

Alternative Investments Styles: What Can Fixed Income Managers Learn?



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Alternative Investment Styles

- Long-short equity
- Market neutral equity
- Convertible bond arbitrage
- Fixed income arbitrage
- Event driven
- Short-selling
- Global macro
- Managed futures

Traditional Style Classification

- Based on asset type
- Based on correlation
- Traditional style analysis may not apply to dynamic trading

Broader Definition

Meta-style drives return generation

- Macro world view
- Decision-making process

What Can Meta-styles Tell Us?

- **Managers and investors need to understand how:**
 - **World view describes return behavior**
 - **Decision-making is conducted**

Macro Premise to Styles

- **Convergent investing views the world as stable, stationary**
 - Traditional fixed income and value investing
 - Arbitrage
- **Divergent investing views the world as ever-changing, non-stationary**
 - Growth or momentum
 - Trend-following

Convergent Worldview

- **World is knowable and static**
- **Market participants generally form rational expectations; errors are random**
- **Divergences are short-lived; markets adjust quickly to new information**
- **Fundamentals do not change dramatically in the short run.**

Divergent Worldview

- **World is uncertain and dynamic**
- **Market participants form rational beliefs; may make mistakes and have biases**
- **Divergences may be dramatic; learning takes time; slow adjustment to information**
- **Fundamental changes are unanticipated**

Convergent Trading/ Return Behavior

- **Strong sense of fair value**
- **Arbitrage trading; value trading; contrarian**
- **Profits from reversion to the mean; concave pay-off functions**
- **Negative convexity trades; negatively skewed returns**

Divergent Trading/ Return Behavior

- No prediction of fair value
- Trend-following; momentum trading
- Profits from extremes; mean-fleeing expectations; convex pay-offs
- Positive convexity trades; positively skewed returns

How do Analysts Think?

- **Decision-making process is important**
- **Quality to explain is fundamental**

Approaches to Decision-making

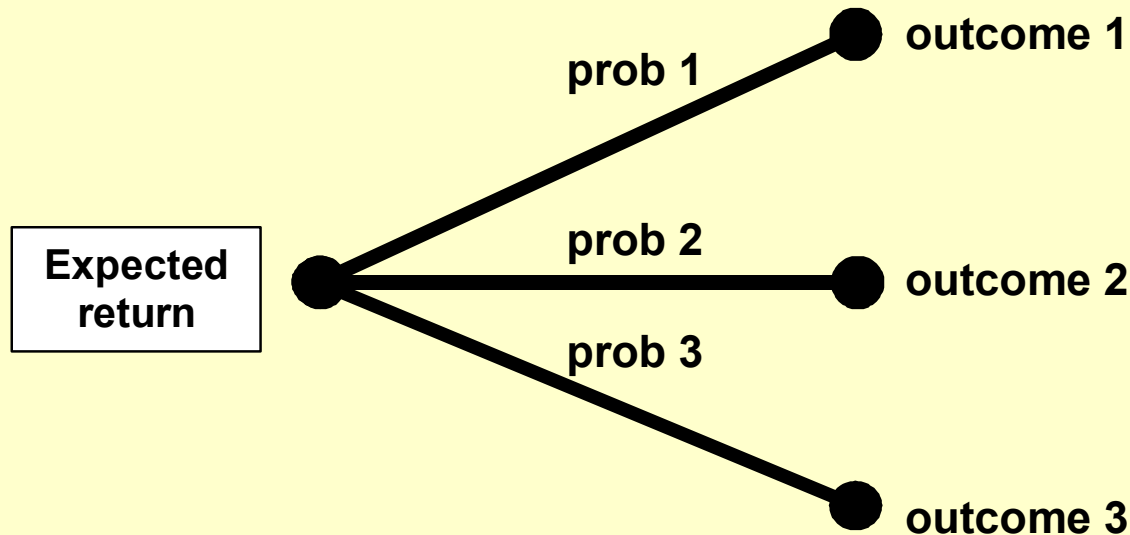
- **Traditional expected utility framework**
 - **Empirical or frequentist approach**
- **Case-based reasoning**
 - **Experiential approach; use analogies**

Contrast of Approaches

- **Expected utility framework**
 - **Measurable probabilities and alternatives**
 - **Quantitative in nature / Data intensive**
 - **Good for repetitive decisions**
- **Case-based approach**
 - **Analogies and experiential**
 - **Useful for high uncertainty**
 - **Good for unique problems**

Expected Utility Approach

Expected utility framework needs probabilities and outcomes

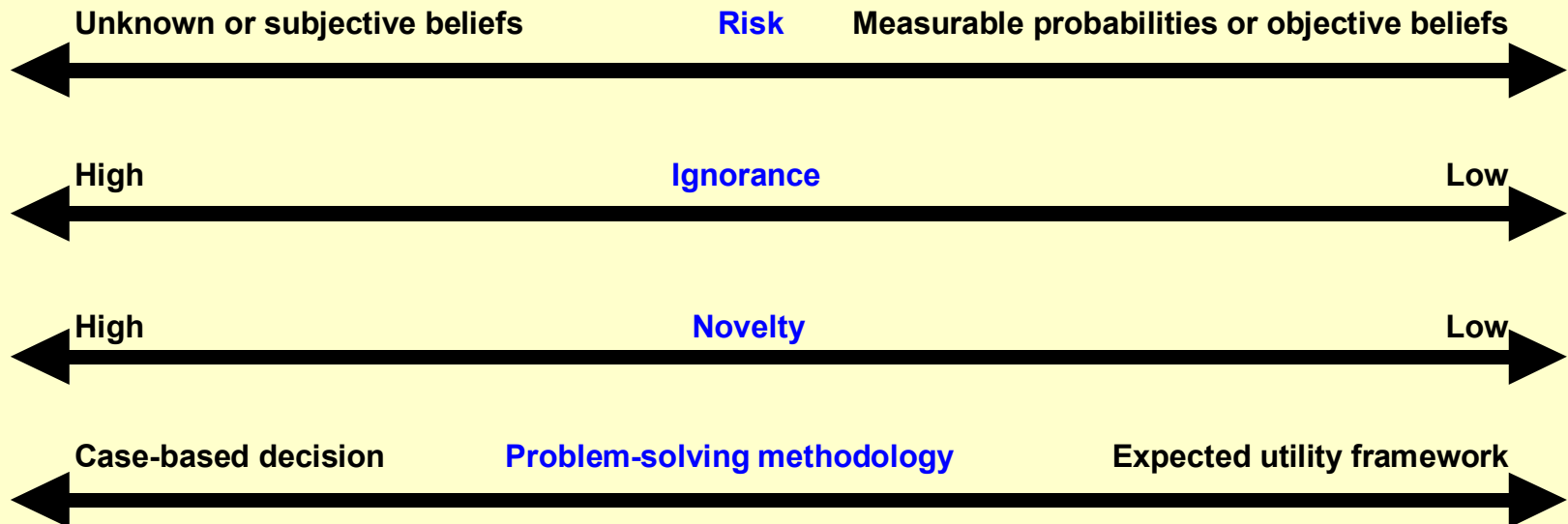


Expected return = sum of prob(j) * outcome(j)

Probabilities must sum to one and outcomes are independent

Continuum of Problem Solving

There exists a continuum of problem-solving techniques based on probabilistic knowledge



Putting it Together

Expected Utility Approach

- *Stat arbs*
- *Fixed-income arb*

- *Managed Futures*

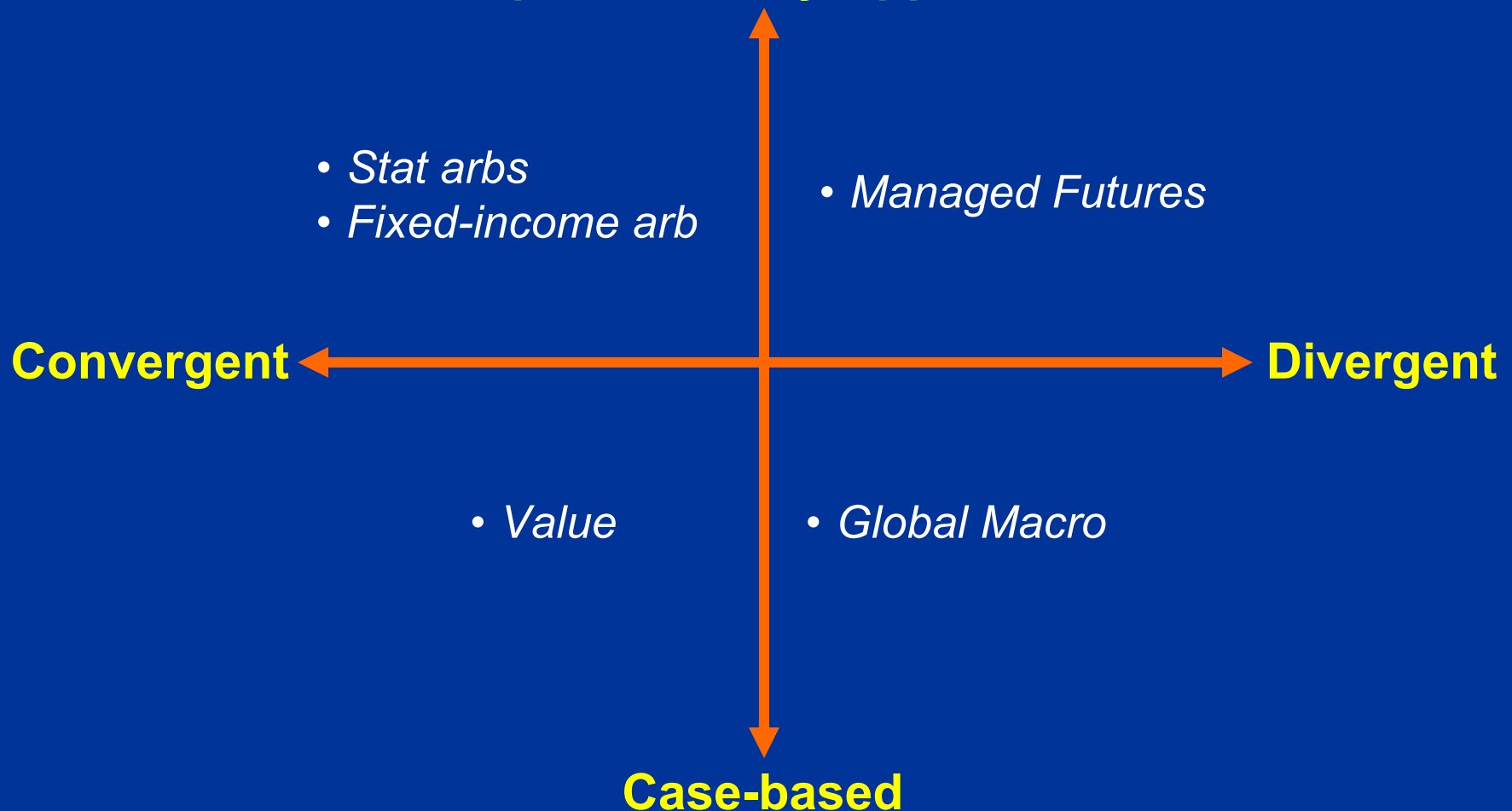
Convergent

Divergent

- *Value*

- *Global Macro*

Case-based



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