

Beginner's Guide to Hedge Funds and Other Alternative Investments

by: Kelly Hollingsworth | August 2003

The dismal performance of the U.S. stock market in the last few years makes now an especially good time to learn about and consider alternative investments for a portion of your portfolio. This article does much more than merely define the term “alternative investment.” It gives traders and investors a whole realm of guidelines in making choices for managers. Further, it puts forth red flags and, conversely, things about which there’s no need for worry.

So, What Is an Alternative Investment?

Although participants in the alternative investments industry might argue over the nuances of an exact definition, the term “alternative investment” generally refers to any investment in which successful performance does not depend on continued upward movement in the stock market. In uncertain times, alternative investments, if understood and handled properly, can make a big difference in the performance of an investor’s overall portfolio.

Some people describe alternative investments as “absolute return” strategies. In essence, that means investment strategies that should perform well each year whether the stock market goes up, down or sideways. That’s not to say that alternative investments always make money—clearly they don’t, because they must assume risk in order to generate a return. However, a continued decline in the stock market should not present a material risk for a true alternative investment strategy.

If you’ve dabbled in futures, options or shorting stocks, you’ve likely participated in an alternative strategy. If your experience was like most, you probably suspect this sort of thing is best left to the experts. Alternative investment managers (such as hedge fund managers and commodity trading advisors) are people who will manage your assets pursuant to an alternative strategy. Some investment managers are experts and some are not, and it can take years to learn to tell the difference. However, keeping an eye out for the following red flags is a good place to start:

Watch out for correlation to the stock market (this correlation is known as beta). If a manager is up when the stock market is up and down when the stock market is down, the strategy is not alternative and will not provide you with diversification from the traditional investments in your portfolio.

Avoid managers who generate volatile performance. Volatile managers may generate positive returns each calendar year, but within the year they show big positive months

and big losing months. If you invest with a volatile manager shortly before a large losing or “drawdown” period, it might take the manager months or years to recover the loss and generate a profit for you—if it happens at all. Better managers generate smooth returns over time, never making or losing much in any one month. With these managers, you should not have to worry about the timing of your investment. Look closely at the manager’s historical returns—if the largest drawdown (on a percentage basis) is more than half the manager’s average annual return, the “risk of ruin” for that manager is probably too high.

Be mindful of returns that are very high. All other things being equal, big returns generally mean big risk. Risk is not necessarily a bad thing. However, you should understand where a manager’s risk lies and how it can hurt you before you proceed with an aggressive strategy. It’s obviously better to invest with a manager who gives you 20 percent year after year than to invest with someone who gives you 50 percent in the first year and loses everything in the second.

Pay attention to the form of compensation the manager receives from you. Good fund managers rely on incentive fees (a percentage of profits) as their main form of compensation, which means they make the bulk of their money only if they perform well for you. They typically also charge a small asset-based “management” fee. Industry standard compensation is generally a one- to two-percent management fee and 20-percent incentive fee. Managers who charge lower management fees may charge higher incentive fees and vice versa. Exceptional managers receive incentive fees as high as 50-percent.

Please! Make sure you request and receive a detailed, written description of the fees the manager will charge you before you place assets with him or her. The shorthand way to discuss fees is to quote the management fee first and incentive fee second. For example, 2/20 means a two-percent management fee and a 20-percent incentive fee; 0/50 means no management fee and a 50-percent incentive fee.

Consider the manager’s track record carefully. It should be long enough to give some assurance that the manager can duplicate the performance and also that he can trade well in the current environment. Lower returns in the most recent part of a track record could indicate that the current environment is not good for the manager. Find out what caused any such deterioration in returns, and get an assessment from the manager (and others) about whether those kinds of conditions are likely to continue. Also, watch for deviation in strategy. Good managers continually will tweak their strategies to address changing market conditions, optimize performance and reduce risk. Inexperienced managers will deviate from strategy entirely, which often causes significant losses.

Separate Accounts vs. Pooled Investment Vehicles

Once you find a good manager, consider the different ways in which you can access his or her talent. Generally, this means choosing between a managed account, also called a separate account, or a pooled investment vehicle in which your money is commingled or pooled with other investors’ money – such as a hedge fund, private investment fund or

commodity pool. This article refers to all forms of these pooled vehicles as “Funds.” If you have a choice between these two options (some managers may offer one but not the other), consider the following features before you make your decision:

Liquidity: This refers to your ability to liquidate or withdraw your investment from the manager. A separate account is much more liquid than investment in a Fund, which may allow you to withdraw your assets only at the end of a calendar quarter or year and which may hold part or all of the money pending the completion of the Fund’s final accounting for that year. More liquidity generally is better than less. However, you may want to consider your willingness and ability to stay with the manager when evaluating the importance of liquidity. Many investors jump ship too early by withdrawing their money in the face of small losses, only to regret it later when the manager ultimately performs well.

Transparency: Transparency means your ability to see the trades or positions the manager makes on your behalf. If you have a separate account, you have 100-percent transparency because the brokerage firm holding your account will send you confirmations of each trade. Depending on the brokerage firm you select, you’ll likely also have online access to your account. Fund investors generally do not have transparency into the Fund’s underlying holdings unless they are very large investors who can negotiate transparency with the manager.

Transparency is a controversial topic. Portfolio transparency can enable you to determine if your manager has deviated from strategy, but it also can encourage you to inappropriately second-guess your manager. If you’re unable or unwilling to review or understand the portfolio holdings, transparency won’t be valuable to you at all.

Some investors won’t invest with a manager unless they have transparency. However, the better managers generally won’t give transparency because their trading methodology is very valuable and, therefore, highly confidential. Therefore, insistence on transparency could likely inhibit an investor’s access to the best and brightest managers.

Access to assets: If you open a separate account, only you and your brokerage firm have access to your money. If you invest in a Fund, the manager also has the ability to access your cash. If you invest in a Fund, you should find out what internal controls are in place to protect assets from theft or misuse. The Fund should be audited at least annually by an independent certified public accountant, and the Fund’s monthly or quarterly performance reports should be prepared by an independent third party, an accounting firm or an administrator, rather than the manager’s internal staff. Regulatory scrutiny also is a plus. Certain Funds are regulated by the Securities and Exchange Commission, Commodity Futures Trading Commission, National Futures Association or other regulatory body, and these provide at least some level of additional scrutiny over your money. Some Funds also implement additional safeguards over assets such as custodial or disbursement procedures agreements. While none of these protections are fail-safe, they do provide some level of protection from misappropriation of assets.

Limits on Liability: The big advantage Funds have over separate accounts is that they typically insulate your other assets from losses over and above the amount you invest. U.S.-based funds usually are organized as limited liability companies or limited partnerships. Investors in such entities are at risk only for the amount that they contribute and any undistributed profits. Because alternative managers generally use leverage, shorting strategies or trade futures or other inherently leveraged instruments, they can generate losses in excess of the cash invested. If the strategy is especially aggressive, this risk can be quite significant.

Minimum Investment: Separate accounts generally require higher minimum investments than Funds. In many cases, the minimum investment for a separate account is so high that they are only available to very large institutional investors.

Expense Load: Fund investors generally are subject to higher expenses (and therefore experience lower rates of return) than separate account investors because Funds are subject to significant legal, accounting, auditing and other expenses that are not applicable to separate accounts. On a percentage basis, these expenses can be quite high, especially if the Fund is small.

Diversification Considerations: What is a Fund-of-Funds?

In adding alternative investments to your portfolio, you should keep in mind that an investment with a single manager is, in all cases, a concentrated, not diversified, investment. Therefore, investing with a single manager – whether or not the manager is especially aggressive – is always an aggressive move. Although a single manager may direct your assets into many different positions (stocks, bonds, futures, etc.), the amount of money you have with a single manager is not diversified, because all of the positions are controlled by the manager. Because alternative strategies, by definition, are not buy-and-hold strategies, the fact that there may be numerous stocks or other instruments in your account at any given time does not constitute diversification. The manager will trade in and out of those positions frequently, so your return depends on the manager's trading skill rather than on the longer-term performance of the underlying instruments. Therefore, the number of underlying instruments does not provide much, if any, diversification protection.

Unless you have enough money to allocate to a number of different managers, you may want to consider investing in a Fund-of-Funds. These multi-manager funds, like other Funds, are collective investment vehicles typically organized as limited partnerships or limited liability companies. The assets in a Fund-of-Funds are allocated or exposed to a number of different managers, either through investment in other Funds or separate accounts, so the investors in a Fund-of-Funds enjoy instant diversification among numerous managers with a relatively small investment.

Some Funds-of-Funds are extremely diversified and allocate their assets to 100 or more managers. Some prefer to concentrate their investments among only a few managers. In general, a more diversified Fund-of-Funds will provide a smoother, less-volatile

performance than one that is concentrated. Certain Funds-of-Funds focus on a particular sector within the alternative investments industry (e.g., futures or fixed income), while others allocate across the broad industry. These Funds-of-Funds provide the closest approximation of an index-type investment available in alternative investments today.

Funds-of-Funds managers may have a great deal of experience in selecting and evaluating alternative investments. They typically employ one or more analysts to interview and monitor the managers and have a thorough initial and ongoing due diligence process. Therefore, Funds-of-Funds usually are better equipped to build and monitor an alternative investment portfolio than a do-it-yourself investor with other time commitments or less experience.

Fund-of-Funds enjoy advantages that frequently elude smaller investors. Like most large investors, Funds-of-Funds may be able to negotiate better fee arrangements than an individual investor could obtain on his own. They also may provide access to managers that an individual investor could not access on his own, either because the manager is not accepting new investors or because the manager's minimum investment is too high for individual investors. As industry insiders, Funds-of-Funds may enjoy access to information about managers that is too expensive or difficult for a smaller investor to obtain on his own.

In consideration for these advantages, Fund-of-Funds investors are subject to some additional costs, including the Fund-of-Funds' operating expenses (the accounting, auditing, legal and other expenses incurred in the organization and operation of the Fund-of-Funds) as well as the management and incentive fees charged by the Fund-of-Funds manager. These fees, which generally are not higher than 2/10 (two percent management fee and ten percent incentive fee) are in addition to the management and incentive fees charged by the underlying managers. A good Fund-of-Funds should generate a return that makes up for these additional costs.

How to Find Information about Alternative Investments

Information about alternative investments can be difficult to find because of the way they are regulated. Hedge funds, for example, generally are offered as private placements pursuant to exemptions from registration under federal securities laws. Because hedge funds are not registered, they cannot be offered to the public or advertised like a mutual fund or other registered security. However, you can find information about alternative investments and the performance of alternative managers by registering on a number of different web sites including www.tradersource.net.

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