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COURSE
82155A

Alternative Investments: Portfolio Integration and Hedge Fund Structures

Knowing how hedge funds fit into a broader portfolio, and how they're legally and operationally structured, is essential for anyone advising clients who hold or are considering these investments. This course covers how alternative investments can be allocated within a diversified portfolio and breaks down the common structural frameworks hedge funds use, including limited partnerships and offshore arrangements. It's practical knowledge for CPAs who need to understand what their clients are actually invested in.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the characteristics of various financial assets.
- Identify the role that limited partners play in hedge funds.

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Chapter 1: FITTING ALTERNATIVES INTO A PORTFOLIO

Chapter Objective

After completing this chapter, you should be able to:

- Recall the characteristics of various financial assets.

Alternative strategies are wildly different from each other. Because hedge funds are simply lightly regulated investment partnerships — and therefore can take advantage of more investment strategies than other highly regulated investment vehicles, such as mutual funds — different funds are bound to invest in different ways. Some managers design hedge funds to be different from other types of investments, and others don't.

Given the limits of the private partnership structure, like restrictions on withdrawals and high fees (see Chapter 2), an investment portfolio is rarely made up entirely of hedge funds. Some investors treat hedge funds as a separate asset class, and others treat them simply as a different forum to hold and manage existing assets.

So do hedge funds fall in a separate asset class or not? How do you fit alternative strategies into a portfolio? How do you use hedge funds to meet your investment objectives? You've come to the right place for answers. This chapter looks at how you can include hedge funds in your investment portfolio to increase your return for a given level of risk.

ASSAYING ASSET ALLOCATIONS

A *real asset* is a tangible piece of property that you can own: a factory, a house, a gold mine, and so on. A financial asset — also called a security — is a claim on a tangible asset: a piece of paper showing partial ownership of a factory, a loan to the factory owner or bond holder, rights to a share of the production of a mine, and so on.

Different assets have different sources of return and present different tradeoffs, and you want a balance of them in your portfolio. I summarize many types of financial assets in Table 11-1 (see Chapter 2 of course 82152B for more details on these assets).

TABLE 11-1 CHARACTERISTICS OF DIFFERENT FINANCIAL ASSETS

Financial Asset	Primary Source of Return	Relative Level of Return	Relative Level of Risk
Stocks (equities)	Capital gains/Dividends	High	High
Bonds (fixed income)	Income	Medium	Medium
Cash	None	Low	Low
Real estate	Income, store of value	Medium	Medium
Commodities	Store of value/Capital gains	Low	Low/High

The chapters of Part 2 cover the different types of hedge funds and hedge fund strategies to give you a sense of how they fall on this matrix. Different fund managers have their own techniques for managing risk and return that make the profiles of their funds different than you may think by looking at the holdings.

When choosing a hedge fund (whose manager chooses assets to invest in) to fit into your portfolio, you need to think about how it will act with the other investments in your fund. Will the fund help you reduce risk, increase return, or both? Will it help you reach your investment goals?

Matching goals to money

Asset allocation is the process of matching your investment goals to your money in order to meet your goals with the lowest possible amount of risk (see Chapter 2 of course 82156B, Chapter 3 of course 82156B for more about goals and the upcoming section "Diversification, risk, and return: How the asset pros and cons play out"). Do you need to generate $100,000 in pretax annual income from your investments? Are current interest rates at 4 percent? If so, you should put $4,000,000 in fixed-income securities with an average coupon (annual interest rate) of 4 percent. Do you need $10,000,000 in 20 years to meet a contractual obligation? Do you think that an 8 percent return is acceptable as long as you experience little variation between your expected return and the return that you get? If so, you should put $2.2 million in a hedge fund with an absolute return strategy (see the section "Absolute return funds" later in this chapter).

The exact amounts and investments you choose will vary with your means and your goals. The other chapters in Part 3 should help you think about what you need. Any professional advisors you work

with should take the time to find out what you need, too (see Chapter 2 of course 82157B for info on working with a consultant).

Warning

Beware of advisors who try to sell you products without finding out what your needs are. It's not only against regulations (a violation of the know-your-customer and suitability rules), but also bad for you.

Chasing return versus allocating assets

"I don't care what fund you put me in, as long as it performs well. How about this fund that was up 40 percent last year?" Whoa, cowboy! Unfortunately, that's a common strategy among investors, and it's a dangerous one. Known as *chasing return*, this strategy ignores long-term goals, near-term constraints, and good investing principles in hopes of landing the big bucks right now.

Return chasers are doomed to fail in the long run, and often in the short run, too. Markets move in cycles, so last year's hot performer will probably cool off this year. Moving your money around too much leads to plenty of taxes and commission charges that eat into your investment base. And without a sense of how much money you really need, when you need it, and with what degree of certainty you're operating, you risk choosing investments that miss your goals by a mile.

Technical Stuff

Mathematicians talk about *reversion to the mean*. In mathematical terms, it means that if you have a large set of numbers, the more that one number varies from the average, the more likely that the next number will be closer to the average.

Now look at it in investing terms. If mean performance for an asset is 10 percent per year, and the asset earns 50 percent this year, chances are good that next year's performance will not only be closer to 10 percent, but also negative so that the mean doesn't change. Investors who chase return usually suffer the negative effects of reversion to the mean.

Warning

Folks who chase return with alternative ETFs are especially likely to get crushed by inverse funds if they don't understand how they work. Inverse funds are designed to perform the opposite of a benchmark index. If the stock market declines in value, an inverse ETF will increase in value. That can be useful for risk management.

But if the market is wrapping up a down period, and you decide to move your money out of losing ETFs into the inverse fund that were the recent big winners, you'll end up with inverse performance when the market reverts to its general upward trend. Yikes!

USING HEDGE FUNDS AS AN ASSET CLASS

One of the biggest debates in the hedge fund world is whether hedge funds and other funds following alternative strategies represent a separate, new asset class, or whether they simply represent another vehicle to manage the traditional asset classes of stocks, bonds, and cash. The discussion affects the way that people make decisions about their money, some good and some bad.

Asset classes are distinctly different from each other, with unique risk-and-return profiles. For example, bonds are loans; the borrower makes regular interest payments and returns the principal at the end of the loan. Changes in interest rates and the ability of the borrower to make the payments affect the bond price. Stocks, on the other hand, are partial shares of ownership in a company. The company's profits and prospects affect the price of stocks.

I don't think that hedge funds deserve to be treated as a separate asset class, but many reasonable and smart people would disagree with me, so I take this section to look at the arguments in favor of hedge funds being in a separate asset class so that you can make the decision for yourself.

Remember

The other side of the argument is that hedge funds are managed uniquely, so they deserve to be thought of as unique assets — even though they're made up of other assets. The problem is that a portfolio may take on the wrong balance of risk and return because it views the hedge fund investment as an investment in a diversifying asset, when really the investment may intensify risks elsewhere in the portfolio. (See the section "Viewing a Hedge Fund as an Overlay" for more on this side of the argument.)

How hedge funds are assets

The argument for hedge funds representing a unique asset class is rooted in the fact that many hedge fund managers design their funds to post completely different risk-and-return profiles than

traditional asset classes. The big idea is that if you have an investment that you design to return, say, 6 percent to 8 percent every year (see Chapter 1 of course 82153B for more) — year in and year out, regardless of how interest rates fluctuate or how the economy shifts — you have an investment that's different from anything else out there. And if your risk-and-return profile is different, you should put it in a different asset class.

Of course, not all hedge fund managers design their funds to perform differently from the financial markets. Hedge funds generally fall into two categories:

- Absolute return funds
- Directional funds

Within these categories, funds generate their returns following a wide variety of alternative strategies.

The following sections cover the absolute return and directional categories in more detail so you can see how these two broad groupings of hedge funds have distinct risk and return tradeoffs, helping you narrow the choices for your portfolio. (See Chapter 1 of course 82151B for more on these two types of funds.)

Technical Stuff

Following the Modern (Markowitz) Portfolio Theory (MPT; see Chapter 1 of course 82153B), you sort out investment return by its source. Most of an investment's return comes from its exposure to the market. This exposure to the market is called beta. Some return may come from the investor's skill. Return from the investor's skill is called alpha. (By the way, many people argue that alpha doesn't exist, and that if it does exist, it is as likely to be negative as positive.)

Absolute return funds

The goal of an absolute return fund is to generate a reasonable percentage return each year, regardless of the state of the financial markets. Absolute return funds rarely aim to beat the equity indexes; they instead opt to have a positive return with relatively little risk. These funds are sometimes referred to as "bond-like investments," because a bond that the holder maintains to maturity generates a steady return from the interest, year in and year out.

Tip

Investment reports often list hedge funds as alternative investments or absolute return investments, not as hedge funds.

An absolute return fund has another moniker: a *pure alpha fund*. In theory, the fund manager tries to remove all market risk (in other words, beta risk) in order to create a fund that doesn't vary with market performance. If the manager removes all the market risk, the fund's performance comes entirely from the manager's skill, which in academic terms is called *alpha*.

Many financial types treat absolute return investments as a separate asset class, and many hedge fund managers and investors prefer to use the term "absolute return strategy" when they invest in hedge funds. The term "hedge funds" seems scary and scandal-ridden, they think, although this type of investment is something else entirely. Of course, much hedging of risk is required to get a steady, low-risk return (see Chapter 1 of course 82153B), so an absolute return hedge fund may be the purest example of the genre.

Technical Stuff

Although the exact definition of hedge fund is vague, the fund widely acknowledged as the original, run by Alfred Winslow Jones, was structured as an absolute return fund. It bought and sold stocks equally in order to have no market risk (see Chapter 1 of course 82151B).

An absolute return fund comes with its own set of problems; the following list outlines two problems with the strategy:

- Determining exactly how to generate a steady target return. Ideally, an absolute return fund will choose two or three strategies and move among them as market conditions change. With this tactic, the risk and return of the fund will stay steady even as the markets move, without the fund manager going in too many different directions. But what happens if the market enters a period where none of the strategies work? Should the hedge fund manager stick to his or her guns, or try something else to meet investor expectations — expectations that may not have been realistic in hindsight? Bernie Madoff's reported return was so steady that it seemed a veritable miracle. Turns out it was all a massive fraud.
- Investors may say that they'd be happy with an 8 percent return if they earn it consistently, but in reality, most investors will be unhappy if the Dow Jones Industrial Average goes up 25 percent and their hedge fund investments go up only 8 percent. What this means is that the fund manager may have an incentive to pursue strategies that will beat the market but that also change the risk profile of the fund to something that it wasn't designed to be. The manager may keep investors happy in the short run, but he or she is no longer operating the fund as one with a unique risk-and-return profile.

Remember

An investment return is a reward for taking risk. The greater the expected return of the investment, the greater the likelihood that the investment may return a different amount. As much as all investors would like tons of return with no risk, you can't entirely eliminate risk, but you can reduce it through diversification (see Chapter 1 of course 82153B, Chapter 1 of course 82154B for more).

Directional funds

Fund managers design *directional hedge funds* to return the maximum amount possible. These funds assume a lot of risk and are sometimes called *beta funds* because they maintain some level of market exposure. In fact, a directional fund manager may even increase market exposure through leverage — by borrowing money to take an even larger bet on the market than the amount of assets in the fund (see Chapter 1 of course 82154B for more on leverage). Because directional funds often have beta exposure, they're sometimes considered to have equity-like returns.

Warning

A directional fund's return may be disproportionately larger than its risk, but the risk is still there. These funds can also swing wildly, giving a big return some years and plummeting big in others. Longer-term investors may not mind as long as the upward trend is positive. It can be frustrating for the hedge fund manager, however, because he or she doesn't earn the performance fee when the fund loses money (see Chapter 3 of course 82151B, Chapter 2).

Technical Stuff

Many directional funds use alternative measures of alpha and beta, optimizing around a different benchmark than that of the market as a whole. For example, they might optimize around a commodities index or a currency basket. The relationship between risk and return is the same, but the base number is different.

Diversification, risk, and return: How the asset pros and cons play out

Does it matter if a hedge fund represents its own asset class or not? Yes, it does, and here's why: An investor should structure his or her investment portfolio to reflect the risk and return that he or she needs. If a hedge fund appears in its own asset class, other assets that the investor selects to offset the portfolio's risk and return characteristics need to appear in the portfolio. After all, some years stocks will be up, and some years bonds will be. A diversified portfolio has exposure to both stocks