Independent Risk Monitoring Limited - Newsletter Q1 2008

- *IRML Opinion*: market turmoil and shades of the 70's in the 07's.
- *130/30 funds*; not as non-sophisticated as some people thought—particularly when it comes to risk measurement.
- *Independent pricing of derivatives*: a new IRML service.

IRML Opinion

On the assumption that the majority of recipients of this Newsletter were either in school or not born in the 1970s, it might be of interest to record a few facts and figures of that era and draw a comparison or two with 2007.

First – the similarities; the 70s and 07s were both blighted by financial crises – the so-called "secondary banking crisis" of 1973/74 and the "sub-prime crisis" of 2007 – to all intents and purposes both unregulated.

The 70s were also marked by rampant inflation; 10 to 12% p.a. in the US, 15 to 20% in Japan and the Far East at large, and 20 to 25% in the UK. 2007 in contrast was marked more by the spectre of inflation – with most of the world insulated from the ravages of steeply rising commodity prices by devaluation of the currency in which commodities are priced – namely the US$.

Inflation was more widespread in the 70s; soft commodities had rocketed, but as we showed in last month's Volatility Report (see www.irml.net) there are some worrying signs that some soft commodity prices are getting out of control – wheat, for example, up 85% year-on-year, with sugar and maize up strongly on bio-fuel demand, and palm oil just starting to spiral.

Second – the differences – one of the most glaring of these, for readers of this Newsletter, is the fact that in the 70's there were hardly any risk tools. Barra was the first commercially available model and it wasn't launched outside Berkeley until 1975 – risk was, in those days, very much a "seat of the pants" exercise.

Also there were few market traded derivatives. Pre-1973 all options were traded OTC. However, in that year the CBEO opened with options on 16 of the bluest of blue-chip US stocks, and Black Scholes was just starting to gain ground. It was not until 1982, however, that the CME launched the world's 1st index futures contract on the S&P 500. Pre-1973, hedging was confined to short selling, stock borrowing and OTC derivative contracts – mainly options. Derivative liquidity was non-existent compared with today's market but, of course volumes were much lower in the olden days – but volatility wasn't!

The other important difference - 70s versus 07s – was the market itself. Wall Street fell 43% in the two years 1973/74 as measured by the DJIA and 57% by the NASDAQ Composite; Japan – the start performer - was down only 27% over the same period but the UK as measured by the FTA All-Share fell 66%. At its turning point January 6th 1975, the UK market stood on a trailing PER of 4x – the reciprocal of the UK's then inflation rate of 25% - and "yes" Wall Street turned on a trailing PER of 8x the reciprocal of America's 12.5% inflation rate.

A far cry from the 07s.

Markets were, of course, weak in 2007 2nd half – but nothing of the magnitude of the 70s – Wall Street was down 5% from the mid-July 07 "high" to year-end, Japan -16% (overweight financials), Europe -3.5%% and the UK -4%. That said, financials were down in 70s proportions – falling on average by 25% - albeit now followed in the opening two months of 2008 by markets in general.

However, as the Chinese word for crisis is written – with two "characters", one for danger and the other for opportunity – so today's market volatility offers the same – and it is the plus opportunities side of the equation that fund managers will now be searching for.

Another "difference" - as we know it today, there was no fund regulation in the 70s, no UCITS III. These facts, perhaps more than any other, are what set 2007 apart from the 70s – pushing the monitoring of risk to the forefront of the industry's minds and resulting – hopefully - in better investor protection.

130/30 UCITS

The wider powers of the UCITS III Directive has unleashed a steady flow of 130/30 fund launches – performance-wise, they have disappointed, but they succeeded in attracting some several €bn of assets, and in more stable market conditions may be expected to fulfil their earlier promise.

However, that will not happen unless the industry's perception of the product changes. From our discussions with clients, we sense that many consider 130/30 funds to be non-sophisticated.

At a recent Derivatives/UCITS III conference we polled delegates (mostly risk managers & compliance officers) on how many of them conducted stress testing of the correlation matrix on their 130/30 funds. The answer was "none" which surprised us although there was consensus that more needed to be done. Certainly by the end of the conference's 130/30 session, opinions had switched from the concept that 130/30 funds were unsophisticated to the reality that they are sophisticated.

Clearly the degree of perceived sophistication will vary from manager to manager but there is nothing wrong with the basic assumption that 130/30 funds should be able to deliver superior returns. Long/short strategies, after all, are not new and it is not necessary for managers to employ complex non-linear derivatives to achieve their objectives. So mapping to an underlying to calculate derivative exposure should be comparatively simple and efficient. Other than for funds domiciled in Ireland, it is not permissible for UCITS funds to short stocks – and in Ireland only under certain strict conditions – so the most popular contracts being used to achieve short exposure are Swaps and Contacts for Difference (CFDs).

Taking CFD strategies as an example, if a fund achieves market neutrality via an ETF or alternative market proxy (e.g. index futures) and gains 30% long exposure in 3 (say) favoured stocks or sectors and shorts 30% in 3 (say) unfavoured stocks or sectors, and if the long and short positions were perfectly correlated, the fund's net exposure would be 100%. And indeed, traditional mean variance models evidence relatively stable sector and stock correlation over the medium to long term within a coherent universe so that the modelled volatility of a 130/30 fund will not be significantly different from that of the corresponding universe benchmark.

In practice, however, the work we have done in this area suggests that this could be a false premise, and perhaps a dangerous assumption. By way of simple example, if a fund achieved its 130/30 objective by going long an S&P 500 contract and 30% (geared) long in 3 weak (relative) sectors and 30% short in 3 strong sectors – an ex-post one month simulation at end November 07 could have produced returns of minus 14% vs minus 1.9% in the S&P. Over one year ending November 2007 using the same hindsight would produce a result of -31% vs 4.3% for the S&P.

So clearly blind reliance on the models could prove disastrous – making regular stress testing a vital component of risk monitoring – not just for regulatory compliance purposes – but as an essential of due diligence and investor protection.

IRML launches an independent OTC Valuation Service

IRML has expanded its services to include the independent valuation of OTC instruments. We use multiple external valuation providers in order to enable us to offer full instrument coverage, "best of breed" service for each instrument type, and independent valuations regardless of a client's current valuation provider. Our valuations are intended to reflect "fair market value" and are based on both market data received from various sources (including market makers, inter-dealer brokers & data aggregators) and on generally accepted pricing models. We provide transparent and auditable valuation reports, which include the "Greeks" – e.g. delta, gamma, rho, theta and vega - and we offer full client support.

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Contact us with your views:

IRML aims to be highly responsive in developing RiskRadar™ in conjunction with client requirements. If you have any questions regarding the latest release, planned projects or would like to learn more about IRML, please contact us:

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