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WHAT THE SMART MONEY'S DOING

Conquest Capital Group

By Mack Frankfurter

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- Marc H. Malek -

Proctor Investment Managers' newest strategic partner is Conquest Capital Group, an alternative asset management firm with approximately $380 million under management. Conquest, which offers five investment vehicles specializing in the trading of futures and FX markets globally, is headed up by Marc H. Malek who is backed by a strong quantitative team.

A key driver in Proctor IM's decision to acquire a stake in Conquest had to do with its proprietary research in the area of managed futures and beta replication strategies. Simply stated, Conquest is on the cutting edge of exotic beta product development.

Hedge funds are in the business of selling 'alpha.' Increasingly, however, investors have been questioning the portion of hedge fund returns attributable to alpha. Taking that line of thinking, the next logical question is how to identify alpha if you don't have an appropriate beta against which to measure certain types of alternative trading strategies?

"That's really the heart of the problem; the 500 lbs gorilla in the room," says Malek, who started his career at Salomon Brothers and later joined UBS to become worldwide head of its Exotic FX Derivatives Group as well as Executive Director in charge of FX Proprietary Trading in Europe. "The whole notion of alpha is kind of funny. My checking account has alpha to my hedge fund, and vice versa… with positive expectancy, hopefully."

It started with Conquest being frequently asked by many of the fund-of-funds what their alpha is. "I ran a derivatives trading desk at banks; no one ever asked me about my alpha. So when I looked up the definition of alpha, it became very evident that you cannot intelligently talk about alpha if you don't have the right beta," says Malek.

With a mathematics degree from Reed College, an engineering and applied science degree from Caltech and a background in neural networks, Malek and team set about figuring out something that described their beta—in an effort to determine their alpha. When they applied it to the rest of the managed futures world, they

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were surprised to see that it actually explained the returns of “virtually every single trend following CTA [commodity trading advisor] with the exception of a few,” says Malek.

That research caught the attention of a major endowment at an Ivy League University, which was trying to get a foothold in the CTA space. They asked Conquest to build for them a beta program focused on managed futures trend following strategies. “There are various sides of CTAs,” explained Malek, “the space is overwhelmingly made up of the trend followers, and then on the periphery you have a few people that do different things.”

The idea of hedge fund replication is a hotly debated one in both academic and hedge fund circles, but the real action is in the rush to package these so-called “exotic beta” strategies. In the past year investment banks such as Goldman Sachs, JP Morgan and Merrill Lynch have also introduced programs designed to “replicate” hedge funds.

There are two questions provoking this new industry phenomenon. First, are supposedly skill-based returns actually just a function of a particular investment approach? Second, why should investors pay two and twenty for a trading strategy that is replicable?

“There is a process that every fund within a sector is going through that drives the correlations,” explained Malek. “High correlation of all the hedge funds in one sector means something. It means that they are all doing something in common.”

Yet, while Malek does believe that hedge fund replication is feasible, he also thinks efforts such as factor modeling or pay-off distribution, which some of these new hedge fund replication products are derived from, are doomed to fail.

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The factor modeling method uses a regression procedure to weight the component factors and construct an algorithm with the goal of replicating a hedge fund index. The approach was originally developed and documented in an academic paper by William Fung, principal at Paradigm Financial Products, and David Hsieh, Professor of Finance at Duke University.

Harry Kat, professor of risk management at London's Cass Business School, developed the method called "pay-off distribution." His approach "aims to provide returns with predefined statistical properties." Unlike factor modeling which "attempts to generate the same month-to-month returns" as a given fund or index, Professor Kat is looking to produce "returns with the same statistical properties as a given fund or index."

Barclay Capital also recently launched its first hedge fund replication index based on the idea of integrating what they considered the best of both approaches above.

Malek argues that these approaches are nothing more than back-fitting, especially when done on a high number of variables. "You cannot take the crème of returns, and have no idea how it was generated, plug it into a matrix, that has the price of oil, stocks, currencies, and come out with some sort of multi-variable equation that give you the weight of the factors historically which would have generated these returns," he explains.

Conquest's approach, on the other hand, is based on what it says is a transparent set of "extremely simple trading rules" purportedly suited to replicate, in the case of its MFS exotic beta product, a generic managed futures trend following strategy. You don't duplicate a strategy being an outsider, says Malek, "you do it the same way that traders in that strategy are doing it… by knowing as much about that strategy as people who are doing it."

Not surprisingly, each of the proponents of these approaches—factor modeling, pay-off distribution and Conquest's mechanical trading—claim to best capture or replicate the hedge fund index they compare themselves to. In the case of factor modeling or pay-off distribution, back-fitting raises the specter of optimization and makes these methods "very controversial" as far as Malek is concerned.

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three years of walk forward actual performance to base its claim of being approximately 90% correlated to the S&P managed futures index. But this still leaves open questions about the veracity of hedge fund indices to begin with, the methods and parameters used to develop the “exotic beta” trading rules, as well as the validity of measuring Conquest’s other funds’ alpha against an index of their own creation.

With respect to the development of Conquest’s mechanical managed futures trend following system, “you cannot get any simpler than what we have created. It doesn’t have any other hard coded parameters. It basically says that trend following happens anywhere between 5 to 200 days,” says Malek. “We could spend two more hours talking about what makes a good back test and what doesn’t. What I can tell you is that this is not a theory anymore, this is something that we have been running for over three years.”

All said and done, by only charging a one percent management fee and no incentive fee, it is obvious that Conquest’s objective is to become an exotic beta juggernaut by producing exotic beta products for managed futures as well as other alternative investment strategies. “What is interesting about it, now we can allow people, to go long or short a trend following CTA,” proposes Malek launching into another cutting edge idea.

The industry has come a long way. “Unlike ten years ago when the hedge fund space was somebody with a bright idea, and dealing with investors that come and put their own money with you if they like what you said,” Malek recalls, “over the last ten years a lot of the risk that use to be taken at prop desks and banks has been outsourced to hedge funds. Institutions like institutions. They don’t like two guys and a bright idea.”

This is the basis for Conquest’s involvement with Proctor IM. “I’m not a marketer,” says Malek, “I have a very quantitative background. They have a very large distribution team that they plan on growing. Meanwhile, I can bounce things off of their legal department; I can rely on them for seed money for some new ideas. It gives us an association with a much larger institution. That I think makes us more stable. It gives us more credibility.”

With respect to their managed futures beta product, “if you look at it on a gross basis, some of those trend following CTAs do actually provide some alpha, but no one does after the two and twenty charge,” explains Malek, adding that he thinks “trend following by itself is a negative alpha proposition after fees, the same way most mutual funds are negative alpha after fees.” That’s why Conquest priced their MFS product at 1% management fee for the first $250 million. Once that class is filled, however, they plan to open the next class at 2%.

“The market is very simple—you have risk and return,” says Malek. “Only way you get compensated is for assuming risk. Now every once in a blue moon, you get somebody who knocks the cover off the ball and is a true star. But ninety-nine percent of the time, you basically make the money the market is willing to give you for assuming risk premium.”