SelectAlts

Wisely Managed Absolute Return Portfolios

WHAT IS AN ALTERNATIVE INVESTMENT?

Investopedia defines an alternative investment as "an investment that is not one of the three traditional asset types:" stocks, bonds or cash." The line dividing traditional investments from alternative investments is subjective. The attributes that commonly characterize an alternative investment are

- Alternative-type asset classes (e.g., **commodities** and real estate)
- Alternative-type forms of ownership (e.g., **hedge funds**)
- Illiquidity
- Short selling
- Leverage
- Incentive fees

Commodities include various raw materials ranging from crude oil to corn to copper to coffee to cotton. Nearly all commodities are owned through futures contracts, but some, such as gold, may be owned directly.

A **hedge fund** is most often a U.S. limited partnership or non-U.S. (offshore) corporation limited to accredited high net worth or institutional investors.

Typically, only institutions and high net worth individuals have been able to invest in alternatives because of high minimums and accreditation requirements. U.S. securities laws limit the ability of an investment manager to collect performance incentive fees to "accredited investors" who meet certain net worth and/or income requirements. Thus, there has been a certain status associated with the ability to invest in alternatives.

Often, alternative investments are highly **illiquid**, requiring investors to commit their capital for multi-year periods. The justification that managers of alternative funds give their investors is that they are often investing in illiquid assets. Sometimes alternative assets do not trade at all, as is the case with direct real estate and private company debt or equity. Often, even those alternative assets that trade are so thinly traded that their pricing is hard to establish with any confidence. Many bonds would fall into this category. The illiquidity of alternative assets often enables managers to smooth out return volatility by dampening the ups and downs in pricing their assets. If there is no market price, any valuation provided by management is completely subjective. For thinly traded securities, management is able to select the pricing sources and may thereby influence the results.

The following table lists some of the major types of alternative investments. These are most commonly available through hedge funds, but some are now available in liquid form through mutual funds or **ETF**s (exchange traded funds):

ETFs (exchange traded funds) are like mutual funds that trade on exchanges like stocks. Most are index funds.

Alternative Asset Classes/Strategies	Description/Comments
Real estate	Typically ownership of properties through limited partnerships
Private equity	Debt or equity in private, often newer/smaller companies
Commodities	Normally owned through futures contracts
Currencies	Often long high yield currencies and short low yield currencies
Convertible arbitrage	Often long convertible bonds and short commong stock of a company
High yield bonds	Credit risk expertise is key
Asset-backed bonds	Asset valuation is key, along with general credit risk
Mortgage-backed bonds	Prepayment risk expertise is key
Bank loans	Underwriting quality is key
Distressed debt	Bankruptcy expertise is key
Emerging market debt	Sovereign credit/political risk is key
Long/short equity	Typically net long with an equity beta of .3 to .7
Market neutral equity	Typically beta of zero to .3
Emerging market equity	May include emerging and frontier markets
Merger arbitrage	Typically long merger targets and short acquirers

The most common type of hedge fund is the long/short equity fund. However, many other alternative strategies include some shorting. **Selling short** involves selling a security that is not already owned (by borrowing it through a broker) with the intention of "covering" the short position with a buy trade later on, which will enable the short seller to deliver the borrowed security to the lender. The hope is that the security will have declined in price meanwhile. Combining long and short positions tends to hedge out much of the risk in a portfolio, hence the term "hedge fund." (Though not all hedge funds use short positions, most do.)

Hedged portfolios often have a different risk profile than long-only portfolios, such as mutual funds. Many people are surprised to learn that the average hedge fund has less than half of the volatility of the average stock mutual fund. So the reality is that the average hedge fund is much less risky than the average stock mutual fund.

Then why do most people consider hedge funds to be risky? This has mostly to do with a combination of a fear of the unknown and unfamiliar, fanned by extremely negative press. Only when a hedge fund runs into problems will you read about one. Why do hedge funds run into problems? Sometimes hedge funds take out a lot of one type of risk (e.g., stock or bond market risk) by hedging with shorts, but add a lot of another kind of risk, such as **leverage** or illiquidity risk. Investors must assume some kind of risk to expect to earn returns. Most of the risk of the typical mutual fund is explained by its market risk exposures. The differences in performance from one large cap U.S. equity fund to the next are not likely to be significant. Not so with hedge funds. The performance spread

Leverage involves multiplying the normal economic exposures of an investment either with borrowed funds or through derivative instruments, such as options or futures.

among hedge funds following a similar strategy will often be huge. Hedge fund managers are rewarded for taking big bets and being right. However, when they are wrong, they can be very wrong, with their investors suffering large losses.

Another type of risk, but one that is difficult to quantify, might be labeled "**headline risk**." This is the risk that a hedge fund might be accused (rightly or wrongly) of some sort of nefarious activity. Perhaps because of the incredible pressure to perform combined with the very lucrative fees involved, sometimes hedge fund maangers push the envelope of the law and are accused of trading on insider information, of taking advantage of other market participants through high-frequency trading, or of pressuring underwriters to allocate "hot" IPOs (initial public offers) to them. Sometimes they are guilty of outright fraud, as was the case with Bernard Madoff**.**

Hedge funds typically charge much higher **fees** than mutual funds. The most common fee arrangement is "2 and 20," or a 2% asset-based fee and a 20% incentive fee assessed on all profits. For example, a fund with a gross return of 10% will have 2% subtracted for the asset-based fee, and an additional 1.6% subtracted for the incentive fee, for a total fee of 3.6% and a net return of only 6.4%! By contrast, the typical mutual fund has an expense ratio of 1% or less and no incentive fee.

As if illiquidity, risk of fraud, and high costs weren't enough, investors also have to contend with **tax complications** when they invest in hedge funds. Taxable investors have to wait until they receive the K-1, often well after April 15, and tax-exempt investors have to worry about whether the leverage used by their hedge funds has generated any **unrelated business taxable income (UBTI)**, which will require them to file a tax return and possible pay taxes and penalties, if not forfeit their tax-exempt status entirely.

Why do sophisticated investors endure these adversities? In a word, **diversification**. Although a few alternative funds have produced stellar returns which attract a lot of public attention, the bulk of alternative investments produce more modest returns, but importantly, lower the overall risk of a stock and bond portfolio by diversifying these traditional investments. I'll address this subject in detail in "Which Hedge Fund Strategies Best Diversify S&P 500 Risk?"

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