

## The Impact of Negative Interest Rates

The zero and negative interest rates increase the prices of equities and real estate until the expected return promised by these asset classes approaches the low or negative rate set by the central bank. In extreme cases, the expected market yields fall even to or below the zero line. But if the central bank has pushed all yields to or below zero, what is left of the free market economy is at an end. Without a positive market interest rate, without having a positive return in sight, saving and investing ceases. After all, every consumer and every entrepreneur is looking for a positive base interest rate, meaning he demands a positive compensation for his abstinence from consumption. Long-lasting negative interest rates are an attempt to override the laws of economic logic. That is unreasonable. The power of the ECB is becoming the power-

lessness of the people. Negative interest rates do not solve the problems, but create other issues whose economic damage cannot be estimated yet. It would be desirable if the central banks sought normalization of interest rates before they could no longer free themselves from this trap. It would blow up the bubbles in the equity and real estate markets, which would be painful in the short term, but healthy in the long run, because reasonable returns could be achieved in all asset classes again. An efficient allocation of resources is the cornerstone of the market economy.



Stefan Steiner

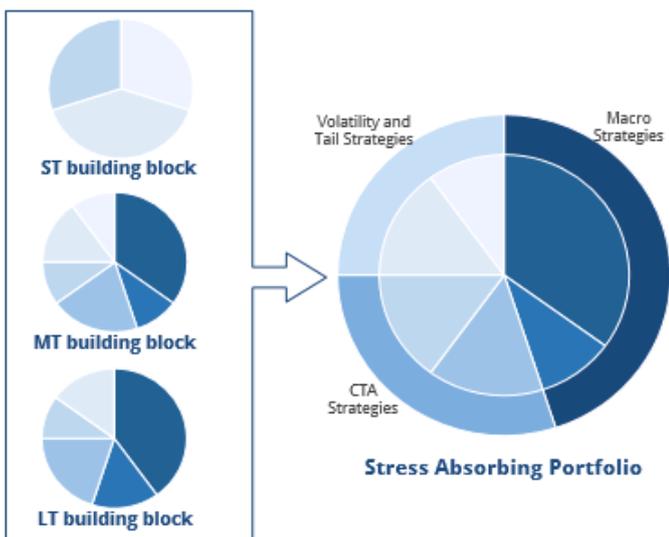
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Fixed Income (USD)	Sept. YTD	2018	2017	3Y CAGR	5Y CAGR	5Y Std Dev
Switzerland Gov Bonds 1-10Y TR	3.92%	3.52%	1.49%	2.73%	2.78%	2.00%
FTSE WGBI (ex-Citi WGBI All Maturities)	6.27%	-0.84%	7.49%	1.19%	1.80%	5.35%
Barclays Global HY TR	8.76%	-4.06%	10.43%	4.77%	4.54%	5.67%
HFRI Event-Driven Index	4.83%	-2.13%	7.59%	4.56%	3.02%	4.54%
HFRI Relative Value Index	5.59%	-0.43%	5.14%	4.03%	3.30%	2.87%
Crossbow Credit Distressed Portfolio	4.41%	-0.75%	3.51%	2.60%	1.16%	2.95%
Crossbow Alpha Portfolio	5.31%	1.77%	3.94%	3.82%	3.56%	2.09%
Equities (USD)	Sept. YTD	2018	2017	3Y CAGR	5Y CAGR	5Y Std Dev
SMI TR Index	26.42%	-4.17%	20.25%	13.90%	8.27%	12.01%
MSCI AC World TR	16.20%	-9.41%	23.97%	9.71%	6.65%	11.71%
MSCI EM TR	5.89%	-14.57%	37.28%	5.97%	2.33%	15.55%
HFRI Equity Hedge Index	8.00%	-7.14%	13.29%	4.78%	3.47%	6.42%
HFRI Macro Systematic Diversified Index	8.87%	-6.62%	2.12%	0.43%	1.10%	7.71%
Crossbow Equity Hedged Portfolio	6.76%	-3.83%	7.86%	2.31%	2.79%	4.85%
Crossbow Trading Portfolio	2.99%	1.70%	5.94%	3.90%	4.50%	3.55%
Crossbow Trendfollowing Portfolio	12.94%	-0.64%	4.45%	5.58%	5.16%	6.28%
Others (in USD)	Sept. YTD	2018	2017	3Y CAGR	5Y CAGR	5Y Std Dev
BVG-25 Plus	12.50%	-0.13%	7.31%	6.36%	5.94%	3.45%
BVG-40 Plus	14.73%	-1.49%	9.72%	7.75%	6.73%	4.99%
BVG-60 Plus	17.79%	-3.31%	13.17%	9.64%	7.75%	7.33%
SXI Real Estate Funds TR Index	16.79%	-2.40%	8.75%	7.40%	8.57%	7.57%



### Hedge Funds as Stress Absorbing Engine

In today's environment, many investors seek to protect their portfolio against a possible equity market downturn. The implementation of such a protective or stress absorbing module is far from trivial as it must address several issues: Magnitude and duration of market correction where protection has to be effective, accepted cost of protection, allocation budget to the stress absorbing module, protection in equities only or across asset classes.



In our opinion, hedge funds are best suited to construct strategic stress absorbing modules that are effective in various correction scenarios and with acceptable costs of protection, while passive protection strategies (e.g. long puts) can prove excessively costly over the long-term. The fascinating aspect about hedge funds is that they form a highly heterogeneous, multi-dimensional universe with a significant granularity behind their broad strategies such as Equity Long/Short, Relative Value or Macro. Within some sub-strategies, hedge funds with a specific combination of investment approach, strategy implementation, trading style, preferred market exposure, time horizon and market focus are designed or seek to perform positively when market volatility increases and/or markets are negative.

Our implementation approach of a stress absorbing portfolio starts with defining the main types of market corrections across three time horizons (this choice is arbitrary and relies mostly on historical market observations):

- Short-term correction: Shorter than 3 months, sharp, causing extreme volatility spike.

- Medium-term correction: From 3 to 6 months, equities decline more than -20%, higher volatility.
- Long-term correction: Longer than 6 months, equities decline more than -30%, higher volatility.



David Friche

We then construct three portfolio building blocks (short-term, medium-term, long-term), each of them being expected to provide positive returns during the corresponding market correction. In the top-down construction phase, we select appropriate strategies after analyzing their return sources, risk/return profiles and criteria such as active trading, liquidity, volatility sensitivity, cost of protection. The building blocks' strategy composition is typically as follows:

- Short-term building block: Tail Risk, Long Volatility, Short-Term CTA.
- Medium-term building block: Discretionary Macro, Systematic Macro, Trend Following CTA, Short-Term CTA, Long Volatility, Tail Risk.
- Long-term building block: Discretionary Macro, Systematic Macro, Trend Following CTA, Short-Term CTA, Long Volatility.

In the bottom-up part of the construction process, a deep understanding of the strategy of each selected manager within each strategy bucket is paramount for the success of each building block during market corrections. The manager analysis and selection also allows to understand profit taking mechanisms and to expand protection beyond equities and thus potentially benefit from the impact of a major correction across markets (especially fixed income and currencies).

Depending on the investor's needs for protection and tolerance for protection costs, his stress absorbing portfolio can incorporate one or several of the building blocks, whose weightings and composition can be further customized. Some investors might for instance opt for the medium- and long-term building blocks, as they have positive long-term expected returns.

Thanks to their vast flexibility, hedge funds offer the possibility to construct stress absorbing portfolios that are diversified across strategies, investments styles, asset classes, geographies, time horizons and are designed to provide highly convex risk/return profiles with positive returns during important market corrections. In today's environment, this is quite an attractive proposition.

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### Text Sophistication and Sophisticated Investors

Assistant Professor Juha Joenväärä (Aalto University) and his fellows Jari Karppinen (University of Oulu), Melvyn Teo (Singapore Management University), and Cristian Tiu (University at Buffalo) wrote a paper asking the following question: **Are sophisticated investors also sophisticated writers?** A priori, it is not clear that they should be. On one hand, sophisticated managers with superior investment skills, who are therefore cognitively gifted, should also write in a sophisticated manner. On the other hand, managers who do not possess investment skills may write in a sophisticated fashion to deceptively signal investment prowess.

The two measures of text sophistication that they enlist, namely lexical diversity and syntactic complexity, allow to distinguish between the two cases:

- Lexical diversity is the propensity of the writer to use multiple synonyms rather than repeated words and has been associated with cognitive ability
- Syntactic complexity is the inclination by the writer to favor complicated sentences characterized by heavy use of subordination and has been linked to deceptive behavior.

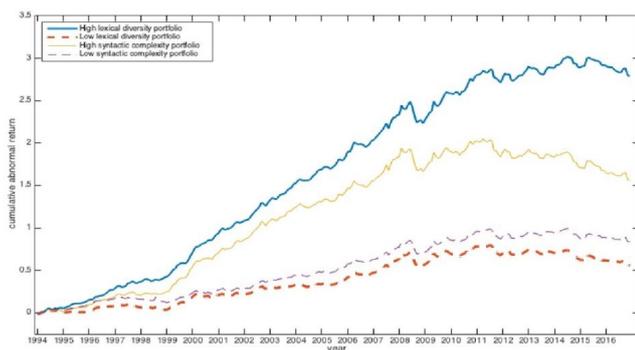


Fig. 2. Cumulative abnormal returns of hedge funds sorted by the lexical diversity and syntactic complexity of their strategy descriptions. Every January 1st, hedge funds are sorted into decile portfolios based on lexical diversity and syntactic complexity. The thick solid line denotes the extreme high lexical diversity portfolio. The thick dashed line denotes the extreme low lexical diversity portfolio. The thin solid line denotes the extreme high syntactic complexity portfolio. The thin dashed line denotes the extreme low syntactic complexity portfolio. Cumulative abnormal return is the difference between a portfolio's excess return and its factor loadings multiplied by the Fung and Hsieh (2004) risk factors, where factor loadings are estimated over the entire sample period. The sample period is from January 1994 to December 2016.

The differential loadings that the two measures have on deception suggest that only lexical diversity, and not syntactic complexity, provides an honest cue to managerial talent.

Indeed, hedge funds with high lexical diversity outperform those with low lexical diversity by an

economically and statistically significant 3.63% per year. Hedge funds with lexically diverse strategy descriptions display several additional attributes that are attractive to fund investors. First, they deliver superior Sharpe ratios, information ratios, and manipulation-proof performance measures. Second, lexically diverse funds manage risk more judiciously. They eschew idiosyncratic risk and tail risk.

The tests further reveal that the second measure of text sophistication, namely syntactic complexity, is associated with deception at hedge funds. Funds whose strategy descriptions are syntactically complex experience more regulatory actions, violate more investment rules, and report more severe infractions, than do funds whose strategy descriptions are syntactically simple.



Armin Vogel

### Public Hedge Funds

“When a fund management company lists on a stock exchange, its clients are not uniformly delighted.

They are aware that potential conflicts of interest can arise that some companies fail to manage.” (Financial Times 2012)

The Journal of Financial Economics published an article from Lin Sun and Melvyn Teo, having a deeper look at this topic. They found that hedge funds managed by listed firms significantly underperform funds managed by unlisted firms. The underperformance is more severe for funds with low manager deltas, poor governance, and no manager co-investment, or those managed by firms whose prices are sensitive to earnings news. Notwithstanding the underperformance, listed asset management firms raise more capital, by growing existing funds and launching new funds post listing, and harvest greater fee revenues than do comparable unlisted firms. The results are consistent with the view that, for asset management firms, going public weakens the alignment between ownership, control, and investment capital, thereby engendering conflicts of interest.

*If you wish additional information on these studies, please contact [av@cb-partners.com](mailto:av@cb-partners.com)*