

## Short Biased Funds

### Investor Perspective

#### Assessing a manager's shorting skills

In the current bearish stock market environment, more investors are examining short biased or short-only managers

Chuck Gulden of Tiedemann Investments says these investor are looking for short biased managers who can make money over different time periods and make money short in periods of market distress on a consistent and uncorrelated basis.

"If you're making money on the short side in an up year, you're probably doing well. Theoretically, if you're shorting and you're losing less than the money is up, then you're adding alpha too," concludes Gulden. He suggests looking at alpha - whether managers outperform a benchmark on a risk-adjusted basis or just outperform a benchmark or the market.

Yet it is not always easy to get information from short-biased/short-only managers. Many managers do not release information because the danger of a short squeeze always exists, says Meredith Jones, managing director of PerTrac.

Some managers may allow investors to sign non-disclosure agreements in exchange for allowing the investor to see the short positions. Other investors can get a glimpse of the manager's short positions from auditor reports without actually seeing the positions. Prime brokers also may provide summary reports on positions.

#### Attribution analysis

Some managers provide attribution analysis where they identify the percentage of positions from specific geographic areas, specific market capitalizations, the long side and the short side.

Jones says a growing number of managers are providing this information because institutional investors are demanding it.

Yet the attribution analysis approach has its problems. One issue, says Dan Karp, director of research at Liberty Gateway Asset Management, a fund of funds, is whether the manager even has a significant short side to begin with - not all do. Another concern is whether the manager will give the investor the attribution analysis. Karp says in his experience only a small number of managers provide attribution.

Moreover, the approach is most appropriate for long/short equity managers but not other strategies.

Jones says no verification exists that what the manager provides is actually accurate.

And finally, the investor has to analyze the statistics which may have inherent statistical inefficiencies.

#### Manager's philosophy

Karp says an investor needs to start with the manager's philosophy. Does the manager want the short side to generate alpha on its own or to hedge i.e. to blunt the volatility from a possibly levered long side or some combination of the two? The objectives need to be clear from the start.

Karp says this goes back to the philosophical issue of what is a hedge fund. "Managers who go long-only with occasional market timing or a slight hedge are not hedge funds," says Karp.

Larry Chiarello of Riverview Alternative Investments, observes that most long/short managers or long directional managers tend not to make money on the short side. "Their objective is not to make money on the short side - they use it to hedge their longs. Most managers will say they make money on their shorts as well as their longs," he adds.

Investors make a distinction between short-only managers and short-biased with most tending to favor the short-biased manager.

Karp won't look at short-only managers, saying that the results have been terrible. He will look at short biased managers if they can get good alpha.

*(Continued on page 12 column 1)*

#### Inside this issue —

##### INTERVIEWS WITH:

- David Hammond, Derivatives Consulting Group 2
- Jim Kastberg & Frank Bianco, Veritas Fund 2
- John Schmitz, SciVest Investment Management 3
- Seth Weinstein, Crescent City Capital Advisors 3

##### ALSO INSIDE:

- Sentiment Indicator: Manager 6
- Universe of Short Biased Funds, Pros and Cons of Short Biased Funds 11
- Statistics - Short Biased Indices, Index & ETF Volumes and Assets 10-11

**David Hammond**  
**Derivatives Consulting Group**  
 By JingLin Huang

**Infovest21: Tell me about your background.**

**David Hammond:** In the 1970s, I started as an options trader on the Pacific Options Exchange and moved to the Chicago Board Options Exchange in the mid 1980s to trade the Options Exchange Index. Another trader and I started and ran our first hedge fund from 1986 to 1988. My partner semi-retired and I moved back to California, joined a small risk arbitrage firm in 1989 as derivative specialist.

We started running short-only capital and became the third largest short seller in the country in 1990. We managed the top performing hedge funds in 1990. I left that firm, started a long/short fund with a partner and after two years sold my half to him in 1994. In 1995, my current partner John Frazer and I formed the Derivatives Consulting Group.

**Infovest21: What are the different approaches to shorting?**

**David Hammond:** The traditional short seller does detailed fundamental analysis on a reasonably concentrated portfolio with the portfolio bias determined by the short analyst's personal approach. Short sellers generally know their ideas better than most so they get very possessive and almost cocky about their positions. They share ideas and research with other hedge fund analysts and therefore end up holding similar positions. There is little diversification and the portfolios end up being somewhat negatively correlated to long portfolios but somewhat idiosyncratic.

When the Standard and Poor's Depository Receipts were introduced in 1993 the short interest in these Exchange Traded Funds became almost \$10 billion overnight. Hedge funds and investors loved them as an alternative to hiring a short seller. You could sell them on downticks and you got a short rebate. The problem was that there was no alpha. Your timing had to be perfect to actually improve your portfolio.

**Infovest21: What is your approach and strategy?**

**David Hammond:** We decided in 1994 that we could create a broadly diversified ETF-like short portfolio that would be widely diversified, have a beta of -1 or greater, and create approximately 1% alpha a month relative to the equity market indices. We spent over a year building our model, collecting data, and in 1996 started marketing the product. We called the strategy Arcas. In 1996, we funded two Arcas strategies and in 1999 added a third short strategy. We currently run all three as widely diversified alpha-generating short portfolios.

**DERIVATIVE CONSULTING GROUP LLC**

- Name of Funds : Arcas Funds
- Inception : November 1996
- Strategy : Short Biased Equity
- Headquarters : Christiansted, US Virgin Islands
- Assets (Firm/Strategy): \$450 million, \$24 million

**DAVID HAMMOND**

Title : Chief Portfolio Manager  
 Prior Experience : Cypress Cove Fund, Pacific Options Exchange

**Jim Kastberg & Frank Bianco**  
**Veritas High Yield Short Only Fund**  
 By JingLin Huang

**Infovest21: Tell us about your background.**

**Jim Kastberg:** I have been managing high yield money for over 20 years. I started at Mitchell Hutchins in the late 1980s. I joined the high yield group at Morgan Stanley in the early-1990s, saw performance improve from the worst performing to best performing fund as ranked by Lipper. In 1998, I started the high yield and structured products group at JH Whitney & Co., a private equity firm. There I raised over \$2.2 billion in structured funds.

We launched the Veritas high yield fund off of the Argent Funds Group platform in October 2002. Assets in Veritas peaked at \$1.1 billion three years ago. Anything with the name Veritas had to do with the high-yield and leveraged loan markets. Veritas gave back \$600 million to investors in May 2006 because of the lack of opportunity in the markets, and a mandate which was specifically predicated on capturing market volatility. Veritas currently manages \$100 million.

We launched the Veritas short-only product in 2004. It came about from one of our investors who wanted to bet against the high-yield market.

**Frank Bianco:** I began my career at American International Group in 1991. I spent four years there working in various credit-related functions. I left AIG to join the Federal Reserve Bank of New York where I spent nearly three years in their credit group. In 1998, I joined McMahan Securities, a convertible bond broker dealer, where I was responsible for healthcare and biotechnology convertible research. I came to Veritas two-and-one-half years ago heading the research department; currently I am managing the portfolio.

**Infovest21: What are the different approaches to shorting?**

**Jim Kastberg:** In high yield, there are a number of different ways to short. You can short the main high yield index i.e. the Credit Derivative Index Series 9 index. The underlying on that is the credit default swaps on a hundred individual names and they trade them in a bundled fashion.

You can also short individual bonds or use some highly correlated indices to the high-yield market, most notably the Russell 2000.

**VERITAS HIGH YIELD SHORT ONLY FUND**

- Inception : 2004
- Strategy : Fixed Income
- Headquarters : Greenwich, CT
- Assets (Firm/Strategy): \$1 billion, \$100 million

**JIM KASTBERG**

Title : Chief Portfolio Strategist  
 Prior Experience : Whitney & Co., Morgan Stanley  
 Dean Witter & Co.

**FRANK BIANCO**

Title : Portfolio Manager  
 Prior Experience : McMahan Securities, Federal Reserve Bank of New York,  
 American International Group

(Continued on page 8 column 1)

(Continued on page 4 column 1)



**John Schmitz**

**SciVest Investment Management Inc.**

*By JingLin Huang*

**Infovest21: What is your role at SciVest?**

**John Schmitz:** I am the primary portfolio manager of our offshore net short equity fund, the SciVest Global Net Short Equity Fund, and the chief investment officer of the firm.

**Infovest21: Tell me about your background.**

**John Schmitz:** I have a degree in mechanical engineering, a Masters in Economics from the University of Toronto, and a PhD in finance from the University of Western Ontario. I am a Certified Financial Analyst as well. For over ten years, I have been managing money using quantitative systems in hedge fund space.

**Infovest21: How did you get into a short only hedge fund?**

**John Schmitz:** I started doing research in the market neutral equity strategy in 1997 and launched our first market neutral equity fund in 2001. It was quite successful in the market neutral space. One of the attractive features of the market neutral equity strategy was reasonable risk-adjusted returns with no correlation to equity markets. By definition, the market neutral equity strategy is market neutral. As a result, one of the primary selling features of the strategy is diversification. If you hold a portfolio with equity, market neutral equity will help you diversify that equity market exposure.

Since market neutral equity is 0% correlated with equity markets, the next logical step would be to introduce a product with negative correlation to the equity markets. You would have a much better hedge for an investor's holdings of equity if you actually had a negative correlation to the equity markets rather than being just neutral to the market. Therefore, it made sense for us to get into the net short equity space. We took what we had learned in the market neutral equity space and applied it to create a net short equity fund in 2004.

**Infovest21: What is the percentage of short exposure?**

**John Schmitz:** The oldest fund, the SciVest Net Short Equity Fund, started in 2004 as a Canadian-based product focused on North American equities. Since then, as we learned more and went global, we launched the SciVest Global Net Short Equity Fund, our offshore flagship fund. That fund is 75% net short and has a target beta relative to the Morgan Stanley World Index of -0.75 at all times. We always maintain this magnitude of short because we believe that timing the markets is a difficult proposition. We also believe that investors pay us to always provide a strong and consistent hedge to their overall portfolios.

**Infovest21: What is your strategy?**

**John Schmitz:** We are a quantitative specialist, so we use computer-

*(Continued on page 5 column 1)*



**Seth Weinstein**

**Crescent City Capital Advisors**

*By JingLin Huang*

**Infovest21: What is your background and experience?**

**Seth Weinstein:** I have over 18 years of Wall Street experience. Beginning in 1990 I worked on the Philadelphia Options Exchange, clerked for the options market makers, and calculated their exposure-volatility, delta, gamma, theta, and fair values for all the positions they were trading.

In 1994, I moved to New York City, and began working as technical analyst and head trader for TCM Partners, a \$40 million hedge fund. In 1998, I was hired by Spear, Leeds & Kellogg, a division of Goldman Sachs, and the largest specialist on the floor of the New York Stock Exchange as a portfolio manager and proprietary trader handling firm capital. I started my own hedge fund company in 2001. I'm a general partner in two separate management companies - Crescent City Capital Advisors, L.L.C. which manages the Crescent City Dedicated Short Fund, L.P. and Logan Equity Partners, L.L.C. which manages the Logan Asset Backed Fund, L.P. I use my options background and programming/quant training as a filter for almost all of my trading and risk/reward decisions.

**Infovest21: What is your short strategy?**

**Seth Weinstein:** My shorting strategy relies on a portable alpha methodology. I invest a majority of the capital from the Crescent City Dedicated Short Fund in the Logan Asset Backed Fund, an asset-backed lending strategy. I then take the income generated from the "alpha" strategy, and inventory options at- and out-of-the money, near- and out-month put options on the S&P 500. The beta is created in the dedicated short fund through the purchase of put options financed by the portable alpha. We take a very low risk strategy to bring in cash-flow to finance the short exposure and create short beta in a higher risk market.

The ABL strategy is a lending strategy that makes loans on commercial real estate. We make primarily first lien commercial real estate loans with a maximum 60% loan to value with an average term of 18 months. When I look at the ABL fund as an options trader, I'm underwriting a mortgage, and giving the property owner the right to put the property to me down 40% (based on the 60% LTV) in 18 months from what I think is its fair value. It is like being short a naked put 40 to 50% out-of-the money on a portfolio of cash flow producing commercial property. It could be anything from strip malls to hotels to gas stations.

The edge behind this volatility dispersion strategy is tremendous. The historical volatility of our portfolio of commercial property has between a 5-7% annualized standard deviation. I am gaining 12 to 14% per year from interest income; if this strategy were viewed as an option,

*(Continued on page 9 column 1)*

**Jim Kastberg and Frank Bianco** *(Continued from page 2 column 1)*

Our approach is to use a combination of all three. We are most comfortable shorting individual bonds and our strength is in our credit research. We take a bottoms-up approach and add value on individual credits by knowing and understanding their place in the industry and their competitive edge or disadvantage.

**Infovest21: Which sectors?**

**Frank Bianco:** It varies. We focus on whatever makes most sense at any particular time. Currently, the consumer seems quite [cash] strapped, so we are focusing on that aspect with a particular emphasis on those companies that sell discretionary items and/or apparel. We also have short exposure to homebuilders and suppliers.

*While we are short, we do offset some of our negative carry with yield-to-call or short duration longs.*

While we are short, we do offset some of our negative carry with yield-to-call or short duration longs. The typical YTC/short duration candidate has a one-to-two year maturity and a solid credit profile. That combination has served us well.

**Infovest21: Describe your fund's portfolio.**

**Jim Kastberg:** The Veritas short-only fund can have up to 10% in any individual name and 20% in any individual category whether it is retail, financial, or brokers, etc. We employ 5% stop-loss limits. If something moves 5% against us, we take it off and re-evaluate it. That doesn't mean that the position won't go back on. That is evaluated on a daily basis. We cut net asset values at the end of the each month.

We like to be timely on the short side because there is the cost to being short, both in bonds and indices. We tend to look for triggers when we put on a short position. If nothing has happened over two to three earning periods, we tend to take off the short and reevaluate why we put it on.

**Infovest21: How do you manage risk?**

**Jim Kastberg:** If a position moves 5% against us, we take it off. That is based on the cost that you put the position on the portfolio. We tend to reset that cost on a monthly basis. As mentioned, we cut monthly net asset values. If our position was down 4.5% on the last day of the month, we are not going to reset the clock on the first day of the next month. But the general guideline is that we will use a 5% stop-loss.

**Infovest21: How long is your holding period?**

**Jim Kastberg:** About nine to 12 months. We follow 60 to 100 positions with 40 to 60 of those being on at any one time.

**Infovest21: What is your investment philosophy?**

**Jim Kastberg:** It is definitely a bottoms-up approach where we focus on each individual company, relying heavily on our research process.

**Frank Bianco:** We start with the financials i.e. the 10K, 10Q, 8Ks, etc., and look at the the balance sheet to gain an understanding of each asset and liability.

From there, we look at the income statement, understand where the revenues are coming from, how that revenue is generated and the sustainability to those revenues. We evaluate cash flow, its drivers, predictability and sustainability as well. We compare cash flows to total debt, among other things, and look at traditional ratios, like debt-

*(Continued on page 4 column 2)*

**Jim Kastberg and Frank Bianco** *(Continued from page 4 column 1)*

to-Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), interest coverage, free cash flow as a percentage of total debt, cap x requirements, etc.

*As we are seeing the economy slow down, we are seeing defaults picking up in high yield.*

We speak to management, vendors and customers where it is appropriate. Understanding where a company is in its life cycle and how it compares to its peers is critical as well.

We spend quite a lot of time looking at covenants to understand what the company can and cannot do. From there, we develop an opinion on the industry in the context of our view of the macro environment. Based on these factors, we determine fair value for the security, how the position will affect the portfolio overall, and make the determination whether to be either long or short the bonds.

**Infovest21: How do you measure short capture?**

**Jim Kastberg:** Our benchmark is the Merrill Lynch Master 2 High Yield Index. Our approach and goal in the short-only fund is to provide two times return on whatever the index is. So if the high yield index is down 5%, we should be up around 10% and vice versa.

**Infovest21: How is this different than using Exchange-Traded Funds or indices?**

**Jim Kastberg:** High yield is a hybrid product. It acts very much as an equity product in a down cycle which we are seeing right now. These are highly levered high-risk companies - that's why they are in the marketplace in the first place. It's really almost a niche-type market, it's a \$1 trillion marketplace. But outside some rough correlations with the Russell 2000, it tends to be a unique animal. As we are seeing the economy slow down, we are seeing defaults picking up in high yield.

This offers a number of opportunities. First and foremost, opportunities exist on the short side. Also the distressed market will be fairly active in the back half of 2008. I think anybody getting involved in distressed right now is going to be a little bit early. But there has been a lot of distressed money sitting on the side that is eager to go in. If you put stock into the slowdown in the US economy and we have seen it across the board, whether it is in real estate, consumer discretionary spending, etc, you are going to see some pretty tough times in the high-yield market place. You will see it there first since it is a highly levered marketplace.

You will be able to capture a greater return being short high yield than just being broadly short an ETF, which is a sector specific fund or an index fund which is even a broader measure of the market.

**Infovest21: What advice do you have for investors in the short biased high yield space?**

**Jim Kastberg:** We tell them that high yield and fixed income should be an overall portion of their fixed income allocations. It's a fairly decent asset class. We clearly have gotten over our skis here over the past 12 months - lending practices have gotten incredibly loose and covenant packages are almost non-existent.

Default rates have fallen very low. The historical average for default rates in high yield over 20 years that the markets have been around,

*(Continued on page 11 column 1)*

**John Schmitz** (Continued from page 3 column 1)

based models for stock selection and risk management. Most true market neutral managers use quantitative methods extensively to manage beta and volatility risk and to generate returns. We bring this unique approach into the net short equity space.

Most traditional managers in this space focus on a small number of stocks and generally focus only on the US. We use a different approach. We are very systematic in the sense that models drive all decisions, both in terms of stock selection and risk management. The result is a disciplined systematic and risk-controlled product.

*It is not about, for example, looking for the next bankruptcy candidate or home run short position. It is about finding value in both the longs and the shorts within the portfolio.*

It is not about, for example, looking for the next bankruptcy candidate or home run short position. It is about finding value in both the longs and the shorts within the portfolio. We are trying to pick up nickels on the long side and nickels on the short side while always being 75% net short within the fund.

While we are opportunistic in the sense that our holding period on the average stock is only two to four months, we are looking for short to medium term singles, not home runs.

We also focus on small to mid capitalization stocks to maximize the return opportunity of our investments. These opportunities are selected from a universe of over 7,000 liquid global equities. Generally, we hold over 1,000 global equities from the top 14 countries by market liquidity.

There is no better risk management technique than extensive diversification. No single long position is more than 1% of the fund's net asset value and no single short position is more than 0.8% of the fund's net asset value. As a result, we can never be stung badly on any single random event that one of our positions might be hit with.

#### **Infovest21: What are your risk controls?**

**John Schmitz:** We use sophisticated risk models to form the ultimate portfolios. These portfolios are always subject to a large number of risk management constraints in terms of liquidity, magnitude of sector and industry bets, exposure to any given stock, exposure to specific investment styles, etc. - all are tightly controlled within the fund. The result ultimately is, what I think is one of the lowest volatility funds in the world within the net short equity space.

#### **Infovest21: What is your volatility target?**

**John Schmitz:** The overall objective of the fund is to deliver returns approximately equal to equity markets with volatility no higher than the equity markets. We are trying to deliver a risk-return package that is similar to any other good investment out there. But our fund will always be 75% net short to equity markets, producing a large negative correlation with almost all other investments.

Over an economic cycle, if we have returns that are 8-10% with volatility 12-13%, like the equity markets, but having beta of

(Continued on page 5 column 2)

**John Schmitz** (Continued from page 5 column 1)

-0.75, then the fund should be held by any investor holding equity because of the immense risk reduction benefits that the fund will produce in the investor's portfolio.

#### **Infovest21: How do you generate returns?**

**John Schmitz:** Our objective is to add alpha on both long and short sides of the portfolio while capturing 75% of a fall of global equity markets.

*Our fund will be 75% net short to equity markets, produce a large negative correlation with almost all other investments, and deliver returns equal and with volatility no higher than the equity markets.*

There are three components to returns in a net short fund. The first is the carry on your shorts, which is a one-for-one function of interest rates - the higher the rates, the higher the carry, and therefore the higher the returns on your fund. The second component is beta, which is your percentage short times the negative of what the market does. For example, if you are short 75%, you would be expected to make 7.5% if the markets fall 10%; conversely, if the market goes up 10%, you would be expected to lose 7.5%.

The third and key component of a net short fund's return is alpha - or stock selection above and beyond interest carry and beta exposure. We seek a strong and consistent alpha over a full economic cycle. We aim for an alpha in the 5-10% range per annum over any economic cycle. As a result, we capture at least 75% of the fall in any market, plus we are adding interest carry, plus alpha on top of that.

#### **Infovest21: What are the returns on average looking like?**

**John Schmitz:** We launched the onshore fund in 2004, near the beginning of one of the longest bull markets in history. Nevertheless, we have been positive every year, except for the first year, when we only had six months of experience. We have been positive in each of the last three years, showing that we can make money even in a bull market. I expect that over the next couple of years, we will produce bear market like numbers which would be well into double-digit returns. You could see this new bear market phase beginning in the fourth quarter of 2007 as the SciVest Global Net Short Equity Fund generated a net return in excess of +10% for the quarter.

### **SCIVEST INVESTMENT MANAGEMENT INC.**

- Inception : June 2004
- Strategy : Short Biased Equity
- Headquarters : Toronto, Canada; Freeport, Bahamas
- Assets (Strategy) : \$ 20 million

#### **JOHN SCHMITZ**

- Title : Primary Portfolio Manager, CIO
- Prior Experience : Money Management, Financial Consulting, and Research Roles

## Sentiment Indicator: Manager

### Recessionary Environment to Impact Hedge Fund Industry

The managers surveyed in Infovest21's February Manager Sentiment Indicator generally felt the recessionary environment would slow the growth of the hedge fund industry as asset raising would be harder as investors would be less willing to take risk. One manager said it would be more challenging to generate absolute returns and to the extent returns moderate, assets would flow away if fees were not justified by the value added.

#### Managers bearish over the short term

Managers' views on most markets continued to be negative looking out three months. The Yen received the strongest vote of confidence as 21% of the managers surveyed felt it would move up significantly.

The managers felt more markets would move down slightly than move up slightly. In six markets, the highest percentage of managers felt the markets would move up slightly. The strongest overall positive sentiment exists for 10-Year Treasury where 63% of the managers felt the market would move up slightly over the next three months. This was followed by 58% who felt the same for Consumer Price Index and 47% for COMEX Gold. About 37% of the managers felt NYMEX oil would move up slightly while 35% felt the same for DJ Corporate Bond Index (the same percentage felt it would fall slightly). 26% of the managers felt that the Yen would move up slightly (the same percentage felt the same for neutral and down slightly).

In nine markets, the highest percentage of managers surveyed felt the markets would move down slightly. DJ Stoxx led the list with 59% while 50% felt the same way for the Pound and the Euro. 45% of the managers felt the Dow Jones Industrial Average would decline slightly while 42% felt that way for the FTSE 100 Stock Average. 39% of the managers felt the 30-Year Fixed Mortgage Rate would fall slightly while 35% said the same for the Dow Jones Corporate Bond Index (the same percentage felt it would move up slightly).

### Three-Month Outlook

	New Highs (%)	Up Significantly (%)	Up Slightly (%)	Neutral (%)	Down Slightly (%)	Down Significantly (%)	New Lows (%)	Total (%)
Dow Jones Industrial Average	0	5	10	10	45	25	5	100
Nikkei 225 Stock Average	0	16	5	11	37	26	5	100
FTSE 100 Stock Average	0	0	21	11	42	21	5	100
DJ Stoxx	0	0	18	6	59	12	6	100
10-Year Treasury	0	5	63	21	11	0	0	100
30-Year Fixed Mortgage Rate	0	0	17	33	39	11	0	100
Dow Jones Corporate Bond Index	0	0	35	18	35	12	0	100
Consumer Price Index	0	16	58	21	5	5	0	100
Euro (in dollars)	0	6	22	17	50	6	0	100
Yen (per dollar)	0	21	26	26	26	0	0	100
Pound (in dollars)	0	6	17	17	50	11	0	100
NYMEX Oil (spot month)	0	5	37	16	32	11	0	100
COMEX Gold (spot month)	0	18	47	6	18	6	0	100

Methodology: Infovest21 conducts this survey on a quarterly basis.

Over the next 12 months, managers' sentiment is still bearish but less so than the three-month outlook survey. The strongest positive nod continues to be given to COMEX Gold - 25% of the managers felt it would move up significantly, about the same level as last quarter. In five out of the 13 categories, the highest percentage of managers surveyed for each group felt the markets would move up slightly. In rank order, they are: 47% for the Yen, 38% for NYMEX Oil, 35% each for Consumer Price Index and the Euro and 29% for the Nikkei 225 Stock Average. In six markets, most of the managers feel the market would stay neutral over the next 12 months. 47% of the managers were neutral for 30-Year Fixed Mortgage Rate while 41% each were neutral for the Dow Jones Corporate Bond Index and the 10-Year Treasury. 37% of the managers were neutral for the Dow Jones Industrial Average compared with 35% for the Consumer Price Index (same percentage felt this market would move up significantly) and 31% for COMEX Gold. In four markets, most managers feel the markets would be down slightly.

## Twelve-Month Outlook

	New Highs (%)	Up Significantly (%)	Up Slightly (%)	Neutral (%)	Down Slightly (%)	Down Significantly (%)	New Lows (%)	Total (%)
Dow Jones Industrial Average	0	5	26	37	21	5	5	100
Nikkei 225 Stock Average	0	12	29	18	29	6	6	100
FTSE 100 Stock Average	0	0	28	22	33	6	11	100
DJ Stoxx	0	0	24	24	41	6	6	100
10-Year Treasury	0	6	24	41	18	12	0	100
30-Year Fixed Mortgage Rate	0	6	12	47	29	6	0	100
Dow Jones Corporate Bond Index	0	0	29	41	24	6	0	100
Consumer Price Index	0	18	35	35	12	0	0	100
Euro (in dollars)	0	0	35	29	24	12	0	100
Yen (per dollar)	0	12	47	35	6	0	0	100
Pound (in dollars)	0	0	19	25	56	0	0	100
NYMEX Oil (spot month)	0	19	38	6	25	6	6	100
COMEX Gold (spot month)	0	25	19	31	12	6	0	100

Over the next five years, managers' outlook becomes more positive.

In eight markets, most managers felt the market would move up slightly. 53% felt this way about the FTSE 100 Stock Average while 47% felt this way about the DJ Stoxx and Consumer Price Index. 42% felt this way about the Dow Jones Industrial Average and 41% felt that way about NYMEX Oil. 39% felt this way regarding the Nikkei 225 Stock Average, 31% for COMEX Gold and 29% about 30-Year Fixed Mortgage Rate.

In three markets, most managers surveyed felt the market would be neutral. In rank order, they are: 38% for the Dow Jones Corporate Bond Index, 29% for the 10-Year Treasury and 29% for the Yen. In two markets - the Pound and the Euro - 47% and 41% of the managers respectively felt the markets would be down slightly.

## Five-Year Outlook

	New Highs (%)	Up Significantly (%)	Up Slightly (%)	Neutral (%)	Down Slightly (%)	Down Significantly (%)	New Lows (%)	Total (%)
Dow Jones Industrial Average	5	37	42	5	5	5	0	100
Nikkei 225 Stock Average	6	33	39	11	6	6	0	100
FTSE 100 Stock Average	6	29	53	6	0	6	0	100
DJ Stoxx	6	29	47	6	6	6	0	100
10-Year Treasury	0	18	18	29	12	24	0	100
30-Year Fixed Mortgage Rate	0	18	29	24	24	6	0	100
Dow Jones Corporate Bond Index	0	6	19	38	25	12	0	100
Consumer Price Index	0	35	47	12	6	0	0	100
Euro (in dollars)	0	18	12	18	41	12	0	100
Yen (per dollar)	0	24	18	29	24	6	0	100
Pound (in dollars)	0	12	24	6	47	12	0	100
NYMEX Oil (spot month)	0	35	41	12	0	6	0	100
COMEX Gold (spot month)	0	12	31	12	12	12	0	100

**David Hammond** (Continued from page 2 column 1)

What makes us different is that we offer investors monthly liquidity and we rebalance between 100% and 160% net short each month.

**Infovest21: How do you build your portfolio?**

**David Hammond:** We decided that to create a widely diversified short portfolio we needed to build a computer model to sift through data that we believe has valuable information content.

We use short interest analysis, capital structure analysis, analyst activity and momentum analysis as inputs into our model. We end up with a process that is replicated each month and that creates a 300-800 short stock portfolio that we rebalance four times per month. The process is the same each month.

The model has proven itself over the past 11 years.

**Infovest21: What time frame do you use on your positions?**

**David Hammond:** We have average holding periods of 6-9 months, we turn over about 15% of the portfolio each month and all trading is done using electronic trading systems for significant cost savings.

**Infovest21: Describe your risk management practices. How are losses monitored and controlled?**

**David Hammond:** In our early years, our alpha was so high and the market volatility reasonably contained so we let the portfolio move to under or overinvested without too much concern. After the wild end of 1999 and first quarter of 2000, we reined in our exposures and have hard rules for total levels of short exposure. If the Arcas portfolio gets over 130% net short, we will automatically adjust the exposure back to 110%.

**Infovest21: How do you measure short capture?**

**David Hammond:** Short portfolios are difficult to understand and measure on a stand alone basis. We run regressions of our monthly and daily data relative to the various market indices to solve for our beta and alpha. This is one methodology that can be used to compare different short seller portfolios.

The best way to measure a short seller is to take an existing hedge fund or fund of fund portfolio and add a 5% allocation of the short and see how much the overall portfolio improves.

**Infovest21: How is this different than using ETF or indices?**

**David Hammond:** ETFs and indices are beta reducers only. Your timing must be exact and while they might lower volatility when added to a larger portfolio, they have a limited ability to increase returns or add alpha. They have limited benefit.

**Infovest21: Where are the opportunities right now?**

**David Hammond:** There are always stocks that outperform and other stocks that underperform. Our model attempts to select and short

(Continued on page 8 column 2)

**David Hammond** (Continued from page 8 column 1)

those that we expect will underperform. It has created significant alpha and very high negative beta for eleven years running.

**If you believe that the funds of funds industry generated 6%-9% annual alpha and has some residual long beta, every fund of funds should seriously look at adding short exposure to their portfolio if the short offers similar or greater annual alpha as a way of improving risk adjusted returns.**


**Infovest21: Is the opportunity for being short over?**

**David Hammond:** The biggest challenge facing shorts is the periodic squeeze that occurs where everyone suffers a giveback of alpha for a period of time. These situations usually occur when the markets get over exuberant, when the Federal Reserve Bank decides it is time to drive interest rates abnormally low, and when hedge funds get caught overshort. These happen and we believe we survive them most efficiently due to our portfolio diversification.

**Infovest21: What is the outlook for short-biased managers?**

**David Hammond:** Short managers as opposed to short biased managers are misunderstood, underutilized and one of the strongest sources of alpha in the hedge fund marketplace.

Short biased managers vary their short exposure and therefore they do not always provide efficient short exposure. We believe that short alpha is very valuable and should be included in virtually all portfolios at all times. If you believe that the funds of funds industry generated 6%-9% annual alpha and has some residual long beta, then every fund of funds should seriously look at adding short exposure to their portfolio if the short offers similar or greater annual alpha as a way of improving risk adjusted returns.

Lastly and most importantly, every family office and every institution in America has significant long exposure through mutual funds or other long portfolios. Every one of them can create their own hedged long portfolio by adding a broadly diversified, alpha generating short portfolio as an overlay or as a separate allocation. Investors can essentially create their own long/short exposure for significantly less fees than allocating directly to long/short hedge funds and we believe that this is a significant growth area for all dedicated short managers. Strategically, a short manager with a quality track record should be highly valued by the investment community. 

**Infovest21 Think Tank Symposium**  
**Institutional Due Diligence on Hedge Funds**  
**April 9, 2008**  
**Call 212 686 6440 to register**  
**[www.infovest21.com/nc](http://www.infovest21.com/nc)**

**Seth Weinstein** (Continued from page 3 column 2)

it would show an implied volatility of over 200%, but the underlying has a historical volatility about 6%, which is an unheard of risk/reward profile.

**Infovest21: You are basing this strategy on the premise that property prices remain as valued, right?**

**Seth Weinstein:** Yes, as long as our primarily commercial cash-flow producing portfolio doesn't drop 40 to 50% in 18 months. Thus far in 50 years, that has never happened. The ABL fund that we invest in launched in April 2006, and has never had a losing transaction or a losing month. The ABL portfolio has a current combined LTV of 52%.

**Infovest21: What does it mean to be long volatility/long gamma?**

**Seth Weinstein:** I am buying at-the-money, and out-of-the-money put options. As the market goes down, the value of the puts generally goes up because there is more demand. Volatility is a measure of option demand and tends to have a negative correlation to the market. Because I have a basket of puts, when the market goes down, it becomes more valuable because volatility goes up, and it is also long gamma. Gamma is the tendency of an option to increase in value exponentially as it goes from out-of-the-money to at-the-money. I am long put gamma and long volatility.

The ABL fund returns 1% a month, and we spend it on S&P 500 puts. In our worst case scenario, the market stays flat or goes up. We make 1% on the portable alpha or ABL strategy and lose 1% on the options strategy. So worst case, you break even.

Best case, the market goes to zero or down, and we make 1% on the portable alpha or ABL strategy and have all the upside of a portfolio of puts that have been accumulating. For example, last month the fund returned 3.65%, but 88 basis points was ABL returns, and the rest was from being long puts.

Also, we are spending 1% per month, but sometimes buying a one to four month outdated option. Over time, I am developing a portfolio of put options in the Crescent City Dedicated Short Fund that I am financing with the portable alpha strategy. The short fund is a hybrid, almost a fund of funds, and it invests in the Logan Asset Backed Fund, but it also buys puts. Alpha is through ABL and beta through S&P 500 puts.

This structure creates true portfolio insurance. Unlike the old portfolio insurance that failed to perform as expected and created the crash in 1987, the put options are already inventoried, so there is no execution risk. In addition, the options are purchased on a cash settled index so there is no execution risk on the exit side in case there is a catastrophic event that causes the financial markets to become decoupled and trading is halted for an extended period of time.

The portable alpha/beta combination strategy is so flexible that within a managed account structure with a fixed duration, it is possible for us to create either long or short portfolios that behave as principal protected proxies to the stock market. The only independent variable is the implied volatility at the time of execution, which dictates the durations required to generate the mandatory alpha.

**Infovest21: What's your beta/alpha?**

**Seth Weinstein:** It depends on where current volatility is when the put options are purchased and where the market is at the time. The

(Continued on page 9 column 2)

**Seth Weinstein** (Continued from page 9 column 1)

higher the current implied volatility, the less notional value of options can be purchased each month. As the market goes down, my beta goes up. My beta is usually between 50% and 400% of the notional value of the assets under management. If I have \$1 million under management, I will have between \$0.5 million and \$4 million of notional put exposure.

The expectation of the short fund is that in an up market of any magnitude, the fund should just about break even. In a gradual down market, the fund should have a beta of approx -.25 to -.50. For every 1% the market drops, the fund should go up .25 to .50%. In a more rapid bear market, the fund should have a beta of approx -.50 to -1.50. In an event (i.e. 9/11), the fund can have the potential to have a lot of gamma inventoried and can have a one month return of 5-10% or greater.

**Infovest21: How are you different than other short managers?**

**Seth Weinstein:** During the past five years, the CSFB Dedicated Short Index was down -21.70% while my strategy (if it had been trading during this period) would have returned flat to mildly positive returns (with the exception of 9/11 in which the strategy would have returned a positive 5-10% month.) These predictions are based on the actual performance of the ABL sector combined with the assumptions that most of our puts purchased in the S&P would have expired worthless.

Compared to the S&P 500, which has been up 10% since the fund's inception, the return on the fund is essentially break even. If the market were to go up a lot, most short managers would have major problems, while my fund would break even. In a severe bear market or in case of an event (i.e. 9-11), the Crescent City Dedicated Short Fund could go up 5-20% overnight because of the potential put gamma.

**Infovest21: How many positions do you hold?**

**Seth Weinstein:** In the ABL fund there are about 50 loans. In the beta portion there is really only one underlying asset (S&P 500 put options), but multiple strike prices and expirations.

**Infovest21: Describe your risk management practices.**

**Seth Weinstein:** The alpha side has very intense risk management practices in terms of the analysis of the loans we underwrite. Our chief appraiser for ABL is also a general partner and is probably the top appraiser in the country, having been chief appraiser for both JP Morgan and Prudential Realty Group. We have a very high degree of confidence in our portable alpha strategy.

If I have 1% from the ABL fund to spend on put options, my beta risk is purely the dollar value I spend on puts. The only real leverage is the long gamma provided by the puts. The beta has a natural leverage component built into it, because we are long options. Also we do not employ much leverage in the ABL fund. If we have \$1 million in the ABL fund, we will underwrite approximately \$1 million worth of loans.

**Infovest21: What is the outlook for the ABL fund?**

**Seth Weinstein:** Many lenders are not lending any more because they had so much trouble. Our portfolio doesn't have a single default even in this current environment. Because it is harder to get a loan now, we are able to increase the rates we demand on our loans. For ABL, there is less competition over the past year or so because the banks are pulling in their reins. Assuming we do our valuations

(Continued on page 12 column 2)

**Statistics**

**Barclay Equity Short Bias Index**

	2008 (%)	2007 (%)	2006 (%)	2005 (%)	2004 (%)
January	6.40*	-1.89	-3.36	4.07	-0.10
February	-	1.01	0.74	1.25	0.84
March	-	0.16	-1.40	2.01	-1.30
April	-	-3.00	-0.34	3.74	3.08
May	-	-2.57	4.39	-3.73	-0.26
June	-	2.10	0.31	0.64	-0.30
July	-	3.98	3.22	-2.08	5.66
August	-	-0.35	-2.08	2.09	0.96
September	-	-0.62	-1.91	1.42	-1.69
October	-	-0.07	-3.20	2.42	-0.62
November	-	7.47	-2.49	-3.74	-4.32
December	-	0.89#	0.75	-0.53	-3.61
Year to Date	6.40+	6.86	-5.55	7.40	-2.03

Source: BarclayHedge, Ltd.

\*Estimated performance for January 2008 calculated with reported data from 19 funds

#Estimated performance for December 2007 calculated with reported data from 19 funds

+All estimates and 2008 YTD amounts are calculated with reported data as of February 25

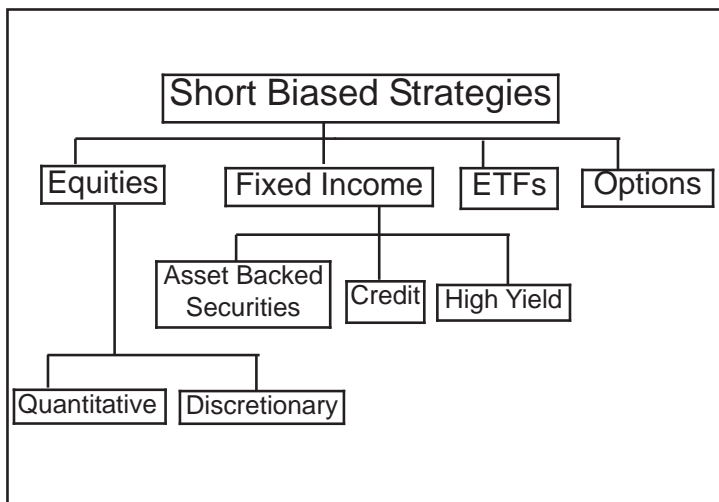
**Hennessee Short Biased Index**

1987-2006 Average Annual Return (%)	-0.20
1987-2006 Standard Deviation (%)	18.50
2006	-4.32
2005	10.11
2004	-2.38
2003	-22.66
2002	15.84
2001	12.81
2000	29.93
1999	-9.91
1998	-23.30
1997	4.97
1996	-16.36
1995	-28.47
1994	10.77
1993	-4.83
1992	-4.66
1991	-23.52
1990	36.10
1989	18.12
1988	10.65

Source: Hennessee Hedge Fund Indices, Hennessee Group LLC

The Index is an equally-weighted average of funds in the Hennessee Hedge Fund Indices.

**Universe of Short Biased Fund Strategies**



**Pros and Cons of Short Biased Strategies**

	Pros	Cons
Asset Backed Securities	Good to short in current market condition	Illiquid
High Yield/Credit Default Swaps	Potential for more defaults as economy worsens	Still expensive
Equities	Diversification among many names	Unlimited downside risk
ETFs	Widely traded, liquid	Index correlation
Options	Costs limited to dollar value spent on options; unlimited upside; negative beta	Out-of-the-money puts expire worthless

**Jim Kastberg and Frank Bianco** (Continued from page 4 column 2)

has been 5% per year. Now, we are around 1% to 1.5%. We have not seen the effect of higher default rates yet. The CCC asset class of high yield, the most risky asset class portion within the high yield market, is at its all-time historical highs. Last year, 33% of new issuance was CCC. Typically, that is closer to 10%, so you have three times the amount of CCC paper out there. 75% of CCC paper defaults, according to Moody's statistics.

We have three times as much CCC paper in the marketplace right now, historically low default rates, and a slowing economy. It doesn't bode well for defaults and that's when you start seeing some pain in the high yield market. Some say that high yield has gotten cheap and it is backed up a great deal, but we are just getting close to historical averages in spreads in high yield right now. The real pain is when you start seeing rolling defaults come across a number of industries, a number of bonds within industries. Up until this year, it has been very industry-specific, whether it is the auto parts suppliers, auto manufacturers, or smaller players in that space. Now you really see what a general economic slowdown does to a highly levered business model, which is the high yield marketplace.

**Infovest21: What is the timeline going forward?**

**Jim Kastberg:** Through 2008, we are going to see a steady increase in defaults. The Fed has been fairly aggressive, but lag times on rate cuts filtering through the economy, so it is not going to help as much in the near term. That is more a forward looking indicator.

As the Fed continues to ease [interest rates], we are going to see a pickup of economic activity. The question is when. 2008 is going to be a very difficult year for high yield. You are going to see a rise in defaults, forced liquidations from CDOs, and CLOs, which we are seeing more frequently which are happening on a daily basis.

We have managers in this asset class that have never managed in a down market before. The last downturn in high yield was in 2001- 2002. So any fund that started after that time period has really been trained to buy the dips every time something came in, and it has hurt a lot of people over the last six to eight months.

**Volume of US Index and ETFs Options Traded (Details on top 5 actively traded options)**

	January 2008 Volume in \$ millions (21 days)	% Change from January 2007 (20 days)	% Change from December 2007 (20 days)	Year-To-Date Volume (21 days)*+
Total Index & ETF	55.8	+59	+59	55.8
ETF Only	32.0	+62	+62	32.0
S&P 500 Index [SPX]	16.5	+78	+56	10.7
CBOE Volatility Index (Options) [VIX]	2.2	+250	+70	0.93
Standard & Poor's Depository Receipts [SPDRs]	7.9	+355	+65	9.4
PowerShares QQQ Trust [QQQQ]	7.0*	+114	+111	8.3

Source: Chicago Board Options Exchange

\*highest volume ever recorded

+as of the middle of February 2008

**Growth in Assets of Selected ETFs**

	January 2008 \$ millions (21 days)	% Change from January 2007 (20 days)	% Change from December 2007 (20 days)	Year-To-Date Volume (21 days)
SPDR Index 500	84,849	+36	-15	84,849
PowerShares QQQ	23,359	+23	+7	23,359
SPDR Equity Gold	18,735	+99	+11	18,735
iShares S&P 500	18,591	+1	+2	18,591
iShares Russell 1000 Gr	13,595	+73	-13	13,595
iShares Russell 2000	9,547	-4	-10	9,547

Source: National Stock Exchange

(Continued from page 1 column 2)

But he says he hasn't seen one yet.

While these managers show how they performed in down markets, Karp replies, "There hasn't been enough down markets for that. It ends up being market timing strategy - I've never seen it work. But never say 'never'."

Jones says her own personal opinion is toward short-biased managers. "Short sellers have two options - being short or being in cash. Short-biased managers, however, have three options - being in cash, being long or being short. A manager who has the ability to be more proactive in different market conditions is more attractive. Yet you need a manager who has talent on both sides - long and short."

**An investor needs to start with the manager's philosophy. Does the manager want the short side to generate alpha on its own or to hedge i.e. to blunt the volatility from a possibly levered long side or a combination of the two?**

#### Warren Buffet: Too hard to short

Karp says the cream of the crop managers such as - Warren Buffet, Charlie Munger, Peter Lynch, Ben Graham- say that it is too hard to short. One possible reason for their antipathy toward shorting is that they are long-term investors, looking for returns over years. Shorting, by its nature, is a trading strategy - one needs short-term views, stops, etc. One would think that those who trade heavily in long positions would have an easier time shorting. In general, however, trading stocks successfully over long periods is not an easy thing to do - long or short.

"Why is shorting so hard? If you're a value manager and looking at stocks that are undervalued, then why with proper diversification can't you get reasonable alpha on the short side?" asks Karp.

Suppose you have a market neutral strategy and you insist your shorts equal your longs and in some cases you're neutral the dollar side, the beta side and the sector side. "The evidence we have is that shorting is too tough. If you put all those constraints on, it is even more difficult. You could have a few good years but it doesn't last. This is a tough thing to do and the more you constrain the manager to limit the risk, the more the return is limited," adds Karp.

#### Size of positions and concentration

Gulden says the typical long/short model is 175% gross - 125% gross long/50% net short for 75% net. "Generally they tend to have lots of shorts and structural shorts but they're never typically large enough to make a performance contribution. If you have a 1% short position and it goes down 30%, you make only 30 basis points."

Other factors to assess are concentration and size of positions. Most short-biased/short-only managers use a short book as an overall hedge on their long book. They tend to have many small short positions.

No information in this newsletter constitutes or should be interpreted as a solicitation for investment in any of the investments reported on. A prospective client should independently investigate an investment manager before engaging the services of that manager and should consult with independent qualified sources of investment advice and other legal and tax professions before using the services of a manager.

**Seth Weinstein** (Continued from page 9 column 2)

correctly, and the commercial real estate market doesn't drop 50% in 18 months, we are in great shape. We don't do the \$20 million house on the beach, we don't do raw land... We look at the strip mall that has a shoe repair, a check-cashing place etc. - very conservative commercial properties.

#### Infovest21: What are the risks in the strategy?

**Seth Weinstein:** The main drawback with the Logan Asset Backed Fund strategy is that although there is little risk, there is limited upside to the strategy returns. We are not going to make 20% or 30% in the ABL fund, but we should regularly make 1% per month, which we spend on put options. The net returns for the alpha/ABL portion has been and should always be in the 12% per year range with no losing months and little volatility. The decrease in consumer demand such as we are expecting to see going forward should be beneficial for our beta/long put strategy. An increase in market volatility should be good for the Crescent City Dedicated Short Fund returns going forward.

#### CRESCENT CITY CAPITAL ADVISORS

- Inception : 2001
- Strategy : Dedicated Short Options
- Headquarters : Boca Raton, Florida
- Assets (Strategy): \$ 1.2 million

#### SETH WEINSTEIN

Title : General Partner  
 Prior Experience : Philadelphia Options Exchange,  
 TCM Partners, Spear Leeds &  
 Kellogg

#### SUBSCRIBE TODAY

\_\_\_\_\_ Please sign me up for one-year subscription to Infovest21 Strategy Focus at **\$1,000**.

\_\_\_\_\_ Please sign me up for the Infovest21 Publication Package, which includes both Strategy Focus Subscription and News Provider Subscription at the price of **\$1,100**. Save \$595

#### Payment (check one):

Check enclosed (payable to **Infovest21 LLC**)

\_\_\_\_\_ Amex \_\_\_\_\_ Mastercard \_\_\_\_\_ Visa \_\_\_\_\_ Diners

Card #: \_\_\_\_\_

Exp. Date: \_\_\_\_\_ Signature: \_\_\_\_\_

Name: \_\_\_\_\_

Address: \_\_\_\_\_

City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_

Phone: \_\_\_\_\_ Email: \_\_\_\_\_

**INVEST 21**

267 Fifth Avenue, Suite 104  
 New York, NY 10016  
 Tel: 212-686-6440 | Fax: 212.686.6289  
 Email: general@infovest21.com