

- Absolute Returns* (Ineichen), xiv, 4, 9, 43, 281
- Absolute-return investing, xii  
philosophy, 4
- Active asset management, xiv  
constrained, 36  
versus passive asset management, 111–115
- Active risk management, xii, xiii, 10, 37, 92, 98, 164–215, 258  
applicability and adaptability of skill, 165–167  
asymmetric returns and, 174–205  
difference between passive and, 101  
future opportunity set for, 308–311  
the law of, 167–169  
leverage as a tool in, 169–174
- Adaptability of skill, intellectual property  
versus, 257–266
- Adaptability versus style drift, 166–167
- Adaptive Markets Hypothesis* (Lo), 266
- Against the Gods* (Bernstein), 8, 27
- Agency relationship, 66
- Aggregate fees, 106–109  
estimate of, in the hedge funds industry, 107
- Alchemy of Finance: Reading the Mind of the Market* (Soros), 142
- Alpha, xi, xii, 10, 30, 47, 56, 59, 82, 105, 131–163, 189, 192, 195, 255–257, 259, 268, 283  
versus access, 253–254  
generating, 174, 260–263
- Alternative investment strategy, 57, 82, 256
- “An Alternative Future” (Asness), 2
- Apriorism, 140
- Arbitrage pricing theory (APT), 264
- Asness, Cliff, 2, 256
- Asset allocation, as capital protection, 54–55
- Asset management  
flexible approach to, 115–117  
future of industry, 2  
stages of, 4–6  
structural change in, 2
- Asymmetric disutility, 118
- Asymmetric returns, xii  
as a business, 240–277  
defining, 9–13  
price of, 65–109
- Asymmetric-risk/return profile, xii, 36, 41, 72, 92, 258  
symmetric- versus, 97
- Asymmetries, summary of, 206
- Austrian economics, 137
- Autocorrelation, 43, 185–186
- Bachelier, Louis, 132–133
- Backwardation, 85
- Bankruptcy, 60
- Behavioral finance, 146–152, 264–265  
loss aversion and prospect theory, 151–152  
overconfidence, 147–151
- Benchmarking, 13, 262, 263, 264–266  
asset or liability, 35, 309  
and investor protection, 52  
outperforming, xii, 132  
underperforming, 132
- Bernstein, Peter, 2, 7, 8, 9, 27, 73, 149, 266, 282
- Beta, 37, 56, 82, 153–163, 170, 192, 195, 255–256, 259  
bifurcation between alpha and, 255  
hedge fund, 259  
long-only, 251
- Bogle, Jack, 7, 8, 9
- Boiling frog syndrome, 23–26
- Brinson, Gary, 7
- Brownian motion, 132–133, 174
- Bubble Act of 1720, 127
- Bubble symptoms, 281
- Buffett, Warren, 4, 7, 8, 20, 27, 47, 57, 111, 316
- Business models, 254
- Buy-and-hold strategy, 37, 79, 201, 256
- Capital asset pricing model (CAPM), 10, 148–149, 264

- Capital depreciation, 35
- Capital-guaranteed structures, 93–104, 117  
 comparison of, 95  
 risk/return comparison, 100
- Capital protection, 52–55  
 asset allocation and manager constraints, 54–55  
 derivatives, leverage, and short selling, 52–54
- Casino gambling, 245–246
- Center for International Securities and Derivatives Markets (CISDM) CTA Asset Weighted Index, 86, 87
- CFA Magazine*, 7
- Chancellor, Edward, 310
- Change, cyclical versus structural, 279–283
- Chartered Financial Analyst (CFA) Institute, 7
- Commodities Corporation, 83
- Commodity Futures Trading Commission (CFTC), 85
- Commodity pool operator (CPO), 85
- Commodity trading advisers (CTAs), 83–86
- Complexity premium, 76, 79, 256
- Compound annual rate of return (CARR), 21, 184, 201, 285
- Compounding capital, 13–17, 186  
 effect of, 14  
 negative, 312  
 positive, as a major business objective, 246–249
- Conspiracy of Fools* (Eichenwald), 224
- Constrained active management, 36, 56
- Controlled total risk, 37–38
- Convertible bond (CB) arbitrage, 125, 166–167, 175–179, 217–227  
 asymmetries in, 176  
 cumulative performance of, 179  
 example, 226–227  
 managers, in 2005, 218  
 monthly returns in, 218  
 return distribution of, 177, 221
- Coppock curve, 15
- Corporate governance, 8
- Correlation of portfolio constituents, 287
- Correlation coefficient, 196
- Correlation matrix, 32
- Cowles, Alfred III, 133
- Critique of Pure Reason, The* (Kant)
- DAX (Deutscher Aktien Index [German]), 210–212
- Default  
 probability, 262  
 rates, 48  
 “Defining Risk” (Holton), 27
- Derivatives  
 asymmetric returns through, 92–104  
 as capital protection, 52–54
- Discretionary trading. *See* Macro
- Distressed securities, 182–186  
 asymmetries in, 183  
 cumulative performance of, 187  
 return distribution of, 185
- Diversifying, as a form of leverage, 172–173
- Dow Jones Industrial Average, 231, 298, 299  
 versus Nikkei 225, 299
- Dreman, David, 28–29
- Dynamic and flexible approach, 308
- Econometrica*, 133
- Economist, The*, 10, 107
- “Econophysics,” 265
- Efficient market hypothesis (EMH), 5, 84, 111, 132, 134–135, 148, 168–169, 264
- Einstein, Albert, 16, 25
- Elasticity (delta), 154
- Ellis, Charles D., 7, 8, 121–122, 137
- Employee Retirement Income Security Act (ERISA), 5
- Enron, 52, 221, 224, 238
- Equilibrium, 279
- Equity  
 bear market, 29  
 bull market, 25  
 hedging, 171  
 long-only strategies, 193–194  
 long-short, 79, 116  
 “q,” 302, 303  
 risk premium, 256, 296, 306
- Equity hedge, 191–203  
 asymmetries in, 192  
 return distribution of, 195  
 underwater perspective, 197
- Equity market neutral, 180–182  
 asymmetries in, 180  
 cumulative performance of, 182  
 return distribution of, 181
- Equity market returns, decomposition of, 305
- Eurohedge, 207
- Event-driven strategies  
 distressed securities, 182–186  
 equity hedge, 191–203  
 multi-strategy, 186–190  
 “Evolutionary finance,” 265

- Excess kurtosis. *See* Kurtosis
- Exchange-traded funds (ETFs), 252
- Expected utility theory, 152, 268
- Faber, Marc, 275, 285
- Fama, Eugene, 265
- Fat tails, 39, 42, 45, 123–130, 178, 194, 225
- Fees, 66–75, 254–256
  - aggregate, 106–109
  - difference between high and low, 69
  - in relation to skill, liquidity, complexity, and risk premiums, 78
- Financial Analysts Journal*, 27, 149–150, 264
- Financial forecasting, 133–136
- Financial Instability Hypothesis, 73
- Financial theory, 264
- Financial Times Stock Exchange (FTSE), 71, 72
  - All-Share Index, 126, 255
- Fortune Sellers* (Sherden), 304
- French, Kenneth, 192
- Friedman, Milton, 119, 144, 264
- Fund of funds, 59
- Fund of hedge funds, 21, 37
- Galbraith, John Kenneth, 285
- Gaussian (normal) distribution, 125, 127
- General Theory of Employment, Interest, and Money* (Keynes), 143
- Gerstner, Louis V. Jr., 116
- Global asset base versus investor base, 241
- Global macro, 88, 216–217, 227–238
  - left tail in, 229
  - negative correlation of wings of distribution in, 233, 234
  - off-diagonal correlation of, 231, 232, 233
  - return distribution of, 227
- Graham, Benjamin, 16, 122, 131
- Grantham, Jeremy, 275
- Greenspan, Alan, 238, 279, 301
- Griffin, Ken, 31
- Gross exposure, 171
- Gumerlock, Robert (Swiss Bank Corporation), 243
- Hang Seng Index, 35
- Hedge Fund Intelligence, 106
- Hedge funds, xii, 5, 6, 17, 30, 50–52, 58, 59, 121, 174, 242, 252–253, 278
  - and beta, 170
  - versus equities, bonds, and cash, 70
  - European, 207–215
  - expectations of future returns, 283
  - as liquidity providers, 189
  - versus mutual funds, 12, 106–109
  - performance of, recent, 236
  - returns in, 253
  - revenues in, 253–254
- Hedge Fund Research Inc. (HFRI), 278
  - Convertible Arbitrage Index, 217, 219, 222
  - Distressed Securities Index, 184, 186
  - Equity Hedge Index, 96, 192, 193, 196, 198
  - Fund of Funds Composite Index, 21, 22, 38, 41, 42, 43, 44, 45, 68, 69, 96, 103, 248, 283
  - Macro Index, 229
  - Relative Arbitrage Index, 237
  - Technology Index, 162, 199
- Hedging, as a form of leverage, 173
- Heilbroner, Robert, 18
- Heisenberg Uncertainty Principle (HUP), 73
- “Hockey stick,” 196
- Hurdle rate, 80, 81
- Idiosyncratic risk. *See* Nonsystematic risk
- Illusionary correlation, 136
- “In Search of Alpha” (Ineichen), 2
- In Search of Excellence: Lessons from America’s Best Run Corporations* (Peters and Waterman), 149
- Incommensurability, 18, 48
- Intellectual property versus adaptability of skill, 257–266
- Internal rate of return (IRR), 21, 202–203
- Internet bubble, 204
- Investment Company Institute, 106
- Investor protection, 50–52
  - benchmark, 52
  - regulation, 50–52
  - transparency, 52
- Irrational Exuberance* (Shiller), 147, 302
- Jaeger, Lars, 155, 256
- Japan
  - rolling annualized five-year real total returns, 293
  - underwater perspective of equity and bond market, 294
- Jones, Alfred (long/short equity) model, 87, 165, 170, 191
- Journal of Finance*, 264
- JPM European Government Bond Total Return Index, 208

- JPM Global Government Bond Index, 21, 68
- Kahneman, Daniel, 136–137, 146, 147, 152
- Keynes, John Maynard, 2, 26, 104, 111, 119, 143, 207
- Knightian uncertainty, risk versus, 26–28
- Kuhn, Thomas, 18, 48
- Kurtosis, 40, 43, 124–130, 178, 181, 188, 203, 210
- Lady Luck: The Theory of Probability* (Weaver)
- LeBaron, Dean, 7, 8
- Leptokurtic distribution, 124
- Leverage
  - as capital protection, 52–54
  - diversifying, 172–173
  - hedging, 173
  - levering up, 172
  - as a risk management tool, 169–174
- Levy, Leon, 31, 64, 302
- Liquidity risk, 30
- Lo, Andrew, 5, 244, 265
- Logic of Scientific Discovery, The* (Popper), 123
- Long-only investing, 5, 53, 189, 193–194
  - asymmetries of, 194
- Long-short equity, 79
- Long/short ratio, 171
- Long-Term Capital Management (LTCM), 31, 169, 221, 238, 244
- Long-term real total returns, 295
- Long-volatility strategies, 87
- Loss aversion, 14, 151–152
- Lotteries, 243, 244–246
- Macro, 79–81, 87–92, 203–205
  - asymmetries in, 204
  - cumulative performance of, 205
  - feedback approach, 91
  - global, 88, 216–217, 227–238. *See also* Global macro
  - information approach, 92
  - model approach, 91
  - return distribution of, 205
- Magical thinking, 282–283
- Managed futures, 82–87
  - difference between long-only exposure to commodities and, 84
- Manager constraints, as capital protection, 54–55
- Manager selection
  - random approach to, 207–215
  - skill, 230
- Mandelbrot, Benoit, 265
- Margins, shrinking, 250–257
  - performance attribution and fees in, 254–256
  - role of innovation and marketing in, 252–254
- Market efficiency, bubbles and, 114–115
- Market inefficiency, 131–136
  - constant or nondegrading, 166–167
  - exploitation of, 132
- Mauldin, John, 277
- Maximum drawdown, 214
- Merrill Lynch, 83
- Mesokurtic distribution, 124
- Mind of Wall Street, The* (Levy), 31
- Minsky, Hyman, 73
- Modern portfolio theory (MPT), 32, 111, 230–231, 264
- Momentum investors, 75
- Morgan Stanley Composite Index (MSCI)
  - Europe Total Return Index, 208
  - HFRI Macro Index versus, 74
  - Japan, 273
  - World Total Return Index, 21, 44, 45, 68, 86, 175
- Morningstar Average Equity Mutual Fund, 12
- Multi-strategy, event-driven, 186–190
  - asymmetries in, 189
  - cumulative performance of, 191
  - return distribution of, 190
- Musical chairs effect, 32–35, 292, 317
- Mutual funds, 68
  - hedge funds versus, 12, 106–109
- “Myth of the Absolute-Return Investor, The” (Waring and Siegel), 47, 154
- NASDAQ (National Association of Securities Dealers Automated Quotation system), 114
  - Composite Index, 21, 114, 199
- Neff, John, 7
- Negative compounding, 312
- Net exposure, 170–171
- Neuer Markt (Germany), 49
- Nikkei 225 Index (Japan), 3, 4, 35, 269, 298, 299
  - Dow Jones Industrial Average versus, 299
- 9 Rules of Risk Management, 61–62
- Nonsystematic risk
  - asymmetries relating to, 216–239

- Nonsystematic risk (*Continued*)  
 broadly diversified, 128  
 systematic risk versus, 55–61
- Objective case, 304, 305  
 Objective economics, 309  
*Open Society and Its Enemies, The* (Popper)  
 Operational risk, 58, 80
- Pareto, Vilfredo, 265  
 Passive asset management  
 active versus, 111–115  
 Passive risk management, 101  
 difference between active and, 101  
 Pension funds, 6  
 Performance attribution, 79, 254–256  
 Platykurtic distribution, 124  
 Popper, Karl, 118–119, 123  
 Positive compounding, 246–249  
 Post-dot-com bubble period, 4, 31, 110  
 Praxeology, 137, 140–142  
 Predictability, 240  
 Principal-agent problem, 66  
 Probabilistic approach, 307–308  
 Profit and loss (P&L), 13, 35  
 Prospect theory, 151–152  
 Protection, investor versus capital, 49–55
- Random walk hypothesis, 132–133  
 Randomness, 153–163, 185–186  
 departing from, 244–246  
 Ratio of frequency, 176  
 Ratio of magnitude, 176  
 Rational expectation, 151  
 Real total returns  
 annualized 30-year, 297  
 long-term, 295  
 Reflexivity, 137, 142–145  
 Regression analysis, 156–157  
 Relative-return approach, 6, 9, 35  
 Relative-value strategies  
 convertible arbitrage, 175–179. *See also*  
 Convertible bond (CB) arbitrage  
 distressed securities, 182–186. *See also*  
 Distressed securities  
 equity market neutral, 180–182. *See also*  
 Equity market neutral  
 Representativeness heuristic, 150  
 Return, calculating investors', 202  
 Return expectations, 284–308  
 Return seeking/risk control matrix, 261  
 Return update and outlook, 311–314  
 Risk (Adams), 120
- Risk, 111–115  
 aversion, 14  
 controlled versus uncontrolled, 37  
 definition of, 23  
 effect of time on, 117–121  
 hedging, 56–57  
 versus Knightian uncertainty, 26–28  
 liquidity, 30  
 management, 23–24, 56, 114. *See also*  
 Risk management  
 measurement, 23–24  
 measurement versus management, 31–35  
 operational, 58  
 perception of, 14  
 prevention versus cure, 28  
 systematic versus nonsystematic, 55–61  
 tail, 222–223  
 total, xiii, 17. *See also* Total risk  
 tracking, xiii, 17. *See also* Tracking risk  
 tracking versus total, 35–49  
 and transparency, 23–64  
 Risk management  
 active, xii, xiii, 10, 37, 164–215. *See also*  
 Active risk management  
 distinguishing between active and passive,  
 xiv  
 measurement versus, 31–35  
 9 rules of, 61–62  
 passive, 101  
 Risk Metrics Group, 61  
 Risk premium, 260  
 strategies, 256, 257  
 Robertson, Julian, 88  
 Rogers, Jim, 89, 280  
 Russell 3000 index, 223, 228, 239
- Samuelson, Paul, 83, 133, 146  
 Scholes, Myron, 283  
 Sector specialists, 198–203  
 Securities and Exchange Commission (SEC),  
 51, 170  
 Sharpe ratio, 98, 125, 129, 179, 184, 185,  
 209, 234, 242  
 Shiller, Robert, 147, 276, 279, 302  
 Short selling, as capital protection, 52–54  
 Short-volatility strategies, 60, 87  
 Single-manager risk, asymmetry of, 216–239  
 Skew, 42, 43, 126, 127, 181, 188, 203  
 Smith, Vernon, 136–137  
 “Snob effect,” 251  
 Soros, George, 89, 137, 142, 144–145  
 Sortino ratio, 98  
 South Sea Bubble, 127

- Standard and Poor's (S&P) 500 index, 11, 22, 71, 72, 93, 94, 96, 99, 103, 126, 223, 224, 228, 231, 239, 246, 302  
 predicting the future of, 269–277  
 Total Return Index, 21, 22, 68, 234
- Statistical arbitrage, 249
- Stock picking, 171
- Style drift, adaptability versus, 166–167
- Subjective economics, 309
- Summers, Larry, 103
- Systematic risk, 56–57, 262  
 versus nonsystematic risk, 55–61
- Systematic trading. *See* Managed futures
- Tail risk, 222–223
- Technology  
 asymmetries in, 199  
 return distribution of, 200  
 underwater perspective of, 201
- Templeton, Sir John, 7
- “Theory of Reflexivity, The” (Soros), 145
- Thorpe, Ed, 163
- Time diversification, 117–121
- Tinbergen, Jan, 91
- TOPIX (Tokyo stock exchange index), 93, 94, 96, 99, 247–248  
 underwater perspective of, 247
- Total risk, xiii, 17  
 controlled, 37–38  
 tracking risk versus, 35–49  
 uncontrolled, 38
- Tracking risk, xiii, 17  
 versus total risk, 35–49
- Transparency  
 of hedge funds, 52, 263  
 under the relative-return model, 37  
 risk and, 23–64  
 in systematic risk, 56
- Trump, Donald, 103, 245
- Tversky, Amos, 146, 147, 151, 152
- Uncontrolled total risk, 38–39
- Underwater perspective, 3, 4, 197, 201  
 of Japanese equity and bond market, 294  
 of TOPIX, 247
- United Kingdom  
 annual real total returns for stock market, 290  
 distribution of annualized 20-year real total returns, 288  
 pension funds in, 255–256  
 return distribution of equity markets, 126  
 rolling annualized 20-year real total returns, 291  
 stock market volatility, 284  
 volatility in consumer prices, 284
- United States  
 absolute-return industry, 108  
 default rates in, 48  
 equity risk premium in, 296  
 excess kurtosis in equity market, 125  
 level of debt to gross domestic product (GDP), 301  
 mutual fund industry, 108  
 stock market volatility, 284
- Unorthodox economics, 136–152  
 behavioral finance, 146–152  
 praxeology, 137, 140–142  
 reflexivity, 137, 142–145
- Van U.S. Hedge Fund Index, 11, 12
- Veres, Robert N., 135
- Volatility, 2–22, 120–121, 123–130  
 versus higher moments, 128  
 maximum drawdown versus, 214  
 short-term portfolio, 2–3
- von Mises, Ludwig, 137, 140, 141, 265
- Voodoo science, 136–152. *See also* Unorthodox economics
- Wealth protection. *See* Capital protection
- Weaver, Warren, 257
- “Winning the Loser’s Game” (Ellis), 7
- “Words from the Wise,” 7–9
- Worldcom, 52, 190, 224
- Worldly Philosophers, The* (Kuhn), 18
- Zero-coupon bonds, 93
- Zero-sum game, 19, 240, 241, 245, 268