

# LAIC Fund Ranking Methodology

Systematic Approach to Ranking and Comparing Liquid Alternatives

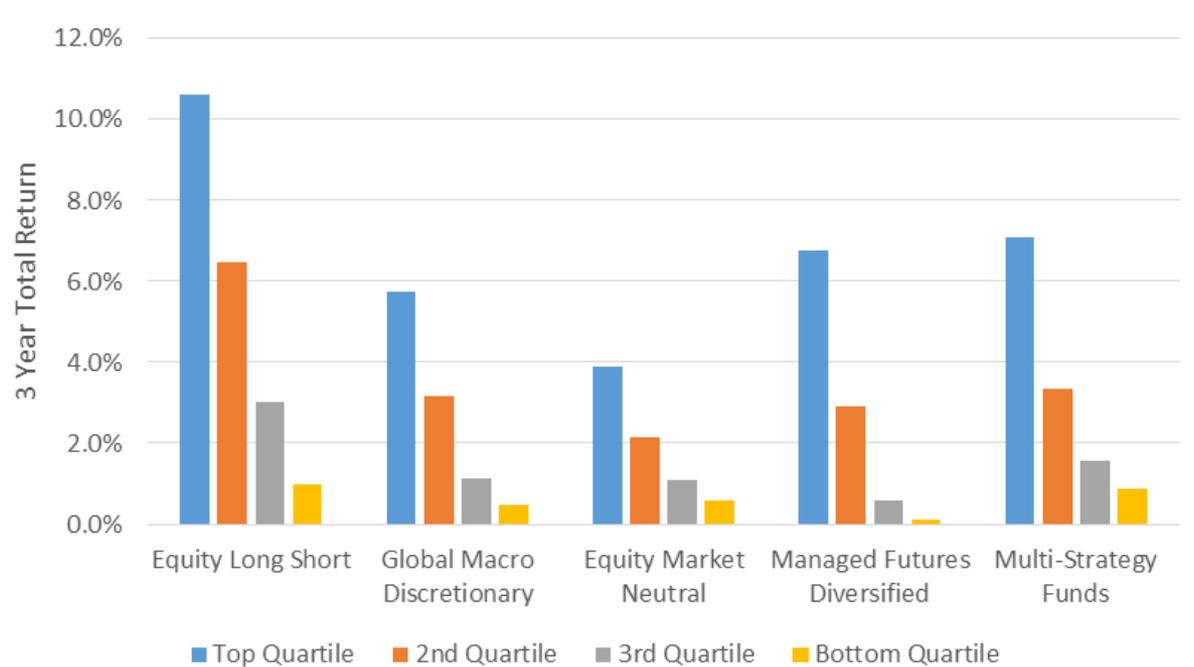
# Issues in Fund Ranking and Selection

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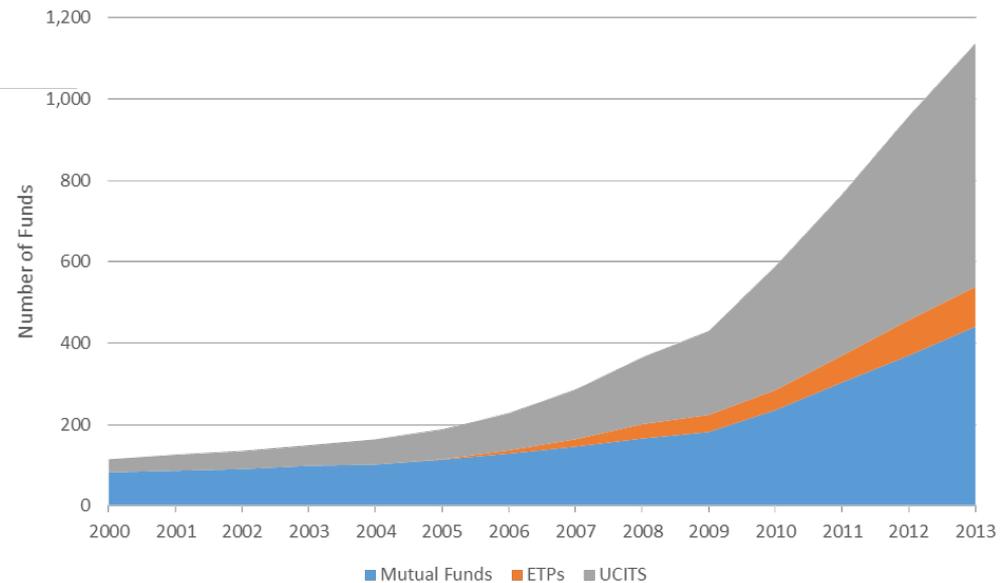
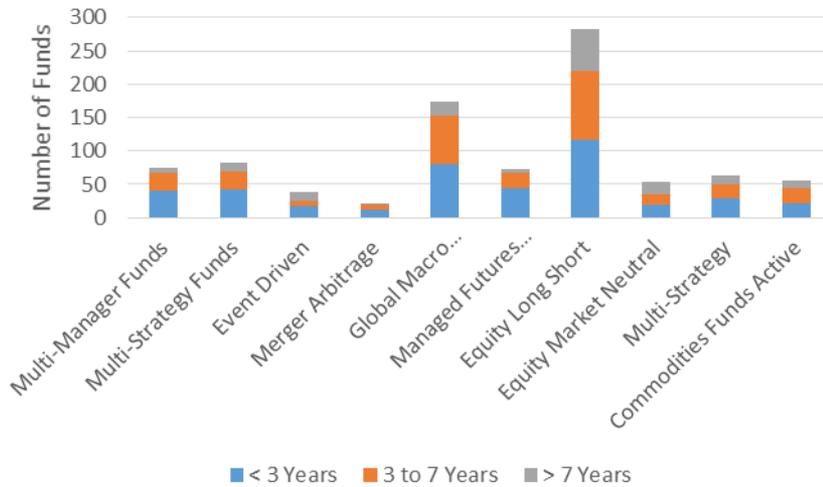
- ▶ Uncertain link between historical and future performance
  - ▶ Persistence
  - ▶ Separating Skill from Luck
  - ▶ Role of manager in performance
- ▶ Dispersion of Manager Performance
- ▶ Graveyard of closed funds
- ▶ Funds closed to new investors and/or requiring minimum investment
- ▶ Uncertain relationship between fund size and performance
- ▶ Uncertain relationship between funds' performance and flows

# Why is Fund Selection so Important: Quartile Dispersion

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# Why is Fund Selection so Difficult: Limited Track Record



# Why Fund Selection is Difficult

## Investor and Advisor Heuristics: Behavioral Economics and Neuro-Finance

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- ▶ **Behavioral Economics**
  - ▶ Herding, Groupthink
  - ▶ Experts: Articulate Incompetents
  - ▶ Optimism Bias
  - ▶ Confirmation Bias
  - ▶ Recency Effect
  - ▶ Emotions impact perception
- ▶ **Neuro-Finance**
  - ▶ Anticipation vs. Rewards
  - ▶ Selective Perception & Retention
  - ▶ A Species of Dopamine Addicts
  - ▶ Endowment Effect of Ownership
  - ▶ Monkeys Love a Narrative
  - ▶ Cognitive Errors Impact Processes

# Investment Heuristics: Mental Shortcuts

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“I can calculate the motion of heavenly bodies, but not the madness of people...” (Sir Isaac Newton, Following substantial losses investing in the South Seas Bubble).

- ▶ herd instinct
- ▶ influence of conformity
- ▶ Anchoring
- ▶ influence of authority
- ▶ power of stories
  - ▶ universal, crossing boundaries of language, culture and age – sense of continuity
  - ▶ Mirror human thought (we think in narrative structures e.g. past, present, future)
  - ▶ Define who we are (easier to identify with an individual than a ‘statistically average person’)

# Investment Heuristics: Disposition Effect

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- ▶ Propensity of investors to lose more money when selling than they would be expected to do by chance alone
- ▶ Behavioral Finance literature explains this lack of skill when selling in terms of ‘prospect theory’ and ‘mental accounting’
  - ▶ Prospect theory centers on the different attitudes to risk when investors are either looking at profits or losses
  - ▶ Mental accounting points out that investors view each position within a portfolio as an entirely separate item and treat them in an inconsistent manner. In particular, investors tend to bucket ‘winners’ and ‘losers’ separately and the chances of something being sold increases simply if they have made a ‘profit’ on the investment.
  - ▶ Consequently it is hardly surprising that potential winners are sold too early and poor performers are retained because they are showing a loss, particularly if the latter involves feelings of regret and loss...

# LAIC's Fund Ranking System

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- ▶ While we recognize the relevance of qualitative fund evaluation in some circumstances, the approach varies widely depending on the practitioner, leading to widely disparate and idiosyncratic results.
- ▶ We firmly believe that one way of reducing the subjective element in fund selection is to include only those funds that have a 3 year performance record and \$50 million in assets, which points to at least some liquidity in the trading and pricing of the funds.
- ▶ LAIC's Fund Ranking System is based on key quantifiable factors that we believe help to alleviate at least some of the issues on fund selection. We group these factors into the following broad categories:
  - ▶ Ranking compared to peer group
    - ▶ Alpha in excess of applicable strategy peer group
    - ▶ Quartile placement over time within applicable strategy peer group
  - ▶ Beta to major market indices including U.S. and global equities and fixed income
  - ▶ Maximum drawdown compared to peer group and including the time period
  - ▶ Volatility adjusted return (Sharpe Ratio)
  - ▶ Absolute return above risk free rate (information ratio)
- ▶ Each fund's ranking is calculated by using a weighted formula that incorporates the above five categories and 25 specific factors. Score is based on placement of hedge funds within their strategy peer group

# Fund Ranking System: Calculation of Manager Alpha and Beta

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- ▶ Beta measures the extent that funds' returns are influenced by market movements
- ▶ Alpha measures the excess return after market sources of return, or value added by manager

$$\text{Total Fund Return} = \text{Alpha} + \text{Beta}$$

- ▶ LAIC measures the alpha of each fund against its peer group (via quartile placement) and the market (via correlation and factor analysis)
- ▶ To compare fund alphas it is necessary to consider their significance as measured by their p-value
  - ▶ P-value measures the significance of the contribution of a given factor.
  - ▶ Alphas that are more significant (lower p-value) receive a higher alpha

# Fund Ranking Factors

Alpha Score	Beta Score	Drawdown Score	Sharpe Score	Raw Performance Score
Fees	Correlations	3-Year Maximum Drawdown	3-Year Sharpe Ratio	3-Year Annualized Return
Minimum Investment	S&P 500 Index	5-Year Maximum Drawdown	5-Year Sharpe Ratio	5-Year Annualized Return
Closed to New Investors	Barclays US Aggregate Bond Index	Post-2008 Maximum Drawdown	10-Year Sharpe Ratio	10-Year Annualized Return
Returns	Lehman High Yield Bond Index			
Expense Ratio				
Net Income Ratio				

Each fund within a category is ranked along each of these variable and provided with a rank order score. These variable scores are then aggregated to provide each fund with its final ranking score

# Individual Fund Reports

LAIC generates a fund report for all the funds in the database the provides important qualitative and quantitative information for that fund, including factor analysis, which indicates the fund's sensitivity to movements in the global markets

## Fund Description

The fund seeks to limit global equities market risk by balancing "long" and "short" positions. It will buy, or take a long position in, equity securities of U.S. and non-U.S. companies that the Adviser believes are undervalued and more likely to appreciate and, at the same time, sell or take short positions in, equity securities that the Adviser believes are overvalued and more likely to depreciate.

## Classification

Category	Hedge Fund Strategy
Strategy	Equity Hedged
Sub-Strategy	Equity Market Neutral

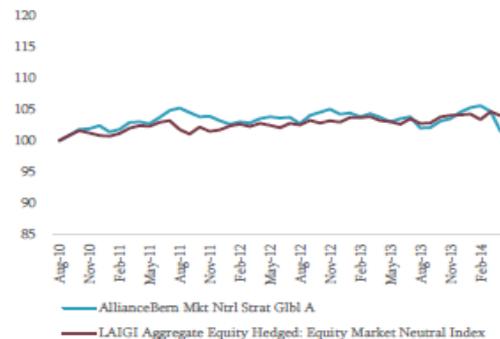
## Performance Statistics

	June	YTD	1 Year	Benchmark		5 Years	Since Inception	BM	
				(BM)	3 Years				
Return	1.3%	-2.3%	-1.4%	1.9%	-0.5%	0.5%	-	0.5%	1.2%
Standard Deviation			4.4%	2.3%	3.0%	2.1%	-	2.9%	2.0%
Sharpe Ratio			-0.45	0.85	-0.44	0.26	-	-0.10	0.18
Maximum Drawdown			-4.5%	-0.8%	-4.5%	-2.1%	-	-4.5%	-2.1%
Sortino Ratio			-0.54	5.32	-0.56	0.48	-	-0.12	0.33

## Monthly Performance

	2009	2010	2011	2012	2013	2014
Jan.	-	-	-1.0%	-0.6%	0.2%	0.7%
Feb.	-	-	0.4%	0.4%	-0.6%	0.3%
Mar.	-	-	1.1%	-0.2%	0.5%	-0.9%
Apr.	-	-	0.1%	0.7%	-0.6%	-3.0%
May	-	-	-0.3%	0.3%	-0.7%	-0.7%
Jun.	-	-	1.0%	-0.2%	0.5%	1.3%
Jul.	-	-	1.1%	0.1%	0.3%	
Aug.	-	-	0.4%	-1.0%	-1.7%	
Sep.	-	0.8%	-0.7%	1.3%	0.1%	
Oct.	-	1.0%	-0.7%	0.5%	1.0%	
Nov.	-	0.1%	0.1%	0.5%	0.4%	
Dec.	-	0.5%	-0.7%	-0.8%	1.0%	
Annual	-	2.4%	0.8%	1.0%	0.3%	-2.3%

## Performance Chart



\* Factor analysis From Sep-2010 to Jul-2014

Factor values represent the univariate regression coefficients and indicate the sensitivity of the fund's returns to the various factors.

## Fund Overview

Structure	Open-End Mutual Fund
Fund Assets	\$ 11 Mil.
Inception Date	8/3/2010
Min. Investment	\$ 2,500
Fund Symbol	AAANX
Closed to New Investors	NO
Company Name	Alliancebernstein Cap Fund,inc
Share Class	A

## Fees

Expense Ratio	1.60%
Management Fee	1.3%
Administrative Fee	N/A
Front Load	4.3%
Redemption Fee	N/A
Turnover Ratio	175.0%

## Fund Factor Sensitivity\*

