Public Funds Versus Private Offerings

By Jim Little, Executive Vice President, Client Development, Campbell & Company, Inc.

A CTA’s decision as to whether to raise capital by directly sponsoring a public futures fund or a private offering can be somewhat complex. While successfully marketing a public fund can be quite gratifying, the decision to attempt such an undertaking can be fraught with potential pitfalls and requires substantial commitments.

This article discusses some of the advantages and disadvantages of both public and private funds to help potential sponsors make an informed decision.

Public Fund Advantages
1. Ability to solicit investors with whom you have no pre-existing relationship through advertisement:
   a. Mass mailings
   b. TV, Radio spots
   c. Magazines
   d. Seminars

Because only a limited number of non-accredited investors may purchase units in a private offering, most investors in a private offering must be accredited.

a. Because there is no limit as to the number of investors in a public offering, the sponsor can afford to lower the minimum investment size, thus broadening the market.

b. Also, because public funds are reviewed by the regulators, the minimum suitability requirements are typically much lower than those for private offerings, which also broadens the market. Because only a limited number of non-accredited investors may purchase units in a private offering, most investors in a private offering must be accredited.

continued on page 2
Modern Portfolio Theory and Its Applications to Hedge Funds: Part 1

By James Park, J.D., Ph.D., CEO, PARADIGM Global Advisors, LLC

Author's Note: This article is the first of a two-part series.

Lessons of Modern Portfolio Theory

Modern Portfolio Theory ("MPT") has given us some important concepts over the last 50 years. The first lesson of MPT is that markets are efficient and active stock pickers (i.e. mutual fund managers) cannot beat the market over the long run. And, this is before fees. Obviously, performance net of fees is even worse. This is one reason why active stock portfolio manager fees and expenses are less than 1%. If hedge fund managers are really capturing long only bull market type returns using leverage or concentration then a fee structure of 1%-2% per year plus 20% of the profits is extremely expensive. It is my opinion that at least half of all hedge fund managers including Soros and Robertson are really stock pickers. They make excess returns during good times and excess losses during bad times. In the end, the investor does not beat a passive buy and hold strategy. Stay away from stock pickers. They may be skillful, i.e. have some alpha, but the fee structure is too high. In fact, for the privilege of paying this fee structure all you end up getting is only higher volatility.

The second lesson of MPT is that diversification reduces portfolio risk by eliminating noncorrelating idiosyncratic risk but does not reduce return. I repeat diversification does not reduce the expected return of the portfolio. Compare two managers who pick 5 or 100 stocks each year. There will be times when the 5 stock manager greatly outperforms both the 100 stock manager and the stock index. Is this luck or skill? Luck, of course. MPT research has shown that over time, since markets are efficient (or to put it another way, random), the returns of both managers, over the long run, will be about the same and slightly below but close to the index. The 100 stock manager with the same long-term outcome as the 5 stock manager, however, will have far less volatility. In fact, the volatility of the 100 stock manager will be very close to the index. If any manager has a real ability to pick stocks, they would build large portfolios of stocks, diversifying the portfolio risk down to the index and then attempt to beat the index through superior stock selection. If there were a statistically large enough group of managers who could outperform the index over a long period of time, then asset allocators would do well to search for these managers. Unfortunately, there is no such evidence and more than half of all the money in the U.S. stock market passively tracks an equity index.

Why Hedge Funds are not Portfolio Managers

What does all this have to do with hedge funds? If hedge funds are like mutual funds, then they are already diversified and you need 4 or 5, maybe a dozen at the most. In fact, hedge fund managers are not portfolio managers. A portfolio manager by definition must hold a portfolio of assets. Real estate, gold, stocks and bonds (due to liquid secondary markets) are assets. A money manager who is long and short at the same time, however, does not hold a portfolio of assets because the asset base is canceling out. Being long Ford and short GM is not an asset. This is a position or a trade but clearly not an investment. Neither is being long a convertible bond and short the stock or long senior debt and short junior debt. We know why hedge fund managers do this. To extract a return by being right about Ford vs. GM and to avoid having any exposure to the overall market. A hedge fund manager positions the fund to exploit what he or she knows about the future relationship between two companies. They know that they do not have the ability to predict future market moves. Indeed, no one really does, so why try?

If hedge fund managers are not portfolio managers then what are they? Hedge fund managers are companies. Hedge fund managers, like companies, can potentially produce a profit all the time (thus, the expression "absolute return strategy") regardless of which way the markets move. Like businesses, results are based upon skill. These skill-based money managers are information-age companies that provide a service: real-time information processing. They proactively monitor, interpret and trade the constant flow of new information. They are the precise opposite of long only indexed managers or active stock pickers. In effect, rather than attempting to minimize deviations from a passive benchmark like the S&P 500, hedge fund managers seek to eliminate any market effect on their portfolio of long/short positions. They produce an alpha through security selection and combine it with a hedging strategy that eliminates the beta with anything long only. Therefore, their returns are completely skill based and unrelated to long only bench-

continued on page 11
marks and as such, traditional benchmarks for measuring or explaining performance will not do. This is also the reason why a 20% performance fee is well justified.

If hedge fund managers are companies then a portfolio of hedge fund managers is analogous to a portfolio of stocks. Stock portfolios have 50-100 stocks or more in them. An equity portfolio of 10-20 stocks is considered to be concentrated and almost all mutual fund managers have correctly rejected this. I studied the diversification effect of hedge funds in a paper published in the *Journal of Alternative Investments* in 1997. This study used a classic Monte Carlo methodology that was applied to stocks and found the same result. Hedge funds have a powerful diversification effect just as stocks do and the number of hedge funds in a portfolio should be 50-100 or more. The only cost of diversification is the cost of finding and monitoring this many hedge fund managers. This is easily overcome by the economies of scale of a large fund. One might say that no fund of funds could possibly monitor 100 hedge funds well. What kind of monitoring are we talking about? Did hedge fund investors with less then a dozen managers really know what LTCM or the Russian hedge funds were doing? Does a concentrated stock portfolio really give the manager the ability to more closely track Microsoft or Amazon.com? Of course, not.

**Three Ingredients of an MPT Approach to Hedge Funds**

An MPT approach to hedge funds has three ingredients:

1. a credible, realistic benchmark to determine the reward/risk profile of a passive investment in hedge funds,
2. a commitment to sufficiently diversify to achieve the benchmark reward/risk profile, and
3. a working manager selection strategy to achieve a greater return than the benchmark with the same or reduced level of risk, net of costs and fees. This last part is crucial. General Motors pension managers do not need an intermediating fund of funds for passive benchmark returns. But they will pay for an expertise or strategy that produces value net of the additional fees.

This first task of developing appropriate benchmarks for hedge funds to get an accurate picture of the true reward/risk profile of this new asset class has turned out to be much harder than most expected. Most databases suffer from at least four biases. Survivorship bias results from the lack of or the elimination of performance data of managers who have gone out of business. If managers go out of business as a result of poor performance, then an index constructed of only the surviving or currently existing managers will be severely biased upwards. After buying and collecting manager data since 1990, I have so far measured this bias to be 10% over 500 basis points.

Self-selection bias is evidenced by the consistently good performance of managers in the early part of their track record. Why is the first year or so almost always their best year, often by a great margin? Many have brushed away the issue by relating it to size and capacity. There is, however, no size effect evidenced in the early part of manager track records when the average size of the manager is well under $200 million. It turns out to be a luck effect. Unskilled or amateur traders, by definition, produce zero or negative value. The subset of the lucky ones among this group who made 400% trading technology stocks in 98 or 99, however, will become hedge fund managers. This self-selection creates an upward bias. A switching regressions methodology identifies the 14th month as a cut off and measures this bias to be over 200 basis points.

Catastrophe bias results from the phenomenon that managers who suddenly lose all of significantly all of their portfolio and go out of business do not report their ending performance numbers to the data vendors or the public. Estimates of this bias come to about 50 basis points per year. More seriously, however, is the fact that this problem occurs during particularly large information shocks such as the Russian default or the LTCM debacle. As a result, this bias is concentrated in certain areas and not spread over the entire index. The consequence of this is an index that will not reflect the full impact of bad performance during difficult times. In other words, this problem distorts the time series information content of the index.

The worst bias, by far, is the bull market bias. Good data for hedge funds exist only back to the early 90s. This coincides with one long bull market. By definition, hedge funds are non-correlated to the stock market. A Commodity Trading Advisors index, for example, has a zero correlation and zero beta with the S&P500. The equity related hedge fund index, however, suffers from a 0.4 beta and a 0.7 correlation with the S&P500. These are the stock pickers disguised as hedge fund managers that I mentioned above.

*continued on page 16*
Marketing Alternative Investments

continued from page 7

order to be held in client accounts at major Canadian investment dealers. And Canadian clients are generally averse to investing in funds or instruments that they cannot hold through their traditional investment accounts at these firms, and brokers are generally prohibited from recommending funds that cannot be so held. Therefore, unless a manager goes through the expense of both creating a fund and listing that fund on fundsource, they will have little success in attracting assets away from the accounts of major investment dealers. Furthermore, Canadian investment dealers and mutual fund companies are beginning to offer their own alternative investment products.

However, the distribution strength of major Canadian investment firms is also the greatest opportunity for alternative fund managers interested in marketing in Canada. Generally, these firms possess national registrations and strong distribution networks, but they lack in-house expertise in alternative investments. As a result, their entry into alternative investments has been characterized by strategic alliances with alternative fund managers. For example, Mackenzie Financial Corporation, a leading Canadian mutual fund company, recently formed a strategic alliance with Tremont to launch the Mackenzie Alternative Strategies Fund. This fund is being sold through the Canadian broker/dealer network. Similarly, BMO Nesbitt Burns has in the past created and sold managed futures products through its national network of investment advisors and, more recently, has formed a strategic alliance with Grosvenor Capital Management out of Chicago.

In summary then, the provincial regulation of the Canadian investment industry coupled with the distribution strength of national investment firms makes the direct marketing of alternative investments in Canada extremely difficult. However, for alternative fund managers willing to form strategic alliances with existing Canadian firms—investment dealers, mutual fund companies or investment counselors—Canada may be a lucrative marketplace to explore. This is especially so given the growing appetite and current momentum for alternative investments by Canadian clients.

Modern Portfolio Theory and Its Applications

continued from page 11

After accounting for all these biases, the hedge fund index returns only 11.6% per year for 1991-2000. It turns out that hedge funds are not a get rich quick asset class. The index, however, exhibits a 6.8% standard deviation and a 1.8 reward/risk ratio. During the same time period, the S&P500 returned 18.3% with 13.0% volatility and the Shearson Lehman Bond Index returned 7.5% with 3.8% volatility with a 1.4 and 2.0 reward/risk ratio, respectively. Even against the bull market of the 90s, hedge funds delivered a competitive risk adjusted return. Stocks and bonds, however, are linked to the business cycle and, therefore, should be summarized over a much longer multi-cycle time period. Long term stock and bond results are more like 11% per year with 20% volatility (0.6 reward/risk ratio) and 5.9% per year with 8.6% volatility (0.7 reward/risk ratio), respectively.

Conclusion and Further Questions
The conclusion is clear, hedge funds, as an asset class, appears to return stock market like returns with bond market like risk levels and little correlation to both stocks and bonds. MPT predicts that a sufficiently diversified portfolio of hedge funds invested passively (i.e. randomly) has an excellent reward/risk profile and should be included in any optimal stock/bond portfolio.

Given this result, the next obvious question is whether an active manager selection strategy produces value. Does a due diligence process or as the Japanese call it, a gate keeping function add value? What about performance records or the Sharpe Ratio? Can they contribute to creating a portfolio that will outperform a passive strategy in the long run? Does past performance indicate future performance? These questions as noted above will be addressed in a follow-up article ("Part II") scheduled to appear in the next issue of The Reporter. Nevertheless, it is clear that the application of MPT to hedge funds raises important questions and provides a context for some new and interesting answers.