

Adding Low Sharpe Ratio Investments Can Increase Your Sharpe Ratio – Tom Basso

Many Fund of Funds managers have focused their attention on higher Sharpe ratio managers with as little correlation as possible. The logic is by adding many high Sharpe ratio managers together you get an even higher Sharpe ratio portfolio. By comparison, CTA style hedge fund managers have had lower Sharpe ratios than the tradition hedged managers. Some Fund of Funds have ignored this area because of the lower Sharpe ratios. This study shows that to be an oversight on their part, since adding lower Sharpe ratios acutally increased the Sharpe ratio of the total fund.

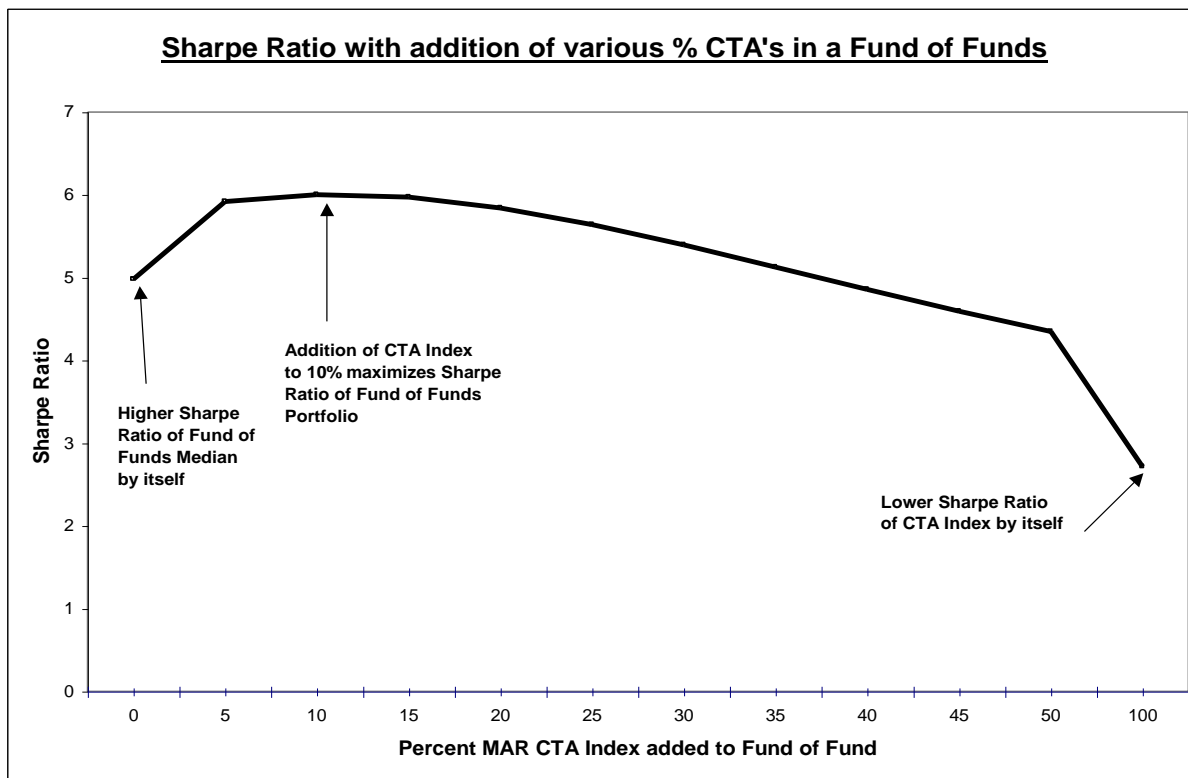
Background on the Study:

To obtain proxies for both the Fund of Funds and the CTA's I used MAR's Fund of Funds median (FOF) and the Trader Advisor Qualified Index (CTA) going back to January of 1990. I used the monthly median numbers for the FOF group and the monthly averages for the CTA group.

Next, I combined the returns together in various combinations from 0% CTA's all the way to 100% CTA's. The 0% level is the level some Fund of Funds currently allocate to CTA's. The 100% level is where some Commodity Pool Operators operate their pools, not using hedge funds in the portfolio. I also tested a variety of other combinations in between these two extremes.

To calculate a reasonable Sharpe ratio, I used a 4% risk free rate over the period. I used the annualized returns of the portfolios, minus 4%, divided by the monthly standard deviation of the returns.

Figure 1



Results of the Study:

In Figure A, I plotted the amount of the CTA investment in the Fund of Funds index against the Sharpe ratio for each combination. The Sharpe ratios were higher with the addition of some CTA index to the FOF index. High Sharpe ratios were found between 5-15% of the total portfolio. The highest Sharpe ratio was achieved by adding 10% CTA's to the FOF portfolio.

Using the research:

In the study, I used indices for Fund of Funds and CTA's. Because of that, my numbers are already going to be smoothed and Sharpe ratios higher than they might be on average for individual managers. Fund of Funds attempting to add CTA's can look at extremely diversified CTA's that would correlate well with MAR's CTA index, hire several CTA's that use different strategies or use an indexed approach to adding a CTA style return/risk component to their portfolios.

Tom Basso is CEO of Trendstat Capital Management, Inc., a Scottsdale, AZ based investment advisor/CTA managing \$145 million in assets.