

Is There an Alternative to Alternatives?

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Abstract

Hedge funds have become common place in the investment management businesses and have become a staple in institutional portfolios. The attraction of these alternative investments has been the “equity like” return profile with more “bond like” volatility. While the return pattern is attractive, there are negatives that come along with these types of investments: illiquidity, high fees, opacity, etc. During times of elevated returns, these negatives are easy to overlook; however, periods of low returns and high volatility accentuate the negatives and bring one question to the light: Can investors achieve the same type of return pattern without the negatives? This analysis will attempt to answer this question and hopefully provide an alternative to hedge funds.

Hedge funds are nothing new; in fact today’s hedge fund structure was first utilized by A.W. Jones in 1949. Jones and three other partners formed a partnership with \$100 thousand. They began investing in stocks, utilizing both short positions and leverage to produce outsized returns (Rappeport, 2007). Although using leverage and short selling were nothing new to financial markets, Jones inserted a unique feature in the partnership in order to align his interests with his partners, an incentive fee of 20 percent of the profits. Jones was quite successful, and so successful in fact that others began to mimic his structure and strategy. By the late sixties, the Securities and Exchange Commission (SEC) estimated that approximately 140 hedge funds existed (Rappeport, 2007). Due to the difficulty in short selling in a market that has a long-term upward trend, many hedge fund managers struggled and not much was made of these investment vehicles. In the 1980s and 1990s, larger than life characters such, as George Soros and Julian Robertson, who gained celebrity by generating outsized profits and attracting large pools of investor capital.

At the time of the “dot com” crash, hedge funds were beginning to make their way into institutional portfolios. As advertised, they were able to effectively protect capital during the stock market downturn from 2000 to 2003. The global stock market (as measured by MSCI All Country World Index) lost 46.3 percent from peak-to-trough, while hedge fund managers (as measured by the HFRI Fund Weighted Index) only lost 2.1 percent. This significant outperformance was followed by record amounts of capital inflows into hedge funds, as well as, record numbers of hedge funds being created. Over the next several years, an occasional hedge fund mishap (i.e. Bayou, Amaranth, etc.) was overlooked by investors because the risk was worth the compensation, especially when compared to equity returns.

Insert the “Great Recession” and hedge funds went headlong into their first true test. While they were able to protect capital during the drawdown (losing 21.4 percent versus 54.6 percent peak-to-trough for global equities) many investors did not anticipate the absolute level of the loss. Most assumed that hedge funds would be able to break-even or lose less than 10 percent. Few thought the drawdown would be over 20 percent. This brought to light negatives. Investors seeking a return of their capital either because of fear or needing

to rebalance their portfolios found themselves unable to access their money due to gate provisions (contractual provisions that state hedge funds have the ability to not liquidate investments during times of crisis in order to protect capital and the other investors). This low return environment also caused investors to focus on the true cost of these vehicles. For example, an investor can justify over 500¹ basis points in fees if the net return is over 20 percent; however, when returns are below 10 percent this level of fee becomes much more difficult to swallow. Opacity also became an issue during the downturn, as counterparties (i.e. Lehman, AIG, etc.) were beginning to falter and investors wanted to know their true exposure. Fraudulent cases in the news, i.e. Madoff, was another contributor to concerns over opacity, as investors became nervous over their portfolios and hedge fund's reluctance to openly discuss positions became increasingly troublesome.

While historical returns for hedge funds have been exceptional when compared to equities (i.e. higher returns with lower volatility), the negatives of illiquidity, opacity, and high fees have become increasingly high hurdles for investors to rationalize. Investors today want to have exposure to this return pattern without having the negatives attached. This analysis will examine alternatives that will allow investors to have similar returns of hedge funds without suffering from illiquidity, opacity, or high expenses.

Historical Performance of Hedge Funds

Most investors invest in hedge funds in order to achieve a higher risk adjusted return relative to equities as well as to gain access to the some of the best and the brightest investment managers. **Table 1** summarizes the historical performance and various statistics for hedge funds (HFRI Fund Weighted), funds of hedge funds (HFRI Fund of Funds), and global stocks (MSCI All Country World). Over the life of the HFRI composites, hedge funds have been able to offer their investors advantages over global equities via: higher annualized returns, lower volatility, higher Sharpe ratios, lower correlations, and less down market participation.

¹ Estimation based on 2.0 percent in management and 20 percent of the performance with a zero percent hurdle. The estimation was calculated using annual returns and "high water" marks from 1990 to 2010. The average fee was 5.2 percent per year (2.0 percent in management fees and 3.2 percent in performance fees).

Table 1: Hedge Fund versus Global Stocks

| | Annualized | | Sharpe Ratio | vs. MSCI ACWI | | | Market Capture | |
|---|------------|------------|-----------------|---------------|------|-------------|----------------|-------|
| | Return | Volatility | | Alpha | Beta | Correlation | Up | Down |
| <i>January 1990 to June 2011</i> | | | | | | | | |
| HFRI Fund Weighted | 11.8% | 7.0% | 1.1 | 8.9% | 0.3 | 75.4% | 56.5% | 15.7% |
| HFRI Fund of Funds | 7.9% | 5.9% | 0.7 | 6.1% | 0.2 | 56.8% | 37.3% | 9.3% |
| MSCI All Country World | 6.6% | 15.7% | 0.2 | NA | NA | NA | NA | NA |
| <i>January 1990 to December 2000</i> | | | | | | | | |
| HFRI Fund Weighted | 17.0% | 7.3% | 1.5 | 12.7% | 0.3 | 66.0% | 66.3% | 2.5% |
| HFRI Fund of Funds | 11.8% | 6.2% | 1.0 | 9.5% | 0.2 | 4.3% | 43.4% | -4.1% |
| MSCI All Country World | 9.1% | 14.2% | 0.3 | NA | NA | NA | NA | NA |
| <i>January 2001 to June 2011</i> | | | | | | | | |
| HFRI Fund Weighted | 6.7% | 6.3% | 0.7 | 4.9% | 0.3 | 88.4% | 46.5% | 25.9% |
| HFRI Fund of Funds | 3.2% | 5.2% | 0.3 | 2.8% | 0.2 | 73.8% | 31.2% | 19.8% |
| MSCI All Country World | 4.0% | 17.2% | 0.2 | NA | NA | NA | NA | NA |

Sources: HFRI; MSCI

The return trade-off versus global stocks seems to be an easy decision due to the level of annual outperformance; however, there are two distinct periods of performance for hedge funds: 1990 through 2000 and 2001 to present. The former period is characterized by extreme levels of alpha generation and high levels of risk-adjusted returns. The latter is still a period of outperformance, but the alpha is a fraction of the early period and the risk-adjusted returns are cut in half. Looking into the history of hedge funds offers an explanation of why this occurs.

Prior to 2001, hedge funds were a growing industry with an average of 325 net new funds opening each year, and approximately \$297.7 billion in net capital in-flows (Hedge Fund Research, 2009). The bust of the “dot com” bubble and subsequent recession changed the hedge fund industry. Many investors who had suffered greatly during the severe drawdown began to allocate to hedge funds in hopes of significantly improving their downside risk characteristics. The impact on the industry was significant, as average annual net new fund creation jumped to 889 from 2001 to 2007 (Hedge Fund Research, 2009). Net new assets also significantly increased during this time, as \$658.1 billion flowed into hedge funds (Hedge Fund Research, 2009).

The growth in the number of funds as well as in the size assets managed by hedge fund managers has made it difficult to achieve the level of outperformance generated during the early years (1990 through 2000). While the alpha and risk-adjusted returns have come down, it remains positive and beneficial to investors who can tolerate the negatives associated with the investment structure. For those not willing to accept the negatives, it seems that there might be a reasonable chance to achieve similar results with other vehicles. The following sections will examine some possible alternatives to hedge funds and test whether the post 2000 track record can be replicated without the negatives.

Basic Hedge Fund Replication Strategy

There have been attempts to create passive hedge fund replication portfolios, mainly focused on utilizing derivative investments to replicate the exposures of hedge funds, thus producing

a market return of hedge fund investments. Most of these types of hedge fund replication strategies are new and their methods for evaluating the exposures are backward looking; therefore, the future performance could significantly deviate from the intended replication, thus making this option less desirable.

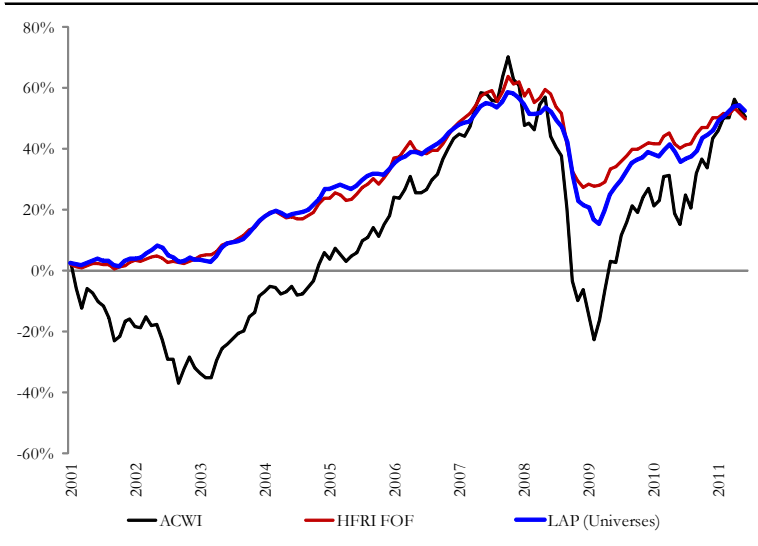
Highland believes that the exposure desired by investors is not necessarily the market exposure, but the value added by superior investment professionals. The main reason hedge funds have been successful has been the performance of talented managers who have enjoyed broad investment guidelines which enable them to tactically deploy their assets as well as to utilize tools that others do not access (i.e. short selling, derivatives, leverage, etc.). In order to reduce investor concern over liquidity, many managers have begun to offer hedge fund strategies in publicly traded mutual funds (i.e. long/short equity, managed futures, distressed securities, arbitrage, etc.). Highland believes that allocating assets to mutual fund managers who have the ability to tactically trade and have access to the same tools as hedge funds should allow investors to replicate hedge fund returns without the three major short-falls (i.e. illiquidity, opacity, and higher fees).

In order to test our theory, a simple asset allocation of 33 percent to global allocation managers and 67 percent alternative strategy managers was created². This allocation is based on Highland's view that hedge funds can be divided into three main types of strategies: (1) directional long/short equity (represented by long/short equity mutual funds); (2) absolute return (represented by equity market neutral mutual funds); and (3) global macro (represented by global tactical asset allocation mutual funds). Due to previous studies performed by Highland, we have determined that equity market neutral funds do not add significant value to a portfolio; therefore, the third that would normally be invested in this strategy was moved to directional long/short equity.

In order to eliminate manager selection bias, we used the Morningstar category average monthly returns for world allocation and long/short equity. This produces a portfolio that equally weights each individual manager in each category, thus exposing the replication strategy to every manager followed by Morningstar. The cumulative returns since 2001 for the Liquid Alternative Program (LAP) are compared to funds of hedge funds (HFRI FOF) and global stocks (ACWI) in **Figure 1**. The result is a portfolio that tracks fairly closely to fund of hedge funds and a cumulative return that is similar to global equities with substantially less volatility.

² This portfolio was rebalanced back to its targets on a monthly basis.

Figure 1: Cumulative Returns Since 2001

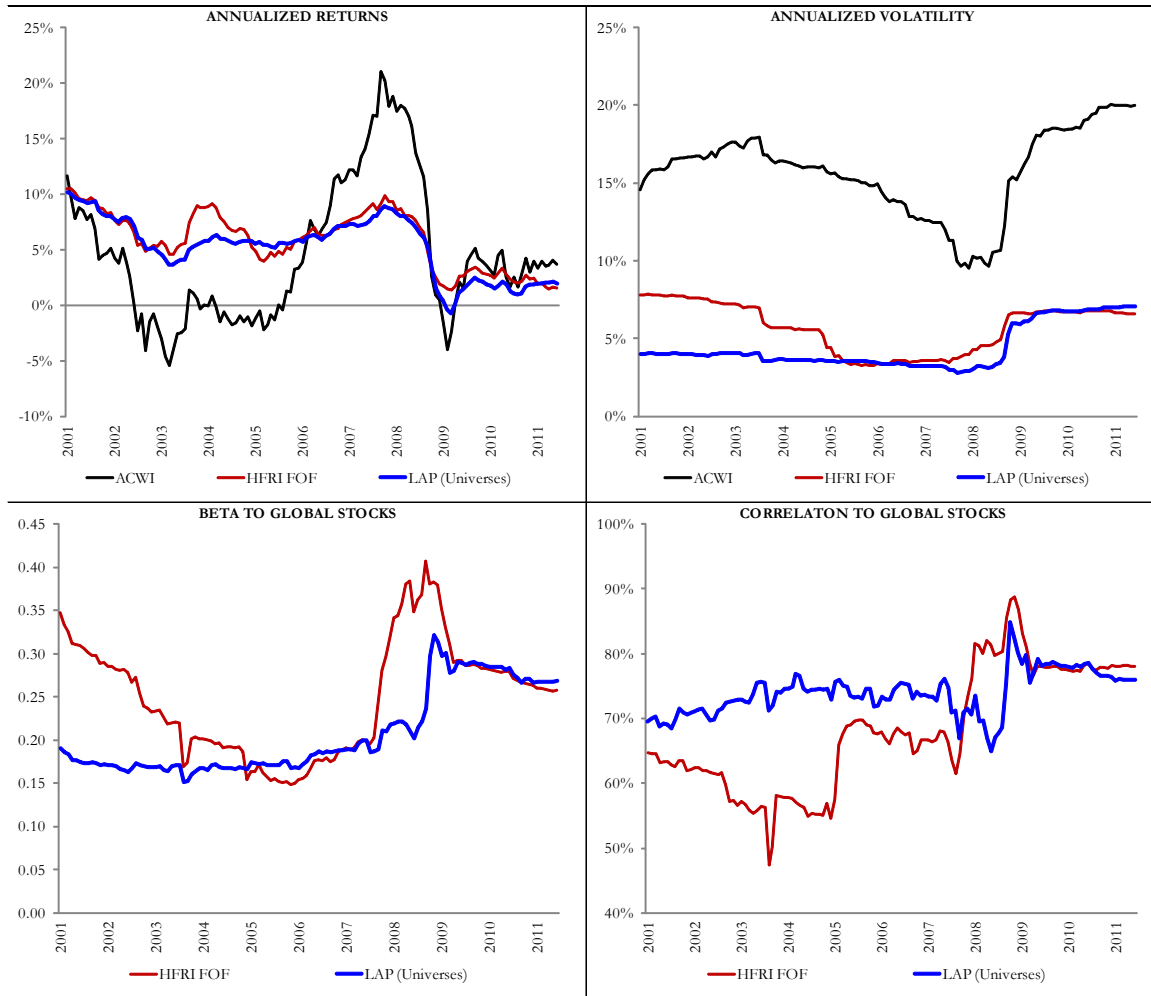


Sources: Morningstar; MSCI; HFRI

Figure 2 illustrates how LAP compared, on a statistical basis, to fund of hedge funds over rolling five-year periods. The portfolio was able to closely mimic fund of hedge funds returns and exposures (i.e. beta, correlation, volatility, etc.); thus showing that asset allocation to managers with broad mandates and access to the proper tools can produce a return pattern with similar results as funds of hedge funds³. Due to the mutual fund structure, LAP does not have the main negatives (illiquidity, opacity, and high fees) that the hedge fund structure often times have.

³ The LAP portfolio was statistically tested utilizing a regression analysis and tested as statistically significant.

Figure 2: Statistical Analysis
Rolling Five-Year Periods



Sources: Morningstar, MSCI, HFRI

Replicating a return stream that mimics fund of hedge funds can be beneficial to investors; however, replicating the returns of the underlying hedge fund themselves would be even more beneficial due to the higher levels of alpha and the elimination of the fund of hedge funds fee. The next section will examine some changes that can be implemented to the basic model that could put investors in position to replicate the return stream of the underlying hedge funds.

Advanced Hedge Fund Replication Strategy

The previous section illustrated that funds of hedge funds returns can be replicated by investing in mutual funds (broad universes) that are tactical and have the ability to utilize similar tools as hedge funds. The next step is to add some basic screens to separate the better managers and produce returns that mimic the HFRI Fund Weighted Index. The first step is to narrow down the large numbers of funds in the world allocation universe to a more manageable number. Highland has used these managers for several years; therefore,

this portion of the portfolio utilizes our internal manager selection process and represents managers that our firm knows well.

The process for sizing down the alternative mutual fund universe was different because these types of mutual funds have not completed our manager due diligence process; therefore, we have not formally approved any of these strategies with our internal investment committee. A basic screen⁴ of the Morningstar alternative universe was performed and the results were a manageable number of funds (although in practice Highland would continue to reduce the number managers included as managers would be eliminated as they moved through our due diligence process). The overall allocation was also altered to an equal weighted portfolio to tactical managers and alternative mutual funds.

Figure 3 graphs the cumulative return of LAP from 2001 to 2011 and compares the results with global equities and hedge funds. Highland’s replicated strategy had a similar return pattern and outperformed both hedge funds and global equities.

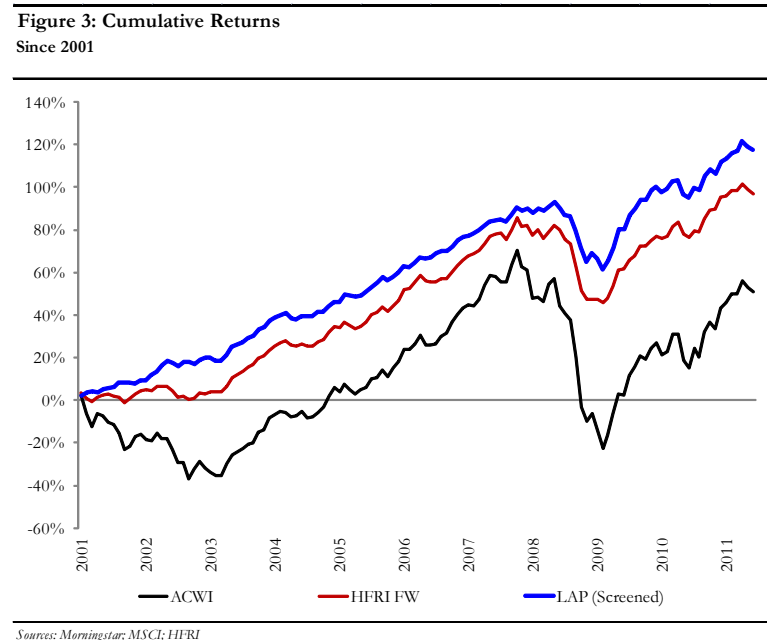


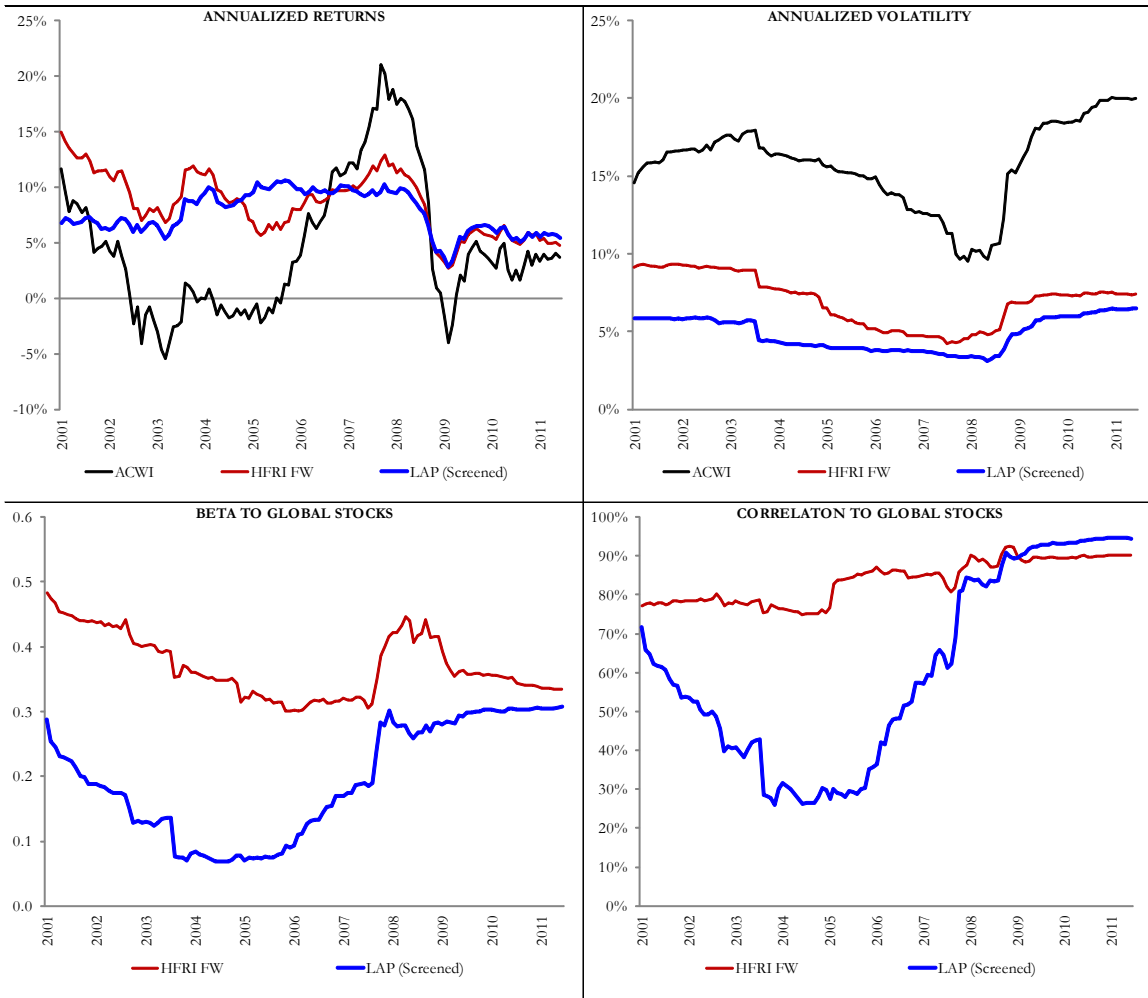
Figure 4 summarizes how LAP performed over rolling five-year periods. The return pattern (top left graph) is consistent with hedge fund returns⁵. This performance was achieved with lower volatility (top right graph) and beta (bottom left graph) to the global stock market. Just as before, this return pattern is achieved via liquid mutual funds that offer full transparency to underlying holdings and lower fees than hedge funds⁶.

⁴ The basic screen that was performed is similar in nature to ones performed by Highland during the initial phases of our internal manager due diligence process. Some of the characteristics used to filter the universe were: (1) assets under management; (2) type of strategy (e.g. fixed income strategies were excluded due to the leverage and illiquidity, commodity strategies were excluded, etc.); and (3) a minimum three year track record.

⁵ The LAP portfolio was statistically tested utilizing a regression analysis and tested as statistically significant.

⁶ The aggregated net fees for the hypothetical portfolio are approximately 1.5 percent. This net expense ratio is calculated by weighted average of all the underlying manager’s net fees stated in their respective prospectus.

Figure 4: Statistical Analysis
Rolling Five-Year Periods



Sources: Morningstar, MSCI, HFRI

Conclusion

The return characteristics that hedge funds offer are extremely attractive for an investor’s portfolio, as they offer equity like returns with a much lower statistical risk (volatility, max drawdown, correlation to stocks, etc.) profile. These positives are unfortunately coupled with several non-statistical drawbacks: (1) illiquidity, which is often overlooked and ignored until it is needed; (2) opacity; and (3) higher fees than traditional investments. The ability to participate in the returns of hedge funds without being exposed to the major negatives could be very valuable to investors; therefore, this analysis examined how investors might replicate these return patterns using mutual fund managers.

The first test was to determine if a basic asset allocation model could provide the results. The analysis concluded that a basic asset allocation was able to produce returns in line with funds of hedge funds. This basic model, however, was not able to replicate the return pattern of the underlying hedge funds. This basic model invested in the entire Morningstar World Allocation and Long/Short universes. As a result, manager selection was completely

taken out of the equation thereby reducing the ability to data mine results. Highland's research of managers has concluded⁷ that manager selection, especially in skilled based strategies such as tactical asset allocation and alternative strategies is extremely important. Effective manager selection can make the difference between sub-par and excellent results.

A second analysis was performed that took the basic model and modified it by replacing the Morningstar World Allocation universe with the managers that have been subjected to the manager selection process utilized by Highland's advisory business. Next, the Morningstar Long/Short universe was replaced by managers that passed some of our firm's basic mutual fund screens. This resulted in a list of managers who have an established track record, a sustainable level of assets under management, and who invest in the common and conservative alternative strategies. These few changes resulted in a portfolio of mutual fund managers who were able to display a return pattern that was consistent with underlying hedge funds.

Based on these results, Highland believes that investors can have the best of both worlds by achieving a hedge fund return without illiquidity, opacity, or high fees. All of the analysis was based on simple asset allocation models and mutual fund manager screens, which was done to illustrate in an unbiased manner that hedge fund returns can be replicated. In practice, a more in-depth manager selection process is needed (similar to the one employed for the tactical managers) in combination with dynamic asset allocation process that utilizes a proactive view on capital market valuation is needed to produce the returns desired by investors.

⁷ Highland has performed thousands of manager searches since the firm's inception in 1987.

References

Hedge Fund Research. (2009). *HFR Global Hedge Fund Industry Report*. Chicago: Hedge Fund Research.

Rappeport, A. (2007, March 27). *A Short History of Hedge Funds*. Retrieved August 11, 2011, from CFO.com: <http://www.cfo.com/article.cfm/8914091>

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