



WHO'S WATCHING YOUR BACK?

Behind the Money

Study Relates Risk Climate and Returns

By Christopher Faille, Financial Correspondent

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NEW YORK (HedgeWorld.com)—A recent study indicates that most hedge fund strategies fare better within risk-seeking market conditions than they do in risk-averse conditions, and that this sensitivity to the surrounding "risk regime" explains the recent run of hedge fund success.

The converse proposition, then, is that an increase in risk aversion, one which would manifest itself in wider spreads and more expensive options, would bring that run of success to an end.

The new paper by Conquest Capital Group LLC, New York, distinguishes five different sorts of risk, each of which generates a premium—i.e., an extra level of compensation for its assumption. The five sorts of risk are: illiquidity, credit, emerging market events, currency exchange volatility, and equity volatility. Since these premia are of variable quantities, each has its own market measurement ("metric"). Respectively, the five corresponding metrics are swap spreads, corporate bond spreads, emerging market bond spreads, FX implied volatility, and the Chicago Board Options Exchange volatility index (VIX).

The Conquest risk aversion index is a binary one, based on these five metrics, taken day by day. If at least two of the five indicated a heightened risk premium on a particular day, the environment is said to have been risk-averse. If four or five showed low risk premia, the environment was risk-seeking. Considering all the days since the index began in January 1997, the percentage of risk-averse days so defined is 30.9%. Considering only the period from Oct. 1, 2002, to Sept. 14, 2005, though, the percentage of risk-averse days is much lower, 10.1%.

For convenience, Conquest then clustered days into months, treating as risk-averse any month in which more than half of the days were risk-averse. It then discovered that the only hedge fund index that performs better in risk-averse months than in risk-seeking months is the CSFB Tremont dedicated short index, which also is the only index with a negative "information ratio" (return divided by volatility) overall.

Managed futures, likewise, do better in risk-averse conditions than in risk-seeking conditions. Managed futures are also "robust," meaning they can yield positive returns under both risk regimes.

What follows from all this in practical terms is that investors might be wise to guard against a change in risk regimes by allocating some portion of their portfolios to managed futures.

CFaille@HedgeWorld.com