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Practice Management

Diversification

Alternative investment strategies can offer significant ROI

Hedge funds and managed futures are 'absolute return strategies' that exploit market inefficiencies

By John J. Grande, CFP

Most people do not have to be reminded of how it feels to witness their investment portfolios declining by up to 30% in 2000 and 2001. Knowing that you are not alone does little to remedy the feelings of loss.

Those investors who methodically and prudently followed the golden rules of diversification are wondering what happened. They carefully applied Modern Portfolio Theory by developing efficient frontiers between negatively correlating asset classes. They diversified between money managers and securities; yet, most still lost money. Contributing to this condition is the fact that during global financial disruptions or recessions, most financial assets become highly correlated to the downside.

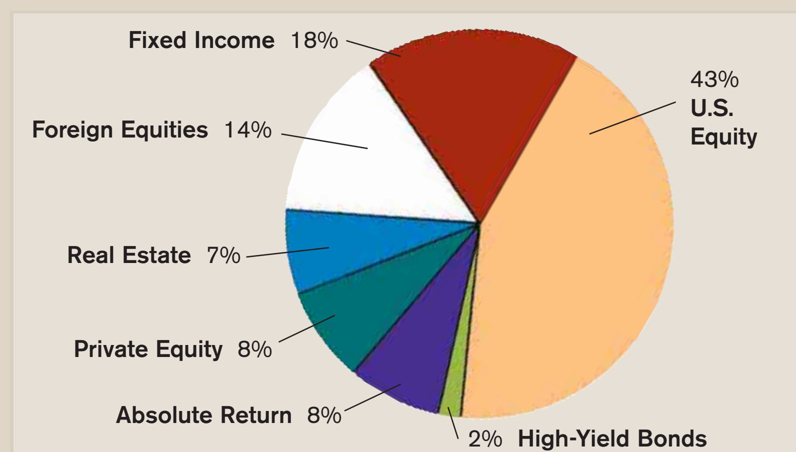
Take-Home Message

Alternative investments are not a panacea for investors. You must be knowledgeable since they are largely unregulated. It is estimated that there are now more than 5,000 managed hedge funds in operation. Inclusion of alternative asset classes in a portfolio is complicated, and, without full understanding, there is risk. Unlike mutual funds, they are not constructed as stand-alone assets. Access to the best managers is critical and the difference between the first and the fourth quartile alternative investment manager can be the difference between success and disaster.

So what, if anything, can be done in the future? How do you diversify in such a way as to reduce risk and enhance returns when it seems as though all asset classes move in the same direction at the same time?

For many reasons, it may be a good time to re-evaluate your investment strategies and explore additional avenues. Consider the following facts.

Figure 1 Average asset allocation of 25 largest universities, December 2000



- The annual rate of return for the S&P 500 through the 1990s was 18%, 11% higher than the average rate of return from 1961 to 1990. Any regression to the mean would indicate lower returns in the future.
- Long-term government bonds are now providing investors with a 5% rate of return, and obviously, after 11 cuts, are now close to or at the bottom of the interest rate cycle. Keep in mind that long bond values move inversely to interest rates. Therefore, chasing returns could be costly because interest rates have no place to go but up.
- Money market and CD rates are somewhere near 1.8%, which means that it would take 38 years to double your money.

Add to this the unprecedented state of the world as it relates to terrorism (event risk) and the possible future disruptions of the financial markets; it is no wonder that investors are looking for noncorrelating, nontraditional ways to make money, especially in down or disrupted markets.

Why the rich get richer

Have you ever noticed that some things never change? The rich still get richer no matter what happens, while the poor still get poorer. Perhaps some answers on how this occurs can be found through a survey done by The Institute for Private Investors.

The findings of this survey show that out of a constituency of 300 families with a net worth in excess of $100 million each, 27% of these ultra-high net worth assets were invested in alternative investments, such as hedge funds, private equities, venture capital, real estate, and leveraged buyout funds. Most interestingly, more than half of those investments were invested in hedge funds.

These types of investments are playing an increasingly prominent role in providing portfolios with absolute levels of return

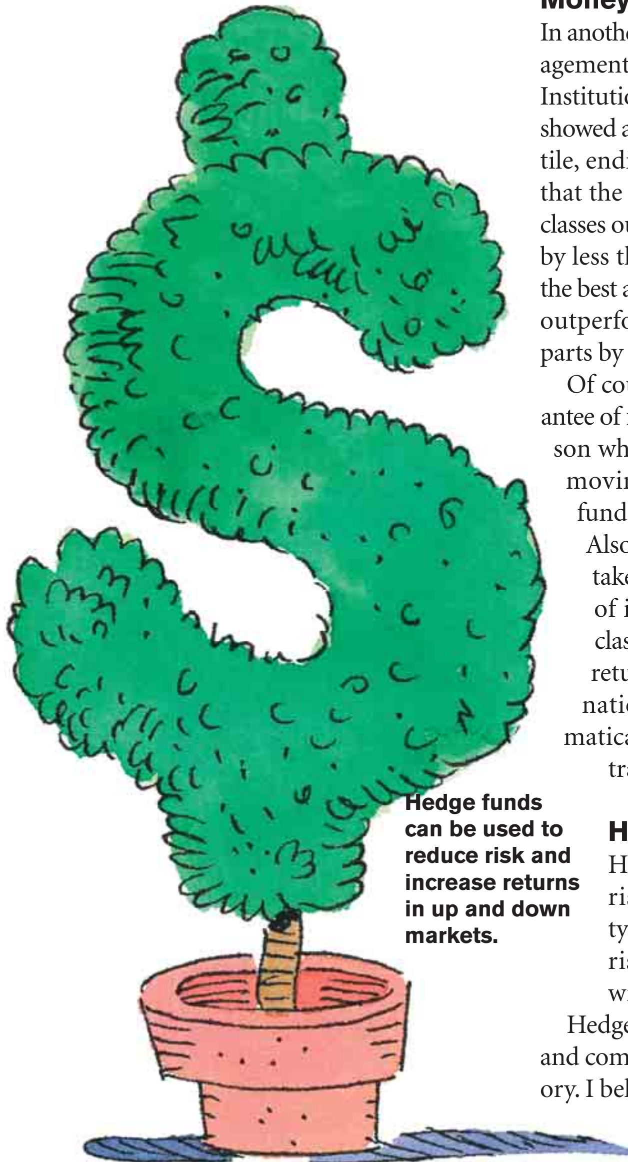
and potential diversification benefits. Typically, they are used for one of two purposes: enhance portfolio returns through higher-risk strategies or diversify portfolios through products that generate returns with very low correlation to traditional assets.

For most investors the mere mention of the word hedge fund can raise the hairs on the back of their necks. Many a red flag can go up. However, you should be aware that not all hedge funds are roulette tables, nor are they created equal. This knee-jerk reaction to the term hedge fund is primarily due to many misconceptions, myths, and lack of information.

Look at the massive investment into the already hefty, estimated $325 billion hedge fund industry (Figure 1). Why would the 25 largest universities, as of December 2000, on average have 8% of their assets allocated to absolute return investments (hedge funds), if there were no value added?

Or, if hedge funds are so unconsciously risky, how can it be that the board of directors of the California Public Employees' Retirement System, the largest public pension fund in the United States, with capital of approximately $160 billion, recently announced their plan to invest as much as $11 billion in market-neutral hedge funds that employ little to no leverage? (Yes, there are hedge funds that use little to no leverage.)

According to Tass Investment Research, an information and research subsidiary of consultant Tremont Adviser Inc., investors allocated $23 billion to hedge funds in just the first three quarters of 2001.



Hedge funds can be used to reduce risk and increase returns in up and down markets.

Money manager comparison

In another report, Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment, David F. Swensen showed a 10-year annualized return by quartile, ending December 31, 1997. He found that the best managers of traditional asset classes outperform below-average managers by less than 3% annually. By comparison, the best alternative investment managers can outperform their below-average counterparts by more than 21% annually.

Of course, past performance is no guarantee of future performance. This is one reason why many institutional investors are moving some of their assets to hedge funds. Research can make a difference. Also, in my opinion, globalization has taken away much of the attractiveness of international investing as an asset class. The correlation coefficient of the returns of the S&P 500 and the international markets has increased dramatically, thereby giving up some of its traditional benefits.

Hedge funds are an option

Hedge funds do not have to be highly risky, even though there are some types that expose an investor to high risks. But, why throw the baby out with the bath water?

Hedge funds can be used as an extension and complement to Modern Portfolio Theory. I believe strongly that hedge funds can be and are being used effectively by affluent, sophisticated investors to reduce risk and increase returns in up and down markets. While long-term strategies are certainly appropriate for young investors or institutions with 20- to 30-year timelines, investors who have already accumulated substantial wealth have different needs.

Reallocating over time 7.5% to 15% of investors' assets to a diversified portfolio of alternative investments may allow them to capitalize on the opportunities in the U.S. stock market without being captive to its volatility and uncertainty. These hedge investors want to avoid losing what they have accumulated. The affluent want investment strategies that offer them absolute returns.

The following is a brief outline of some of the terms and conditions of investing in alternative investments. Due to the constraints of space, this article is merely intended as an introduction to the concept of alternative investing and under no circumstances should be used as a guide to investing.

Types of alternative investments

Alternative investments are defined as investments in oil and gas, equipment leasing, real estate, and stock exchange programs. But, the largest group of alternative investments is absolute return strategies, which can be broken down into its two major sub-groups: hedge funds and managed futures.

These investments are designed to exploit market inefficiencies through techniques such as arbitrage, opportunistic investing, and short selling as well as utilizing various degrees of leverage. These strategies are generally used by high net worth investors either to enhance returns or as a diversifying technique that has a very low correlation with traditional asset classes.

A hedge fund is a term generally used to refer to a pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public. Hedging was used by businesses as far back as the 17th century.

The term hedge fund came about some time in the 1950s to describe an investment fund that used incentive fees, short selling, and leverage. These strategies were developed to give added advantages to the managers by providing more flexibility.

The first hedge fund dates back to 1949. At that time almost all investors took only long positions. In the 1940s A.W. Jones pub-

lished an article in *Fortune Magazine* arguing that investment managers could do better if they would take some short positions as part of their strategy. His premise was that performance could be enhanced by picking out and holding long positions of stocks that would rise more in a good market, but go down less in a bad market, and selecting and selling short those stocks that would go up less in a good market, and go down more in a bad market. This would allow the manager to make money in any kind of market.

A short position means that money managers sell stock that they do not own in hopes that the value will go down in the future, at which time they can buy the stock, sell it at the previously determined and agreed-upon higher price, and keep the difference as profit.

A.W. Jones started two funds, and from 1962 through 1966, according to a July 2001 white paper entitled "Alternative Investments and the Semi-affluent Investor," published by Undiscovered Managers, LLC, he outperformed the top mutual funds by more than 85% on a cumulative basis, net of all fees. He introduced the idea of the 20% incentive fee, which I will cover later. Even today, many of the long/short hedge funds use his model.

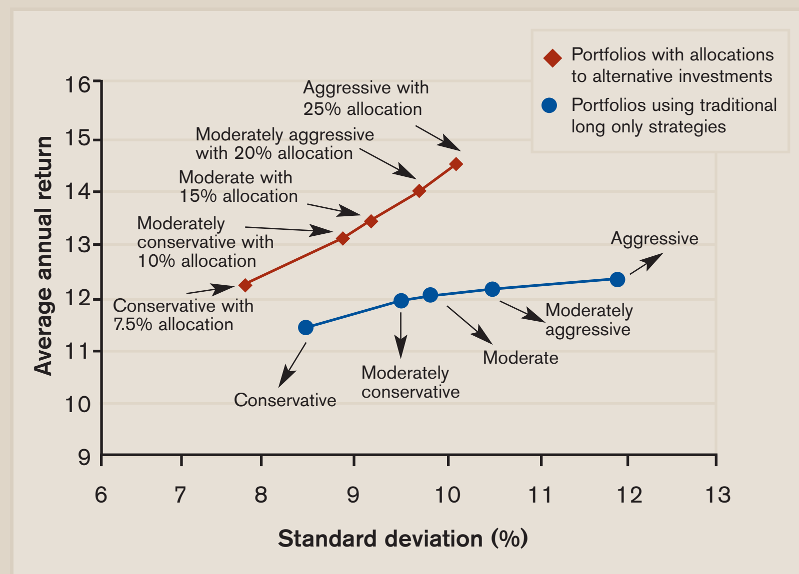
Table 1 Statistical summary of long/short strategies for 5-year period ending December 31, 2000

	Return	Standard Deviation	Correlation to S&P 500
Long/Short*	22.35%	11.35%	0.64
S&P 500	18.33%	16.08%	1.00
Lehman Aggregate Bond	6.46%	3.42%	0.21

*HFR Equity Hedge Index

OT Graphic Ophthalmology Times / Source: Standard & Poor's Micropal and Hedge Fund Research Inc.

Figure 2 Improvement in portfolio returns by making allocations to alternative investment products



OT Graphic Source: Standard & Poor's Micropal and Hedge Fund Research Inc., NCREIF

Hedge funds vary

There are many types of hedge funds, varying in degree of style as well as risk. Some of these include:

- event driven, long/short equity,
- equity market neutral,
- convertible arbitrage,
- opportunistic, distressed securities, and
- risk arbitrage.

Also, listed under absolute return strategies are managed futures. Most hedge funds do business in the form of a limited partnership.

Of all alternative investments, according to Hedge Fund Research Inc. and Standard and Poor's Micropal, 55.6% of investments go into relative value and of this, 37.9% goes into long/short equity. Long/short equity generally has a rate of return target of 15% to 20%, pre-taxed, regardless of market returns.

Again, according to Hedge Fund Research Inc. and Standard and Poor's Micropal, long/short managers in the aggregate have produced the highest absolute returns of any hedge fund category. A broad-based index of long/short managers posted 22.35% average annual returns over 5 years ending December 2000 (Table 1). More importantly, they did this with a standard deviation of 11.35% in contrast to the S&P 500, which had a standard deviation of 16.08%. Past performance is not a guarantee of future performance.

Noncorrelation to traditional assets means reduced risk and increased return (Figure 2). By combining the different aspects of alternative investment products, investors have historically increased returns and decreased risk in portfolios, as seen in 1990 through 2000.

Hedge fund differences

What is it that makes a hedge fund different from traditional investments? For one thing, they are unregulated and unregistered. However, they do have to comply with the Investment Advisor's Act and Commodity Exchange Act, respectively. As a personal decision, and to add to an investor's comfort level, some hedge fund managers do choose to become registered.

Because of the fact that they are hedge funds and therefore are unregistered, they are under few obligations or requirements to disclose information. In fact, it is difficult to obtain information not only on the industry, but on individual investments as well.

A term frequently heard in the hedge fund industry is "transparency," meaning how much information is available to in-

vestors on an ongoing basis. The more information and reports, preferably audited, the better. This industry has always been known for its secrecy.

Interestingly, because of statutory reasons, hedge funds can neither advertise nor hold themselves out as investment opportunities to the public. And, under regulation D, an investor must have certain qualifications to be able to invest in hedge funds. Not only do government regulations exist as to minimum assets needed to qualify as an investor, but many investment firms impose their own, sometimes even more stringent, requirements.

An accredited investor must have a net worth of $1 million or $200,000 of annual income for the past 2 years and for the upcoming year. A qualified investor must have $1.5 million in net worth. Some alternative investments require up to $10 million in net worth.

There are also limitations as to how much an investor can place into an alternative investment. These maximums range between 5% and 20% of an investor's total net worth and further depend on the amount of invested assets and whether the investment is for a qualified retirement plan or nonqualified money. Not all alternative investments have such high requirements with some having as low as a $200,000 minimum net worth. This depends on the type of program.

The typical minimum investment is between $100,000 and $500,000, although some investments offer as low as a $5,000 entry level and others have $1 million as their minimum. Illiquidity, as well as the increased risk of a hedge fund, is one of the reasons for the minimum asset requirements and the maximum investment percentages.

Questions to ask before investing in a hedge fund

- How long has the fund been in business?
- Has its performance been verified?
- Has the fund been audited?
- Is its performance the result of only 1 year?
- How large and how deep is the organization?
- What percentage of their own money do the managers have invested?
- How much reporting will you get?
- How transparent is the fund?
- Is the investment manager registered?
- Who has custody of the funds, and where will they be kept?
- What other charges are there besides the typical management and incentive fees, such as distribution or administrative fees?
- How liquid is the investment and are there back-end surrender charges?

Ophthalmology Times / Source: John J. Grande, CFP

Hedge fund fees

Most hedge funds typically have between a 45-day and a 3-year lock-in period. Some have back-end surrender charges for the first year. The fee structure in the industry is fairly standard. Hedge funds generally have a two-part fee structure: a 1% to 2% annual management fee as well as a performance fee. The performance fee is what brings the top talented managers to the industry.

Their incentive is that they get paid 20% of whatever profits an investor has on a quarterly basis. And most of the partnerships use a high water mark so that a manager must exceed the highest values before reaping the 20% of profits. The more money the investor makes, the more the money manager makes. There can also be an upfront commission of between 1% and 4%.

The money managers usually will have between 70% and 80% of their own personal wealth, less their residences, invested in their funds, which are subject to the same losses and profits as the investors.

Should these fees be a deterrent to investing in a hedge fund or a managed futures limited partnership? No, because net is still net. A report by KPMG Consulting in 1998 stated that the long-term average performance of hedge funds as a group can be estimated to be in the range of 17% to 20%—several percentage points higher than traditional returns. **OT**

author info

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