

VOLATILITY

MEAN REVERSION IS DRIVEN BY PAIN AND PLEASURE RATHER THAN GREED AND FEAR



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Do you agree with the statement that even the best volatility fund managers are not immune to losses? Why or why not?

No one is immune to occasional losses. The assumption I am making in such a case is that we are referring to losses that are not major when compared with the assets being managed.

Of significance would be whether those losses arise from a well diversified statistical arbitrage or relative value strategy, or from an unbalanced concentrated bet. In the case of the former, some trades are expected to lose and some are expected to gain with the majority gaining, assuming always - equal bet sizes. Then, the occasional losses are just part of the expected payoff distribution. In case of the latter, however, losses are often the result of "bad luck" - and suggest that the strategy being followed is one that is based on luck as opposed to skill. This is cause for concern.

Hence it is important to determine and understand what caused the drawdown rather than fret over the fact that it exists. The nice thing about volatility is that keeping relative prices at unreasonable levels is very expensive. Mean reversion for closely related products therefore tends to be exceptionally reliable.

What makes it so difficult to avoid losses?

Most volatility fund managers bet directionally, even though they claim otherwise. Most also tend to bet with insufficient diversification and on absolute value rather than really arbitrage volatility which usually means betting on relative value.

Then again, if a manager did everything right, he/she would still have to contend with occasional negative payoffs as the market is not always rational. However, if the individual "bet" size is small enough and the positions placed are well diversified, it should not impact the overall performance substantially. Relative value can be estimated with high certainty and reliability, in contrast to absolute value, which cannot.

Drawing on your experience, what are the lessons you have learnt that help you stem and minimise losses?

- Bet on relative value rather than absolute value and look for arbitrage opportunities rather than trying to pick the bottom and top.
- Gaining exposure to volatility is quite expensive and directional.
- Getting exposure to "volatility of volatility" can be nearly free and in the ideal case it is completely non-directional. So one stands to make money irrespective of whether it goes up or down. (frequency vs. direction)
- Another key is to constantly create new positive risk profiles.

What differentiates volatility as an asset class? Peculiarities?

As volatility is mean reverting, it must be traded rather

than invested in to achieve market independent, optimal returns. It has a limit to the upside and the downside. Also, the holding costs increase with the level. Normal assets don't usually get more expensive to hold when their prices rise. Therefore mean reversion is driven by pain and pleasure rather than greed and fear.

If prices are driven apart too far, it is very painful to hold a position that bets on prices moving even further apart. This makes things mean revert quite reliably and quickly.

Finally, there are a huge number of products that are based on the same underlying asset which are inter-connected to each other via strong relative value and forward relationships. So there is an abundance of arbitrage opportunities as the multitude of contracts allow for a very precise estimation of relative value, even though absolute value would be difficult to assess.

Who should be investing in volatility? Why?

Anyone seeking truly market independent returns or those seeking to leverage, protect or yield enhance their portfolio in an efficient manner should have a closer look.

To achieve market independent returns, however, significant skill and infrastructure are required. So, for most investors it's likely to be more efficient to "outsource" this to a competent hedge fund.

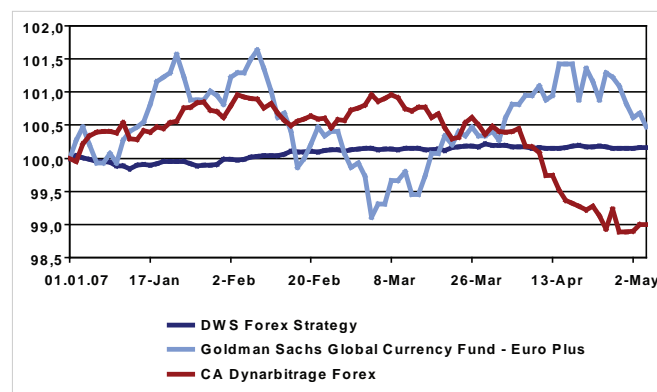
Volatility offers true alpha if used correctly. It also allows for very precise tailoring to meet customised risk profiles and payoffs. In effect - it allows an investor to sell exposure they do not want or need and from those proceeds, they can acquire those that they want or need.

What should an investor bear in mind when he/she evaluates a volatility manager?

- To spend sufficient time to find out if the bets are directional or are truly non-directional.
- Directional exposure can be gained simply and cheaply by any investor. True alpha generation however is the domain of experts.
- Lack of diversification and many underlying securities in the portfolio are usually simple signs of hidden directionality.
- In many cases it might be worth getting outside advice to assess the soundness of a strategy
- In general, any strategy with less than 30-50 similar but largely off-setting positions will most likely be quite directional.
- Finally, any strategy that is highly model dependent has hidden risks that are often hard to assess.

By the way, in response to the growing needs, we have just set up a new firm, which among other things, offers consulting services aimed at helping investors set up their own derivatives pricing, trading and risk management capabilities as well as helps them evaluate and deploy derivatives based strategies effectively.

CURRENCIES



Fund's performance vs. its competitors

Source: DWS, Datastream

DWS FOREX STRATEGY

Focus:

- Fund exploits exchange-rate volatility around the world via transactions in currency forwards and options combined with long and short positions in more than 30 currencies that are balanced in size
- Fund was re-launched on the 01.06.05 (it shifted from being a multi-manager to a single manager fund)

Strengths:

- Daily liquidity
- Low correlation to traditional asset classes

Weaknesses:

- In order to avoid sharp draw downs, the fund avoids carry strategies (pure market beta)

Opportunities:

- Low transaction costs; global foreign exchange market turnover, daily average USD1.9 trn
- Diversification - as an asset class currencies have a low correlation to traditional asset classes

Threats:

- Lack of volatility, sideways trending markets can challenge performance

Risk Management

☐ Low
 ☐ Low / Moderate
 ☐ Moderate
 ☐ Moderate to High
 ☐ High

- Fund's major risk: **shrinking risk premia** owing to low volatility
- How risk is managed and mitigated: "RiskMetrics" and via its business risk dept. (stress tested daily - against risk scenarios such as the Russian Rouble crisis, Mexican Peso crisis, a 10% breakdown of USD overnight)
- Proven FX skills: ☐☐☐☐☐
- Trading leverage related risk: **can up to 5x** (but since the re-launch in June 05- hasn't been deployed)
- Bank's Credit rating: **S&PAA**

- Success achieved:
 - In translating macro economic views into profitable trades :
strategic: gamma trading : 50 % and tactical and traded transaction: 65%
 - In identifying market inefficiencies: ☐☐☐☐☐
 - In identifying risk: ☐☐☐☐☐
 - Market timing: (crucial to tactical approach) ☐☐☐☐☐
 - Relative value trades: ☐☐☐☐☐
 - Trading and execution skills: ☐☐☐☐☐
 - In effectively implement risk budgeting: ☐☐☐☐☐

Performance Parameters

☐ Insufficient
 ☐ Adequate
 ☐ Satisfactory
 ☐ Good
 ☐ Outstanding

- Avg. no. of trades: **8**
- Fund's avg. annualised performance since re-launch: **6.53%**
- Sensitivity to FX cycles: **trending fundamental, flow driven and high volatility cycles**
- Since re-launch, consistency in delivering targeted returns: ☐☐☐☐☐
- Fund's correlation to:
 - Monthly returns S&P 500 EUR based and EUR/USD: **+0.07**
 - Monthly Returns 10year Government Bonds for EUR-based Investor and EUR/USD: **-0.33**
- Commodities annualised (CRBI): **-0.03**

- Diversification:**
 - Geographic:
 - Non-OECD currencies +/- 33%; Non-deliverable currencies: +/- 10%
 - OECD-currencies:
 - AUD, CAD, CHF, CZK, DKK, EUR, GBP, ISK, JPY, HUF, KRW, NOK, NZD, MXN, PLN, SEK, SGD, SKK, TRY, USD
 - Non-OECD currencies
 - HKD, ILS, RON, RUB, THB, ZAR
 - Non deliverable currencies
 - ARS, BRL, CLP, CNY, COP, EGP, IDR, INR, KRW, KZT, MYR, PHP, TWD, UAH
 - Strategies: **relative value, trend following – discretionary blended**
 - Time horizon: **strategic 6 months, Tactical: weekly & ad hoc opportunistic**

Outlook

- Barriers to entry: **daily liquidity, currency expertise, experience**
- Threat posed by competitors: **exists but has no bearing on performance**
- Outlook for investing in the FX as an asset class: **opportunities will always exist**
- Outlook for a fund such as DWS: **upside to range bound**
- Fund's ability to deliver targeted return's over:
 - 1 year **70%**
 - 3-5 years **100%**
- Fund tends to outperform when:
 - Volatility in FX markets exists and it has the ability to capture risk premia
- Worst case scenario: **as is being experienced currently - a break down of FX volatility, fundamentally unjustified FX strengths**
- Suitability for inclusion in:
 - Conservative portfolio: **high**
 - Balanced/growth portfolio: **high**
 - Aggressive portfolio: **fairly high**

Investment

- Fund is targeted at: **sophisticated investors**
- Current AuM: **EUR292mn**
- Targeted AuM: **EUR 500mn**
- Recommended holding period to optimise returns: **min 3 year**
- Fund's base currency: **EUR**
- German regulated hedge fund vehicle
- Fund's complexity for an investor: **simple**
- Transparency provided to investors: **full transparency and daily liquidity**
- Ratings/rankings/awards: **S&P: 3 stars**

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ASSET CLASS

“MANNA”

Asset Class as defined by Investopedia : “A group of securities that exhibit similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations. The three main asset classes are equities (stocks), fixed-income (bonds) and cash equivalents (money market instruments)”

Do you agree with the definition above and is this how you would define “asset class”?

Before I answer your question, we need to talk about why the definition is relevant. Investors desire diversification, which can be achieved by investing in multiple asset classes that are uncorrelated to each other.

An asset class should not be limited to securities alone. For example, derivative financial instruments, collectibles, and horses are not securities but are asset classes. Asset classes may exhibit low correlation to other asset classes, but it is not a requirement. For example, say German bonds and Korean equities were highly correlated, I doubt that anyone would consider them part of the same asset class.

I would classify investments as either traditional or alternatives.

So then, what are traditional assets?

Traditional investments include equities, fixed income, and cash equivalents. Alternatives include:

- Hedge funds
- Real estate/oil & gas
- Private equity/venture capital/LBO
- Commodities/Currencies
- Derivative financial instruments
- Classic cars/horses
- Collectibles
- Anything else that is not “traditional”

Would you say “traditional” investments trade in increasingly efficient markets (diminishing risk premia) vs. alternatives (majority are still inefficient – and offer risk premia).

As more capital infuses the latter market, the efficiency gap between the two is diminishing. After all, hedge funds, for example, exploit market imperfections, which, therefore, make the markets, in which they trade, more efficient.

Is it possible to regulate investing in horses? Or cars? How relevant is the issue of regulating assets?

The roles of regulation include protecting investors from fraud, and maintaining the integrity and stability of markets. Of course, it is possible to regulate assets, but with government's limited resources, it may be more practical to focus on the investment vehicles and the markets rather than the assets themselves. In any case, whether an asset or industry is regulated should have no bearing as to whether it is part of an asset class.

What differentiates an asset class from an “investment vehicle”?

An investment vehicle is an investor.

Are investors “asset classes”?

Would you call pension plans, university endowments, and Bill Gates asset classes?

An investment vehicle is a business model that contractually governs the relationship between the investor and the manager of such vehicle.

Equities, bonds, cash (and its equivalents): is “everything else” a permutation, combination and re-packaged version of the former?

Absolutely not. For example, “classic cars” should be uncorrelated to equities, bonds, and cash.

How would you christen “something” that provides “superior”, risk-adjusted returns, no or low correlations to financial market instruments, achieves diversification, is liquid, regulated, has no capacity constraints...?

I'd call it “manna.”



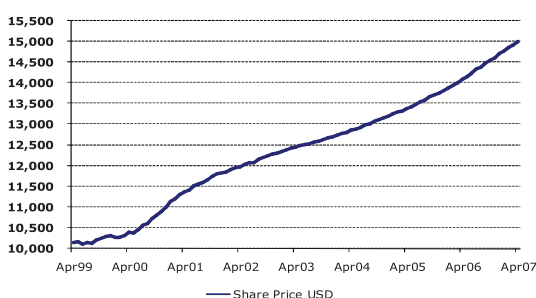
Leon Metzger, since 2004, has been an adjunct professor and lecturer at schools like Columbia, NYU, Wharton, and Yale, where he teaches hedge fund management courses. He also consults on financial services matters and was associated with Paloma Partners Management Company for 18 years, most recently as its vice chairman and chief administrative officer. Metzger has testified before Congress on capital markets, and has appeared as an expert on valuations and hedge funds before various government agencies.

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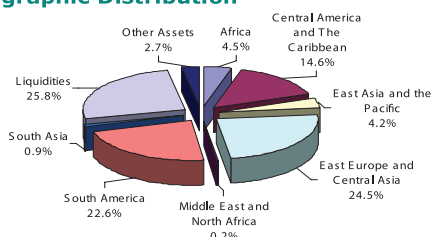
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MICROFINANCE/ SOCIALLY RESPONSIBLE INVESTING

USD Share Price



Geographic Distribution



Funds performance since inception and portfolio's geographic distribution
Source: BlueOrchard Finance

DEXIA MICRO CREDIT FUND (BLUEORCHARD)

Focus: • A commercial investment fund designed to refinance microfinance institutions specialised in financial services to small companies in emerging markets; targets returns of US 6 month LIBOR +/- 1-2%

• BlueOrchard specialises in selectin microfinance institutions via its well established network of contacts in socio- economic, developmental and promoting organisations

• BlueOrchard's evaluation serves as a basis for the investment decisions taken by Dextra's financing committee

It is active in 25 developing countries in Latin America, Asia and Eastern Europe, and finances 60 institutions, which serve over one million micro-entrepreneurs.

Strengths: • Network, expertise, track record (incepted in September 1998)

Weaknesses: • Have to balance capital inflows with capacity constraints; high fees/transaction cost with respect to the annual returns generated.

Opportunities: • At least 10,000 micro finance funds exists globally; it is estimated that roughly 2% of those are open to investors

• According to research many microfinance institutions (MFIs) report historical repayment levels on loans of 97% or more

• Threats: geo-political risks, easily available subsidised money; if banks were to turn active in the space

Risk Management

Low Low / Moderate Moderate Moderate to High High

• Major risk at fund level: **Non performing loans, fraud related risk**

• Expertise in identifying genuine micro finance investment opportunities:



• Access to deal flow:



• Ability to secure capacity:



• Expertise in conducting due diligence (onsite)



• Ability to track performance:



• Ability to secure interest payments due



• Liquidity of underlying asset :



• Loan related risks

• Valuation:



• Default:



• Fraud:



• Non-performance:



• Collateralisation:



• Currency :



• Key person risk :



Performance Parameters

Insufficient Adequate Satisfactory Good Outstanding

• Performance - last 5 years annualised = **4.51%**

• Total no. of loans = **398**

• Efficiency in putting investor capital to work:



• Management Fee: **2.5%**

• Worst case scenario: **High default and non performing loans, fraud**

• Ability to consistently deliver targeted returns since inception:



• Diversification achieved:

• Geographic: (28 countries: E. and Central Europe: 24.5%; South America: 22.6%)



• No. of MFI: **75**

• By type of loan:



• Loan avg. maturity **23.6 months**

Outlook

• Barriers to entry : **Network**

• Threat posed by competition: **by new vehicles such as CDOs - where the risk is rated and a secondary market make exist**

• Outlook on investing in this sector: **Upside Potential**

• Outlook for a fund such as Dextra: **Range Bound**

• Ability to deliver targeted returns over the next:

• 1 year: **Upside Potential**

• 3 - 5 years: **Upside to Range Bound**

• Ability to deliver in up, side ways, down markets: **Upside Potential**

• Suitable for:

• A conservative portfolio **Suitable**

• A balanced portfolio **Fairly Suitable**

• An thematic portfolio **Suitable**

• Peculiarities displayed by the underlying sector: **Investors are all chasing the same limited, but fortunately growing opportunities**

Investment

• This fund is targeted at: **Thematic investors looking at socially responsible investing**

• To optimise returns recommend avg. holding period of: **Min 2 years**

• Geographic restrictions - **different classes serve different investor bases**

• Fund's base currency **USD** and other currencies the fund is available in **EUR, CHF**

• Fund complexity for an investor: **simple**

• Liquidity provided: **monthly, with no exit fee**

• Transparency provided to investor: **moderate**

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