THE GREENWICH

Roundtable Letter

KNOWLEDGE, VERACITY, FELLOWSHIP

July 2003
Volume 1, Issue 2

www.greenwichroundtable.org

The Greenwich Roundtable Inc.
Two American Lane
PO Box 4019
Greenwich, CT 06831
TEL: (203) 862-1400
FAX: (203) 862-1410
rsvp@greenwichroundtable.org

Inside this issue

The Founder's Council

While we have been operating for almost 8 years, getting funding while we keep our independence has been difficult. Every year I have been going out with a tin cup to plead our case. But last year, Jeff Silverman invited me to lunch with Mark Dalton in the Tudor offices. While waiting in their conference room I noticed a small photograph of a statue of Thomas Jefferson taken on the University of Virginia campus. During lunch we discussed the GR mission and our plans for the future. Mark indicated his interest in underwriting our activities only if we kept our focus on education, best practices and ethics. Tudor would help us if we continued to 'raise the bar', and if a small group of likeminded underwriters participated. At long last, we had found someone who believed in our true mission. And on that day in January our Founders Council was born. In two months **DPM, Barclays Capital, Standard & Poors,** and **Putnam Lovell**, in that order, offered to help us deliver on our mission. Then in late May, when visiting Monticello, I began to understand the spirit of our friends at the **Tudor Group**. Thomas Jefferson was an amazing human being. He borrowed the best, most enlightened, principles of politics, agriculture, society, and economics to design an amazing blueprint for a new nation. Jefferson also launched and funded Lewis and Clark's expedition of discovery. Our mission at the Greenwich Roundtable is not as noble as Lewis and Clark's. But it will be done with the same sense of curiosity, open mindedness and integrity as theirs was. The Tudor Group and our Founder's Council have launched and funded our journey of discovery. And we are very grateful.

What is the Founder's Council? The Founder's Council serves as a small group of sustaining underwriters of the Greenwich Roundtable. Its purpose is to facilitate the efforts of the Greenwich Roundtable in its ongoing educational mission. Dedicated to the development of best practices, general understanding and the advancement of alternative investments, members of the Founder's Council provide the funding needed to sustain the programming.

The Founder's Council enables the Greenwich Roundtable to host the broadest range of programming that serve the interests of the limited partners and investors who are its members. Five organizations of good standing make up the Founder's Council. These organizations shall be active in their support of best practices and research in alternative investments. Their activities will embody the diversity of the alternative investment industry.

What is the Greenwich Roundtable? The purpose of the Greenwich Roundtable is to provide an educational venue whereby the leading practitioners of wealth creation and investment philosophy are free to express their point of view. Operating in the spirit of an intellectual cooperative and a forum for the best minds in the business. The Greenwich Roundtable is a non-profit membership organization funded by its Founder's Council and its Members. Members are sophisticated private and institutional investors of good standing who allocate capital to alternative investments.

Steve McMenamin

Greenwich Roundtable Approved for 501(c) 3 Status

On July 1, 2003 we received notice from the Internal Revenue Service that The Greenwich Roundtable is exempt from US federal income tax as described in Section 501(c)3. This means that your dues and contributions to the GR are deductible from December 31, 2002 going forward. While this is an Advance Ruling, it is nonetheless an important development in our growth. This not only renders your dues deductible, but it also makes us eligible for grants and donations to be applied to projects like a code of best practices and for building-out our website. The Advance Ruling Period ends on December 31, 2006 when the IRS will determine whether anything has changed that would cause us to be no longer exempt. As long as we get our funding from the "Public" rather than one large donor, we expect to maintain this status. You will get a letter from us at the end of the year as a record of the tax-exempt portion of your contribution.

Greenwich Roundtable Committees

The following minutes represent paraphrased highlights of the many committee meetings held in the first half of 2003. Please respond the committee chairs via e-mail with your comments or suggestions.

Audit Committee IRS has approved our tax-exempt 501(c) 3 status. The GR books and records are being reviewed by committee chair with recommendations for improvement. A treasurer's report is being prepared. Chair: Steve Bondi, bondi@assetalliance.com

Education Committee Mark Pearl reviewed over 2000 pages of current industry best practices and wrote a 43 page summary. His review revealed some interesting bias, missing links and unspoken opportunities for improvement. He then attended the SEC Roundtable sessions as a GR representative and sat with congressional staff. With a degree of skepticism he came away impressed. In his opinion, it is probable that the SEC will: 1. Change investor suitability requirements, 2. Require registration of all hedge funds, and 3. Require some degree of greater disclosure. Kevin Mirabile presented a very comprehensive overview of operational, liquidity and counter party risks, which have typically been underestimated in favor of a focus on return risk only. EC members agreed that authoring a Code of Best Practices for the alternative investment community is insufficient in itself to bring about desired change. GR Best Practices recommendations should reflect the best input from diverse investor perspectives. A parallel to the AIMR reporting standards was made. However, this is a good framework to consider in our efforts, and we would hope that the recommended standards are adopted as applicable to any individual hedge fund. Chair: Marilyn Freeman. marilynrf@aol.com.

Executive Committee There needs to be a plan for the Succession of the Board of Trustees. This task will become the responsibility of the Executive Committee. A plan will be developed and voted on by the Board on September 18, 2003. We need to balance an institutional memory at the Board level with the desire to introduce new ideas and perspectives from new Trustees. Chair: Marc Goodman, km@kenmar-us.com.

Governmental Affairs Committee We have been contacted by Chris Shays (R, CT) to conduct a "Town Hall" meeting on the subject of Hedge Funds and Regulation. Shays is bringing Richard Baker (R, LA) incoming chair of the House Finance Committee and the Senate Finance chair. It was suggested that we expand the mission statement beyond the GAC Charter. A limited partner perspective should become the guiding ethos. Close coordination with the Education and Best Practices committees would be wise. It was recommended the GAC carry the Best Practices recommendations developed in the Education Committee to policy makers and regulators. Chair: Steve Ruchefsky, sruchefsky@paloma.com

Membership Committee Last months' experiment with name tags was a qualified success. It could be improved upon by requiring their use for GR guests only. Due to the extraordinary demand there is a need to create a "pressure release" mechanism to accommodate existing members and their guests. Attendance shall be confirmed on a first-come, first-served basis with few exceptions. A confirmation with a confirmation number will be sent back with RSVP. Preference will be given to Fellows. Guests may be asked to "stand-by" during extraordinarily popular sessions. Underwriters will be protected on 10 seats. Guests could be assigned to wear a different color name badge. A sign will be posted in prominent places asking everyone to allow members (white badges) to be seated at the table first. Friends of the Roundtable are marketers and those who neglect their annual founder's contribution shall be invited to participate on a stand-by basis. They will receive e-mail summaries and space available invitations. Friends will initiate all special sessions that take place in the evening with the express purpose of building relationships amongst members and the sell-side. These sessions will be part professional and part social. The Board must sanction them. GR's legal counsel, Rubin & Rudman, strongly urges the Board to secure signed membership applications from all members with appropriate indemnification language. That language was reviewed and approved by the committee. Chair: Lloyd Hascoe, lloyd@hascoe.org.

Programming Committee Over 25 subjects and 75 speakers were discussed. Speaking invitations and dates are being coordinated. On the occasion of Fed Governor, Ben Bernanke, declining our invitation to speak after learning there would be no media attending, we discussed the wisdom of allowing media. Chair: Steve McMenamin, steve@iharbor.us.

Members

Lawrence D. Bartimer
Reid Bernstein
Kelsey Biggers
David Blatte
Stephen Bondi
Kitt Boyatt
William Brown
Mr. Camille Chebeir
Laurent Chevallier
Mark Cirilli
Charles Clarvit
Brian Clifford
Barry Colvin
Berry Cox
Rian Dartnell
Alain DeCoster
Nick DeMonico
Susan Dubin
Charles Eaton
Uwe Eberle
Marilyn Freeman
Lesley M. Friedman
Jeff Geller
Caroline Gillespie
Marc Goodman
John L. Griffith, Jr.
John Griswold
Allen Hall
Albert Hallac
Lloyd A. Hascoe
Ellen T. Horing
Elise Hubsher
Ajit G. Hutheesing
Luke E. Imperatore
Thomas Israel
Heather J. James
John W. James
Mary Ann Johnson
Gregory Joseph
Mark Jurish
Jean Karoubi
Peter Karpen
Michael Kelly
Thomas Kuntz
Karen A. Labenski
Jeff C. Landle
Heidi Lankeit
Adam Lavin
Peter Lawrence
Oscar M. Leal
Scott Ledbetter
Paulo Lemann
Peter Levy
W. Brian Maillian
Douglas S. Makepeace
John Massad
Kota Matsuura
Rafael Mayer
Stephen J. McCarthy
Scott McIntosh
Stephen McMenamin
Juan M. Meyer
Paul Mortimer
Jerrold Newman
Brunello Nucci
Stanley H. Pantowich
Mark A. Pearl
James D.Pelgrift
Todd Pines
Donald H. Putnam
Afroz Qadeer
Mark F. Raskopf
William Raver
Tony Riley
Brooks Ritchey
Egidio G. Robertiello
Charles Royce
Steven B. Ruchefsky
Dean Scheinert
Barry Seeman
Paul Selian
Ken Shewer
Jeffrey S. Silverman
Ian Slome
Ronaldo Steinberg
Lawrence M Stern
Mark Stitzer
David Storrs
Seth D Strickland
Jeffrey Tarrant
Hunt Taylor
Shigeto Toriyama
Margaret M. Towle
Ken Tropin
Warren Vincent
Francois M. De Visscher
Michael Waldron
Susan Webb
Joelle Aractingi Weiss
Brian Welker
Valerie Witoshkin
John Wolcott
Rosalie J. Wolf
William S. Zegras

2003 Fellows

Robert M. Aaron
Paul R. Aaronson
Stephen Bondi
William Brown
Michael Castine
Mark Dalton
Rian Dartnell
Marilyn Freeman
Marc Goodman
John Griswold
Albert Hallac
Lloyd A. Hascoe
Luke E. Imperatore
Michael Kelly
Peter Lawrence
Douglas S. Makepeace
Stephen J. McCarthy
Stephen McMenamin
Juan M. Meyer
Kevin R. Mirabile
Mark Pearl
James D.Pelgrift
Donald H. Putnam
William Raver
Steven B. Ruchefsky
Ken Shewer
Jeffrey S. Silverman
Mark Stitzer
Seth D Strickland
Jeffrey Tarrant
Brian Welker
Valerie Witoski

Managed Futures: Ready for Prime Time?

Greetings from the Greenwich Roundtable. Our session titled *Managed Futures: Ready for Prime Time?* was held as stocks continue their decline, war with Iraq looms and with the belief that CTAs make money in times of instability. This was an outstanding overview for investors who are new to this asset class. Our experts described how managed futures are a good hedge against stocks and bonds. David Hseigh, a rising academic, offered his unbiased research. Barry Bausano, an experienced allocator, articulated the bull case. David McCarthy, a savvy fund of funds manager, offered his formula on the nuance of selection.

John Griffith and **Lily Knight**

David Hseigh
Duke University

We analyze hedge fund risks and then characterize their returns over different market environments. We link returns with their common sources of risk. Amongst commodity hedge funds, there are many common correlations. The single most common source of risk comes from "trend-followers" who try to capture large price movements. Trend followers capture volatility. Bonds, commodities and currencies dominate a trend-followers return stream. Volatility erupts when the stock market goes down. Bonds, commodities and currencies do well when things go bad. Trend-followers are a very good insurance policy against poor stock and bond environments. Our 1997 study shows that commodity fund returns are good in volatile environments. When the S&P 500 fell, trend-followers returns rose. Arbitrage funds are short volatility and do well in quiet markets. They are like selling catastrophe insurance. You collect a steady return when there are no catastrophes. Trend-followers are the opposite. You get paid when volatility arrives. They offer a good balance to stocks and bonds and are much better than buying put options on the S&P. Performance persists when the environment persists.
dah7@duke.edu

> "Trend-followers are a very good insurance policy against poor stock and bond environments".
> – **David Hseigh**

David Hseigh

Barry Bausano
Deutsche Bank

Yes. Managed futures are ready! Transparency is good. Liquidity is very high. They are negatively correlated to stocks and bonds. Managed futures managers are agnostic and don't care why things happen. Performance persistence is difficult to achieve. Most styles run in 3-4 year cycles. It takes years to collect fund managers who are consistent. They reduce your risk and increase your returns. The gap between the best and worst managers is widest at the ends of these cycles. Disadvantages are that futures are not a very specific hedging source. Fees are high but talent is in short supply. Paying low fees is wasted money here. Be careful….you need a basket. The basket needs to be constructed to perform well in different market environments. 20-30 managers seem to be the optimal construction. Buy a fund of funds expert to: identify the best managers, get diversity, perform due diligence, anticipate the best opportunities and get access. I'm a fan of allocating 33% of your entire portfolio to alternatives.
barry.bausano@db.com

> "Managed futures managers are agnostic and don't care why things happen. The gap between the best and worst managers is widest at the ends of these cycles. Fees are high but talent is in short supply. Paying low fees is wasted money here."
> – **Barry Bausano.**

Barry Bausano

> "If managed futures are 5-10% of your portfolio, you'll need 12-18 managers to capture the benefits of the class. A fund of funds may be a more efficient way to play. Transparency is not a useful measure of their utility." – **David McCarthy**

David McCarthy
Martello Investment Management

Is prime time ready for managed futures? CTA is a regulatory description, not a hedge fund style. Most of these styles rely heavily on quantitative techniques. CTAs fall into four styles. Trend-followers are highly homogeneous, act in a similar manner to each other and conduct technical analysis. Global macro managers look at relative strength between currencies & countries and make trades on a discretionary basis. But in major market moves they are all in the same trade. Systematic non-trend managers are trend followers who aren't correlated to each other. They are managers who follow very short-term systems. They are highly heterogeneous. Relative value managers using currency and commodities are heterogeneous, operate in different markets and do not correlate with each other. Trend-followers and global macro managers tend to be correlated with each other. They also tend to be short volatility. Relative value and non-trend traders tend to be long volatility. High frequency traders and short-term breakout traders need volatility to increase their average profit per trade. There is a near term risk that trend followers may not be a good hedge to stocks. Interest rates have been in a secular decline. They will then short bonds as stocks rise and rates edge up. A geopolitical crisis at that point will cause flight capital to go back into bonds. This will hurt trend-followers while they're short. If managed futures are 5-10% of your portfolio, you'll need 12-18 managers to capture the benefits of the class. A fund of funds may be a more efficient way to play. Look for a fund of funds manager with a rational philosophy. Transparency is not a useful measure of their utility. Investors should expect 10-15% returns going forward.
dmccarthy@martellofunds.com

David McCarthy

Please join me in expressing our gratitude to Kevin Mirabile, of Barclays Capital and of our Founder's Council.
kevin.mirabile@barcap.com

Kerry Pacello, **Sakae Takushima** and **Valerie Witoshkin**

March 20, 2003
UNDERWRITTEN BY –
Standard & Poors

The Mathematics of Investing

Greetings from the Greenwich Roundtable. Our session titled *The Mathematics of Investing* was held as a follow-up to the original GR session on *Mathematics, Common Sense & Good Luck* delivered by Jim Simons in 1996. Our panelists were masterful in reducing the complexities of their craft into simple terms. Cliff Asness, an accomplished practitioner and quantitative researcher, reframed our understanding of quant strategies with his common sense and good humor. Andrew Lo, the legendary researcher and statistical arbitrageur, offered some guidelines for investors and a glimpse at the next frontier.

L to R: **Hunt Taylor, Bill Brown, Cliff Asness, Steve McMenamin, Andrew Lo** and **Paul Aaronson**.

Andrew Lo
Alpha Simplex Group

Mathematics is useful when it's used as tool and it's applied appropriately. It's least useful when it's misinterpreted or when it's used to mimic the human cognitive processes. For example, when neural networks were popular, a pension fund asked me to build a model to learn asset allocation to replace his staff. Black boxes are sometimes promoted as mysterious and amazing when in fact they are nothing more than mathematical tools designed to solve specific problems. There are two types of black box: when someone can't articulate how their model succeeds or when they choose to keep their model secret. Here are my five rules of thumb for using mathematical tools in investing. First, no matter how complex and subtle a strategy is, no matter how sophisticated it might be, it must be possible to describe that strategy in simple and intuitive terms. Second, you will never see a bad back test. If you torture the data long enough, it will tell you anything you want. But there are tools to gauge the degree of bias in any back test. Third, any mathematical model should leverage human judgment, not replace it. This is most evident in statistical arbitrage and pairs trading where judgment is needed to establish whether an anomaly is real or not. Fourth, mathematical models are like power tools. You need to know when and how to use the right tool to solve a problem. Fifth, human preferences are the next undiscovered continent. The challenge lies in developing a mathematical model of human preferences, cognition and learning. Models of prices and probabilities are plentiful. But there are few models of the cognitive biases that we all suffer from. Every discipline has its strengths and weaknesses. It's important to be aware of how to use them properly. The best approaches are agnostic and opportunistic.
alo@alphasimplex.com

Andrew Lo

> "There are two types of black box: when someone can't articulate how their model succeeds or when they choose to keep their model secret. Human preferences are the next undiscovered continent. The challenge lies in developing a mathematical model of human preferences, cognition and learning." – **Andrew Lo.**

Clifford Asness
AQR Capital Management

Jim Simon's secret to success was not luck but highly repetitive luck. Mathematical finance has brought many investable discoveries that have worked well. Three unplanned observations: First, "Stocks for the long run" is a back test with some flaws. A century of measuring the strongest economy on the planet is misleading. Eight percent return is not guaranteed. Going forward stocks not only get a lower return but may also experience losses. We don't just lose the average return but we lose the certainty. Second question relates to Bill Miller's winning streak. Everyone ponders the shocking question of 'how can such a sustainable record exist?' But our analysis reveals the embarrassing question of 'why weren't there 14 more just like him?' Third, the conventional quant argument against timing the market is not what it seems. Some common knocks against quantitative portfolio management: First, it's like driving with a rear view mirror (non-quantitative managers choose to drive without rear view mirrors). Second, it's a black box and a mystery (it's not mystery if the manger maintains secrecy for competitive reasons). Third, quantitative models eventually blow-up or stop working (judgment-based strategies do too). Fourth, quantitative management has a vague LTCM aura about it (LTCM was a prop desk, not a quant shop). Fifth, there is anti-geek racism festering (geeks are a race united by an inability to dance). There is a bit of Luddite in us all. But the most dangerous manager is a quant with good performance, fresh off the physics farm. The market has not taught him any lessons yet. Markets are inefficient in very small ways and in many places. Quantitative techniques are useful in finding and capturing them.
cliff.asness@aqrcapital.com

Clifford Asness

Paul Aaronson

Joy Rendahl

Jon Hedley and **Luke Imperatore**

Please join me in expressing our special gratitude to Paul Aaronson of Standard & Poors whose generous grant made this symposium possible. Paul and his team will be publishing the *Greenwich Roundtable Quarterly* with selected readings from the best of the Roundtable.
paul_aaronson@sandp.com

Rian Dartnell and **Greg Ferraro**

> "….the most dangerous manager is a quant with good performance, fresh off the physics farm. The market has not taught him any lessons yet. Markets are inefficient in very small ways and in many places. Quantitative techniques are useful in finding and capturing them. "
> **– Clifford Asness.**

April 17, 2003

UNDERWRITTEN BY –

Putnam Lovell

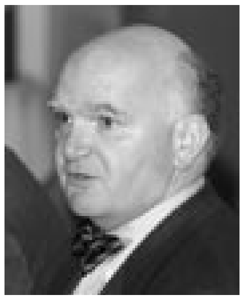
Hard Assets: Timber, Water & Art

Greetings from the Greenwich Roundtable. Our session titled *Hard Assets: Timber, Water & Art* was held as we examine defensive investments on the road less traveled. John Dickerson, a hedge fund that specializes in water investments, made the case for looming shortages. Clark Binkley, one of the world's largest and most knowledgeable timber investors, compressed 25 years of timber experience into 12 riveting minutes. Peter Sutton, one of the world's most knowledgeable art experts, cautioned us against the class while he dazzled us with prices and pictures. Peter is, more importantly, the head of the Bruce Museum and the Greenwich Roundtable's landlord. All provided us with some surprising alternatives to financial assets while we try to survive this nuclear winter of investing.

Clark Binkley
Hancock Timber Group

Lots of people have made money investing in trees. Weyerhaeuser earned a 7.5 % annualized return on the value of land they purchased in 1900 on top of the 8% cash yield they earned by harvesting the timber. In modern portfolio theory terms, timberland is a low risk investment by many measures. Its volatility is low compared to stocks. Returns are poorly or negatively correlated to stocks, bonds and real estate. Trees are an uncorrelated class because of their biological growth. Trees have low storage costs. If prices are low, they "store well on the stump". Timber is a good diversifier. It has outperformed the S&P for the past 40 years. We'd recommend a 1-3% allocation. Harvard & Yale have increased their allocation to 5%. Public timber stocks have not been good investments. And private timber is illiquid. A long view is necessary to wait out low prices. Minimums are high. $50 million is needed for a separate account. $1 million is needed for a commingled account with a 10-year lock-up. Family office investors have been underserved. Political risks are an issue. Environmental groups have been known to disrupt the harvest. The spotted owl issue reduced the timber harvest and drove up prices (which helped our profits). Forest fires are not

> "timber returns are poorly or negatively correlated to stocks, bonds and real estate. Trees are uncorrelated because of their biological growth. Trees have low storage costs. If prices are low, they store well on the stump". – **Clark Binkley.**



Clark Binkley

a big issue. They take less than .1% of our crop each year. We prefer plantations to forests because growth rates are higher. We believe you need to be regionally diversified. Timber is a good asset class as long as people continue to build houses, the sun shines and trees keep growing.
cbinkley@hnrg.com

John Dickerson
Summit Water Equity Fund

You ought to buy water because they're not making it anymore. But they are making more people. There are 6 billion people consuming and polluting a geometrically diminishing supply of water. Aquifers are being drawn down faster than they can be replenished. Only 20% of the world has access to running

John Dickerson

> "94% of water utilities are municipal-owned monopolies…. consolidation of the water industry is an opportunity. Aging infrastructures force municipalities into becoming distressed sellers." – **John Dickerson.**

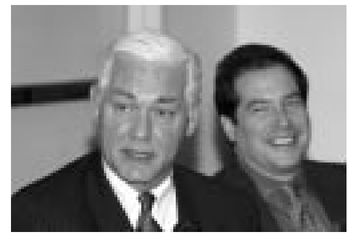
water. 80% of all diseases effecting the planet are water born. Water stocks are under-researched and under-owned. American Water Works has been one of the best performers on the NYSE. 6% of water companies are investor owned. 94% of water utilities are municipal-owned. They enjoy a natural monopoly. Barriers to entry are high. There is no economic substitute for water. Demand for water is unaffected by inflation, recession or interest rates. Growth of water usage is consistent. Yet the underlying assets do not reflect its economic value. I don't know if there's a catalyst but consolidation of the water industry is an opportunity. 56,000 water utilities serving less than 2000 users are candidates for consolidation. Aging infrastructures force municipalities

> "Art has under performed all other asset classes… it should be a lifestyle choice not an investment decision. It pays pleasurable dividends every day."– **Peter Sutton.**

into becoming distressed sellers. Economies of scale reward the consolidator. Ben Franklin once said, "When the well is dry, we'll all know the value of water".
jdickerson@summitglobal.com

Peter Sutton
The Bruce Museum

Unlike timber or water every work of art is unique. There is no central exchange. The global are economy is small, only $23 billion in global sales last year. There is little liquidity. You can consign it to an auction or dealer and wait and hope that it sells. Art has under performed all other asset classes. The British Rail Pension discovered this the hard way when they sold their impressive holdings with less than T-Bill returns. Van Gogh's *Dr. Gauche* sold for $82 million. This sale represented demented Japanese buying which marked the top of a speculative bubble. Irish painting outperformed Impressionist paintings and rose at 12%. The most expensive 20th century painter was Picasso. The most expensive recent artist was Andy Warhol. But art goes down too. The most expensive living artist is Jasper Johns. In 1989 his *Two Flags* brought $12 million and in 1999 it brought $7 million. Old Masters are beginning to outperform Impressionists and the Cubists. Art market economy is fickle. The art market in the last 2 years has been selective and shaky. The supply of good art is increasing. Values are available. But art is not a good investment. It is a luxury. It should be a small part of a diversified portfolio. Artnet.com



Peter Sutton, Larry Lee

is a good place to check prices. Art should be a lifestyle choice not an investment decision. It pays pleasurable dividends every day. pcsutton@brucemuseum.org

Please join me in expressing our special gratitude to Dan Kochav and Putnam Lovell whose gen-

L to R: **Clark Binkley, John Dickerson, Hunt Taylor, Peter Sutton** and **Steve McMenamin**

erous grant made this symposium possible. Putnam Lovell is one of our earliest supporters and the last member of our Founder's Council. Putnam Lovell was invited to the Founder's Council because of their commitment to education and their reputation in the money management industry. **Dkochav@us.nbfinancial.com**.

May 15, 2003

UNDERWRITTEN BY –

Barclays Capital

Behavioral Finance: Psychoemotional Perspectives on Investing

Greetings from the Greenwich Roundtable. Our session titled *Behavioral Finance: Psychoemotional Perspectives on Investing* was held as we continued our discussion first held in June 2000. This session was held as investors try to come to grips with the "soft" forces that influence market movements. Greed and fear are no longer adequate explanations for all possible emotions experienced by market participants. Our speakers, keen to share their insights, shifted our paradigm with some surprising anecdotes. Woody Dorsey is a hedge fund manager with a unique strategy that gets its trade signals from crowd emotion. Nassim Taleb is a hedge fund manager whose best selling book has elevated him to guru status within the industry. Bob Shiller is the Yale professor whose pioneering research gave birth to and legitimized this overlooked investing discipline.

Woody Dorsey
Semiotics Partners LLC

Behavioral Finance is a simple rediscovery of our competitive instincts and our cunning. Investor motivations have always been mysteriously described as "Mr. Market" or the "Invisible Hand". Behavioral Finance is not the study of distressed securities but the study of distressed security traders. We have been taught to believe the market is perfectly rational. But humans are irrational and emotional. Therefore markets are irrational and emotional. Cognitive science offers new insights here. Mimetics offers us a quantitative measure of market emotions that I call an "emotum". My simple sentiment model outperformed the market by 57%. Fear and greed are not polar opposites. It is impossible to conquer our emotions. Irrationality rules. And it may have rules. Historically, market extremes are characterized by popular market slogans or transient investment themes. Examples of this include the "e-greed" of the late nineties and the "equi-phobia" of recent months. A recent slogan search revealed that when Iraq was mentioned in the news it had an 85% negative correlation to the stock market. Technical analysis is useful in identifying a trend. Persistent bidders and exhausted sellers are labels that reveal how markets repeat themselves and their errors. Fundamentals are what we think about the market. Technicals are how we act on the market. Psychologicals are how we feel about the market. My Triunity Theory optimizes these three disciplines. It is sometimes useful in predicting some markets. The invisible hand does leave some fingerprints. The herd does leave some footprints. Wall Street will simplify behavioral finance themes to sell its merchandise. The opportunity of the behavioral school lies in its benefit to society as told by Shiller's *The New Financial Order*. Its risks are difficult to predict. Observe everything, believe nothing, and invest on the behavioral errors of others. **woodydorsey@ marketsemiotics.com**

> "Because the idealized models of the mathematicians don't fully fit the real world, we need behavioral insights. People are not wired to recognize big abstract risks. Vague possibilities are emotionally difficult and people tend to postpone decisions." – **Bob Shiller.**

> "Fear and greed are not polar opposites. It is impossible to conquer our emotions. Observe everything, believe nothing, and invest on the behavioral errors of others." – **Woody Dorsey.**

Nassim Taleb
Empirica Capital LLC

Behavioral Finance has predictive qualities but they are not precise. It is not a moneymaking strategy. But there are some tricks you can use as a trader. We trade small specific empirical pockets of irrationality, not general untestable ones. Selling long-term calls against improbable outcomes is testable. People have a tendency to miscalculate probabilities. They are fooled by randomness. Psychologists are better than economists in understanding how people deal with illusions. A strategy that has highly predictable, highly persistent profit streams is at risk of being lulled into complacency and then being wiped out. It is a strategy that has 99% probability of making one dollar every month and 1% probability of losing ninety-nine dollars in one month. People have a bias of choosing a small probability of losing a lot to a high probability of making a little. You can insure against that 1% probability and take only 50 cents. People take risks not out of bravery but because of their ignorance of the consequences. Their decision-making framework does not include negative outcomes. Slovitz' *On the Preference for Insuring Against Small Probable Losses Compared to a Large Improbable Catastrophe* argued the need to subsidize people to pay for insurance against disaster. We have two brains. One we use when thinking. One we use when reacting. There is little correlation between them. **ntaleb@empiricacapital.com**

> "People have a tendency to miscalculate probabilities. They are fooled by randomness. Psychologists are better than economists in understanding how people deal with illusions. People have a bias of choosing a small probability of losing a lot to a high probability of making a little. People take risks not out of bravery but because of their ignorance of the consequences." – **Nassim Taleb.**

Bob Shiller
Yale University

The "risk as feelings" premise is that people are not wired to recognize big abstract risks. Vague possibilities are emotionally difficult and people tend to postpone decisions. The Efficient Market revolution of the 1970's was an important scientific improvement. It introduced a mathematical discipline to the markets. Today we understand derivatives pricing and capital assets pricing much better. But the CAPM described how the world *should* work. Not how it is. Because the idealized models of the mathematicians don't fully fit the real world, we now need behavioral insights. A new financial order should be interested in both behavioral and mathematical finance. I have a vision for the future. My critics say they are impossible but here are the six ways we need to change our financial institutions. First the insurance industry needs to create policies against household values such as livelihood risk. This would be an extension of disability insurance and cover labor market risk. There would be home equity insurance to cover declining home valuations due to falling economic conditions. Second would be the creation of securities that represent an investment on the earnings streams of households. People would sell shares on their salaries. Third would be interest payments for household borrowers that are pegged to an index of borrowers who have the same occupation. Fourth would be insurance issued by the government to cover inequality. This might mitigate feelings of oppression and guard against violence. Fifth would be intergenerational insurance to guard against big risks not shared by the elderly and the middle aged. Sixth would be for international agreements on risk control. World leaders would arrange GDP swaps between their populations. Today new information technologies are producing fundamental changes in our society that will make these six ideas possible. **robert.shiller@yale.edu**

This session was held in the memory of Leon Levy. He was scheduled to speak today but passed away suddenly. He was a gentle giant in our community and a leading sage on the psychology of the markets. Please join me in expressing our special gratitude to Kevin Mirabile of Barclays Capital whose generous grant made this symposium possible. Kevin and his team have done an excellent job of analyzing hedge fund operational and liquidity risk for our Best Practices Committee. **kevin.mirabile@barcap.com**

June 19, 2003

UNDERWRITTEN BY –

DPM

Trading Strategies and the Monitization of Ideas

Greetings from the Greenwich Roundtable. Our session titled *Trading Strategies and the Monetization of Ideas* was held as we began an examination of strategies that are agnostic and flexible. This session was held, as our search for certainty has uncovered few predictable profit streams. Quickly locking in lots of small predictable trading profits has become attractive. Our speakers, all relatively undiscovered masters of the craft, shared many of their secrets. Although secret, they spoke freely, confident in the knowledge that even professionals have difficulty executing on these insights. Ken Grant, the cerebral and seasoned risk-manager, provided us with a buyer's guide for picking traders and trading funds. Netta Korin, a disciplined and instinctive trader, captivated this jaded group with a description of profits earned by harnessing the delusions of market participants. Hilton Nathanson, an unflappable London-based trader, with steady hand and nerves of steel, described some unusual cultural anomalies he exploits between the US and Europe.

Ken Grant
Exis Capital Management

Our fund employs a multi-strategy approach to short term trading. We are a manager of traders. We believe trading is beneficial to the marketplace because it provides risk transference, price discovery and liquidity. Investors reflect and traders react. Trading is a skill. Few are good, most are mediocre and some are terrible. Good traders are hungry and instinctive. In these rapidly change markets; trading is not a game for amateurs. Capital has flooded into trading funds. Thousands of funds try to do trading. Anomalies are evaporating. Macro and currency strategies experienced this boom and bust cycle years ago. The reward has converged to those that take more risk. But we take simple risks and take risks that others don't want. If we are on the wrong side, we can liquidate quickly. We get paid for taking instantaneous event risk. We battle for every tick. We prefer bull markets to bear markets and prefer rallies on the long side because prices will fall. Volatility is our friend. We look for ways to capture the entire price action. The hedge fund industry spun out of a market inefficiency that is being exploited away. Returns are falling and the players are converging. Mutual funds may become competition. Proprietary trading desks are our natural competition. Look for traders who are consistent, can articulate their edge and it makes sense. ken.grant@exis-capital.com

Ken Grant

"Investors reflect and traders react. Trading is not a game for amateurs. Anomalies are evaporating. We battle for every tick."
– Ken Grant.

Netta Korin
Amgis Capital

In our short-term trading fund we extract profits by trading around positions rather than just holding them. Price fluctuations make this possible. Every position is evaluated against the opportunity cost of buying (or selling) something better. Our portfolio is evaluated at least 12 times a day. We continuously ask ourselves 'is this position still working'? My five trading rules: 1. Sell when you can, not when you have to. 2. Your best trade may be not trading at all. When the real opportunity arrives, you will probably have more money and less fear to tackle it. This may be the most difficult rule to master. 3. Know how to size a trade and when it should be 10% or 1%. Know when to trade with conviction or when to play it safe. 4. Never have an ego. Listen to the stocks and the markets, not your fundamental view. Markets know more than you do. 5. Never fall in love. Combining trading savvy and research techniques allow us to navigate difficult markets. The "reverse lemming" trade allows us to move against the crowd profitably. "Crowded trades" sometimes provide the biggest profits by taking the other side. Market psychology is always changing. Traders must adapt their techniques constantly. Liquidity is important. Getting in and out without disturbing the price is difficult. The proliferation of hedge funds trying to out-game each other has made this more difficult. Reg FD has leveled the field. Good analysts must now move further away from the company CFO for information and into its supply chain for an edge. netta@amgiscapital.com

"Sell when you can, not when you have to. Your best trade may be not trading at all. Know when to size a trade. Never have an ego. Never fall in love."
– Netta Korin.

Netta Korin

Hilton Nathanson
Marble Bar Asset Management

Trading has been my lifelong fascination. European markets are less efficient and slower to react. Europe has a large bureaucracy. US markets are more informed and more efficient. These cultural differences create opportunity. Europe follows the US rather than the opposite. Here's a day in the life of a European trader. From 8-12am GMT, we don't care about the US. From 12 noon GMT to 4:30pm EDT we focus on the S & P 500 and the US Bonds. Remember that we are not as large as the US. But from 3:45 to 4:30pm GMT our market builds its own momentum. I have no predictive views on the market. Offering a point of view diminishes my edge. Liquidity has begun to return to the market. The mutual funds are back. Hedge funds are not dominating the trading volumes anymore. And it is harder to move prices. Correlations in the last few years between stocks and bonds have broken down. Something is changing. Our discipline is an evolutionary and systematic approach. It is always different. But it is always the same. hiltonn@mbamfunds.com

Hilton Nathanson

"European markets are less efficient and slower to react….cultural differences create opportunity. I have no predictive views on the market. Offering a point of view diminishes my edge."
– Hilton Nathanson.

Please join me in expressing our special gratitude to Catherine Banat and Bob Aaron of DPM whose generous grant made this symposium possible. raaron@dpmllc.com

Taylor

Summer Fall Symposia

VERY IMPORTANT! Sessions are typically held on the third Thursday of each month. “Big” speakers pick their months. Consequently, our schedule can change at a moments notice. Unless the Programming Committee decides otherwise, here is a tentative list of dates and possible topics. Do not plan on being at the Museum without first receiving an invitation and a confirmation. RSVP@GreenwichRoundtable.org

July 24, 2003:
China: Sleeping Beauty or Waking Giant

August 21, 2003:
Demographics

September 18, 2003:
Asset Allocation for 2004

October 16, 2003:
Extremism,
Economic Uncertainty & National Security

November 20, 2003:
Trading Strategies in Managed Futures

December 18, 2003:
Private Equity: Issues & Outlook

E to the Power of 9

In grappling with the events of the past few years and focusing on the critical need for education (read “investor class” here), particularly in light of the passing of what many market pundits have called the age of “entitlement” (mid-late 1990’s), I have tried to come up with a useful shorthand for the experience of the past 28 months in the global markets. It is now very clear to this writer that the recent tumultuous period and its myriad themes can be traced to a key letter of the alphabet – “**E**” – in the following manner/sequence –

(1) **E**lections – both 11/00, with its dramatic photo finish and subsequent countrywide agita, as well as 11/02, with its historical (potentially significant?) mid-term success for the Republicans.

(2) **E**asings – Eleven Fed rate reductions from 01/01 thru 11/02 have dropped current interest rates to multidecade lows and prompted appx. $100-150 billion per year in both 01 and 02 in cash out refi’s to maintain consumer liquidity.

(3) **E**conomy – From outright recession, thru tortured “LUV” descriptions and finally grudging sub par growth at the current time (did I hear a whisper of double dip?).

(4) **E**mployment – From under 4% to almost over 6%, U.S. unemployment may become sticky downward do to technology/productivity gains.

(5) **E**xchange Rates – Euro/$ moving from .83-1.10 during the last year despite poor growth prospects in the EU (and exacerbated by the US CAD of 5%) as well as $/yen being managed (manipulated?) by Japanese officials concerned about their exporters (as well as their domestic consumption/bank NPL problems no doubt!).

(6) **E**thics – Headline grabbing scandals/lack of corporate governance have been front and center topics of concern on both Wall Street and in the boardrooms of America’s leading companies.

(7) **E**arnings – from inflated to definitional (read 8/02-SEC certification) to reduced by sell side/buy-side analysts everywhere, it seems everyone wants to know the appropriate “e” for evaluation and p/e multiple purposes.

(8) **E**nergy – the current “oil tax” on the consumer, which may hopefully be reduced if the $22-28 per barrel range OPEC now targets holds post the Iraq conflict.

(9) **E**motions – the ultimate in behavioral finance (homage paid here – but no royalties to Professor Schiller for his memorable “irrational exuberance”) – investors of all stripes, both institutional and retail alike, are worried about event risk and have become inveterate BLOOMBERG/FOX/CNN newshounds and tape watchers.

There you have it…“**E**” to the Power of 9. Now if only we can resolve **E**liot’s issue (Spitzer and the Wall Street settlement) in a timely fashion, defeat of the **E**nemy (Saddam Hussein and the terrorists) that generates the needed **E**xpenditures (particularly capital spending) from the business sector, we may finally be able to embark on a long awaited cyclical (not secular!) bull market in **E**quities.

How **E**xciting! Do I hear the words temporary **E**uphoria?

For your benefit and amusement by Steve McCarthy

The Greenwich Roundtable
Two American Lane
PO Box 4019
Greenwich, CT 06831

Non-Profit Org.
U.S. Postage
PAID
White Plains, NY
Permit No. 5432