Liquid Alternatives

By Gregory S. Horn and James W. Graves

Conviction has been hard to find in the markets over the past five-plus years. The gut-wrenching plunge of 2008 was followed by 2009’s retracement, and the past three years have been punctuated by global monetary stimulus-fueled surges. The backdrop to the markets’ discounting mechanism has involved a questionable economic recovery in the United States, a slowdown in Europe with its serious sovereign problems, slowing growth in Asia, and social and political destabilization in the Middle East. The equity markets have stair-stepped higher since the March 2009 bottom, but global fears have further fueled the 30-year bull market in bonds, driving U.S. interest rates to record lows. Investors and their advisors have sought out investments to shield them from the volatility created by these uncertainties and, following the lead of the institutional investment community, increasingly have turned to alternative strategies. Indeed, perceived shortcomings of hedge funds have led to a proliferation of investment products for individual investors that embody the desirable attributes of hedge funds.

Some of these products (or, perhaps more appropriately, product structures) are new and others have been around for the better part of two decades. Importantly, innovations have made these investment strategies more accessible to individual investors, but each solution presents nuances and/or potential shortcomings of which investors should be aware. Below are the structures that deliver alternative investment strategies (i.e., hedge funds) to the advisory marketplace, listed in rough chronological order:

- Regulation D Limited Partnership
- hedge funds and fund of funds
- Registered Investment Company (RICs) (aka ‘40 Act Funds)
- Separately managed accounts
- Open-end mutual funds
- Exchange-traded funds and notes (ETFs and ETNs)

Regulation D LP Hedge Funds

For experienced high-net-worth investors, access to hedge funds traditionally has come through Regulation D privately placed limited partnership vehicles (LPs), typically structured as single-manager funds or multiple-manager funds (i.e., funds of funds). In these structures, managers have broad latitude and provide limited portfolio transparency. Tax reporting involves a K-1 form commonly completed and delivered after April 15, requiring investors to file for an extension with the Internal Revenue Service. Limited partnerships, by design, have been available only to investors who meet the specified minimum investor qualifications, which typically are based on income or net worth. Depending upon the specific regulatory exemption upon which the private placement relies, LPs are allowed only a limited number of investors in the fund (either 99 or 499). Liquidity is typically quarterly after an initial minimum holding period (or lock-up), often one year. It is not uncommon to see annual liquidity provisions in some LPs. Managers typically charge a base management fee, augmented by an incentive fee linked to the fund’s performance. While some investors are of the opinion that the fee structures are egregious, others prefer that the manager have some “skin in the game” so that the manager’s interests are more closely aligned with those of the investor.

‘40 Act Funds

Registered ‘40 Act funds are the next step in the progression toward being more investor friendly. Even some professionals make the mistake of using the terms “‘40 Act funds” and “mutual funds” interchangeably. The ‘40 Act registered structure allows the fund manager or sponsor to accept subscriptions from an unlimited number of investors and eliminate consideration of how much retirement-plan money is invested in the fund; however, the accredited-investor standard still must be met in order to invest. These funds offer more-rigorous governance via an independent board of directors and registration with the Securities and Exchange Commission and regular quarterly filings. Liquidity typically is offered via quarterly tender offers (a formal solicitation by the manager to repurchase a stated percentage of shares on a specified date). These funds often have no lock-up. Some funds that are operated accordingly generate a 1099 for tax reporting, simplifying the investor’s tax preparation; otherwise a K-1 is standard.

Democratization of Hedge Funds: Open-End Mutual Funds

Open-end mutual funds, the most common investment vehicle structure for retail investors, have been developed to invest in single and multiple hedge fund strategies while offering daily pricing and liquidity. However, due to the regulatory requirements of a mutual fund and the inability for the fund to pay incentive fees to underlying fund managers, investors will observe a certain selection bias. Equity-oriented strategies tend to be the most prevalent due to the daily pricing and liquidity feature. Some providers, especially
those offering funds of funds, have established managed accounts with the underlying managers to facilitate access to and control of the assets, in turn, relying on the manager to meet liquidity demands. (Managed accounts are run in parallel with the manager’s LP fund; however, the assets are held in a separate brokerage account in the name of the investor.) Additionally, regulations limit the extent to which leverage may be used—an integral aspect of many relative value-oriented strategies.

The mutual fund structure eliminates the investor qualification requirements and facilitates substantially reduced minimum investments (some as low as $1,000), thus making the strategy more broadly available to investors. The regulatory constraint governing a manager’s inability to earn performance-based incentive fees limits the pool of managers willing to participate in this structure because incentive fees are a major source of revenue and motivation for top managers (high returns drive higher revenue for the manager). Overall expenses in these funds can reach 4 percent a year, a lofty performance hurdle before investors begin to make money, particularly in today’s challenging investment climate. However, when and if gross returns reach levels in excess of 10 percent to 12 percent, these fixed fees may be relatively attractive compared with the traditional hedge fund fees, typically 1.5 percent plus 20 percent of profits (over a high-water mark). Finally, mutual funds do not offer maximum tax efficiency because investors do not have a unique cost basis in the underlying securities.

**Separately Managed Accounts**

Institutional investors increasingly are requesting that hedge fund strategies be managed in a separate account. Sophisticated investors tend to seek position-level transparency and, when liquidity is demanded, do not want their redemptions to be gated or suspended by the fund’s general partner. This is beginning to trickle down to the high-net-worth investor in the form of access to separately managed hedge fund accounts. Here, an investor owns a brokerage account in which a manager’s hedge fund trades are replicated. This virtually eliminates the operational risks associated with owning a percentage of a limited partnership—especially that of a newer or emerging manager whose revenue stream may raise questions about the sustainability of the incremental staffing and infrastructure to support multiple separate accounts. The fees for a managed account are typically similar to those charged in the manager’s LP, but the investor now has full transparency, liquidity, and control.

**Continuing Evolution**

Alternative strategies have evolved significantly over the past 70+ years, from LPs to registered ‘40 Act funds to open-end mutual funds. Equally evolutionary are the creative ways in which marketers have evolved the products. In its earliest days, hedge fund investing was about long/short equity investments—driven predominantly by security selection with a hedge component to mitigate against market declines. The same long/short mentality migrated into various other securities markets—convertible bonds, relative-value fixed income, pairs trading, merger arbitrage, and later, activist and event-driven investing.

More recently, with the ascension of the quantitative analytics promulgated largely by the academic community, statistical arbitrage evolved into high-frequency trading. Retail investors reluctant to be underinvested were presented with 130/30 funds—130-percent long, 30-percent short—creating 100-percent equity market exposure with astute security selection from the 130/30 intended to generate incremental returns. Various investable hedge fund indexes have been developed by numerous institutions (e.g., Hedge Fund Research, Dow Jones Credit Suisse) with the latest iteration of hedge fund replication strategies designed to capture the exposures to certain indigenous factors embedded in hedge funds. These factors include such things as credit-spread risk, interest-rate risk, volatility, equity market beta, size, value/growth, and other statistically significant factors. In the vernacular, they are collectively referred to as “exotic” or “alternative betas.” Most often, these replication strategies are offered as ETFs. One recent offering seeks to replicate hedge fund beta by employing a fund of funds approach, investing in other ETFs (Rowland 2012). Superior stock selection would appear to be far-removed from these iterations with their obsessive application of the scientific method and its reliance on quantitative measures.

**Long/Short Equity: Alternative Investment or Active Equity Management?**

For many years, investment funds that go beyond traditional long investments in stocks and bonds (or related securities such as convertible bonds and stock options) have been considered alternative investment strategies. In our opinion, long/short equity investing should be considered within the traditional equity allocation in a portfolio rather than an alternative investment. Indeed, this was the way in which 130/30 strategies were introduced to the investing public. The ability to sell stock short is simply a less-constrained way of investing in equities. (For an academic perspective on this last tenet, see Grinold 1989.) Still others see the ability to go both long and short as the primary means available to actively manage risk (Ineichen 2012). Historically, a major obstacle to incorporating long/short strategies into equity allocations has been the nature of the available vehicle structure, which necessitated a loss of liquidity. Perhaps these limited-liquidity structures (LPs and ‘40 Act funds)
present the rational for considering long/short equity as an alternative.

Recently, other investment consultants have begun to comprehend the merits of true active management and are advocates as well. As shown in figure 1, the long-term risk-and-return profile demonstrates the potential for long/short equity to improve the performance of an investor’s equity allocation if properly deployed. As we consider the attributes of long/short strategies, what becomes evident is the predominant underlying fundamental risk exposure—equity market risk.

Correlations
One long-held, defining characteristic of alternative investments has been low correlation to the other asset classes in a portfolio. Table 1 shows the correlation (or directionality) of various hedge fund strategies vs. the equity indexes as measured by the Russell 3000 and the MSCI EAFE foreign equity index. The correlation of long/short strategies to these equity benchmarks is high (0.77 and 0.67, respectively) relative to other hedge fund strategies, which typically are employed within a more absolute-return oriented hedge fund allocation. Strategies producing these lower correlations (some might refer to them as “uncorrelated returns”) could properly be considered alternative investments.

Underlying Assets
Another defining characteristic of alternative investments has been the nature of the underlying investment instruments themselves, often including illiquid and hard-to-value assets such as real estate, private equity, and timber, or derivatives such as swaps, which introduce counterparty risk. Most long/short equity managers, however, invest primarily in liquid stocks.

Protecting and Growing Capital
The next logical question is, “Has the performance of the equity tool set to include long/short equity strategies improved the risk/return relative to long-only investing?” When looking at the returns for long/short equity relative to the long-only indexes over the past 20 years as shown in table 2, the HFN Long/Short Equity Index materially outperformed long-only benchmarks with significantly less volatility.

The results depicted may be counterintuitive given our previous observations about correlations. The widely accepted conventional rationale for investing in hedge funds before the financial crisis has been debunked. Seeking diverse sources of return drivers in a portfolio should provide more certain insulation from complete susceptibility to market direction (notably down), but Ineichen (2012) presents a more-intelligent way to examine the benefits of hedge funds. Ineichen (2012) demonstrates that the key to successful long-term investment returns is to minimize the time the investment spends “under water” That is, by experiencing shallower and shorter drawdowns (mark-to-market losses),

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**FIGURE 1: LONG-TERM RETURN/RISK OF LONG/SHORT EQUITY VS. LONG-ONLY**

*Left:* Long-term 20-year cumulative returns for the HFN long/short equity index. *Right:* Relative risk (standard deviation)/return vs. the S&P 500. Over this period, in spite of significant variance in the annual performance between the two, hedge funds (represented by this index) have demonstrated superior risk-adjusted performance.

Note: The HFN Long/Short Index is an equal-weighted average of the performance of 1,647 hedge funds in this strategy. Underlying hedge funds report net of fees performance to HFN within 45 days of the end of each month. It is not possible to invest directly in an index or the HFN Long/Short Index. The S&P 500 Index consists of 500 common stocks and generally is considered representative of the U.S. stock market. It is heavily weighted toward companies with large market capitalizations and represents more than two-thirds of the total market value of all publicly traded domestic common stocks. Past performance is no guarantee of future results. Index returns are shown for illustrative purposes only. Source: Index data from PerTrac and HedgeFund.net, calculations by Persimmon Capital Management, LP. Long-short standard deviation is the median standard deviation of reporting funds during the decade. From 1992 through 2001 there were returns data available for 254 funds and from 2002 through 2011 there were 1,643 funds.
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