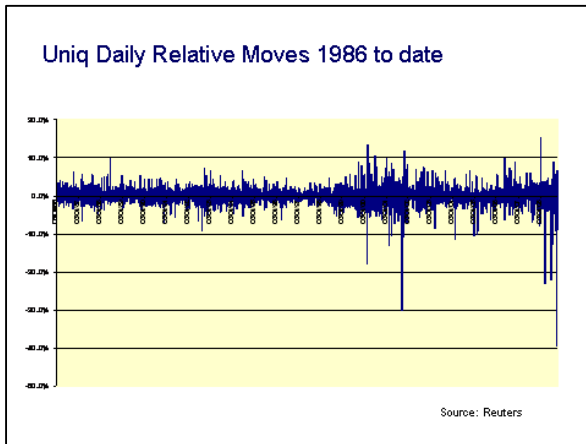
Selected Price Earnings Ratios (per analysts, prospective)	
	p/e
Punch Taverns	2.3x
Yell	1.8x
Ferrexpo	1.7x
Uniq	4.8x

estimates of prospective price/earnings ratios. For a few of you, this may confirm your view that stockmarkets have gone mad, and offer exceptional value, but I differ. Indeed these four stocks are all ones that I am currently short of, or have recently been. What would possess a hedge manager to sell shares at these ratings? I have focused on p/e, but there are many similar examples of large companies that look incredibly good value on discounts to assets or with dividend yields of more than 10%. I have not even taken the obvious route of including banks here - which would look even sillier, but might more clearly flag up that things are not always what they seem.

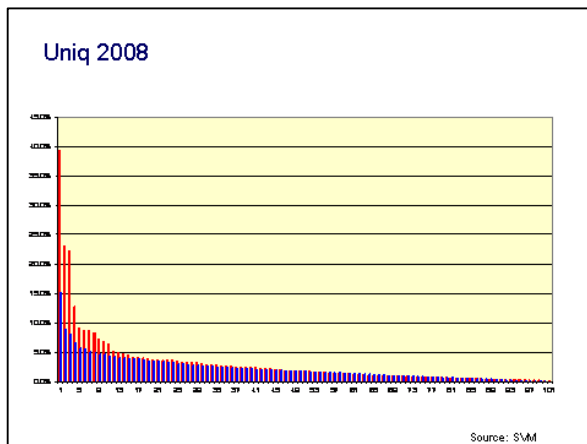
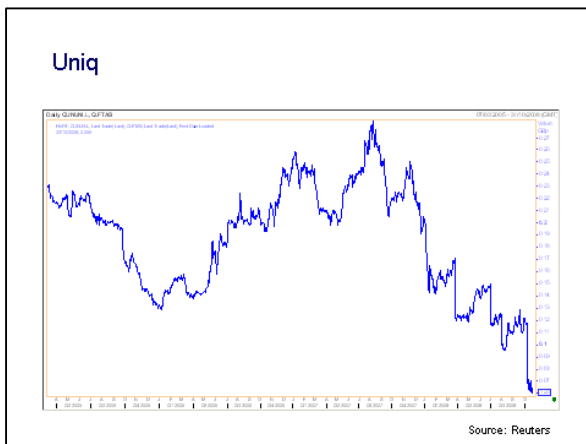
If you look at the performance relative to the All-Share Index for these stocks, you will see that not many in the market believed the ratings, either. In absolute price terms, the share price falls are even more dramatic. This does tell us that portfolios that look cheap on total p/e, or yield, or price-to-book, may in fact be extremely risky. There actually are underlying reasons for this. For example, companies can use buy backs or increased leverage to game the earnings per share growth that certain investors demand, but may ultimately create an unsustainable capital structure. Many large companies in a wide range of sectors have made this same mistake. So, there may be little point in expecting value managers to have a particular type of portfolio. It gets worse if consultants and trustees, more used to analysing conventional managers, attempt to apply the same approach to hedge.



We know that market volatility has picked up recently, as the VIX graph shows. This is actually evident in individual stock prices, as can be seen with Uniq, one of the companies on the previous list. There was the same widening of volatility in 2001 and 2002. We should expect volatility to subside again. But, what is particularly interesting about the pattern of returns this year, is more evident from the next slide. We can see the pattern has been asymmetric, with some sharp falls. For a hedge fund with a short position in this company, that represents profit and alpha. But, it is not emerging smoothly, although many will find its lack of correlation with the market attractive.



In fact, if we look again at its relative performance graph, the sharp falls are more easily seen. In fact, many other shares have shared this pattern over the past 18 months, with technical analysis being a far better predictor of future performance than fundamental analysis. The failure of the stock to descend smoothly, in line with a steady emergence of disappointing information and a correct analysis of that, is not a result of short selling, but a failure of conventional investors. This has been more readily evidenced this year in bank shares, falling more sharply during the period in which short selling restrictions were imposed. Conventional investors exhibit a number of behavioural failings, including anchoring and endowment effects.

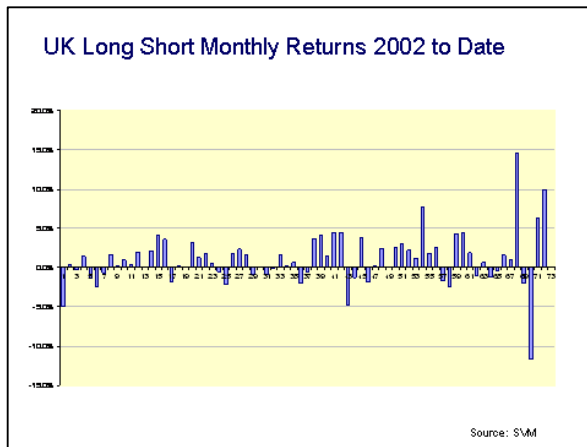
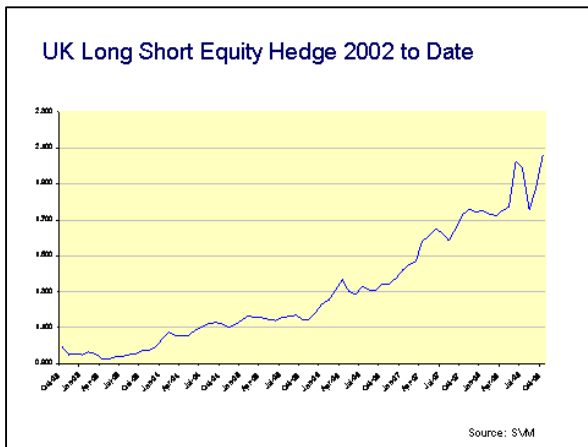


What this does produce for Uniq, a food producing group incorporating the old Unigate business - shown more clearly on the next slide - is that the alpha, or performance from a short position, is delivered in large lumps in a surprisingly small number of days – and clearly not symmetric with gains. The graph shows this. Much of conventional analysis of portfolios and managers may not capture this, and yet a hedge fund clearly can exploit it. It is necessary to step aside from much of what passes as conventional wisdom in capital markets analysis. In a short position, I am more interested in the stock's red down days, and whether other market and factor risks have been correctly balanced.

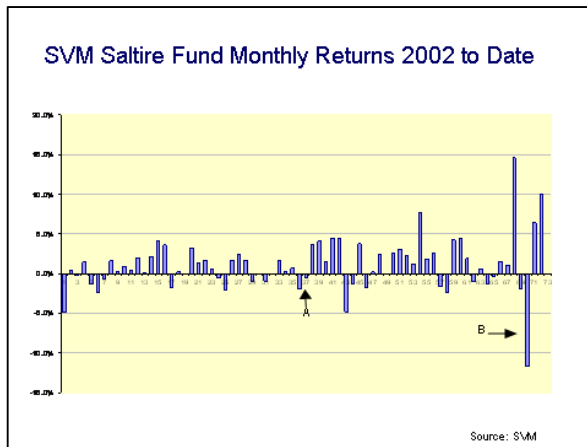
It is important to recognise this asymmetry in stock returns, which should be the key to delivering the hedge fund effect. Most investors in hedge funds are looking for optionality – possibly accepting just 80% of market upside, but with the hope of some capital protection of perhaps no more than 40% of downside. The truth is that some managers have cynically gamed this, using derivatives structures for the trade-off - in line with their incentivisation. It has taken some extraordinary market conditions to highlight the risk involved and asymmetry of reward. However, many investors also believe that managers can achieve this optionality by timing – that they can readily move in or out of the market. With major market moves coming within

weeks or even days, this is clearly unrealistic, and nor have I seen any manager identified as consistently calling market direction over a lengthy period. I believe that it is important for the desired characteristics of hedge funds to be built in - hardwired in analysis, risk management and stock selection. That should be derived from an underlying asymmetry in securities returns.

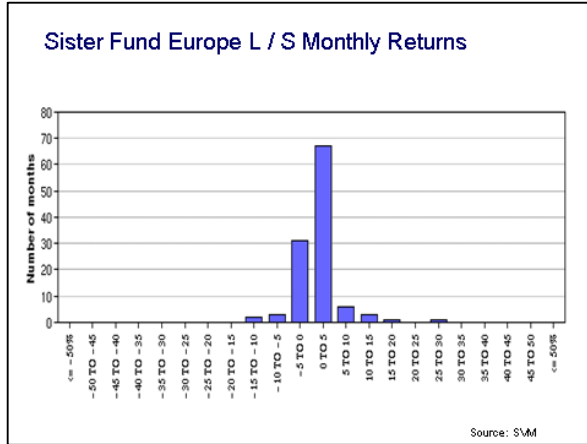
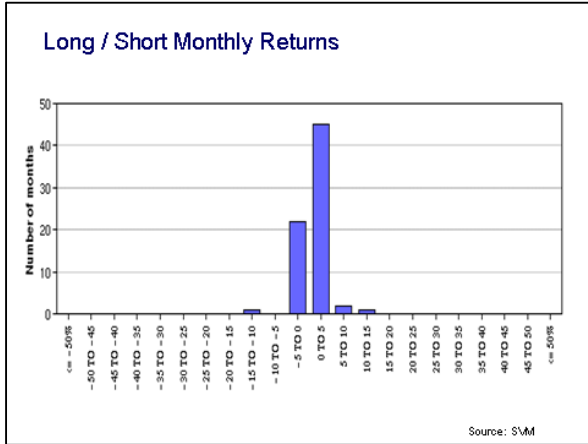
I would now like to highlight some of the issues involved in analysing and selecting hedge funds. This includes some funds I consider to be good, as well as some that I believe are unattractive propositions. But, your views may differ depending on your appetite for reward and risk, and the overall composition of your assets and liabilities.



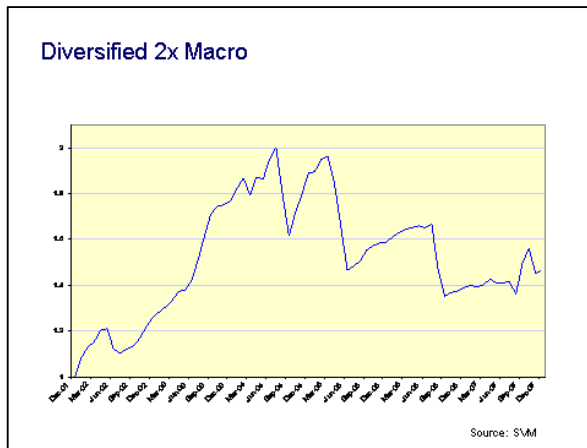
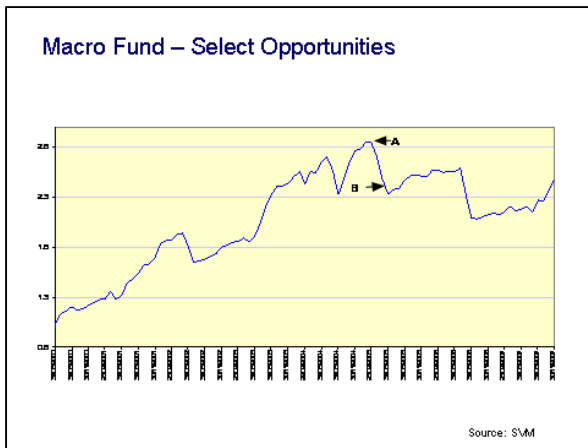
We manage a hedge fund that operates in the niche of small and mid cap companies, which tend to be less crowded trades and less well researched. The performance from inception in 2002 of this fund is shown on the next slide. Most would be happy with a fund that has more than doubled over six years in which the All-Share Index was little changed. There are two aspects to this that are just visible from the graph and a little clearer on the bar chart. We can see that volatility of returns has recently picked up a bit and August this year delivered an exceptional negative, albeit surrounded by three remarkable positive months. Given what we saw with the VIX slide and overall market volatility, this move is unsurprising and few risk controls could have avoided it. It is largely uncorrelated with market direction. There are two clear issues for analysis, marked “A” and “B”. “A” represents a change of underlying manager, following a three year period in which the annualised return was just 4.5%. That change might have been a good entry point, but in fact was characterised by an exit from the largest investor, a US consultant. The second three years annualised at 21.6%. Volatility and potentially risk, is clearly higher, but nevertheless positive returns in June, September and October this year, with a negative in August, would have complemented a long fund or long biased hedge fund quite nicely.



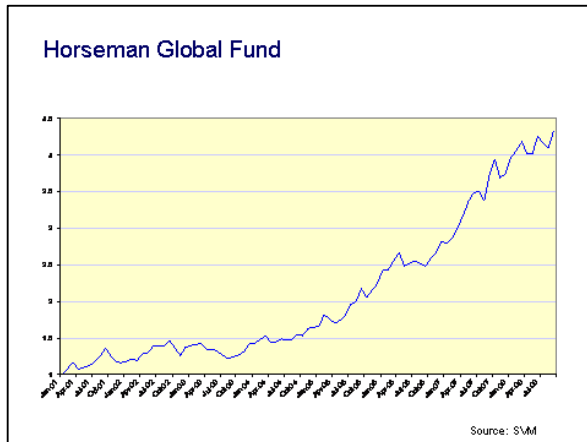
I think we can see more clearly in the pattern of returns both in this fund and in its sister fund, that a clear majority of months are positive, and within the desired 0 to 5% range. The sister fund covers almost 10 years of monthly observations and therefore two bull periods and two bear markets. I believe that too many selected long biased hedge funds based primarily on analysis in the bull market environment running from 2003. The key is to understand what a rare and valuable thing genuine alpha is and the effort that must be made to incorporate it.



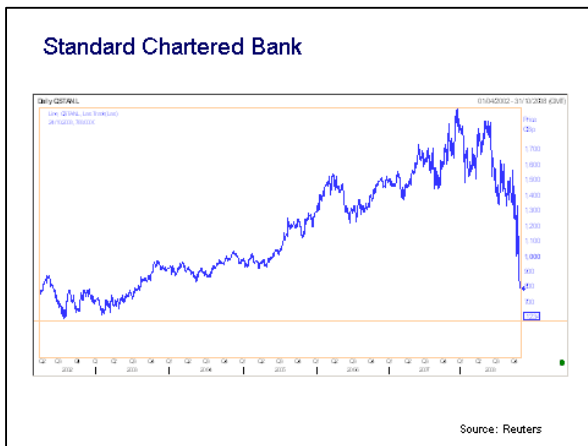
I will now turn to some other funds – with the next one being a major high profile macro fund that grew dramatically in size after its first few years, before then shrinking. We invested in this quite early on, but came out at the point marked “B”. In fact, given quarterly redemptions, the difference between notice at point “A” and eventual exit is also clear. The reason for our exit, however, is less apparent from the graph alone. What did happen was that in the previous year, returns began to correlate less with gamma and more with a straight trade in treasuries. We sought additional transparency, in the form of weekly values, but ultimately the manager withdrew that transparency for investors and also became secretive about the total fund size. Some argument was advanced about reverse engineering their positions and gaming against them. Betting against them would have been good! That huge increase in scale, diversion into incubating other funds, disturbing correlations and monthly moves, and a breakdown in trust and transparency were a good signal to exit. The sister funds generally did even worse, as the next slide shows.



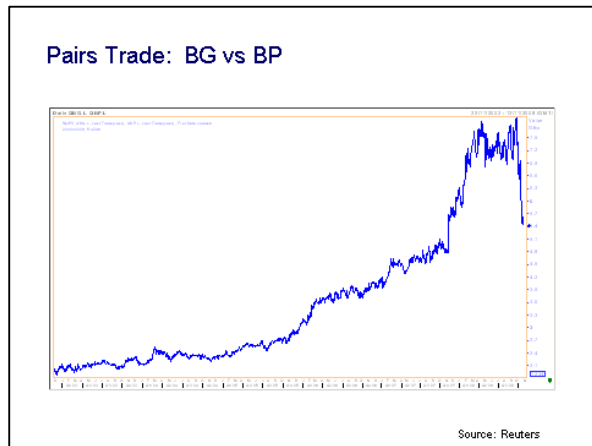
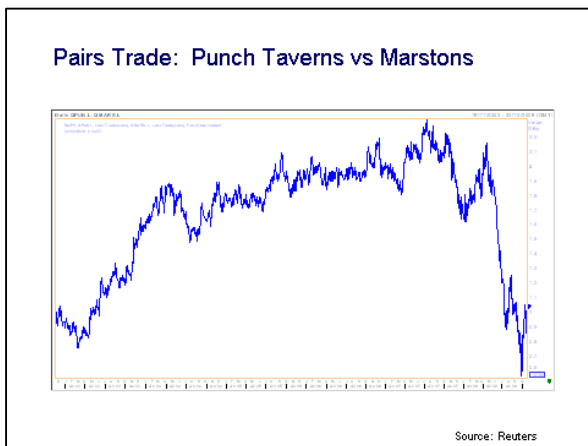
Horseman Global Fund is the largest investment within SVM Global Fund and we invested from inception, when John Horseman set up a global macro fund after more than 20 years’ investment experience with long funds at GAM. The graph rather disguises an earlier wobble and the more recent slightly greater (upwards) volatility. However, we addressed the earlier concern a few years’ ago with a visit to the manager, and have been happy investors since. He is a very talented manager. We have a good sense of what the Fund should correlate with and the likely size of monthly moves.



Next, I would like to make some more general points about problems with hedge funds. Some of these stem from misperceptions about equity performance and also CAPM failings. A number of the long biased managers have advanced claims about risk management through overlays – selling futures against a conventional long book. In fact, the relationship between stock performance and the indices is far from stable and likely to let investors down just as other relationships break. Each of these three stocks was a joy to own for five years before suddenly breaking down. Whilst all in different sectors, this would largely have happened at the same time.

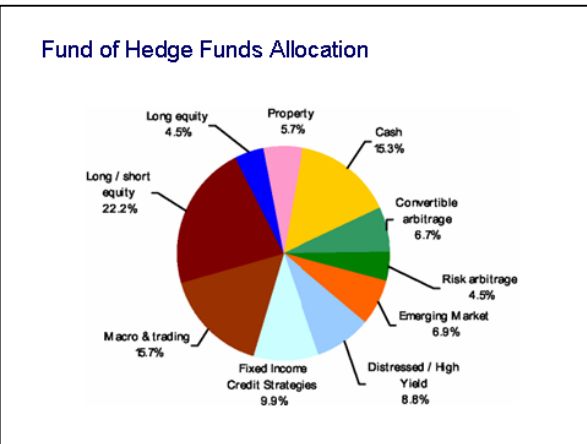
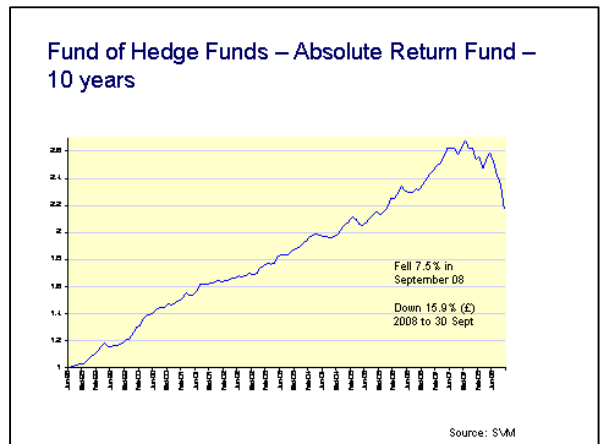
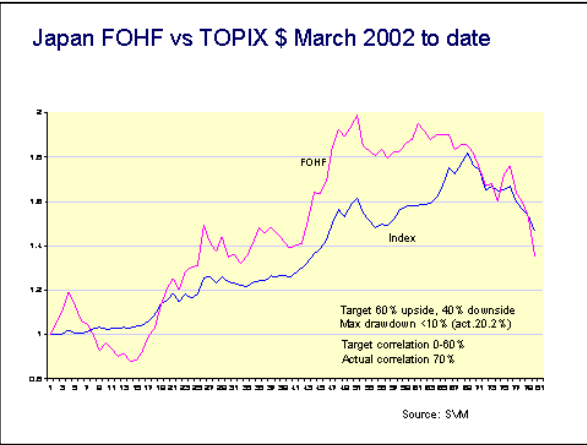


This carries through into issues about pairs trading, also advanced as a way of reducing risk. We ran a pairs fund for more than two years in the late 1990's and found the returns, though attractive, extremely unstable. Risk is difficult to manage. This is largely because risks can be misunderstood, as a long position in a good company or more leveraged one, steadily trends against another in a bull market and even the early stages of a bear market. However, the risk of a premium rated, superior margin business ultimately falling sharply in a recession as sales, margins and rating all shrink at once is great. The examples, first in pubs and then in oil and gas show this. I believe there is a lot of beta involved in these trades.



There are also some areas promoted as hedge funds that I believe simply lack any evidence of being able to hedge and deliver absolute return. In Japan, emerging markets and commodities, I genuinely believe that there are not effective hedges and hedge funds carry considerable underlying market correlation and risk.

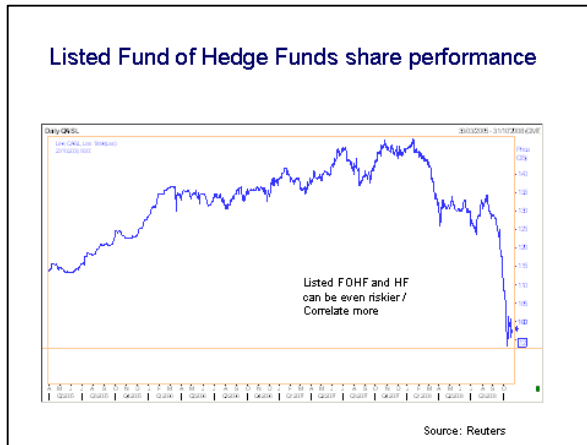
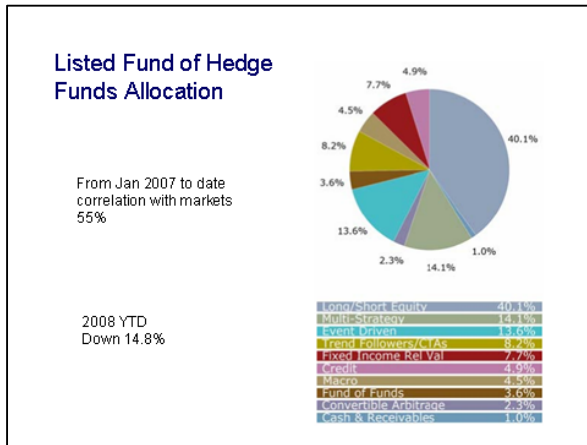
The first example is a fund of hedge funds in Japan run by a manager with long experience in the fund of hedge funds area – more than 10 years. I think the correlation is pretty obvious. In fact, I was surprised given the graph, that this fund quotes an actual correlation of just 0.16, well within the expected band of 0 to 0.6. In fact, adjusting the index into Dollars – the nominal currency of the fund – I calculate the correlation as 0.7. Interestingly, drawdown is running at more than twice the predicted maximum, now over 20% and counting. I think the graph gives some idea of whether this type of fund of hedge funds really can be opportunistic. Certainly it has captured more of the previous upswing, but it also appears to have given more than 100% of the downside. This fund is typical of many fund of hedge funds invested in Japan, and I do not believe this type of vehicle has a future.



I will next move onto a more broadly based fund of hedge funds which aims at global diversification and has allocated across a range of strategies. While it is easy to present this type of fund now as doing less badly than the stockmarket, it has clearly been marketed as an absolute return fund. Again, we can see that it appears to have changed characteristics dramatically after 10 years, but when we look at its allocation it might be hard to see why this has happened. It appears to be diversified across a range of strategies. However, irrespective of current correlations caused by counterparty and other risks, I do believe that, at times of stress, many of these strategies essentially converge in nature to being equity-related. Merger arbitrage, emerging market, long equity, long/short equity, property and some macro strategies are likely to correlate significantly. However, there are some successful multi-strategy funds and CTAs as well as successful global funds, such as Horseman.

Next, I move onto another listed fund of hedge funds run by a very longstanding manager. No claims are made on market correlation, but the actual correlation with markets has been 55% more recently. Again, there is a diversification across different strategies, but the result for the year to date is largely driven by the equity nature of several of these. In fact, it gets worse, as many have had their first introduction to funds of hedge funds through listed shares. I show the share performance since listing and we can see not only the fall, but the exacerbated correlation caused by discount widening in the current bear market. As with the

graphs I showed earlier on Arcelor, Man Group and Standard Chartered, I do not think that in advance this was obvious to many.



Finally, I would just like to show some of the bullet points that might be covered in due diligence. Increasingly this is focusing on counterparty and risk issues. A few months ago, pre-Lehman Brothers' failure, few would have heard of re-hypothecation. I think that much of this is sufficiently technical for it to be best to use specialist diligence teams. I believe some of the key issues are with pricing and governance, and that hedge funds are best structured with involvement of an independent administrator and custodian, rather than leaving a prime broker to handle all capital management, pricing and capital introduction.

- ### Due Diligence
- Prime Broker /Custodian /Payment Bank ; what is Fund's exact percentage exposure to each?
 - Provide most recent Risk Assessment/Management report emphasizing counterparty risk
 - How do you evaluate and monitor the counterparty risk?
 - How regularly do you review your counterparties and their credit quality?
 - How is liquidity monitored and investment in thinly traded securities controlled?
 - What controls are in place to monitor concentrations of investments?
 - Please provide a brief description of your dealing / front office methodology and controls:
 - What are the front and back office systems used? If developed in-house, are they documented and are copies of the programmes held offsite?
 - During the past 12 months have there been any variances which could not be reconciled? If yes, please explain what action was taken?

- ### Due Diligence
- Please provide details of the disaster recovery procedures and have these recovery procedures been tested in the past 12 months, and what were the results of these tests?
 - Does the compliance testing check for adherence to Offering Memorandum?
 - Is the Fund subject to continuous monitoring by the Compliance Officer and Risk Officer?
 - Please confirm that you have not currently, nor will you in the future, hypothecate, pledge or otherwise enter into contracts or transactions that do or would use the assets of the Fund as collateral for the obligation of any third party, except as provided for in the agreement
 - Do you use side pockets? Please show record of any side letters, special terms.
 - Is there a lock-in period or are investments gated?
 - Above excludes many issues to do with regulatory and governance requirements that would apply to all fund managers based in UK or USA. eg fair trade allocation, commissions, pa dealing, indemnity insurance, broker approval, stale prices etc

Finally, I will offer the summary of how we select funds and hedge funds for SVM Global Fund. It does not impose a structure on each, but does involve us becoming comfortable with the managers and understanding what to expect. One consultant told me "we see good returns at some boutiques and would like to increase clients' exposure. The problem is getting comfortable with them". Unfortunately, conventional "wisdom" will not give that comfort, and the manager himself may not be genuinely comfortable with all his positions, no matter how thorough the analysis or risk framework. In profiting from successful long term managers, as with stocks, it is necessary to live with a degree of concern, but to know its boundaries. If returns are made by profiting from others' failings or analysis,

- ### Finding the Best Funds
- Identify exceptional investment managers
 - Skill is key – regardless of asset class, style
 - Genuine edge, evidenced by achievements
 - Look for managers with uncommon insights
 - Diversify at Global Fund level, not via regional funds
 - Avoid the popular focus on style / fit / asset class/box ticking
 - Ensure fees and incentives are aligned with investors' interests

portfolio behaviour will not be identified by a conventional approach – that will only see the risks. Many of the best performing long investments have looked very cheap in p/e, yield or price-to-book – just as many good shorts appear astonishingly cheap. This will mean that it is harder to get widely available metrics to give comfort and, indeed, a much lower than average p/e or higher dividend yield, might even be a cause for concern. There are great opportunities in today's market, but the manager you select may profit by going against conventional wisdom (and even yours!).

I believe that this approach has led us to identify some exceptional managers, such as John Horseman, and have the conviction to stick with them for many years. These managers are themselves opportunistic, but we do not attempt to be opportunistic in moving in and out of them.

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