

Methodology for the
**IPE-EDHEC Institutional Asset
Management Awards 2008**



June 12 - CNIT Paris la Défense





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THE IPE-EDHEC INSTITUTIONAL ASSET MANAGEMENT AWARDS (IAMAs)

FOREWORD

The measurement of the performance of investment funds is an important issue for professionals, because it is through performance measurement that their know-how and their products are evaluated.

EDHEC Business School and Investment & Pensions Europe have decided to set up the **IPE-EDHEC Institutional Asset Management Awards** in 2008 with the support of the European fund data provider EuroPerformance. The awards will be presented to winning asset managers at a gala reception in June 2008 in Paris on the occasion of the EDHEC Institutional Days, before an invited audience of investors, asset managers, investment bankers and other industry advisers and suppliers.

The idea behind the methodology for these awards is to use concepts for which there is a certain consensus among academics and practitioners. The goal is not to use the latest research but to use a standard that is reasonably well understood in the industry and is subject to consensus. The aim is to make conceptual progress in relation to the ratings and methodologies that are habitually used in fund and investment awards¹, while remaining "mainstream" so as to be understood and accepted by as many observers as possible.

For example, although peer grouping is used in the industry for differences in performance between peer groups or in comparison with a market index, despite the weaknesses of these approaches², EDHEC prefers to use proven academic techniques by thinking more in terms of multi-factor models and alpha for benchmarked funds and investment in order to truly distinguish that which results from the active manager's skill in this type of investment (security selection, tactical allocation) from the "normal" returns due to the choice of benchmark, which remains the responsibility of the institutional investor.

With regard to the presentation of the awards, the **IPE-EDHEC Institutional Asset Management Awards** have a self-imposed constraint which is that the methodology should be repeatable by those who receive (or do not receive) awards, so anybody with a reasonable degree of financial knowledge should be able to reproduce it. The **IPE-EDHEC Institutional Asset Management Awards** therefore use public data rather than statistical artifacts such as principal component analysis. Although the latter could be useful, the factors would not be readily observable. The **IPE-EDHEC Institutional Asset Management Awards**, in short, wish to allow outsiders to check the results by reproducing them. In this context and for the sake of robustness, the **IPE-EDHEC Institutional Asset Management Awards** favour economic analysis over statistical analysis.

1 - The methods that are usually employed by awards and ratings are not very robust and have been subject to extensive criticism from both the professional and academic worlds. For a critical analysis of the main fund rating systems, please refer to an article by Noël Amenc and Véronique Le Sourd entitled *A Critical Analysis of Fund Rating Systems*, published in 2007 in Volume 11 N° 4 of the *Journal of Performance Measurement*.

2 - We recall that in 2001 the Myrers review of institutional investment in the UK highlighted the risk of peer group benchmarking in evaluating the performance of investment managers. See notably page 61 of the Myrers Review: *Institutional Investment in the UK*, available at the following web page: <http://www.hm-treasury.gov.uk/media/1/6/31.pdf>

INTRODUCTION: ABOUT THE IPE-EDHEC INSTITUTIONAL ASSET MANAGEMENT AWARDS (IAMAs)

The aim of the IAMAs is to provide awards for asset managers on an objective basis by using state-of-the-art financial research. It represents the first time that Europe's institutional asset management industry will have an awards programme based on objective and transparent criteria. The IAMAs correspond to a quantitative evaluation of the quality of the institutional asset management offerings from investment management firms in Europe. This evaluation will take account not only of the performance of active portfolio management (alpha), but also of the relevance of the long-term allocation choices (beta) and the quality of the risk management.

The IAMAs will reward the best active investment management offerings from European asset management firms. The funds will broadly come under two categories:

- Benchmarked investment management, through which the manager adds value by beating the benchmark (producing alpha). Equity and fixed-income funds will be included in this category.
- Investment that is not benchmarked or uses dynamic allocation, whereby the allocation represents the added value and which is not evaluated by the alpha but by an indicator that is appropriate for the management goal, namely return/VaR. Balanced and absolute return funds will be included in this category.

It would not be appropriate to use the same indicators for both categories, because a meaningful indicator for benchmarked funds is some measure of alpha (the manager's skill in generating alpha). These are funds with relatively tight tracking error, where the asset allocation decisions have been made by the investor, not by the manager. In that context, alpha is a meaningful measure of the value added.

If we consider absolute return and diversified funds, then a large part of the expertise involves coming up with a coherent asset allocation decision, so rewarding the manager for pure alpha skills would not take the most important part of value-added into account. For these funds, investors look at risk-adjusted performance rather than alpha. They want to know whether the performance was good and the level of risk was acceptable.

The philosophy of the awards is to rate all the asset management company's funds and to use the average grade per category to evaluate the company's overall ability to deliver alpha for each category. Therefore, a company will receive an award because it had the best average grade for its funds in that particular category.

It should be noted that alternative investment funds (hedge funds, real estate, commodities, private equity, etc.) are excluded from the awards. These funds will be included in a future ranking which IPE and EDHEC are currently examining.

1. CALCULATION METHODS

1.1. BENCHMARKED (EQUITY AND FIXED-INCOME) FUNDS

Equity funds will be evaluated on the basis of the alpha they produce. Alpha measures the outperformance ("abnormal return") compared to the risks taken by the manager. This magnitude is not directly observable; it is measured by the difference between the fund's returns and the "normal" returns that reward all of the portfolio's risks. This approach is based on a multifactor model drawn from the style analysis model developed by the Nobel Prize winner William Sharpe in 1992.

The decomposition of the performance between the alpha and the reward for risks is specific to each fund. The alpha is an arithmetic magnitude that is easy to compare and is independent from the prevailing situation for an asset class or the definition of a ranking category.

The main idea behind the methodology for the IAMAs is to favour economic analysis over exclusive trust in statistical calculations. The latter should serve the former rather than replacing it. For both stocks and bonds, the IAMAs therefore favour a set of factors that are subject to consensus from an economic point of view in explaining the variability in fund returns over the long term, and then use a widely accepted statistical approach, not to select the right factors, but to eliminate the factors that are not useful in calculating alpha.

For example, for stocks, with the idea of using a consensual multi-factor model to extract the normal returns in order to isolate the alpha, EDHEC has decided to follow the Fama-French multi-factor model by favouring styles which have been well documented in academic work as explaining the cross-section of expected stock returns. The advantage of this model is that while it is an improvement over peer group or single index assessment, asset managers remain within their comfort zone because the style index factors are something that they are familiar with.

The IAMA methodology is based on a two-step process:

- Eliminating factors through a constrained regression (style analysis). All relevant factors are selected (style factors for the particular region are the candidates in terms of factors). A very small set of factors is selected for reasons of parsimony. One choice would be to use all the factors in the alpha estimation process, but since these are somewhat correlated, we try to avoid using a factor that is not useful. The fund may for example be Value rather than Growth, so we run a constrained style analysis regression (which is equivalent to a passive replicating portfolio for the manager). This could tell us for instance that the fund has zero exposure to small-caps, so we know that the manager is large-cap and we will not introduce the small-cap factor into the multi-factor model.
- Performing the alpha estimate through an unconstrained regression using only the factors retained after the first step (multi-index model).

1.1.1. MEASURING ALPHA

To do this, we propose to use the conceptual framework of the performance and risk style analysis proposed by the Nobel Prize winner William Sharpe (1992).

1.1.1.1. Style analysis

William Sharpe (1988, 1992) introduced the following model to provide an objective breakdown of the manager's real style, as opposed to the style breakdown announced by the manager. This method is known as *return-based style analysis*.

$$\text{Model: } R_{it} = w_{i1}F_{1t} + w_{i2}F_{2t} + \dots + w_{ik}F_{kt} + e_{it}$$

where:

- R_i = excess return (net of fees) of a given portfolio or fund
- F_k = excess return compared to index j for period t
- w_{ik} = weight of the style (the sum of the weights is equal to one)
- e_{it} = error term

Style analysis is differentiated however from the standard linear regression by the fact that specific constraints are imposed on the coefficients so that they can be interpreted directly as weightings:

- Portfolio constraint: the sum of the coefficients must be equal to one
- Positivity constraint: the w_{ik} coefficients must be positive

In essence, the model divides the fund's return into two components:

- The "Style": $w_{i1}F_{1t} + w_{i2}F_{2t} + \dots + w_{ik}F_{kt}$ (the part attributable to market movements)
- The "Skill": e_{it} (the part specific to the manager)

The term of "skill" can itself be attributed to:

- The manager's exposure to asset classes that are not included in the analysis
- The manager's active anticipations: active selection within the asset classes and/or timing in relation to these same classes.

It is tempting to interpret the term of "skill" or total excess return e_{it} in a style analysis as a measure of abnormal return. There are however two major opposing elements:

- Distortion of the results: introducing the portfolio and positivity constraints into the style analysis distorts the results of the standard regression. As a result, the standard desirable properties for linear regression models are not respected.
- The absence of appropriate risk adjustment: an analysis of that type does not provide an explanation for the abnormal return on a risk-adjusted basis.

1.1.1.2. Multi-index model

These two imperfections of style analysis are handled by using a factor model, which constitutes a satisfactory theoretical response to the problem of risk-adjusted performance measurement.

In practice, one important question remains: the choice of factors.

There are four types of factor models:

- Implicit factor model. In this approach, one carries out a factor analysis (for example, a principal component analysis) to extract the return series factors statistically. It is without doubt the best approach, because it avoids the problems of including the wrong factors or omitting the right factors. However, the factors can be difficult to interpret.
- Explicit macroeconomic factor model. In this approach, economic variables are used as factors. For example, Chen, Roll, Ross (1986) use the inflation rate, the growth of industrial output, the difference between long-term and short-term interest rates and the difference in ratings between bonds.

- Explicit microeconomic factor model. In this approach, microeconomic attributes are used as factors. The BARRA model is a popular example of this type of model.
- Factor model with explicit factors made up of indices. In this approach, market indices are used as factors. This is consistent with the idea of using portfolio returns as factors. The most popular example of this approach is the CAPM (Sharpe (1964)), where the return on the market portfolio, approximated by a broad index, is used as a factor. The idea of using “replicating portfolios” as an approximation of the true factor, which is not known, is also found in Fama and French (1992).

In this context, in order to provide the methodology with factor transparency, traceability and easy-to-interpret results, we have chosen to use a multi-index factor model, which is written as follows:

$$R_{it} - r_f = \alpha_i + \beta_{i1} (F_{1t} - r_f) + \beta_{i2} (F_{2t} - r_f) + \dots + \beta_{ik} (F_{kt} - r_f) + e_{it}$$

where:

- α = the abnormal performance of the fund
- R_i = return (net of fees) of a given portfolio or fund
- r_f = the risk-free rate
- β_{ik} = sensitivity of the fund to factor k
- F_k = return of factor k for period t

This factor model is similar in its form to that used by Elton *et al.* (1993) to estimate the performance of the managers' fund.

This equation can be seen as a weak form of style analysis, which consists of relaxing the positivity constraint and the portfolio constraint, and including a constant term in the regression.

From a practical point of view, this approach also allows us to consider the question of benchmarking and performance measurement in a unified manner: once the appropriate indices have been selected, they can be used both for return-based style analysis (strong form of the style analysis with the positivity constraint and portfolio constraint) and for abnormal return measurement (weak form applied to the excess returns).

1.1.2. IMPLEMENTATION WITHIN THE AWARDS

1.1.2.1. Analysis categories

In William Sharpe's model, all asset classes are represented. In certain market conditions this can lead to statistical adjustments that no longer describe the fund's real allocation. Experience shows that return-based style analysis and portfolio decomposition-based style analysis work best when they are associated. To be more precise, we use a decomposition-based method for the observable attributes, for example the geographical zone. In order to limit the risks of collinearity between the indices, the fund universe has been divided into distinct categories. This breakdown into precise geographical categories thereby enables the number of regressors that are used in the style analysis to be limited and therefore makes the latter more relevant and robust. We further use a return-based method for the non-observable characteristics, in particular the investment styles, as opposed to the investment styles that the managers themselves claim to use, and for which information may be missing or uncertain.

1.1.2.2. Style indices

For each category, a set of style indices averages the returns of the securities in which the fund is liable to invest for a given management objective. For the indices, to comply with the issue of differences in valuation days between funds, EuroPerformance calculates weekly performance for each day of the week. In that way, each fund is compared to a set of indices that value at the same date as the fund. In the case of international management, the international indices, which are often expressed in USD, have been converted into euros on the basis of exchange rates provided by the AFG (the French Investment Management Association), before calculating their returns.

For the equity class, we have chosen MSCI because they can provide indices for all possible geographical areas. It is important to note that there is a clear difference between the categories used for the awards and the categories that EDHEC is using with EuroPerformance to calibrate the factor model. For example, in the case of a Euro Equities category, if a fund is invested in French stocks then the MSCI France index, not MSCI Europe, will be used in the factor model.

For the equity class, the MSCI indices are still the obligatory reference point for nearly all funds on the international level. They are thus, *de facto*, the best proxies for the markets that they evaluate and represent.³ For the indices that cover the bond class, there is no consensus. Merrill Lynch was selected from among the providers, because it offers the broadest panel of indices, and it is one of the major references in the fixed-income world.⁴

1.1.2.3. Selecting regressors

The constrained regression of the style analysis allows for the selection of the “right” regressors which are used in the second regression to determine the fund’s alpha.

To limit the effects of collinearity between the indices, regressors with a low or null weight in the style analysis regression are removed from the alpha calculation model. In more precise terms, the regressors are classified according to their weight. The regression for the alpha calculation uses the first three at least.

1.1.2.4. Calculation period

Style analysis and alpha are calculated on a weekly basis over the last 156 returns (3 years). Alphas are annualised by multiplying the weekly alpha by 52.

1.1.2.5. Management of fund valuation

It is important in the assessment of different ratios and style valuations to use indices that have the same valuation method as the fund being studied (indices valued at opening prices for funds valued on opening and indices valued at closing prices for funds valued on closing). As the style indices for funds based on opening rates are not available, funds valued at the start of the day are analysed using closing prices from the previous day.

One opts for an analysis based on the previous day:

- if the coefficient of determination (R^2) for style analysis in the regression model calculated on a given day and for the previous day are higher than the threshold for the category (70% or 60% for international equity funds) and there is a more than 15% variance between the two coefficients in favour of the previous day.
- if the calculated R^2 on the given day is lower than the threshold and the calculated R^2 on the previous day is higher than the threshold for the category plus 5% (75% or 65%).

3 - For pure sector equity funds, we use the MSCI sector indices rather than style indices.

4 - It should be noted that to avoid collinearity problems, which are considerable in the fixed-income universe, we have replaced the regression onto the indices with regressors that are made up of term and credit spreads.

1.2. NON-BENCHMARKED (BALANCED AND ABSOLUTE RETURN) FUNDS

With balanced and absolute return funds, the investor is not seeking alpha (relative performance), but instead the manager's added value in terms of absolute performance. EDHEC wished to employ a widely accepted indicator of risk-adjusted performance. One possibility would be to use the Sharpe ratio, because it is the most commonly used indicator. The problem with the Sharpe ratio is that volatility is not necessarily the right proxy for risk, and we should care about capturing the extreme risk.

EDHEC has therefore decided to use the Return to Value at Risk ratio. The advantages of the VaR are that it is widely accepted, it can be required by the regulators, and it is Sharpe-like.

More often than not, the notion of risk is reduced to the variability of the returns. The most common indicator is the volatility. While this measure characterises the average risk of the portfolio (average uncertainty in the distribution of returns), a complementary approach consists of focusing on the fund's potential for extreme loss. The Value-at-Risk (VaR) responds to this need. The VaR also allows all the risks of a portfolio split between several asset classes to be reduced to a single value.

1.2.1. VALUE-AT-RISK

There are essentially three methods for calculating a portfolio's VaR: the parametric method, the historical method and the Monte Carlo method.

The parametric method is often based on normal return assumptions. However, the historical return distributions of market variables are often fairly far removed from a normal distribution. In particular, one observes distributions that are skewed and present fat tails. It is obviously possible to postulate a distribution law that accounts for the existence of distribution tails that are fat compared to those of the normal distribution (Student's law, Pareto's law, etc.), but the requirement to impose a prior choice leads to a strong specification risk called "model risk".

The historical methods, on the other hand, do not set a prior assumption on the shape of the return distribution and therefore only take into account the data in the sample to calculate the VaR. In this case, the quality of the historical series is important. There is a significant sample risk and it would require only a small amount of missing or aberrant data to render the result obtained irrelevant. Like for the parametric method, this method can be implemented rapidly.

The Monte Carlo method uses the same principle as the historical VaR but the data used is obtained through stochastic simulation. This method is cumbersome to implement because it requires many simulations to be carried out to obtain a good level of accuracy in the results, which leads to numerous calculations. It is used primarily in estimating VaR for complex instruments (options) which provide flows that are non-linear functions of the base assets.

1.2.1.1. Cornish-Fisher type VaR

It is possible to implement a VaR calculation method based on an "intermediary" approach that achieves a balance between the advantages of the historical VaR approach (no model risk) and the parametric approach (limitation of the sample risk). The method in question is the semi-parametric VaR, in an environment of fat distribution tails. This method for determining the maximal potential loss initially involves calculating a

VaR by using a normal distribution formula and then correcting it through a development referred to as Cornish-Fisher to take into account the skewness and the kurtosis (third and fourth order moments of the return distribution).

Within the Gaussian framework, the VaR can be calculated explicitly by using the following formula:

$$P(dW \leq -VaR) = 1 - \alpha$$

$$VaR = n\sigma W dt^{0.5}$$

where:

- n = number of standard deviations at $(1-\alpha)$
- σ = annual standard deviation
- W = the portfolio's current value
- dt = fraction of year

The analytical side of this normal VaR formula is then adjusted by using the Cornish-Fisher (1937) extension as follows:

$$z = Z_c + \frac{1}{6}(Z_c^2 - 1)S + \frac{1}{24}(Z_c^3 - 3Z_c)K - \frac{1}{36}(2Z_c^3 - 5Z_c)S^2$$

where:

- Z_c = the critical value of the probability $(1-\alpha)$
- S = the skewness
- K = the excess kurtosis (i.e., kurtosis minus 3)

The adjusted VaR is therefore equal to: $VaR = W(\mu - z\sigma)$

1.2.1.2. Risk-adjusted measure based on VaR

VaR allows the set of risks associated with a portfolio diversified over several asset classes to be summed up in a single value. VaR measures the risk of a portfolio as the maximum amount of the loss that the portfolio can sustain for a given level of confidence. This definition of risk can be used to calculate a risk-adjusted return indicator for evaluating the performance of a portfolio. In order to define a logical indicator, we divide the VaR by the initial value of the portfolio and thus obtain a percentage loss compared to the total value of the portfolio. We then calculate a Sharpe-like indicator in which the standard deviation is replaced with the risk indicator based on the VaR, and defined as the maximum percentage of loss that may happen for a given level of confidence, which is written:

$$\frac{R_p - R_f}{VaR_p}$$

where:

- R_p = the return on the portfolio;
- R_f = the return on the risk-free asset;
- VaR_p = the VaR of the portfolio.

Note that calculating the VaR supposes that a confidence threshold has been chosen, so the VaR-based ratios for different portfolios can only be compared for the same confidence level.

1.2.2. IMPLEMENTATION WITHIN THE AWARDS

For each fund, a VaR is calculated using a Cornish-Fisher type semi-parametric approach, with a threshold of 1%. The risk-adjusted ratio based on this VaR is then computed. This ratio is then used to rank the fund. The higher this ratio is, the better the fund has performed for a level of risk.

2. MANAGEMENT RULES AND PRINCIPLES

In order to ensure that the competing asset management companies are sufficiently representative to be included in pan-European awards, we shall implement the following management rules:

- the asset management firm must operate in at least three European countries;
- each of the funds ranked in the award category should have institutional assets under management of at least 150 million euros.

The philosophy of the awards is to rate all the asset management company's funds and to use the average grade per category to evaluate the company's overall ability to deliver alpha for each category. Therefore, a company will receive an award because it had the best average grade for its funds in that particular category.

The presentation categories for the awards will be as follows:

- Europe Equities
- Euro Equities
- International Equities
- US Equities
- Asia Equities
- Asia ex Japan Equities
- Emerging Market Equities
- Euro Bonds
- US Bonds
- GBP Bonds
- Emerging Market Bonds
- International Bonds
- High Yield Bonds
- Europe Balanced and Absolute Return
- International Balanced and Absolute Return

Funds do not receive a grade if:

- the VaR is greater than the average + twice the standard deviation in its analysis category
- the coefficient of determination (R^2) resulting from the style analysis is lower than 70% or 60% (for international equity funds)
- EuroPerformance's statistical check for non-normality of the residuals shows a fund that exhibits very pronounced skewness

For all categories, the fund must:

- belong to the category analysed
- have three years of weekly historical returns
- not have more than two returns missing for the previous 156 weeks

Specialist country funds will not be rewarded in the broader categories of the IAMAs (for example, a French manager of a purely French fund will not receive an award in the Euro Equities category).

3. VALIDATION OF THE METHODOLOGY AND SCHEDULE

The methodology outlined in this document has been approved by the international advisory committee of the IPE-EDHEC Institutional Asset Management Awards.

The comments and recommendations of the advisory committee have been examined and implemented by the official data provider for the awards, EuroPerformance.

Validation of the list of asset management firms eligible to compete for the awards will be completed by Friday March 28, 2008.

The calculations will be performed by EuroPerformance so as to provide an initial analysis of the results by May 9, 2008 at the latest.

The members of the advisory committee will receive the list of winners one week prior to the official announcement of the results at the gala reception in Paris on June 12, 2008.

With the exception of information to the members of the international advisory committee and the winners of the various awards, no information on the results of the IAMAs 2008 will be disclosed before the prize-giving ceremony.

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ABOUT THE INTERNATIONAL ADVISORY COMMITTEE FOR THE IPE-EDHEC INSTITUTIONAL ASSET MANAGEMENT AWARDS

To oversee the corroboration of the rules and methodology of the awards, EDHEC and IPE have set up an advisory committee consisting of key representatives from Europe's institutional investment community.

On the basis of the methodology drawn up by EDHEC, the committee validates the relevance and usefulness of the calculations proposed for institutional investors. The committee defines the rules for the prizes, in particular by validating the categories that are representative of the main asset management offerings and correspond to institutional investors' manager selection and/or allocation practices.

Members of the International Advisory Committee for the IPE-EDHEC Institutional Asset Management Awards (IAMAs) as of March 14, 2008:

- **Eric Breval**, *Director AVS Compensation Fund (Switzerland)*
- **Riccardo Gandini**, *Director of Investments, Inarcassa (Italy)*
- **Jean-Pierre Grimaud**, *Chief Investment Officer, Swiss Life (France) and President, French Association of Institutional Investors*
- **Theo Jeurissen**, *Director, Investments, PMT (Netherlands)*
- **Peter Moon**, *Chief Investment Officer, Universities Superannuation Scheme (United Kingdom)*
- **Paola Muratorio**, *President, Inarcassa (Italy)*
- **Risto Murto**, *Chief Investment Officer, Varma Mutual (Finland)*
- **Lars Rohde**, *Chief Executive Officer, ATP (Denmark)*
- **Günther Schiendl**, *Chief Investment Officer, VBV-Pensionskasse (Austria)*
- **Michael J. Somers**, *Chief Executive Officer, National Treasury Management Agency (Ireland)*
- **Tom Steenkamp**, *CIO of Allocation and Research and Member of the Board, ABP Investments (Netherlands)*
- **Erik Valtonen**, *Chief Investment Officer, AP3 (Sweden)*

ABOUT IPE

Investment & Pensions Europe is the leading monthly magazine written for those responsible for running pension funds in Europe. Since its first issue was published in February 1997, IPE has built an influential position within the European institutional investor marketplace. It now has a monthly circulation of 10,505 copies, of which 75% is in continental Europe. In addition to the magazine, IPE publishes monthly supplements on a wide range of topics designed to keep readers abreast of specialist areas in greater detail.

For the past seven years, IPE has organised the IPE Awards for European Pension Funds, which are regarded as the largest gathering each year of pension fund investors in Europe.



IPE International Publishers Limited
320 Great Guildford House
30 Great Guildford Street
London SE1 0HS
United Kingdom
Switchboard: +44 (0)20 7261 0666

ABOUT EDHEC

EDHEC Business School, founded in 1906, is among the select few institutions to have garnered international recognition through the triple crown of EQUIS, AACSB and Association of MBA accreditations. With its three campuses in Lille, Nice, and Paris, its 4,700 students, more than 25% of whom are from abroad, and its 100 full-time faculty, EDHEC has been ranked among the top European business schools for several years.



EDHEC's participation in the IAMAs follows on from its previous methodological work on the Alpha League Table, the reference rankings of asset management firms in Europe, which are drawn up in partnership with EuroPerformance and published by the *Financial Times* in the United Kingdom and *Les Echos* in France; and rankings of French fund of hedge funds and asset management companies in partnership respectively with financial newspapers *La Tribune* and *L'Agéfi*.



EDHEC
BUSINESS SCHOOL
Lille - Nice

393-400 promenade des Anglais
BP 3116 - 06202 Nice Cedex 3 - France
Tel. +33 (0)4 93 18 78 19 - Fax +33 (0)4 93 18 45 54
www.edhec-risk.com

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320 Great Guildford House
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United Kingdom
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