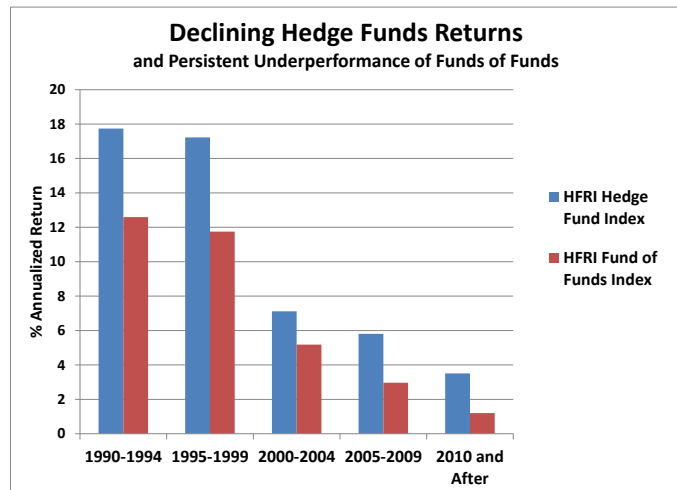


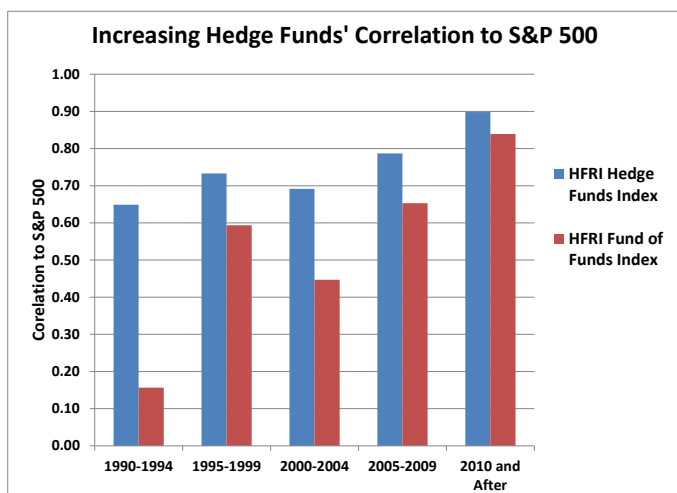
## ARE ALTERNATIVE ETFs BETTER THAN HEDGE FUNDS?

### Comparing Hedge Funds and ETFs

In another paper I showed that the returns of hedge funds have been steadily declining for the past couple of decades. Also, the returns of funds-of-funds (FOFs) have also been declining, but have also shown a persistent and large level of underperformance relative to the overall universe of hedge funds. Two effects may help explain the return shortfall of funds of funds. The first is that there are well-documented upward biases in hedge fund databases. “Retrospective inclusion bias” has to do with the fact that only successful hedge funds ever make it into the databases, usually with considerable back history added once a fund has proven successful. “Survivorship bias” refers to the fact that databases often cull non-surviving hedge funds from their databases, and usually these funds meet their demise because they have performed poorly. Finally, hedge fund managers often stop submitting their performance to databases once their fund is in its death throes. Besides these upward biases found in the HFRI Hedge Fund Index (and HFR is widely regarded as the best hedge fund database), the second reason FOFs tend to underperform broad hedge fund indexes is rather straightforward—FOF managers add a layer of fees on top of those charged by the hedge funds, and it has proven difficult for them to add enough value in manager selection to overcome that drag.



Another troubling trend, also documented in another paper, is the increasing correlation of hedge funds with the S&P 500. This has largely eliminated one of the key features of hedge funds for most investors—their diversifying characteristics. By the way, don’t be fooled by the fact that FOFs tend to have a lower correlation with the S&P 500 than hedge funds—any asset with a zero return will have a zero correlation!



Of course, “hedge funds” are not an asset class. Hedge funds employ many diverse strategies in many different asset classes and this diversity is masked by the broad indexes. Some hedge fund strategies may still be attractive from a risk-return and diversification standpoint.

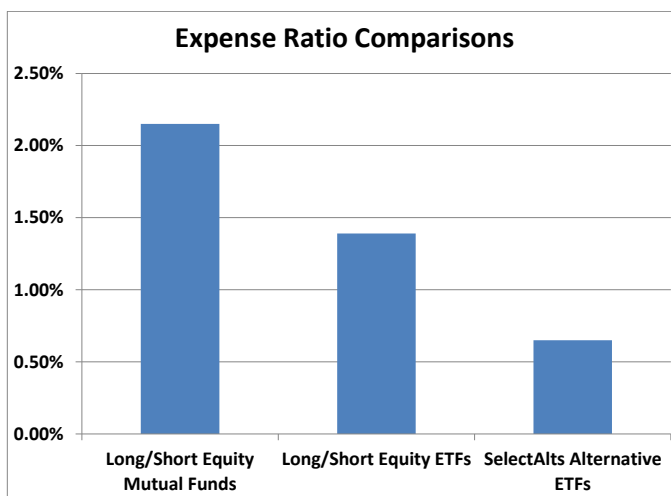
## Comparing Hedge Funds and ETFs

The bulk of this paper is dedicated to comparing the returns of HFRX hedge funds indexes with ETFs<sup>1</sup> that pursue a similar investment strategy. We use HFRX indexes, rather than HFRI indexes, because the former tend to have less bias because the rules for inclusion are stricter. Also, at least some HFRX indexes claim to be investable through funds offered by HFR Asset Management LLC, further enhancing the reliability of the returns presented. All HFRX returns are net of all fees and expenses. The constituent funds are all over \$50 million in assets and typically have at least 24 months of live performance before being included in an index.

Alternative ETFs use hedge fund-like strategies. Like nearly all ETFs, they are index funds. This feature offers three important benefits. First, despite the fact that most alternative ETFs are quite new, because their underlying indexes often have a considerable performance history, providing the data we need for historical comparisons. To make the historical index returns more realistic simulations of the live fund returns, we subtract the monthly pro-rata expense ratio from the historical index returns.

The second benefit from the fact that ETFs are index funds is that their strategies are transparent and consistent over time. An investor can count on the fact that an ETF will stick with the strategy of the underlying index, which eliminates the tendency for managers to panic and change strategies after a period of poor performance, which is often exactly the wrong time to make such a move.

The third benefit is low cost. Because ETFs are not actively managed, they tend to have much lower expense ratios than actively managed mutual funds with similar strategies. The average and median expense ratio of the 130 or so alternative ETFs in our universe is only 0.65%, considerably lower than competing mutual funds, much less the notorious “2 and 20” charged by the typical hedge fund. (Not to mention the additional layer of fees larded on by funds-of-funds!) According to Morningstar’s *Long/Short Equity Handbook*, which contains data as of September 2011, the average long/short equity mutual fund had an expense ratio of 2.15% (vs. 1.39% for long/short ETFs).



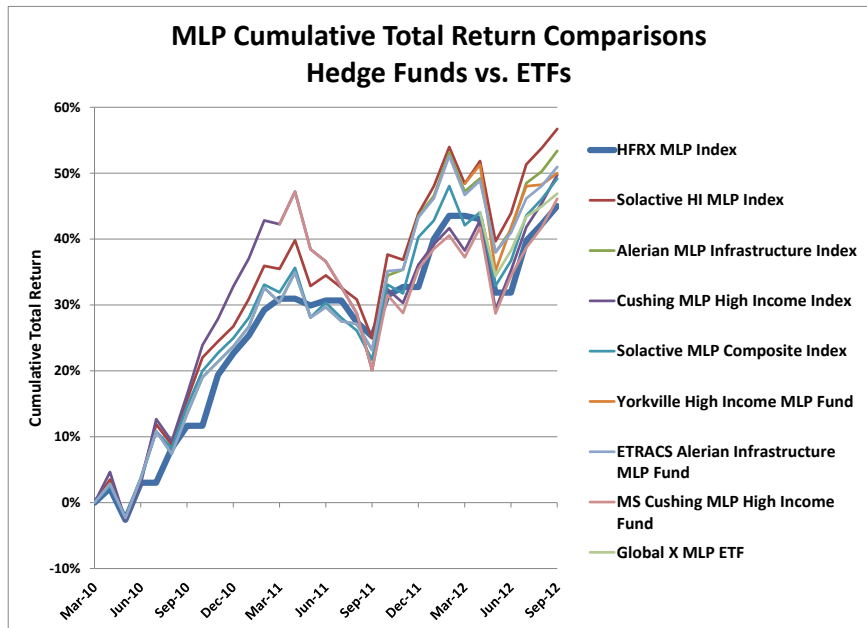
Do investors give up in return what they gain in expense reduction? On balance, when comparing hedge funds with ETFs using similar strategies, the answer appears to be no. While the hedge fund indexes that we examine sometimes have lower volatility (owing in part to the natural effects of including many different funds in the index and in part to the well-known stale pricing problem with hedge fund returns), it appears that ETFs have typically had returns at least comparable to the HFRX hedge fund index, and often considerably better.

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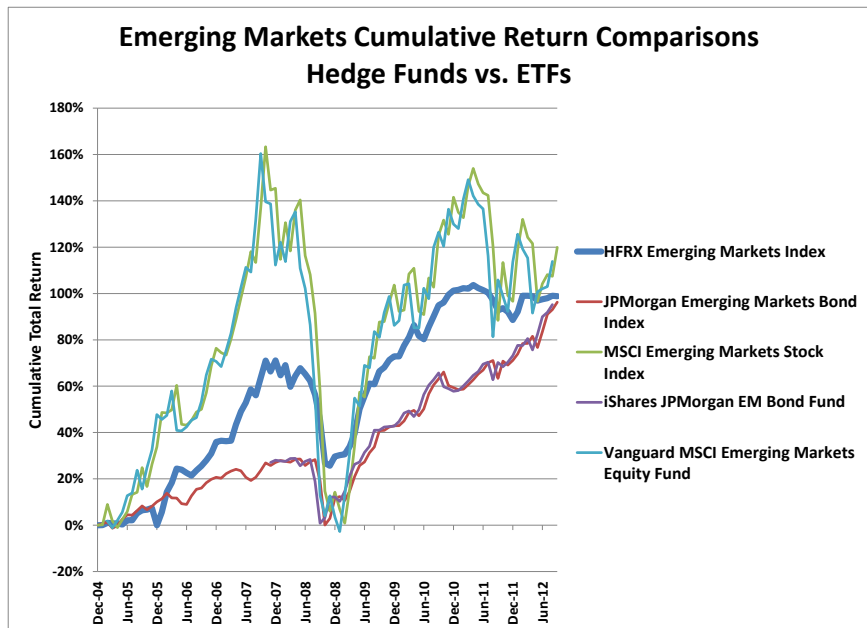
<sup>1</sup>We use the term “ETF” to refer to all exchange-traded products, including exchange-traded funds (ETFs), exchange-traded notes (ETNs), and other exchange-traded vehicles, such as certificates, trusts and partnership units.

Hedge Funds vs. ETFs – Cases of High Correlation

The various indexes of master limited partnerships (MLPs) appear to yield very similar returns among the four MLP ETFs in our universe even though we chose these four specifically because of their somewhat different universes of constituent MLPs. The HFRX MLP Index (of hedge funds that focus on MLP investments) had a very high correlation with these indexes. It should be noted, however, that the cumulative hedge fund index return trailed the pack, probably due to somewhat higher expenses.



The HFRX Emerging Markets Index includes both debt and equity from emerging markets, whereas the emerging markets ETFs focus on one or the other. We include only one of each in our universe. A simple 50/50 average of the two ETF return lines would closely approximate the hedge fund index, however, so we consider this one to be another example of “high correlation.”

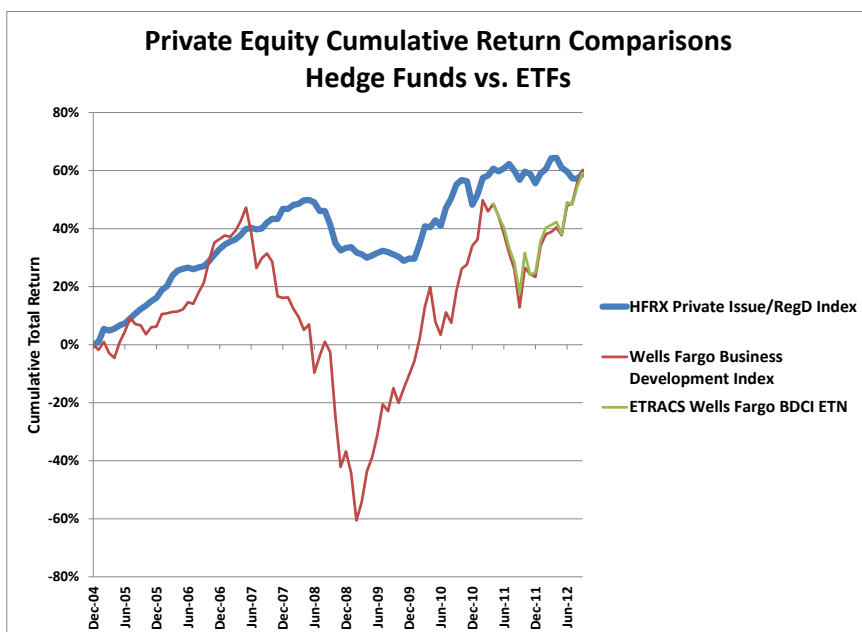
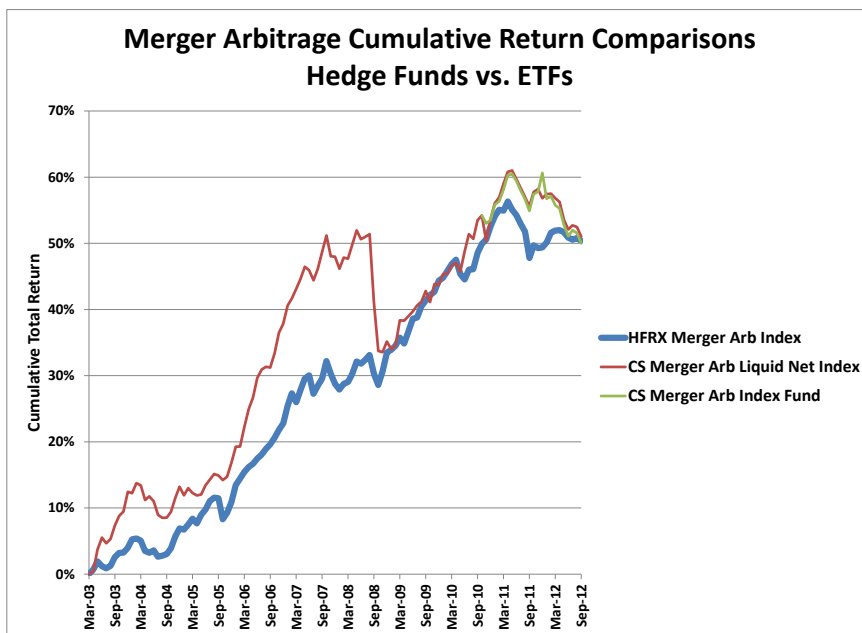


So, should an investor be indifferent between these ETFs and the competing hedge funds? I think not. ETFs have daily liquidity, significant investor protections, and completely transparent pricing, all features lacking in hedge funds. To endure these significant disadvantages, investors should demand considerably higher returns, considerably less risk, or both.

## Hedge Funds vs. ETFs – Cases of Low Correlation with Similar Returns

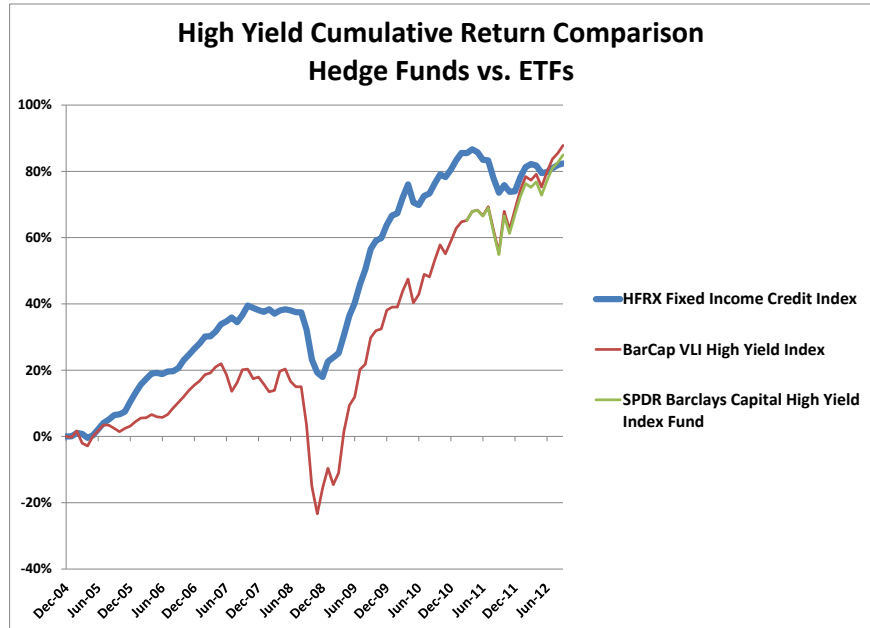
Merger arbitrage strategies involve buying long positions in stocks of to-be-acquired companies and shorting the stocks of the acquirers. Hedge funds purport to have skill in either anticipating takeovers not yet announced or in managing the deal risk of announced takeovers. The ETF simply buys long all announced targets and shorts the corresponding acquirers, as long as the stocks are sufficiently liquid. (By the way, the red line is the underlying index and the green line is the live fund—we will always show both for each ETF.)

You may wonder how an ETF could possibly invest in private equity. The answer is that this ETF invests in publicly traded private equity/venture capital in the form of business development companies (BDCs). BDCs are listed public companies that register under the Investment Company Act of 1940, and invest in start-up companies, mostly using mezzanine debt financing, so they tend to have high yields.



The HFRX Private Issue/RegD Index of hedge funds has a considerably lower level of volatility than the ETF. Doesn't that make the hedge funds more attractive for investors? Not necessarily. The ETF invests in publicly traded companies, with absolute pricing transparency. The hedge funds tend to invest mostly in private deals with no public market. Pricing here is hard to come by, and is often subject to the judgment of the hedge fund manager. Hedge fund managers are notorious for "smoothed pricing." That is, they will drag their feet in marking down their portfolios, hoping that the market will come back if they wait long enough. Sometimes the SEC sues hedge fund managers for this kind of thing, but rarely.

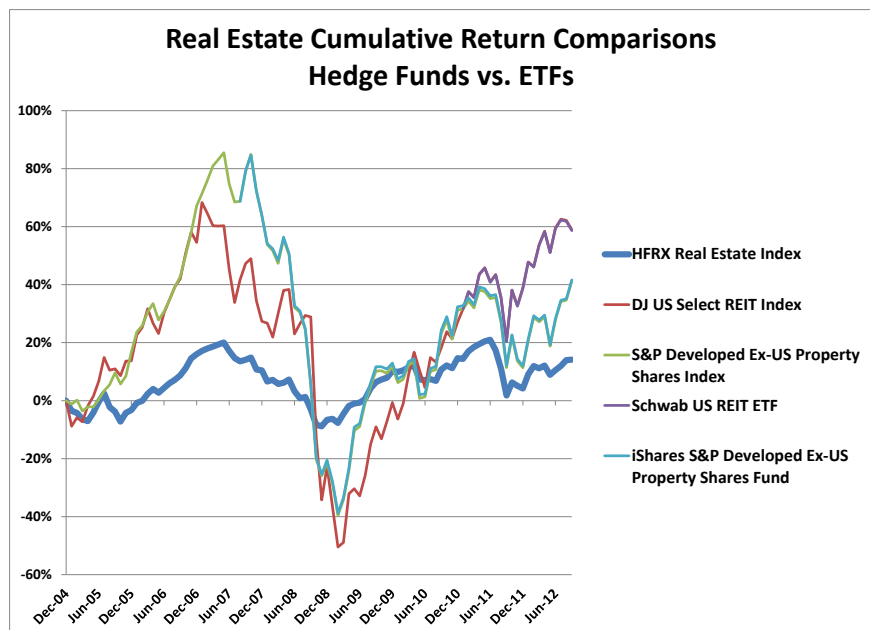
The case of high yield/credit-oriented fixed income investing provides a somewhat less extreme example of what amounts to the same thing—smoothed pricing. Only in the case of these bonds, pricing is just difficult, rather than impossible, to obtain. Because the markets for high yield bonds can be very thin, many bonds have no trades at all many days. Consequently, managers must call various dealers to obtain price quotes. They decide which dealer quotes to include, and dealers have an incentive to not harm their customers with low quotes. By contrast, the ETF includes more liquid high yield bonds, and because it is based on an index fund, Barclays has little incentive to fudge and little room for judgment under the index construction rules.



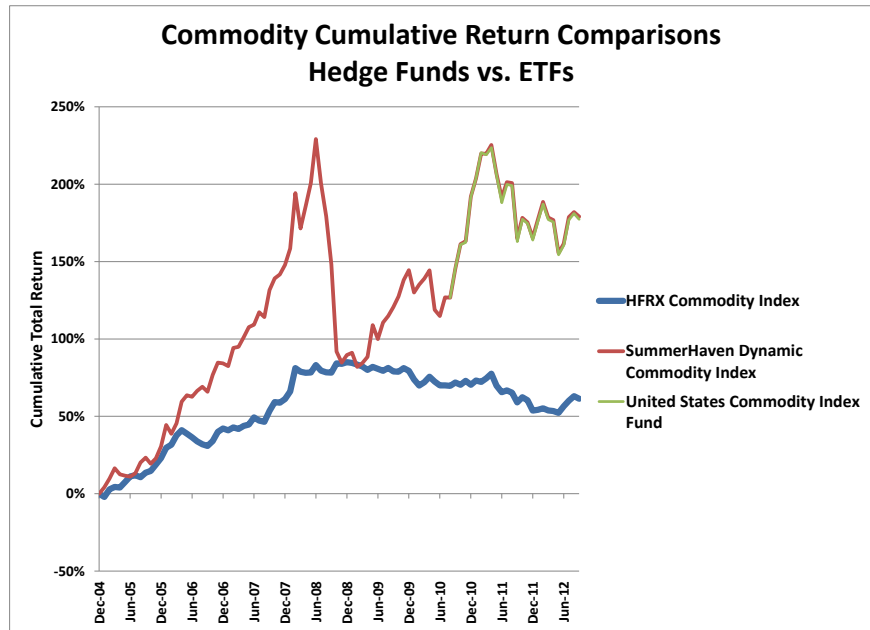
Hedge Funds vs. ETFs – Cases of Low Correlation with Divergent Returns

Hedge fund investment in real estate is typically private and subject to the same artificial pricing that plagues all private investments. Even if the managers employ professional appraisers, they typically will have their properties valued only once a year, if that. And appraisers are selected by and paid by the managers. The conflicts are obvious.

There are two real estate ETFs in our universe. Both invest in real estate investment trusts (REITs), which are publicly traded forms of investing in commercial real estate. One ETF invests only in U.S. REITs, the other only in non-U.S. REITs. Although both have had a higher level of volatility than the hedge fund index (because they are based on real, transparent, public market pricing) both have also had a considerably higher return.

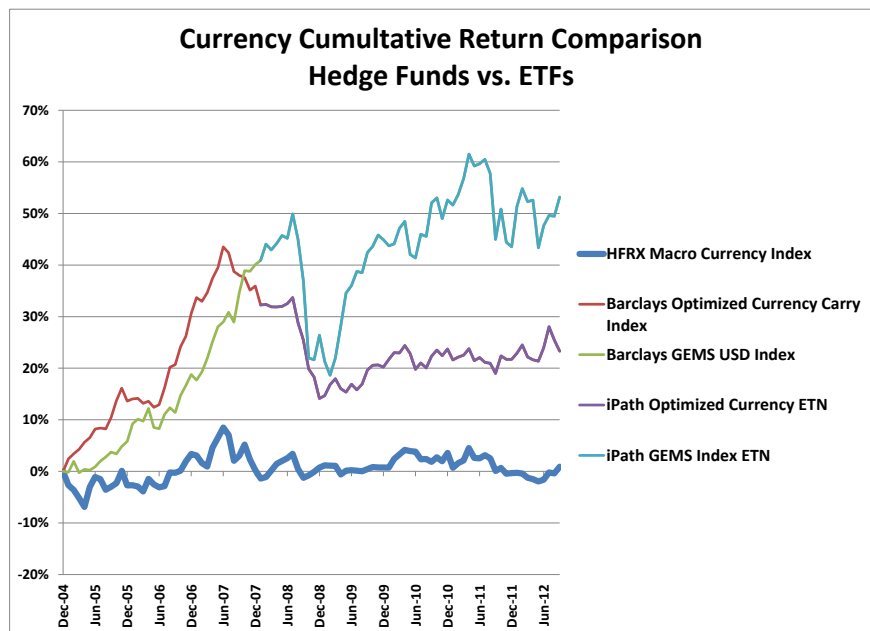


Sometimes ETFs just have a better investment strategy than the average hedge fund. Such is the case with “second generation” commodity ETFs that use various techniques to maximize returns. Our favorite is the one illustrated here, the United States Commodity Index Fund, which systematically selects 14 commodity futures from among a universe of 27. Seven are selected based upon spot price momentum, and the other seven are selected on the basis of the shape of the futures curve—emphasizing futures contracts that roll up to a profit (“backwardation”) and avoiding those futures markets in which futures roll down to a loss (“contango”).

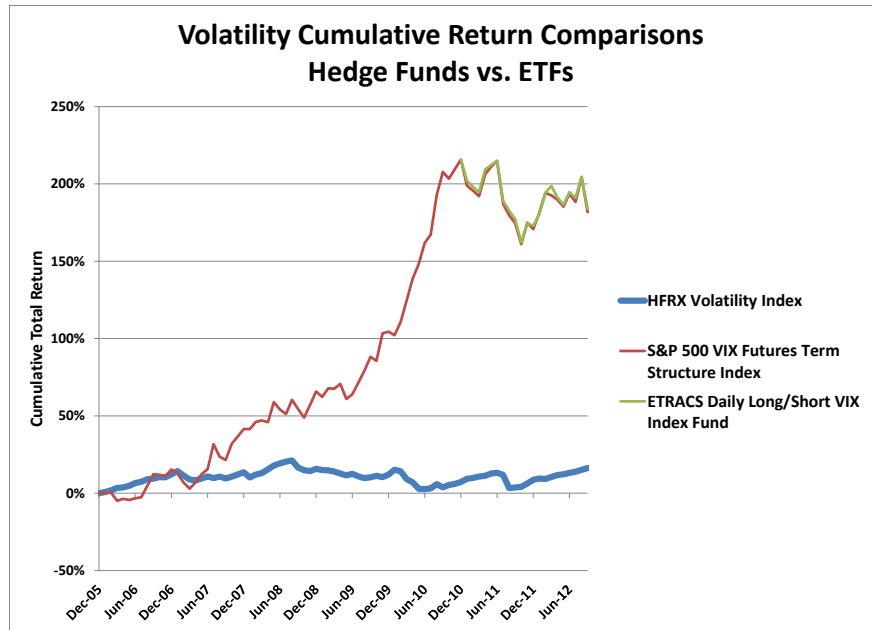


Most of the historical return from investing in commodity futures was due to positive roll yield (backwardated futures markets), not because inflation caused a general increase in spot prices. Unfortunately, so much money has poured into commodity futures in recent years that most futures markets are in contango most of the time, meaning that investors buy futures contracts at prices *above* the current spot and then watch those prices roll down for a loss. They probably wonder why the historical average returns they were told about when they were “sold” on commodity futures are not showing up for them!

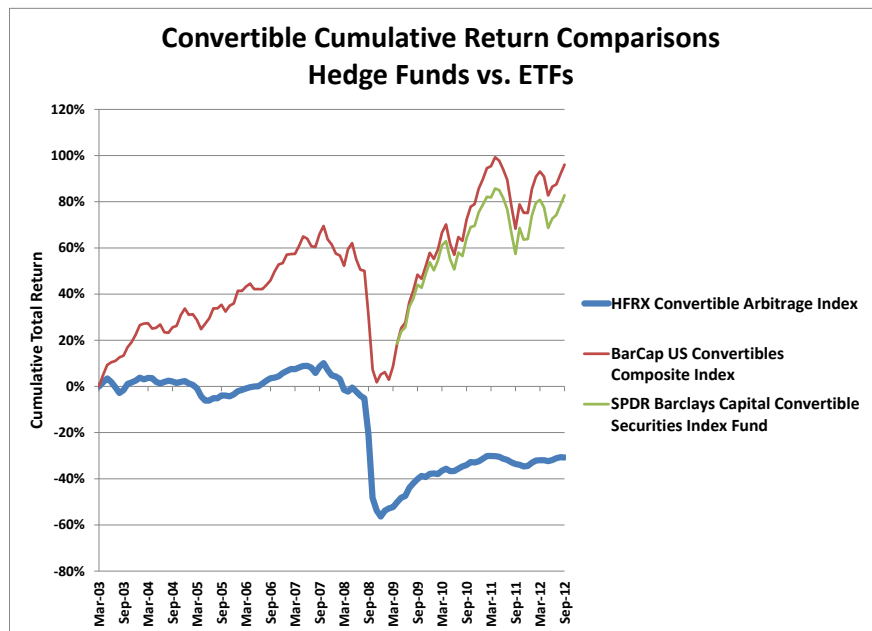
Similarly, second generation currency ETFs use smart investment techniques to maximize returns. The two ETFs shown here are both based on Barclays indexes. The one focused on developed market currencies plays the “carry trade,” by investing in high yield currencies and shorting low yielding ones. The Global Emerging Markets Strategy (GEMS) index simply invests in a broad basket of 15 emerging market currencies. Both have handily outperformed the average currency hedge fund.



Volatility funds mostly invest in the VIX Index in one form or another. The VIX is the ticker for the Chicago Board Options Exchange Market Volatility Index, based upon the option-implied volatility of near-the-month S&P 500 options contracts. It is a popular instrument for hedging stock market risk because it has a very high negative correlation with the S&P 500. As was the case above, our favorite volatility ETF is a smarter “second generation” version that combines short positions in the nearby VIX contracts that tend to be most steeply in contango with long positions in further out contracts where the futures curve is not so steep.



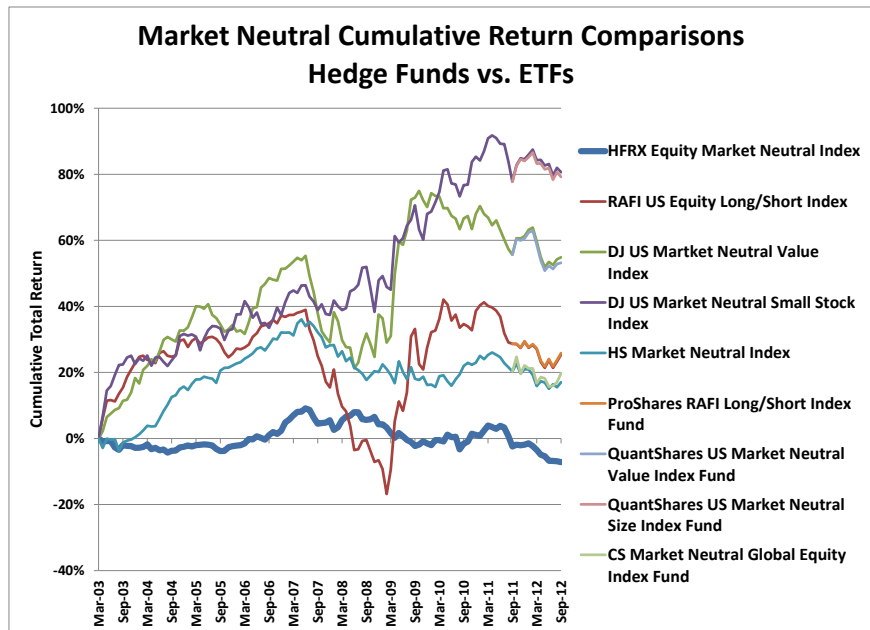
Sometimes a disciplined (some would say “mechanistic”) approach to implementing a strategy is superior, perhaps because it avoids the foibles of human emotion. Typically, convertible hedge fund managers buy long selected convertibles and sell short the corresponding common stock to hedge their risk. The ETF, on the other hand, simply buys long a very broad list of convertibles designed to represent the entire market of U.S. convertible securities. It does not sell short, or hedge. Selling short can be very expensive, especially in recent years, because the popularity of the convertible arbitrage strategy can make borrowing the stock of issuing companies very expensive. Simply buying long the convertibles takes advantage of the well-known tendency for convertibles to be undervalued in the market, but avoids the costs and risks of selling short.



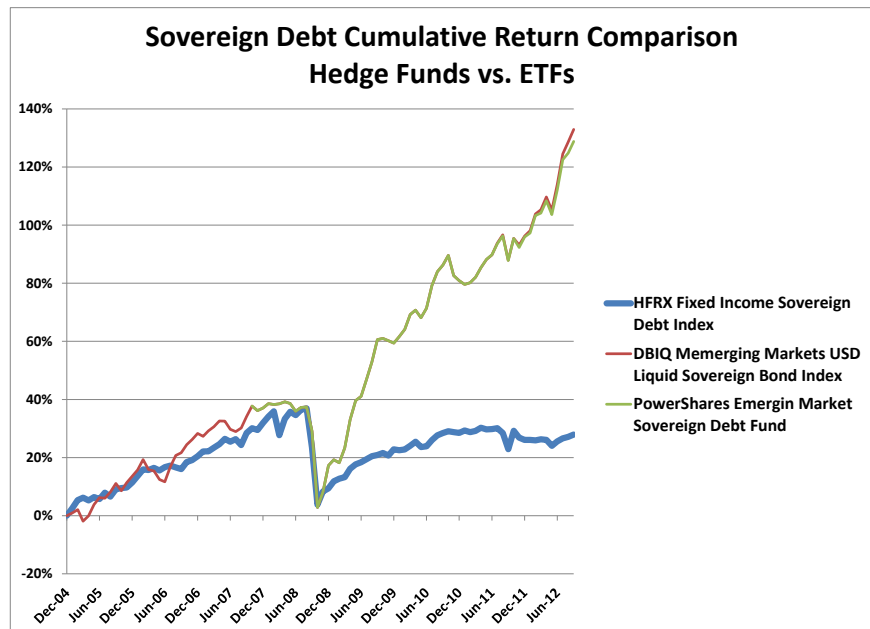
By the way, notice how the green line (the “live” fund) has fallen below the red line (the underlying index minus the fund’s expense ratio). This is probably because convertibles are relatively illiquid expensive to trade.



There are a number of equity market neutral ETFs. We selected four of them for illustration. All are similar in that they equally balance long and short stock positions so that their net invested position is nearly zero, or “neutral.” Two of the four have easily identifiable strategies—long small stocks and short big stocks, and long cheap stocks and short expensive stocks—and two have more complex strategies. All four have handily outperformed the average equity market neutral hedge fund.



Sovereign debt refers to debt issued by non-U.S. governments. We prefer to invest in emerging market government bonds because emerging market countries tend to have lower deficits, higher growth rates, and better demographics than developed market countries. Emerging market government bonds also tend to have higher yields and lower correlations with U.S. stocks and bonds, providing more attractive diversifying properties. By avoiding many of the recent problems with



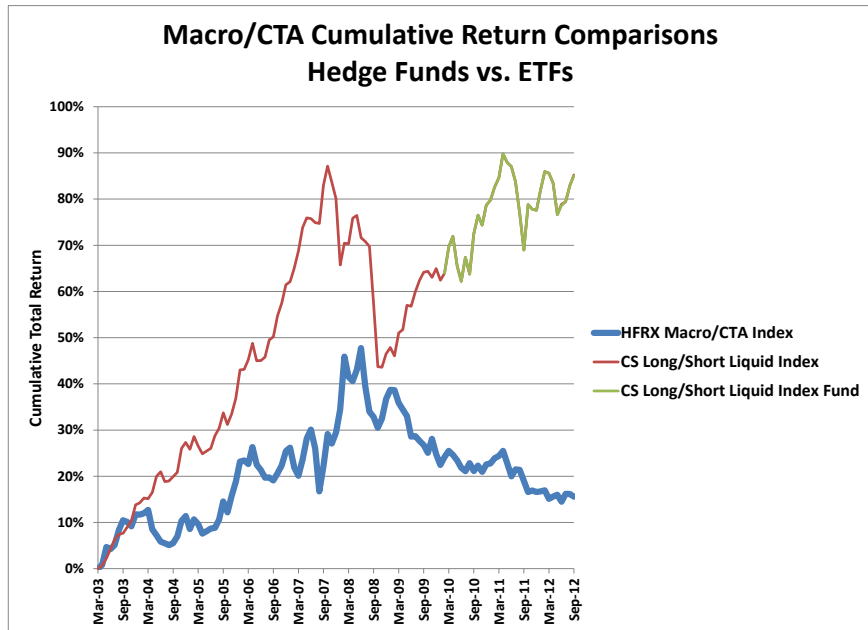
European government bonds (the so-called “PIGS—Portugal, Italy, Greece and Spain) the returns for emerging market sovereign bonds have far outpaced the average sovereign hedge fund where managers are no doubt trying to time the turnaround.

Our last example of “divergence” is truly dramatic. Macro/CTA hedge funds typically invest in a combination of long and short futures positions in stocks, bonds, currencies, and commodities, with a particular emphasis on stock and bond futures. “CTA” stands for commodity trading advisors, a regulatory label applied to pooled funds that are regulated by the Commodity Futures Trading



Commission. These are “big picture” funds that attempt to call the major moves in the world’s capital markets.

This is a very nebulous and varied group of hedge funds, with very little in common in terms of either strategy or results. Macro hedge fund managers attract money after they have had a run of positive results because investors readily acknowledge that “past performance is no indication future results” and then go ahead and behave as if it did.



Typically, they are disappointed in the results, especially if conditions change, as they did in 2008, and those with previously hot hands suddenly find they have turned cold.

Our ETF is a hedge fund replication instrument designed to replicate the Credit Suisse/Tremont Long/Short Equity Hedge Fund Index. It is based upon quantitative research that identifies the underlying factors that drive the benchmark index. The fund takes positions in these factors which are often tied to various futures contracts.

### Summary and Conclusion

Hedge funds have traditionally been the primary vehicle for investing in “alternatives.” However, in recent years hedge fund returns have declined and their correlation with the S&P 500 has increased, making them much less attractive. At the same time, a number of alternative ETFs have come on the scene. The returns of these ETFs have often been at least as good as, and often better than, those of competing hedge funds on average, but without the attendant problems of illiquidity, non-transparent pricing, and risk of fraud. Furthermore, as index-based products, ETFs combine low cost with consistent implementation of their investment strategies, making them very attractive building blocks for constructing alternatives portfolios.

Kevin Means, CFA  
Principal  
Select Alternative Investments LLC

November 26, 2012

## **SELECT ALTERNATIVE INVESTMENTS LLC**

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