Benefits & Compensation DIGEST
Vol. 42, No. 10 | October 2005

WEB EXCLUSIVES

Alternative Investments: An Introduction

by Edward D. Patchett

Alternative investments are complex and often present unique investment and fiduciary risks for trustees. This article provides a brief overview of the alternative investments class and highlights some key investment characteristics and risks associated with alternative investments.

The words "alternative investments" usually evoke desperate reactions from ERISA plan trustees and their attorneys. "Aren't alternative investments too risky?" or "Aren't they very complicated?" Without a doubt, alternative investments are complex and often present unique investment and fiduciary risks. Nonetheless, fund trustees are embracing this asset class more than ever.

What's All the Fuss About?

Traditionally, most institutional investment fund boards of trustees have focused their investment efforts on publicly traded stock and bond portfolios. However, the returns and risks of the stock market over the past several years have concerned many trustees that publicly traded stocks alone cannot satisfy their desire to grow plan assets over the long term while also meeting near-term obligations. In the current market environment, questions regarding the strength and sustainability of the economic recovery, continued geopolitical concerns and stock market valuations underscore this uncertainty. Thankfully, bonds have generally performed well over the past several years. By and large, this strong bond market performance has been driven by a long, secular decline in interest rates that began in the early 1980s. However, with interest rates near 40-year lows, the capital gains earned by bond investors in recent years are unlikely to be repeated in the near future.

With an uncertain stock market and lower prospective bond market returns, many investors have turned their attention away from the "public" investment markets and toward alternative investments. Conventional wisdom suggests that such investments are attractive for two primary reasons. First, many believe that returns for many alternative investments can exceed those of traditionally managed stock and bond portfolios. Thus, investing in alternatives can potentially increase total plan returns at a time when attractive stock and bond returns may be hard to come by. Secondly, many believe alternative investment returns aren't highly correlated with those of other asset classes. As a result, alternative investments may increase total plan diversification and reduce the volatility of total plan investment performance.

What Are Alternative Investments?

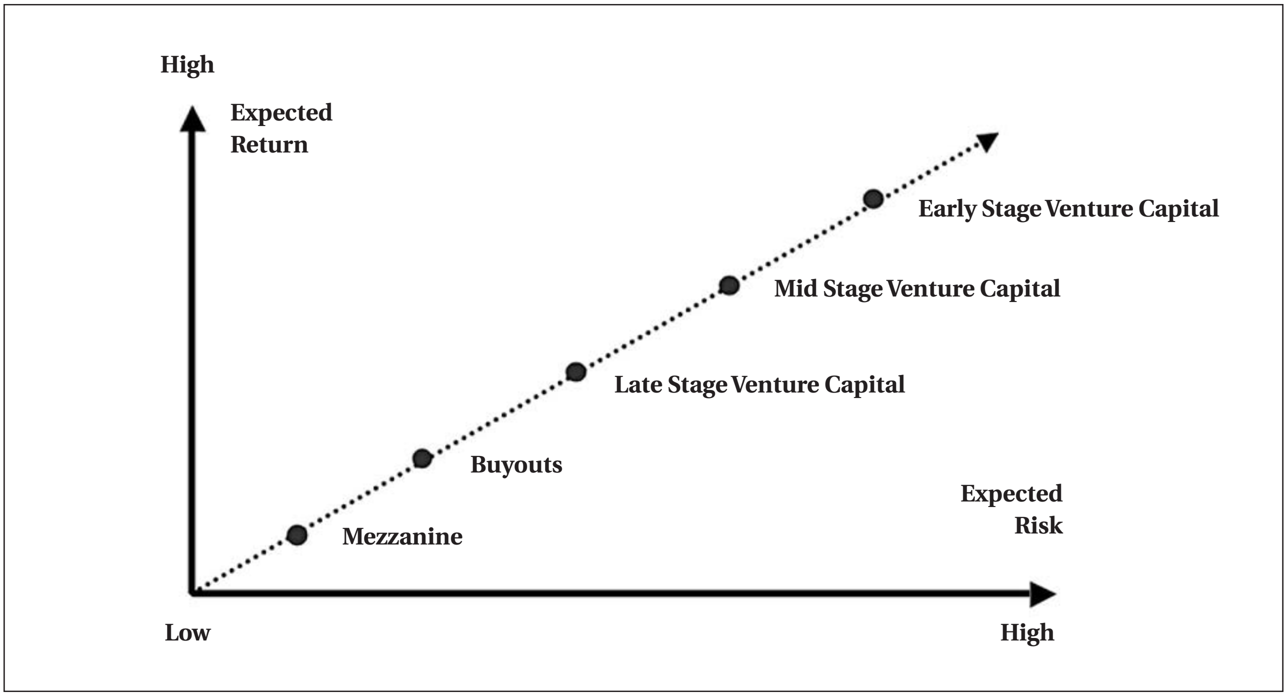
Broadly, *alternative investments* is used to describe investment asset classes other than traditionally managed, "long-only" stock and bond portfolios.[1] With that definition, one might question whether real estate could be considered an alternative investment. Twenty years ago, that was probably the case. However, over time, the real estate asset class has become "institutionalized," and professional investment management firms have developed strategies and products to facilitate investments by ERISA plans. Today, many investors consider real estate a "traditional" asset class.

Setting real estate aside, *alternative investments* today normally refers to private equity, hedge funds, and managed futures or commodities. While these types of investments represent a diverse universe of investment opportunities, they have several structural characteristics and risks in common. First, they are normally structured as private limited partnerships. Typically, the general partner (GP) of the partnership is the sponsoring entity (or an affiliate of the sponsor) and the investors are limited partners (LPs). These partnership investment vehicles are offered for investment under various exemptions from registration under the federal securities laws. To qualify for this exemption, the partnership is usually limited to a certain number of investors that must meet certain minimum qualifications in order to invest. In any case, the LP's investment interest in a partnership is not listed on any exchange and is not freely or publicly tradable. Thus, an LP's interest in a partnership is "illiquid."

An additional common characteristic or risk of alternative investment vehicles is that the GP may or may not be a registered investment advisor (RIA) under the Investment Advisers Act and rules of the U.S. Se-

Figure 1

Risk and Return of Private Equity Strategies



curities and Exchange Commission (SEC). This fact, coupled with the lack of registration of the partnership itself, means that many alternative investments are offered and operate largely outside any federal regulatory oversight. While one may argue this structure can encourage fraudulent activity by GPs, registration and oversight in and of itself cannot assure investors they will avoid such activity (note the cases of Enron, WorldCom and the current mutual fund scandals as examples).

Boards of trustees whose investment activities are governed by ERISA also need to concern themselves with an important issue regarding their own fiduciary exposure. Simply stated, ERISA permits a board of trustees to delegate fiduciary responsibility for day-to-day investment decisions to an "investment manager" (as defined under ERISA), and therefore the trustees' fiduciary responsibility is limited to prudently selecting and monitoring that investment manager. In the case of many alternative investment partnerships, the GP may not be an investment manager either because it doesn't meet the necessary requirements or because the partnership itself has been structured so as to avoid being deemed "plan assets" under ERISA. A board of trustees investing in a partnership structured in this way has not delegated to or hired the GP as an investment manager and thus exposes itself to a higher level of fiduciary responsibility (and liability, if a problem occurs) than if it had delegated to an investment manager. Other key investment characteristics and risks posed by alternative investments are presented in the following sections.

Private Equity

Generally speaking, companies finance their business by issuing bonds (IOUs) or selling stock (an equity interest in the company). Publicly issued stocks and bonds undergo a formal registration process and are then eligible to be sold to investors who can then trade their interests (e.g., buy or sell their shares on an organized stock exchange). Traditionally, institutional investors have invested in publicly traded equity through investment managers they retain. *Private equity* means investments that aren't made via the public market. A company may choose to raise capital in the private market for many reasons, often because its business is in its infancy or because of the time and/or cost of capital being raised. The two major forms of private equity investments, venture capital and buyouts, are described below.

Venture Capital

Venture capital involves financing to start a new business or to grow an existing one. Venture capital investing has existed for many years, but was formalized in 1958 when Congress passed the Small Business Investment Company Act creating the Small Business Investment Company (SBIC) program, which is administered by the federal Small Business Administration.[2] Many people tend to associate venture capital investing with technology companies. To be sure, many such companies were the recipients of venture funding during the Internet boom in the 1990s. However, the term really applies to all sectors of the economy.

While there are no hard and fast definitions for the stages of venture capital investing, the following are generally accepted.[3]

Seed Stage: Investments in start-up companies; often investing in an idea or "concept"

Early Stage: Company typically has a management team in place and a business plan; a working prototype of the product may be available.

Late Stage: Financing often used to fund production, sales and marketing; carries company to revenue producing stage.

Mezzanine or Pre-Initial Public Offering (IPO): Final round of financing that helps carry the company to a public offering of stock.

Venture capital funds normally specialize in a particular stage of private equity investing. Generally speaking, seed and early stage funds tend to be more risky, given that the companies in which they invest may have no product or proven business model. Therefore, investors demand a higher expected return on this type of private equity. Mezzanine investing, on the other hand, is often viewed as a relatively lower risk private equity investment strategy. Investors often think about the relative risk and return of private equity strategies as depicted in Figure 1. Regardless of the stage of investing, many venture capital funds specialize in a single industry or sector (like biotechnology, computer hardware, software or networking) and staff their operations with investment professionals that have a deep understanding of the particular area in which their fund is investing.

Not surprisingly, some venture capital investments never become profitable and others only modestly so. However, successful venture capital partnerships often only need a handful of investments to be successful in order to deliver sharply positive returns.

Buyouts

This type of private equity investing involves providing financing to entrepreneurs (often existing company management) seeking to acquire a majority or controlling interest in an established business. Such businesses being acquired are often divisions or subsidiaries being sold by larger companies seeking to refocus on their "core" business. *Leveraged buyouts (LBOs)* involve buyers making a small equity investment in a company and paying the rest of the purchase price using borrowed funds (thus *leveraged*).[4] In this kind of transaction, the assets of the company are used as collateral for the loans, and cash flows from the business are used to pay off the debt over time. In order to earn attractive returns for their investors, buyout funds seek to build value by not only providing capital but by assisting management in growing sales and improving profitability.

Additional Private Equity Fund Considerations

From an investor's perspective, the investment horizon required for making private equity investments is very long. Normally, investments are made by a private equity GP during the first five to seven years of the partnership's life, during which time capital is called from the LPs as needed to make investments. The total partnership term typically lasts ten to 12 years. During the investment phase, the GP is paid its annual management fee (usually 1.5% to 2% on committed capital). Since partnership investments are normally carried at cost during the early years of the partnership (and any early failures are written-down) while the GP is earning its management fee, private equity funds typically post negative returns to LP investors in the early years of a fund. Over time, as the fund becomes fully invested and (hopefully) investments perform as expected, positive returns are realized by LP investors. This return pattern is known in private equity investing as the "J-curve" effect as illustrated in Figure 2. The implication for LPs is that they must be comfortable with the likely prospect of negative returns in the first few years of their private equity investment, recognizing that positive returns will (hopefully) be recognized later in the fund's life.

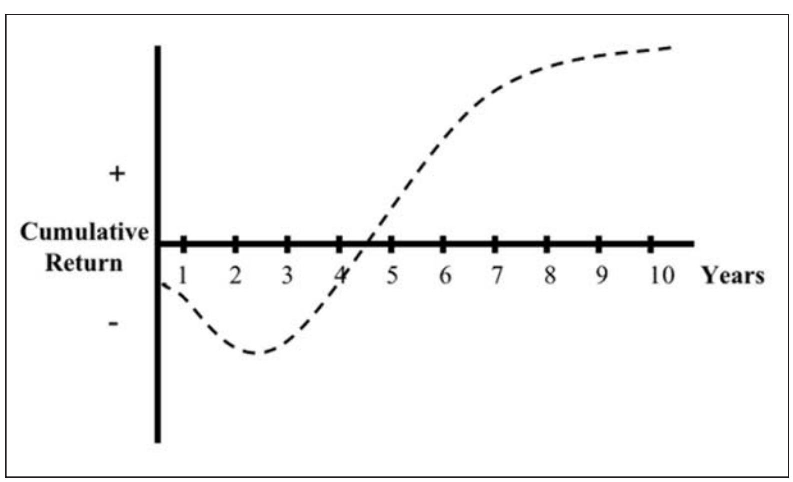
Hedge Funds

The term *hedge fund* is often misunderstood. The term dates back to 1949 when an investor named Alfred Winslow Jones constructed a portfolio of undervalued stocks he expected to increase in price (the long portfolio), and at the same time sold short overvalued stocks he expected to decline in price (the short portfolio).[5] In a rising market, Jones figured his undervalued stocks would outperform his overvalued stocks (he'd make more money on the long portfolio than he'd lose on the short portfolio). Conversely, in a falling market, he expected the reverse would be true (he'd make more on the short portfolio than he'd lose on the long portfolio). Thus, Jones expected to make money on the overall portfolio over time through good stock selection regardless of whether the stock market rallied or fell. His portfolio was "hedged" against overall stock market movements.

Many hedge funds today engage in "Jones-style" long-short investing, but *hedge fund* has come to mean any investment fund that isn't managed using traditional, long-only stock and bond strategies. Therefore, *hedge fund* applies to many types of strategies and securities (including stocks, bonds, currencies, futures and derivatives). However, hedge funds all have a few common characteristics. First (like private equity), they are normally established as limited partnerships and are available only to a limited number of qualified investors. Additionally, hedge fund managers

Figure 2

The "J" Curve Effect



normally have very broad discretion in their investing activities and may use leverage to enhance returns. Hedge fund managers charge investors both an asset-based management fee and a performance incentive fee (more on this subject later). Finally, hedge fund managers also tend to invest a substantial portion of their own capital in the hedge funds they manage.

Liberal use of the term *hedge fund* has led many to many generalizations (e.g., "All hedge funds are risky") based on a few well-publicized "blow-ups" of a small number of funds. Nonetheless, institutional investors have become increasingly interested in hedge fund investing over the past few years, and a considerable amount of money has flowed into such funds across many different types of strategies.[6]

Hedge fund management differs from traditional portfolio management in several very important respects. As illustrated by the Jones approach described above, hedge fund managers concern themselves with generating absolute, positive investment returns in most market environments. By contrast, long-only managers construct portfolios and view results relative to a given market benchmark (like the S&P 500 Index). This means that a traditional equity investment manager will seek to earn "incremental return" above its performance benchmark (e.g., earn a higher return than the benchmark when returns are positive and lose less when benchmark returns are negative). While the traditional equity manager tends to view risk relative to its benchmark, the hedge fund manager simply views risk as the prospect of losing money. Finally, the key factor driving absolute investment performance for a traditional investment manager is the market return, whereas hedge fund manager skill (and not overall market movements) drives the returns of such funds.[7]

Hedge Fund Strategies

Although hedge fund strategy definitions can be ambiguous, industry participants often categorize them into three distinct strategies as depicted in Figure 3. Each of these strategies seeks to earn positive investment returns, regardless of the direction of the overall stock and bond markets.

Relative Value

Managers using relative value strategies seek to take advantage of relative price discrepancies between related securities using mathematical, fundamental or technical analysis to determine misvaluations. The manager may identify securities that are mispriced relative to another underlying security, related securities, groups of securities or the overall market. As shown in Figure 3, such strategies can include equity market neutral, convertible arbitrage and fixed income arbitrage.

Event Driven

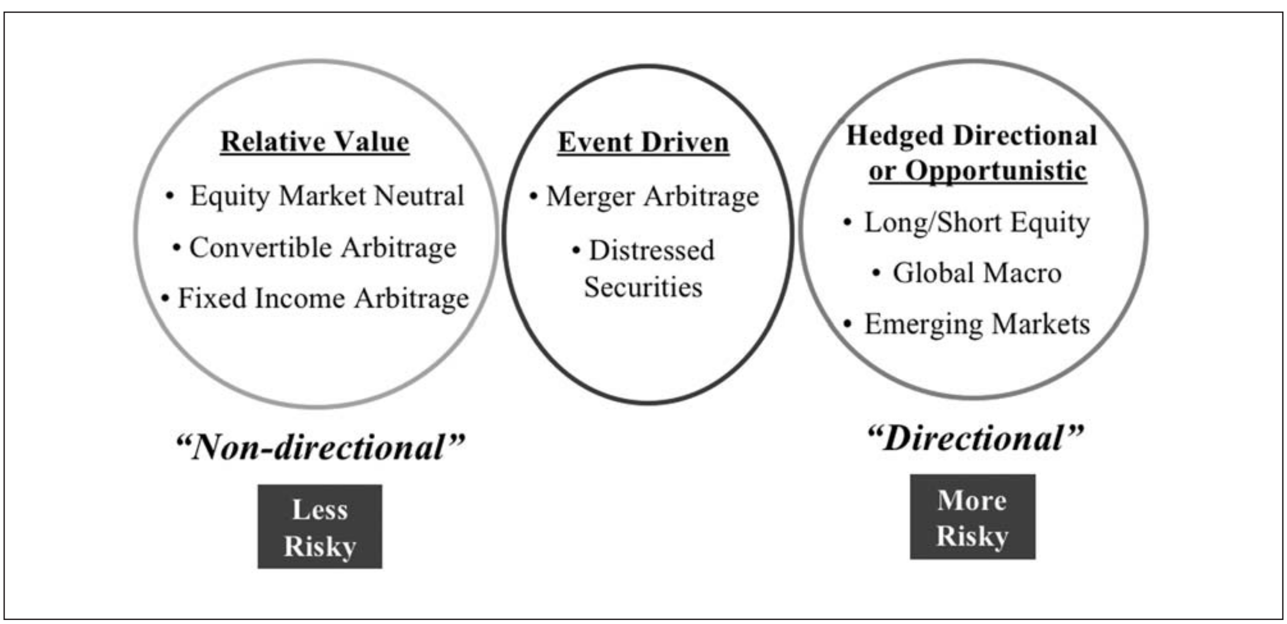
Hedge fund managers using event-driven strategies seek to exploit opportunities created by significant corporate events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks. For example, investing in distressed securities involves purchasing the stocks or bonds of companies experiencing financial difficulty. Given the distress, hedge fund managers can often buy such companies' securities at deeply discounted prices and realize profits if the company is successfully reorganized or liquidated (if the bonds owned were senior in the company's capital structure and purchased for less than liquidation value). In the case of merger arbitrage (often called risk arbitrage), hedge fund managers seek to exploit merger activity by locking in the spread between the current market price of securities and their (higher) value in the event of a successful merger.

Hedged Directional and Opportunistic

This category covers a wide range of hedge fund strategies. The two most often

Figure 3

Hedge Fund Strategies



associated with this category are equity long/short and global macro. Equity long-short strategies simply refers to the Jones style of investing described earlier involving equity-oriented investing on both the long and short sides of the market (however, the objective is not equity market-neutral). Hedge fund managers pursuing this style of investing usually shift freely from value to growth stocks, and from small to medium to large capitalization stocks. They also may move from a "net long" position to a "net short" position and may use derivatives to hedge portfolio positions. Their focus may be sector specific, such as long/short technology stocks, or regional, such as long/short U.S. or European stocks. Global macro managers construct portfolios based on their "top-down" view of global economic trends by analyzing factors such as interest rates, economic policies, inflation, etc. These hedge fund managers tend to focus on broad asset classes (owning or selling short stock or bond indexes, currencies and commodities) rather than individual securities.

Additional Hedge Fund Considerations

Like private equity managers, hedge fund managers charge fees that are much higher than traditionally managed portfolios. The typical hedge fund manager will earn an annual management fee of 1% to 2% of the fund's market value, and share in a percentage of the hedge fund's returns (usually 20%). Relative to private equity investments, hedge funds can provide the LP investor more liquidity. Typically, hedge funds require LPs to commit to an initial "lock-up" period for their investment (often one year), after which time LPs may have periodic liquidity rights (e.g., quarterly or semiannually, subject to advance notice of withdrawal by the LP).[8] Hedge funds require this notice because underlying hedge fund holdings are sometimes illiquid, and the manager does not want to be forced to sell investments under adverse market conditions in order to meet LP redemption requests. In such market conditions, relationships between securities that apply under normal market conditions can temporarily "break down." When this happens, prices tend to fall across many asset classes and liquidity "dries up" as investors shift investment assets into U.S. Treasury securities.[9]

To varying degrees, hedge fund managers may provide investors limited information regarding actual securities and strategies within the portfolio (known as *transparency*). Hedge fund managers fear that if their actual portfolio holdings are widely known (particularly their short positions) other investors could exploit that information to the detriment of their partnership. Thus, LPs sometimes receive summary portfolio characteristics and risk statistics for monitoring purposes as opposed to a complete list of portfolio holdings. Additionally, some hedge funds use borrowed funds, or leverage, to increase portfolio returns. While leverage will magnify positive returns, it will also magnify losses. When used by managers, leverage is often limited to more conservative hedge fund strategies. Finally many hedge funds invest in derivative instruments to gain market exposure, to hedge risk and/or to exploit pricing anomalies between a derivative and an underlying security.

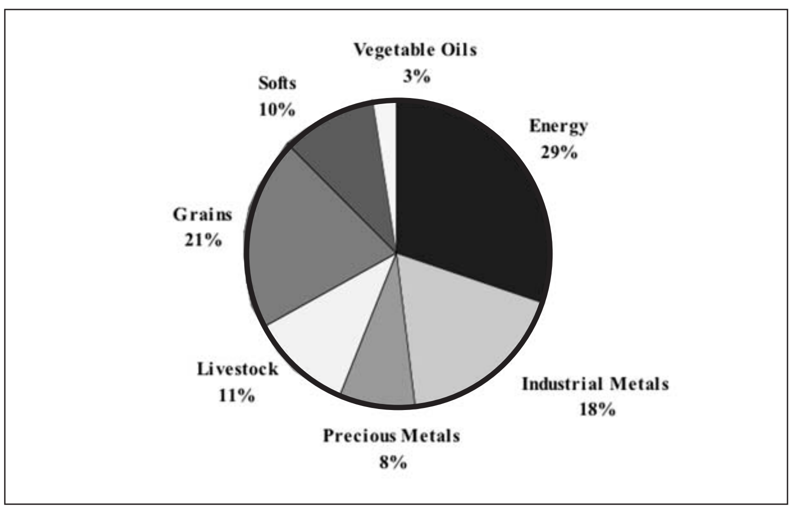
Managed Futures/ Commodities

Investing in managed futures and commodity-related strategies still remains a new concept for many institutional funds. Thus, this section provides only a brief overview of this type of alternative investment strategy.

Commodities are raw materials: assets that are tangible. By way of example, Figure 4 illustrates various commodities that are included in the Dow Jones-AIG Commodity Index, which is comprised of 20 different commodities.[10] Major commodities include energy (crude oil, natural gas, unleaded gasoline and heating oil), grains (soybeans, corn and wheat), industrial metals (aluminum, copper, zinc and nickel) and livestock (cattle and hogs). Commodities can be an attractive investment because their prices tend to have a high degree of correlation to changes in expected inflation and a low correlation to stocks and bonds. Investment managers in this kind of alternative strategy are called

Figure 4

Commodities



Source: Data as of March 31, 2004 provided by Dow Jones & Company. "Dow Jones," "AIG," "Dow Jones-AIG Commodity Index," "Dow Jones-AIG Commodity Index Total Return" and "DJ-AIGCI" are service marks or trademarks of Dow Jones & Company, Inc. and American International Group, Inc., as the case may be. Dow Jones does not sponsor, promote or sell any product based on the DJ-AIG Commodity Index or DJ-AIG Commodity Index Total Return and none of AIG Financial Products Corp., Dow Jones or AIG International Inc. (AIGI) makes any representation herein regarding the advisability of investing in the DJ-AIG Commodity Index or DJ-AIG Commodity Index total Return or any product based on such indices. Historical results presented should not be and cannot be viewed as an indicator of future performance. AIG Financial Products Corp. and AIGI are not and do not purport to be advisors as to legal, taxation, accounting, regulatory or financial matters in any jurisdiction. The recipient should make an independent evaluation and judgment with respect to the matters referred to herein.

commodity trading advisors (CTAs). As in traditional equity investing, some managers have unique skills in specific markets, while others take a generalist approach. CTAs analyze the supply and demand for commodities, seeking to identify imbalances that will lead to rising or falling prices. CTAs implement their investment decision making using exchange-traded commodity futures and forward contracts.

There are basically two types of CTA trading styles. Systematic trading CTA managers use proprietary, quantitative models to identify market opportunities. These managers tend to be trend followers: They seek to identify a trend or pattern in commodity prices and position the portfolio to stay invested so long as the trend persists. Such strategies don't normally work well when prices are volatile but without a persistent pattern. Discretionary trading CTAs use fundamental analysis of relevant market data and subjective judgment in managing portfolios.

Conclusion

Investing in alternative assets can be difficult. These assets present some unique challenges in terms of investment and legal due diligence, planning and risk controls. However, prudent investments in alternatives may increase total fund diversification and enhance long-term returns. Before making any investments in the asset class, trustees should work with their fund professionals (investment consultants and attorneys) to develop a sound investment policy statement that clearly articulates their fund's objectives and limitations regarding such assets. Investors should remember the terms *private equity* and *hedge funds* are often used generically and represent a wide range of investments with widely different levels and types of risk and return. Therefore, new investors in these asset classes should perform extensive due diligence and tread carefully.

Finally, investors should consider whether the dollar amount of their allocation to alternatives is large enough to achieve significant diversification, and whether they have the expertise and resources to make investments directly in the alternative strategies described here. If not, such investors should consider using a "fund-of-funds" approach. For example, a hedge fund of funds is a limited partnership vehicle which in turn makes investments in many individual underlying hedge funds.[11] While fund-of-fund vehicles introduce another layer of fees, they can provide diversification across many types of strategies and add professional management, due diligence and oversight.

Endnotes

1. Stocks and bonds owned in a portfolio are often referred to as held "long." "Long-only" portfolios do not permit short selling.
2. David M. Toll, *Private Equity Primer,* Galante's Venture Capital & Private Equity Directory.
3. Ibid.
4. Ibid.
5. Short sellers seek to profit from expected stock price declines by borrowing (not buying) a security and selling it at the current market price, repurchasing the stock in the future at (hopefully) a lower price and returning it to the lender.
6. Recent estimates by various industry observes put total hedge fund assets at between $800 billion and $1 trillion.
7. Hedge fund strategies are sometimes referred to as "skill-based" or "pure alpha" strategies as opposed to "market-based" strategies.
8. Hedge fund GPs often reserve the right to suspend LP redemptions in certain circumstances if the GP determines such suspension is in the interest of the partnership. In the event of a complete withdrawal, the GP will often hold back a small percentage of the LP's investment pending completion of the fund's next independent audit.
9. Note the liquidity crisis in 1998 touched off by the Russian default and sharp decline in the U.S. markets in August. The crisis led to the collapse of Long-Term Capital Management, a large hedge fund engaged primarily in fixed-income arbitrage.
10. Dow Jones and Co., as of March 31, 2004.
11. For managed futures/commodities, the vehicle is offered by a commodity pool operator (CPO).

This article is excerpted from the Foundation's recently published Employee Benefit Issues—The Multiemployer Perspective—Volume 46. *Edward D. Patchett presented this paper at the Trustees Institute for Jointly Managed Training and Education Funds in 2004.*

Edward D. Patchett, CFA, is vice president of Independent Fiduciary Services, Inc. in Washington, D.C., where he works in investment policy design, asset allocation modeling, investment performance measurement, reporting and analysis. He previously was with Wilshire Associates, where he was primarily responsible for, among other things, investment manager due diligence for the firm's clients, including the $15 billion investment program of the Pension Benefit Guaranty Corporation (PBGC). Patchett graduated from Ferris State University with a B.S. degree in business and earned his M.S. degree in business/finance from The Johns Hopkins University.