A Better Paradigm for Selecting Alternative Investments

By Nathan Lee, CFA®, Kyle Cox, CFA®, and Patrick R. Morris

Extensive studies have shown that many mutual fund investors use recent performance as their primary, if not sole, investment criterion. This can be true even of investors in the alternatives space. The remedy for this situation involves more than cobbling together additional criteria into a longer checklist; a more nuanced process is needed. Of course, there is no single best way to evaluate alternative investments, but some processes are better than others. In our opinion, the better processes share three key principles: 1) they prioritize risk management over recent performance; 2) they identify the key drivers of performance; and 3) they assess rather than assume the sustainability of past performance into the future. These principles should guide investors to those alternative investments that most effectively improve the risk-return balance of their overall portfolios.

Representativeness Heuristic
Do investors fixate on recent performance when allocating cash? When it comes to stock and bond mutual funds, the answer appears to be “yes.” The evidence lies in the behavioral finance studies that show mutual fund inflows accelerate after a recent period of strong performance (Baden 2011). These results suggest that investors chase past performance, either relative or absolute, in the hope that it continues into the future, ignoring disclaimers to the contrary. Behavioral finance formalizes an explanation of this behavior in its theory of representativeness heuristics. Per this theory, investors choose investments solely on past performance, especially when other information that can be used in the evaluation process is either too plentiful or too scarce, or just too complex (Shiller 2005).

Even sophisticated investors can be observed to chase past performance when choosing alternative investments (Baquero and Verbeek 2007). This may be surprising but is to be expected as well, especially if the investment lacks transparency or is highly complex. For example, unless required to do so, some hedge funds may avoid reporting their positions to keep rivals from reverse-engineering strategies. Hedge funds also may trade esoteric instruments that investors don’t understand. In these situations, historical returns may be practically or literally the only information an investor has in making a decision.

Believing the Hype
The behavioral finance literature asserts that the financial media can motivate investors to chase past performance, especially if that performance is exceptional. When investors repeatedly hear of outlier performers in the news, they then dramatically modify their expectations of future returns, aligning them with what they have heard or seen. Eventually, investors grow accustomed to outlier performance and mistake it for the norm. This behavior can lead to a speculative bubble, which was the case in dot-com stocks when prices became divorced from investment fundamentals. The media also may propagate theories that rationalize the speculative bubble as the advent of a new economic era, where traditional valuations and business cycles no longer apply (Shiller 2005). Alternative investments have plenty of performance outliers that the financial media can vividly showcase. In 2007, the S&P 500 index returned 5.5 percent for the year, but more than several hedge funds reported gains five to 100 times that amount (Burton and Strasburg 2008). To those who see hedge funds as the path to overnight riches, such news is further impetus to chase past performance and ignore fundamentals. Even complete transparency couldn’t help an investor who believes the hype that the manifold gains of an alternative investment can be sustained indefinitely, with little to no risk, irrespective of the economy and exogenous events.
Past Performance Eventually Disappoints

To the chagrin of even sophisticated investors, the future performance of many investments can differ wildly from their expectations (Corkery 2011). There are behavioral and valuation rationales for why hot performance can’t persist indefinitely.

Behavioral studies have documented how chasing hot performance can damage investment results in two ways. First, on average, investments chosen because they outperformed in the past eventually underperform the market in the future. Second, investments ignored because of past underperformance outperform in the future (Baden 2011). There is a sensible explanation to these apparently perverse findings. Many investment strategies seek to capitalize on market sentiment, credit spreads, interest rates, and corporate earnings, which are all cyclical in nature. However, investors who chase performance overlook this. They overreact to peaks and troughs and ignore mean reversion in market cycles.

Alternatively, from a valuation perspective, investors who prefer investments that outperformed in the past typically underestimate the risk of owning them in the future. As a corollary, investors who shun investments with past underperformance then go on to overestimate the associated risk of owning these same investments in the future. As an example, Robert Shiller of Yale University created a time series of U.S. equity risk premia that span a century. These data show that the equity risk premium for the U.S. stock market is negative in periods when equity investors are euphoric and performance is strong, as they were in the dot-com bubble and the roaring twenties. This is because when the equity risk premium is negative, euphoric investors are in effect paying to bear investment risk. When U.S. stock investors grew overly pessimistic after World War I and performance was weak, the equity risk premium rose as high as 15.8 percent (Voss 2011).

Investors are not the only ones screening for outlier performance. In its search for insider trading and Ponzi schemes, the Securities and Exchange Commission (SEC) recently disclosed that it is screening investment manager returns for outlier performance (Eaglesham and Eder 2011). Such screens have netted results. Since 2009, the U.S. government’s investigations into insider trading have implicated some very high-profile funds; as of early 2012, 63 cases had resulted in 56 guilty pleas or convictions (Strasburg et al. 2012). Not all top performers are frauds or criminals, but financial criminals and frauds do generate outlier performance. The most cautionary point here is that even some due-diligence veterans have unwittingly invested in Ponzi and insider trading schemes.

Prioritize Risk Management

How does one improve the process of selecting alternative investments and safeguard wealth from the dangers described above? First, the investment paradigm must shift from chasing short-term performance to prioritizing risk management. Additionally, the investor’s investment objectives should refocus at the portfolio level, not the security level. Those who harp on short-term performance screen out alternative investments that can play a key role in portfolio efficiency and capital preservation. Thus, investors first should understand where the biggest sources of risk are in the portfolio, then determine which alternative investments best diversify those risks. As an illustration, consider that many U.S. investors consider stocks a core asset. As of November 2011, Investment Company Institute (ICI) reported that mutual fund investors held $5.3 trillion in stock funds and a combined $2.8 trillion in taxable and municipal bond funds. Hence, the portfolio betas to the stock market for these investors are much greater than zero. By some estimates, portfolio betas can even be as high as 4 for ultra-high-net-worth individuals. With that high a beta, many investors who get rich do not stay rich (Frank 2011). Therefore, such investors might consider alternative investments that have volatilities less than that of the equity market. We use volatility for our illustration because it is used conventionally, widely known, and supported by modern portfolio theory; investors, however, can substitute other measures that better quantify their ideas of risk. Also, we are measuring risk relative to the asset portfolio; investors, however, may prefer to measure risk relative to their biggest liabilities.

Additionally, for our illustration, computing the correlation (technically, the Pearson Product Moment Correlation Coefficient or $r$) of an alternative investment to the equity market should highlight any strategy that is likely to be diversifying if included in the portfolio. Those investments showing high correlation will have swings synchronized with the equity market. Therefore, the investor with a high beta portfolio should avoid alternative investments with high correlation and high volatility relative to the equity market. Instead, this investor should consider investments with relatively low volatility and low correlation values.

To complete our illustration, we assume an investor is considering alternative investments as diversifiers to stocks, being cautious on cash and bonds lest low yields make these vulnerable to any upside surprise in inflation. We also assume the S&P 500 is a good proxy for the equity market. Using Hedge Fund Research indexes (HFRX), we compute and plot volatility and correlation values for some major alternative strategies, using monthly returns from December 31, 2004, to December 31, 2007 (see figure 1). December 31, 2007, is the start of a recession in the United States (NBER 2008). The cumulative returns for these same indexes for this same period appear in figure 2.

© 2012 Investment Management Consultants Association. Reprint with permission only.
From figure 2, we see that the HFRX Total Emerging Markets Index generated more than 51 percent, the highest cumulative percentage return of any strategy. So in our illustration, our investor, if applying the representativeness heuristic, would sell S&P 500 exposure and direct the proceeds into emerging market hedge funds, although the latter has comparable volatility and a fair amount of correlation to the S&P 500 (see figure 1). Our investor would have screened out altogether equity market-neutral strategies, which returned the least. However, these actions would prove to be mistakes as the returns in the subsequent calendar year of 2008 show (see figure 3).

From figure 1, we see that equity market-neutral strategies appear at the bottom left of the chart, because these strategies have both the lowest volatility and lowest correlation values relative to the S&P 500. With only 2-percent correlation and 3-percent volatility, equity market neutral might be the best diversifier for equity exposure and should not have been automatically excluded. From figure 3, we see that much more capital would have been preserved using equity market-neutral and not emerging market strategies. This example illustrates our point: Chasing the past performance of alternative investments can cause investors to overlook great diversifying strategies and realize worse performance, especially at economic inflection points.

**Demand Good Transparency**

If the past is not always a prologue for alternative investments, then investors should see themselves choosing among investment processes, not investment outcomes. Investors should strive to understand which key factors drive performance. To do this, investors should insist on a good level of transparency. Transparency means a lot more than getting real-time performance updates. Transparency is information availability
as well as how investors process that information to better understand evolving risks. We give a few examples of what can be inferred with good transparency.

Good transparency means information is available to the extent that investors can understand how specific risks are generating the observed performance. For example, suppose one hedge fund is concentrated in a few big positions but is unlevered. Another hedge fund has a diversified portfolio but is levered. Both have the same performance. Without position-level data, an investor who knows only the different leverage ratios might choose the concentrated fund because it is unlevered, though it may be the riskier of the two. Position data also permit investors to identify how a manager’s thesis is executed in the portfolio and, when positions don’t match performance, flag potential frauds.

Good transparency will allow investors to judge if a manager is drifting from his core competency in order to keep up performance. For example, suppose a manager’s track record was based on successfully finding credit arbitrage opportunities, but he now holds positions in thinly traded futures, making big directional bets on commodity prices and taking significant liquidity risk.

Good transparency will let the investor gauge if binary outcomes and tail risks are likely. Absent this transparency, investors might assume returns are normally distributed and underestimate the frequency or extent of big losses. For example, selling credit default swap contracts in a bull market can generate very good risk-adjusted returns, but in a bear market the likelihood of large losses increases. Making a concentrated bet in a distressed company’s stock based on expectations of a regulatory approval of products or subsidies is another example of a trade with a nonnormal or bimodal distribution.

Assess Sustainability of Performance

Finally, investors should assess rather than assume the sustainability of past performance. When analyzing past performance, investors must be aware that some alternative investments may never again replicate past success due to evolving competitive or regulatory landscapes. Regulatory flux can impact a wide range of alternative investments. For example, a credit hedge fund manager could have generated outsized gains in 2007 by betting against the subprime housing market using highly customized over-the-counter (OTC) derivatives. However, any regulation requiring broker–dealers to act as fiduciaries might preclude some of these OTC trades if a counterparty can’t be located (Ackerman 2011). Macro-trading and commodity-trading-advisor-related alternative investments that outperformed by significantly leveraging commodity bets may be impacted by new regulation limiting the position sizes for as many as 25 different commodities (Meyer 2011). Based on recent insider trading cases, Massachusetts became the first state to announce plans to regulate the widespread use of expert networks and restrict the flow of information to equity hedge funds (Stein 2011). Late-trading of mutual funds was an exceptionally lucrative strategy that the SEC eventually deemed a violation of federal securities law (Labaton 2003). However, an investor at the time of that ruling would have had to discount the track record of multi-strategy or multi-manager funds invested in late-trading strategies.

As money continues to flow into alternative investments, competition necessarily increases. When this occurs, an investor should understand that the sustainability of past performance can be impaired. For example, a hedge fund with super-fast computers could engage in “flash trading.” It might discover a motivated seller before slower market participants do. That same hedge fund could purchase the shares first in spite of having a less competitive bid, and then turn around and cash out against the slower traders and earn a spread. Hedge funds that were early adopters of this strategy likely enjoyed handsome trading profits. As other hedge funds mimic the strategy, however, super-fast computers can end up trading against other super-fast computers, and profits fall to fractions of a penny as the slow-moving human trader plays a small and diminishing role in average daily volume (Bookstaber 2009).

Conclusion

Because of fluid mandates and the ability to lever and short sell, alternative investments can have significantly higher returns than traditional investments, but investors should resist the temptation to chase performance and focus instead on risk management, understanding how performance is generated, and assessing the potential for sustainable performance. An investor who does this will have a better process for selecting alternative investments. Specifically, such an investor will be able to screen out financial frauds, better navigate financial cycles, survive exogenous shocks, and achieve better risk-return efficiency than investors who emotionally pursue past performance.

Nathan Lee, CFA® is the lead portfolio manager at HAGIN Investment Management. He earned an AB in cell biology from Cornell University and an MBA in finance with distinction and an MS in statistics, both from New York University. Contact him at nlee@haginim.com.

Kyle Cox, CFA® is an associate portfolio manager at HAGIN Investment Management. He earned a BA in economics from Trinity College. Contact him at kcox@haginim.com.

Patrick R. Morris is chief executive officer at HAGIN Investment Management. He earned a BA from Syracuse University and an MS


References


