"Costanza Asset Management" Project

Product and Organizational Philosophy For A New Generation Asset Management Company

An Alternative Organisational Solution For Systematic Funds and Funds of Funds

Version 1.7

Summary

Principles and Definitions

Bibliography:

Paolo Sassetti, *Investire controcorrente. Il conformismo finanziario e le alternative possibili*, FrancoAngeli, 2002, chapters 5, 8 and 12.

Paolo Sassetti, *Perché liberalizzare la gestione del risparmio,* BorsaExpert, 2003, chapter 4.

Why the name “Costanza” (Perseverance)

Perseverance – also defined “operating discipline” – is the major virtue for success in asset management. Systematic models are the most disciplined by definition and, therefore, cultivate, most of all investment philosophies, the virtue of perseverance.

Basic Idea

Offering systematic investment products to Italian and European institutions and high net worth individuals who, today, have access mainly to low volatility – low return funds.

Extending systematic investment techniques, normally applied in derivatives' trading and hedge fund management, *also* to traditional mutual funds through:

- systematic <u>switching</u> techniques among asset classes/sectors
- <u>market timing</u> tools

The Italian hedge fund industry is still in its infancy and truly "differentiated" products may gain important market shares.

The mutuals fund industry is the most conservative and unsophisticated and retail customers may gain the highest benefits from simple product innovations.

What a Systematic Investment Model is.

It is a model which does not try to forecast the future of the markets but fits their current behaviour on the basis of rules defined after a backtesting process. Key feature of a systematic model is avoiding the “strategic” mistakes of discretionary asset management (tipically caused by fear, greed and personal ego) *such as maintaining an important long position in a primary bear market*. When properly built, a systematic model behaves like a spring: during losing periods the model ideally accumulates power and then releases this power during the winning periods. In a good system, the released power is higher than the accumulated power, in other terms the extension of the spring is stronger than its compression.

Advantages of Systematic Vs. Discretionary Management (1)

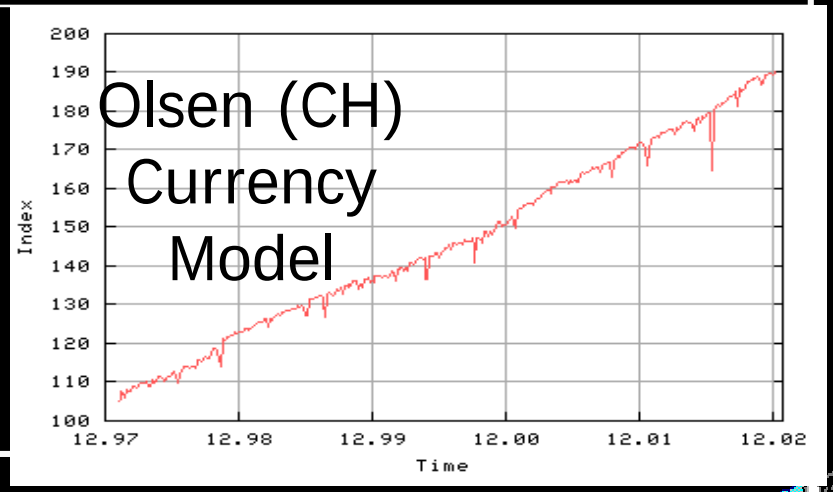
- Overcoming the principle of the “common and shared wisdom” in asset management, which usually leads to following benchmarks
- Operating discipline
- Radical changes made possible in asset management policies (dynamic asset allocation), avoiding interpersonal conflicts in the management companies
- Backtesting and unbiased evaluation of the models under changing market conditions

Advantages of Systematic Vs. Discretionary Management (2)

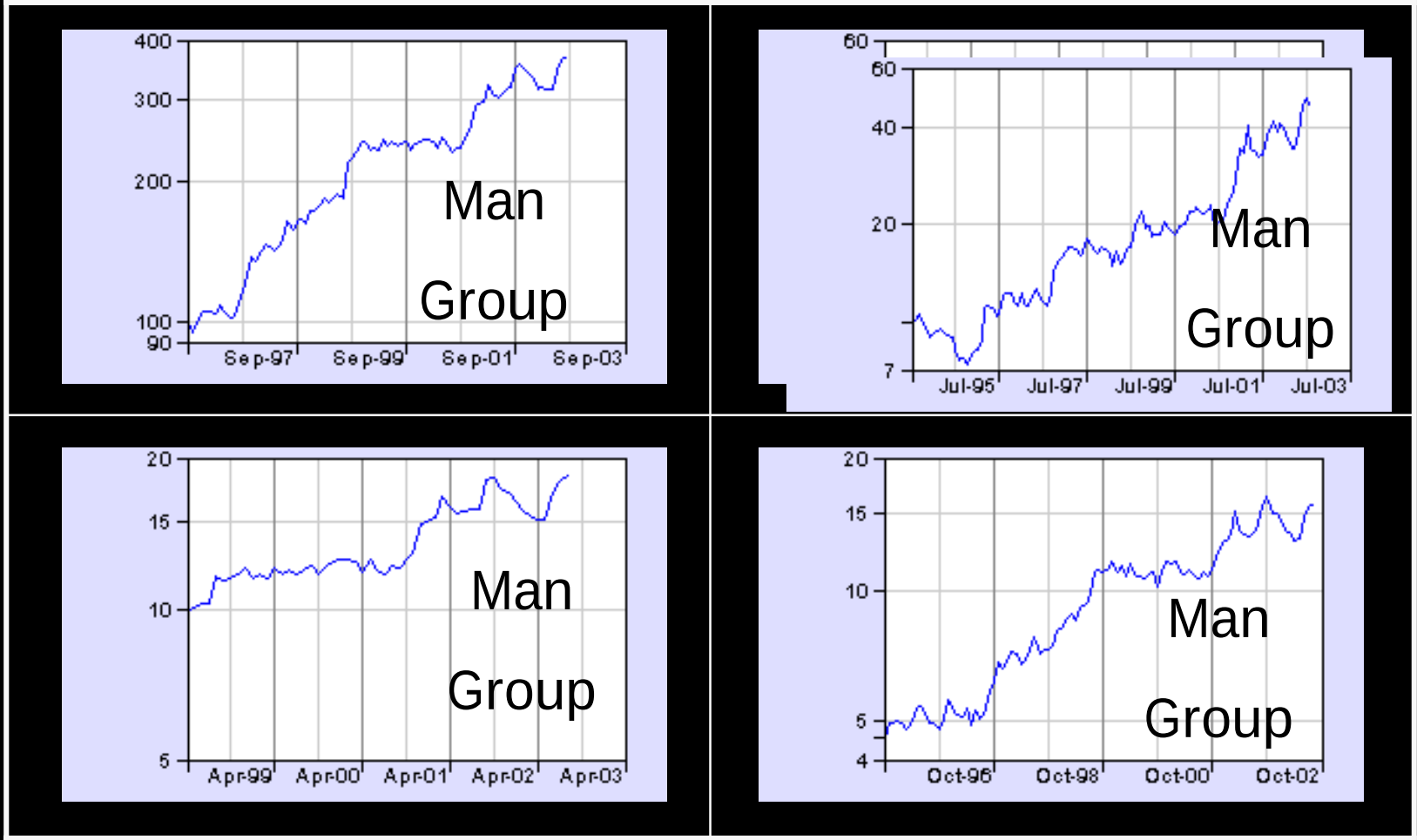
Parallel

Computers, even though programmed by men, very often defeat men playing chess. Some champions beat computers, but computers usually defeat men. Computers do no have emotions and can store all the possible game combinations.

Equity Lines of Systematic Models (1)



Equity Lines of Systematic Models (2)



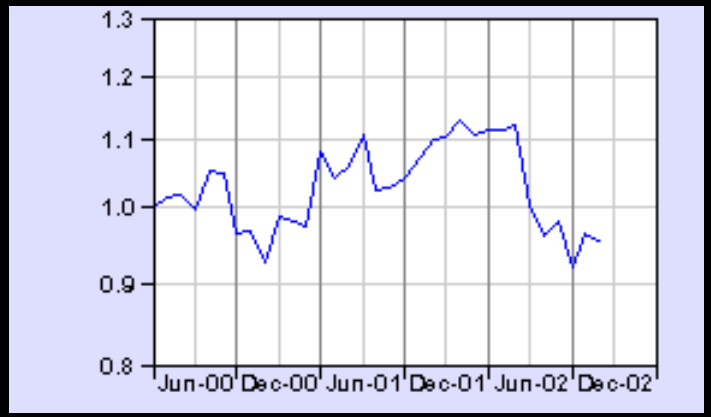
Equity Lines of Systematic Models (3)

The equity curves of the 8 previous investment models refer to different markets, investment styles and risk tolerance.

Nethertheless they have three features in common:

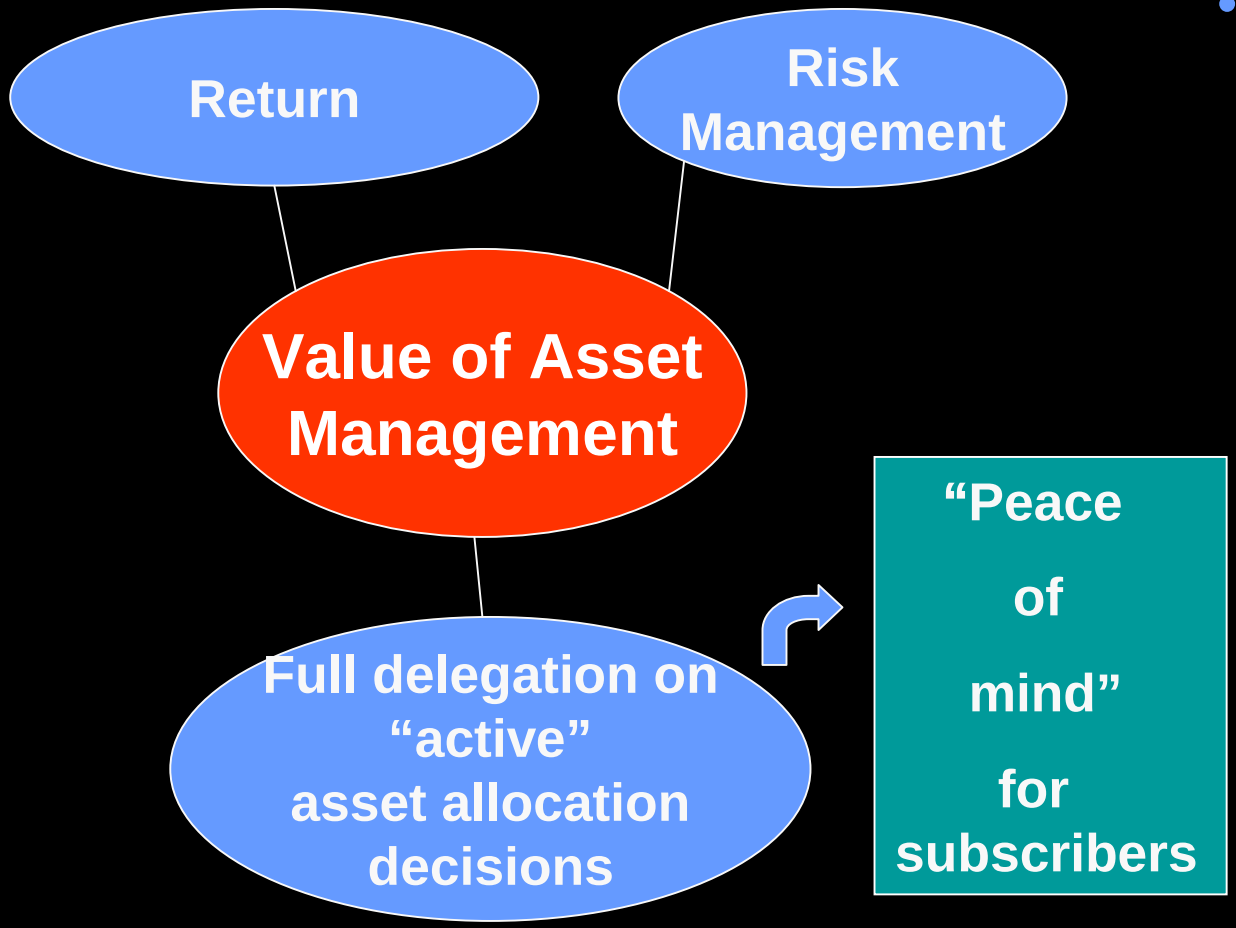
1) they are all systematic models
2) their equity curves *systematically* peak in a short-medium time frame
3) their equity curves are lowly correlated to financial mkts

...even though one can not be successful every time ...



Needs of the Investors, Problems of Mutual Fund Industry and Opportunities for Active Asset Management

The Unsatisfied Needs of Mutual Fund Subscribers



- Mutual funds do not meet these needs because they are more and more indexed to benchmarks. Their subscribers are forced to carry out their own asset allocation even though they do not have the skills for this task

Reasons for Growing Indexing in the Mutual Fund Industry

- Officlal reason: volatility and risk control
- Unofficial reason: managerial mimetism

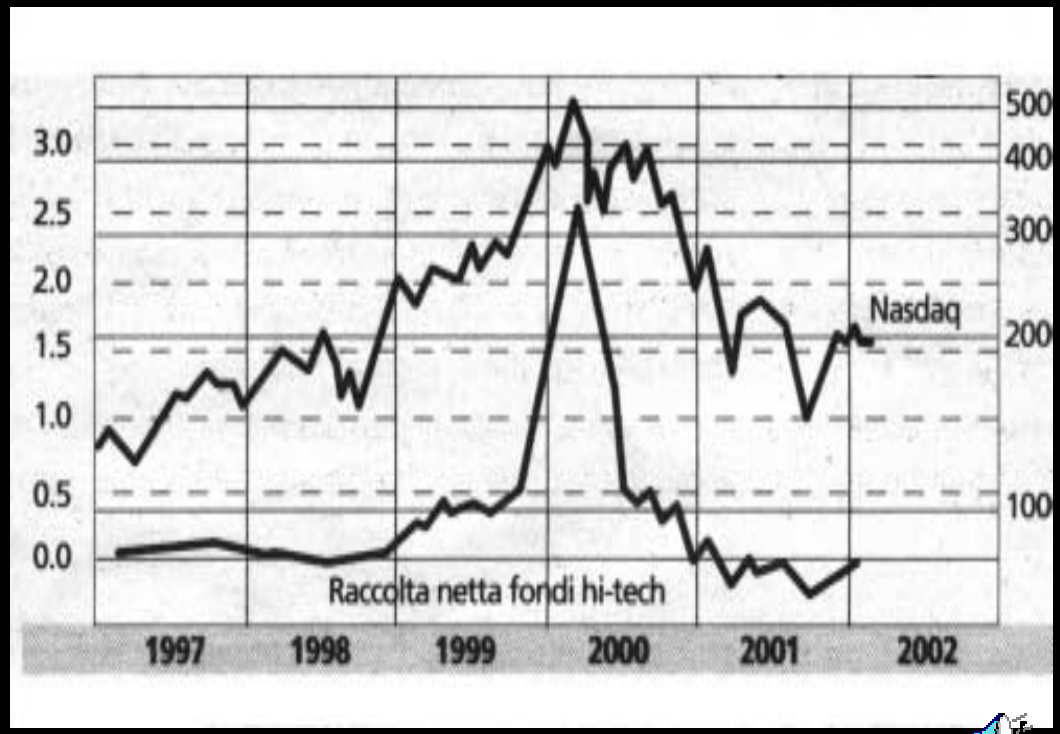
Beating the markets using mainly “fundamental” investment techniques and discretionary judgement is difficult, random and source of interpersonal conflicts in the management companies.

Discretionary Market Timing is Normally Unsuccessful

As Marc Faber wrote:

"I analyzed all the major investment themes in the last 30 years and investors have always been late in recognising a new theme"

The last case: net raising of tech funds vs. Nasdaq

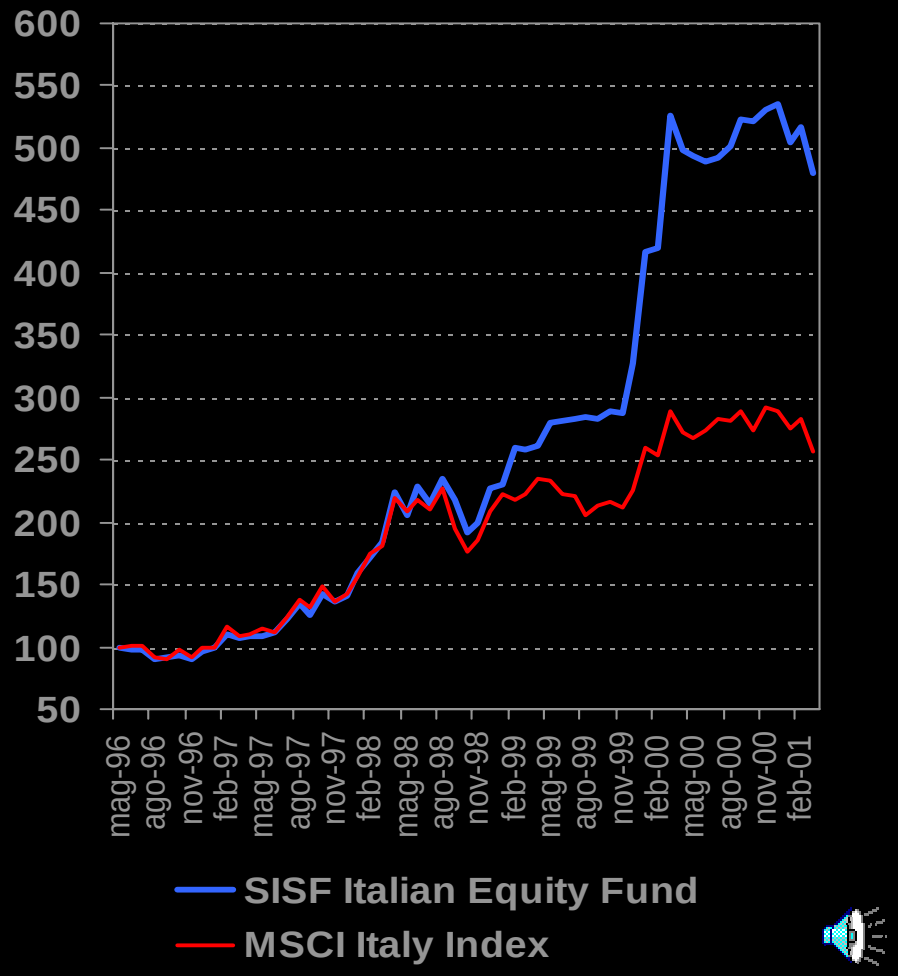


Non-Management of the Key Variables of Returns in the Mutual F. Industry

- Most of the resources in the financial research are spent for *stock picking* but it is well known that *stock picking* has a secondary impact on total portfolio returns
- More important variables for total returns are *sector rotation* (e.g. gold & real estate in years 2001-2002) and *mkt timing.* These variables are more easily and effectively managed through statistical techniques rather than discretionary decisions. Nethertheless these variables are not very popular in the mutual fund industry.

Results Achieved Through Systematic Methodologies (1)

Schroder Italian Equity fund has changed its investment policy from pure indexing to investing, in a bull market, only (and simply) in shares with Beta coefficient > 1, regardless of their fundamentals



Results Achieved Through Systematic Methodologies (2)

In August 2002, of all the equity products of Julius Baer, only a systematic fund showed a positive return for the previous 12 months

Project’s Goals

Project's Goals: Performances for Customers First

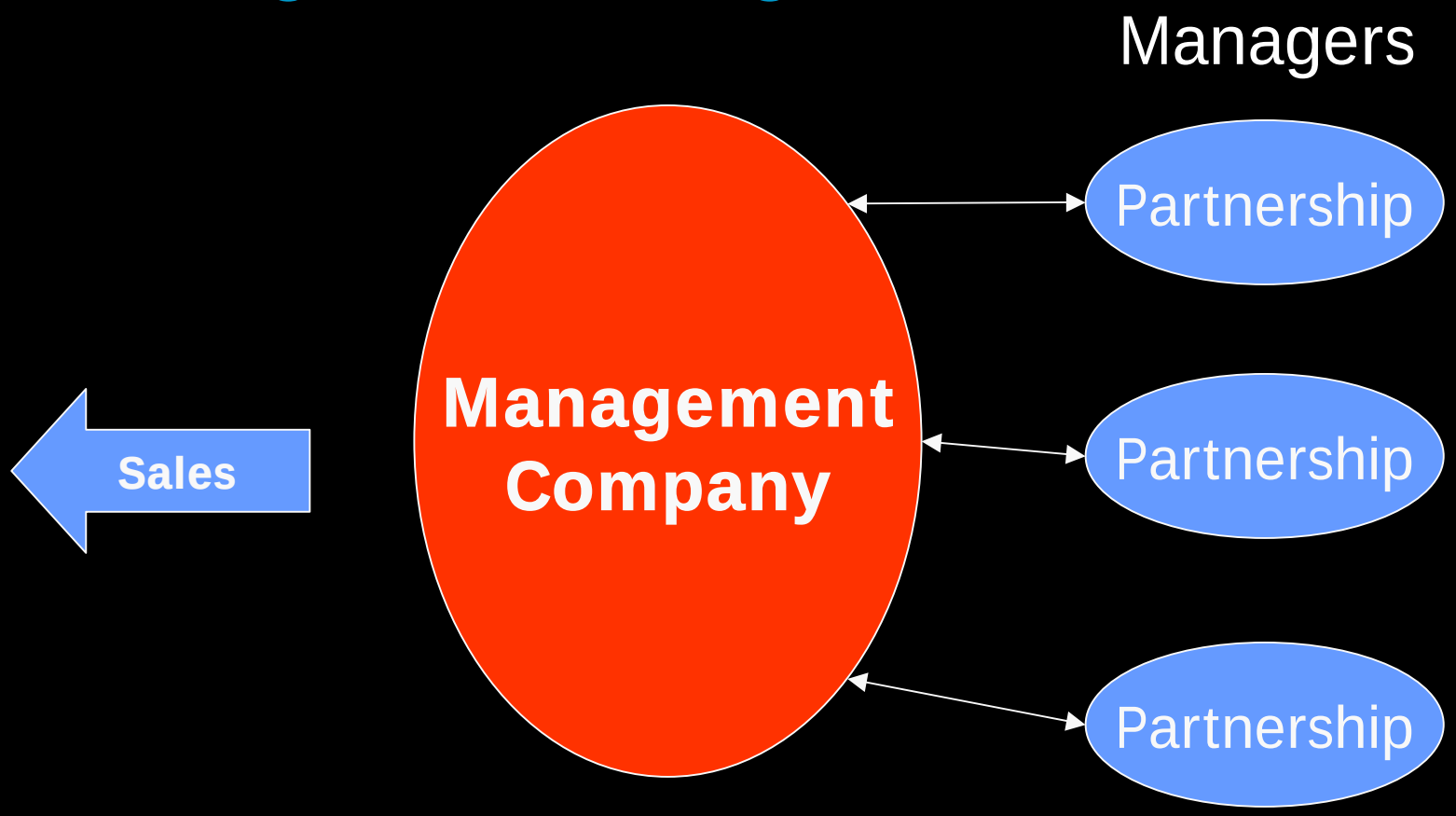
- Offering financial products with superior *compound* returns even at the expense of a higher asymmetrical volatility; recovery time of equity (from peak to peak) one of the key indicators, more important than Sharpe ratio and the like
- Competing *also* in the market of mutual funds through specialty funds managed by systematic investment techniques, importing concepts from the hedge fund industry

Project's Goals: Benefits to Shareholders

- Structuring "specialty" financial products rewarded with superior performance commissions (and higher probability to earn them: short peak to peak recovery time...)
- Continuous product innovation process through the selection of unscouted talents
- Establishing the first Italian entity specialized in systematic investments as a reference for the domestic community

An Alternative Organizational Solution

An Answer to the Problem of Fund Indexing: a New Organizational Model



Portfolio Management
Traditional Models vs. New Model

- Discretionary portfolio management
- Mainly passive management
- Optimization models
- Risk control through portfolio diversification
- Human resources inhouse

- Systematic portfolio management
- Active management aimed at catching strong mkt/sector movements
- Heuristic models
- Risk control through money management
- Selection and agreements with external talents

Role of the Company

- Scouting, testing, valuation (robustness, scalability) and selection of the investment strategies
- Research on specific and very relevant investment themes
- Definition of the contractual relations with investment managers and traders
- Administration
- Monitoring the strategies' efficiency
- Allocation of capital about various partnerships
- Marketing

An hybrid model, half way between portfolio management and venture capital, new to Italy. Requires an international partner.

Examples of Possible Products

Case 1 – Flagship Product: Fund of Systematic Funds (1)

Fund of systematic funds. Investment concept: systematic management aims at recovering equity drawdowns in a reasonable time (hopefully quarters and not years), a fund of systematic funds offers a superior protection thanks to diversification among markets and styles.

Possible candidates (mostly **veterans** and **"masters"** whose stories speak for themselves)

John Henry (USA), Graham Capital (USA), Trout Trading (USA), Renaissance Technologies (USA), R. Niederhoffer (USA), Northbridge (USA)

Man Investment (UK), Aspect Capital (UK)

Olsen (CH), Wolf (CH), Rivoli (F)

Technical Top Trader (A), Quadriga (A)

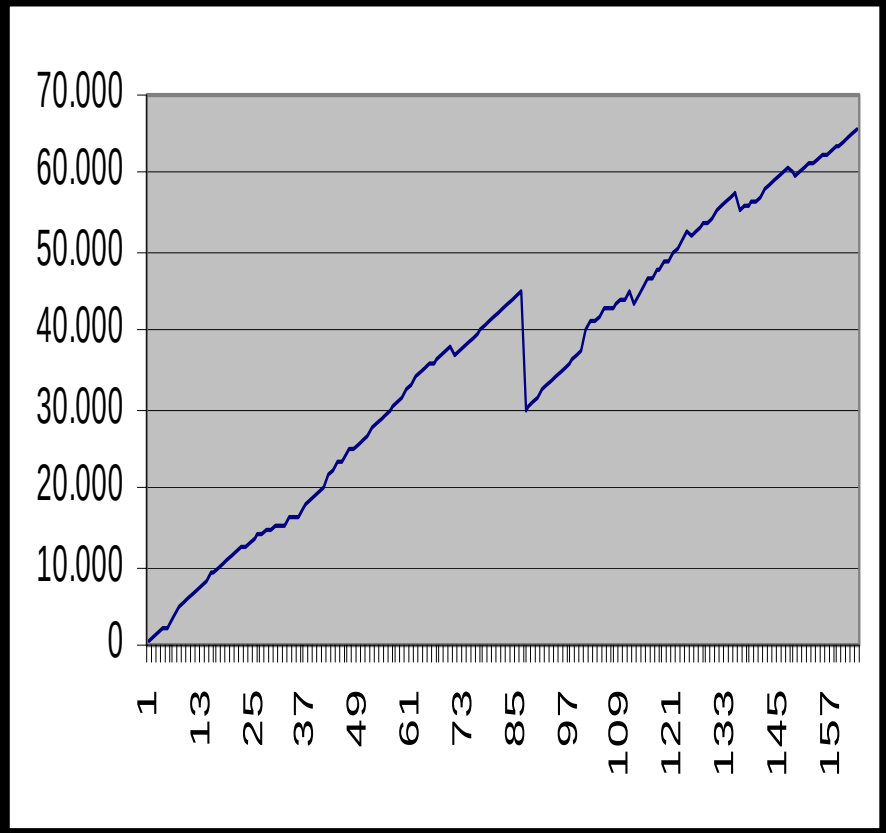
Case 1 – Flagship Product: Fund of Systematic Funds (2)

A well selected pool of systematic portfolio managers may achieve superior returns and work as a **multiplier / hedging tool** vs. “long only” positions. Recovery time <= 2 years is worth higher volatility.

The hedging strategy for entrepreneurs that Martin Ebner missed to carry out!

Case 2 – Futures Trading (Hedge)

- A group of Italian system analysts has developed an intraday model, integrating a traditional counter-trend approach with a neural net.
- The model, after a backtesting process, works with real money since November 2001 on seven futures markets: S&P500, FTSE, Dax, Fib. Bund DJ Eurostoxx, €/$



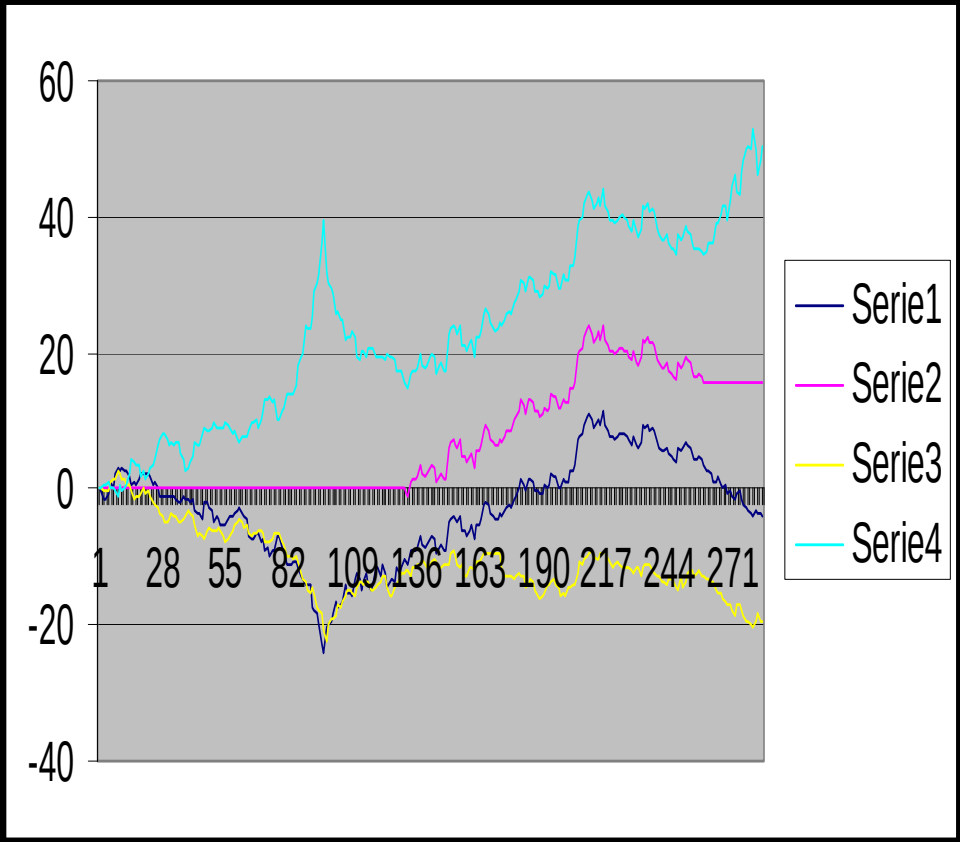
Case 3 – Emerging Markets (Mutual)

- An econometrician of the best Italian school, after leaving Bank of Italy, has developed a model to detect the turning points in the equity markets of some emerging countries. The system crosses historical series of the equity markets with those of the money markets of the same countries.
- The developer of the model claims to have regularly beaten the benchmarks thanks to a “long-out” strategy.

		MODEL AND BENCHMARK PERFORMANCE			
MSCI Free Index in US$		Annual		Return	
	Weight	turnover	6-month	12-month	24-month
Modello	**100,00**	**5,9**	**15,37**	**19,37**	**10,42**
Benchmark			*5,97*	*7,24*	*-3,58*

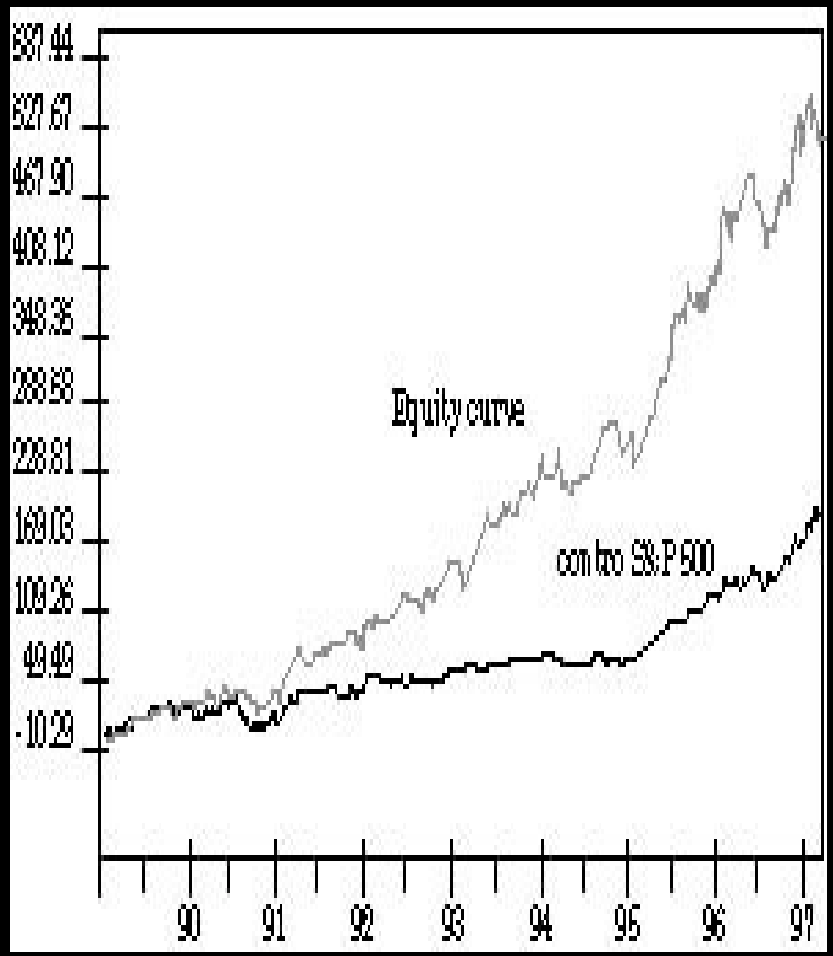
Case 4 – Sector/Country Rotation (Hedge/Mutual)

- An Italian seasoned systematic trader has developed a model which is long or short in 3 country equity markets, selected from a universe of 17 country equity markets by an indicator of strength.
- One of the variations of the model (light blue line) is long/short (hedge version), another variation (red line) is long-out (mutual version)
- A test has shown significant added value of the model vs. the benchmark (yellow line) and vs. a “buy & hold” strategy.



Case 5 – Sector Rotation (Hedge, Statistical Arbitrage)

- Paolo Sassetti has developed and tested some models of sector rotation which use the funds of the Fidelity Select Sector family. These models do pretty sistematically better than the S&P 500 and may be applied to a statistical arbitrage fund. The models are generically described in Paolo Sassetti's last book, *Investire controcorrente*, Franco Angeli, Milano, 2002



Conclusions

Qualified Elements of the Project

- New generation of managed products with high risk control and high partecipation to customers' performances (with no conflicts of interest with customers) even at retail level
- Coherence between products and organization
- Innovative communication made possible in an enviroment dominated by traditional banks: *"The funds in which their managers invest. Does your portfolio manager invest in yours?"*
- Business model based on performance differentiation and incentives to private bankers
- Strategy difficult to be copied (low local competition in the coming years)

Why Italy (1)

- Italy has a relevant stock of family savings and still one of highest saving rates in the world
- Italy has approved probably the most liberal regulation in Continental Europe on hedge funds
- Level of financial sophistication and competition are still low and enable interesting commission levels (as a key element of an aggressive commercial strategy)
- At the same time, domestic asset management industry, being highly concentrated, has inhibited true product innovation so far: the Italians look desperately for new <u>actively</u> managed products

Why Italy (2)

- Italian financial institutions do not have the capabilities and the culture to develop “quant” products inhouse but they are strongly attracted by “quant” philosophy for style diversification: Banca Intesa (the largest Italian bank) bought a small management company founded by a university professor specialized only in CPPI method
- US and UK single hedge funds can not significantly enter the market of the invidual investors without a local base because of:

  - tax burden on foreign products

  - suspect (“who says you are one of the best?”)

Why Paolo Sassetti

- Quantitative background (theoretical and practical)
- Understanding of the conditions for success in systematic investments
- Trades lightly the Italian stock index future with a systematic intraday model which has been a great learning school
- Was responsible for “traditional” equity accounts in excess of €200 mln in the early ’90s
- Managed successfully one of the Italian pioneer portfolios of futures and hedge funds in the early/mid ’90s (US$ 36 mln) and is familiar to the hedge fund industry. The portfolio had roughly a 9:1 debt/equity ratio and some reasonable mistakes were part of the learning process. It was set up to hedge ideally an international private equity portfolio
- Used to “venture capital” philosophy, business angel
- Is known in Italy as a financial “contrarian” and innovator (founded one of the first Italian equity research departments, managed successfully an hybrid portfolio of international hedge funds and private equity investments, invested in Eastern Germany soon after the reunification, managed one of the fastest and most successful deals in the Italian new economy era, etc.)
- Writer of papers on corporate finance, asset management and systematic investing , he is well known as a “liberal” analyst sided against too bureocratic regulations in finance

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