NORTHFIELD
EUROPE / MIDDLE EAST

2019 Investment Seminar – London
Wednesday, April 10, 2019
To be held at Ironmongers' Hall
Shaftesbury Place, Barbican, London EC2Y 8AA

Agenda

9:00 Welcome coffee, pastries and Registration

9:30 Welcoming Remarks

9:30 Why Getting Risk Right is Wrong?
Dan diBartolomeo, Northfield Information Services

Many investment professionals who use risk models make a common mistake. They assume that a risk model is working well if the amount of volatility realized by a particular asset or portfolio is consistent with what the model had predicted. They believe that volatility forecasts should be an unbiased estimator of subsequent realized volatility. In this presentation we will provide five different rationales as to why seemingly unbiased estimates of volatility are undesirable both statistically and economically. The implications of these arguments are that professional investors routinely take too much risk, back-tests and simulations fail to capture the true risk of strategies, and that evaluation of investment performance is biased toward perceiving luck as skill -- leading to upward biased performance related compensation.

10:30 Communicating with impact: Illustrating (semi)active returns, risks and manager value add
Matthew van der Weide, FactSet Research Systems

In the current market environment expected returns are historically low, and while it's true that every basis point matters there seems to be a shift away from focusing primarily on returns to purely looking at cost. In his presentation Matthew will argue that regardless on which side of the active - passive spectrum you are, what is important is to communicate the value add that you are delivering to your clients. Essentially when taking on risk to produce above benchmark returns, this should be part of the performance and risk decomposition showing that risk and returns are aligned, and clients are paying for skill not luck. Matthew will show by means of practical examples how one can communicate the value add making it easier to justify (semi)active fees.

11:30 Coffee Break

11:45 Can Credit Risk Be Hedged with Equity Options?
Davide Avino, University of Liverpool

We derive theoretical hedge ratios of credit spreads to equity options based on the structural credit risk model of Merton (1974) and the compound option pricing model of Geske (1979). We empirically test the model hedge ratios on a sample of North American firms for which both credit default swaps (CDS) and equity options are available. Our results show that these contingent claim models generate accurate predictions of the sensitivity of CDS spread changes to changes in the value of equity options, in particular for portfolios of lower-rated firms. Interestingly, relative to hedge ratios estimated empirically from the observed sensitivity of credit spreads to option returns, our model hedge ratios improve hedging effectiveness, reducing volatility by 15% in an out-of-sample setting including the entire portfolio of firms. We also document that the product of the option's delta and the option value implied by the compound option model explains an additional 2% of the variation in credit spread changes that cannot be explained by firm-specific stock market variables. Our findings are relevant for credit risk managers: the hedging approach we propose aims at offsetting losses in the market value of a long credit risk position. As a result, it is a more efficient alternative to methods adopted by practitioners which are based on hedging default losses subject to substantial recovery risk.

12:45 Lunch

14:00 The Liquidity Risk Time Bomb
Chris Kantos, Northfield Information Services

During the financial crisis years of 2007-2009, much of the declines and volatility experienced by global markets purportedly had to do with liquidity related concepts. These effects ranged from the "hedge fund meltdown" of August 2007 to the destabilization of money markets triggered by the failure of Lehman Brothers. The near-failure of numerous other financial institutions contributed further to the misery, to which central banks responded with unprecedented injections of massive liquidity into financial markets.

Since then, the equities world has been subjected to lots of discussions on "crowding" of strategies and factors. Interest rates have gone to zero or even negative in many countries. The rapid growth of ETFs makes the current problem worse, as ETFs are traded with high liquidity but without regard to the fact that many of the underlying securities may not be equally liquid. Regulators such as the US SEC and the various aspects of MIFID II in Europe have begun to require that asset managers of open-end funds and ETFs carry out analyses of their liquidity risk. In addition, regulators desire trading practices that do not unfairly shift the cost burden of large liquidations to remaining investors from those investors withdrawing.

In this presentation, we will describe various approaches that different participants in the asset management industry are taking to analyze liquidity risk. Unfortunately, we find that in all but a few cases the analytical approaches being undertaken are unsound. These flawed analyses give the impression that market liquidity to transact securities is far greater than it actually is.

We will conclude with an optimization-based approach for managing liquidation costs in crisis conditions.

15:00 Coffee Break

15:15 Implicit Investment Management for Private Equity and Venture Capital General and Limited Partners: Risk, Return, and Diversification Moments
Dan diBartolomeo, Northfield Information Services

With its appeal of early insight-driven performance, combined with yield-hungry investors in a low interest rate environment, private equity has attracted vast amounts of capital and interest. Due to the inherent focus on keeping investment insights private to preserve their value for the benefit of both GPs and LPs, the requisite data has not been readily transparent to subject the asset class to the same quantitative analytical approaches as its public equity counterpart, leaving a great deal of "take it or leave it" risk for investors.

In this presentation, we assert that this should not be a defining limitation of the asset class. Armed with only innocuous information about the portfolio investments and the manager's past performance, a well-defined expectation of future performance and risk can be established for the partnership. This analysis can then be seamlessly integrated in a methodical approach to optimal illiquid asset investing.

16:15 Concluding remarks

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