Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments

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I believe we are living in dangerous times both politically and economically. As professional advisors, it is our duty to protect our client's assets. With equity markets going sideways, interest rates rising, and oil prices going through the roof, how are you going to insulate client portfolios from the shocks caused by these unpredictable economic changes and geo-political events?

I believe that one of the very best things you can do for your clients and your practice is to use alternative assets such as hedge funds to reduce the total risk your clients are exposed to. Today I will be focusing on using hedge funds as a means of reducing these risks.

Do you know what the phrase to "Hedge your bet" means? In this context, it means reducing risk by taking a position opposite your primary one in order to reduce your risk. A hedge fund is an investment vehicle whose key priority is to minimize risk and preserve capital while attempting to deliver profits under all market conditions

Why have hedge funds been in the headlines over the past few years? In the 90's you could virtually throw darts at a list of stocks and still make money. Risk? The more the better. After all, greater risk meant greater returns, right? Well, as we all know in hindsight, this certainly isn't necessarily true in the short to medium term. People who thought they were comfortable embracing risk in the 90's found out the hard way that losses really hurt. Weary of the constant decline in portfolio values, they have been desperately looking for a "better way".The pain inflicted on investors by one of the most savage bear markets ever, has caused people to take a look at non-traditional investments

There are problems inherent in traditional investing. By traditional investing I mean investing, long only, in stocks, bonds and cash. Traditional portfolio managers such as mutual fund managers are typically measured relative to a benchmark such as the S&P 500. The term "relative to the benchmark" means that if, in a given year, the portfolio manager lost 8% and the S&P 500 went down 10%, the manager has been successful. There is no focus on capital preservation. Managing risk would appear to be less important than tracking benchmarks.

Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments *(continued)*

Also, there are only a small handful of money managers that consistently outperform – most revert to the mean.

A recent study of top quartile money managers over 5 years showed that out of 54 top quartile performers, only 20 were top quartile again the following year. The year after the number dwindled to 7; the next year down to 2 and in the fifth year only one manager from the initial group was still in the top quartile.

There is also the lack of accountability to investors. The fact that an investor lost money is blamed on "the market".

The other major problem with traditional investing is a misalignment of interests. The money manager is compensated based on total assets under management. Positive performance, which is the investor's objective, isn't a factor in determining the manager's compensation. So, even if they lose money they will still be paid well.

You may think that hedge funds are a recent phenomenon, but in reality, the first hedged fund was created in 1949 by a gentleman named Alfred Winslow Jones. Jones wasn't an investment professional. He was a sociologist working on an article for Fortune magazine. His assignment: interviewing some of Wall Street's best and brightest and find out how they do what they do.

He concluded these people were indeed very bright, but there was one major problem: they couldn't control or predict market direction; a major determinant of investment returns.

Jones set out to create a better mouse trap. He wanted to eliminate most of the market risk involved in holding long stock positions by short-selling other stocks. He thereby shifted most of his exposure from market timing to stock picking. The hedged or short positions allow capital to be leveraged, while also enabling larger positions to be taken with limited resources.

I trust most of you know how shorting works, but here's a quick refresher: When you "short" a stock, you are actually betting it will go down. Short sellers assume they will be able to buy back the stock at a lower price than the price at which they originally sold it short. Shorting reverses the normal buy/sell process. You sell first and pocket the proceeds; maybe place them into t-bills or potentially even use the money to buy long positions. Later when the stock has fallen in price you use a portion of the proceeds to repurchase the stock and return it to its rightful owner.

Another genius feature Jones thought of was having an incentive fee amounting to 20% of any realized profits or gains with no additional fixed fees. He also invested a substantial amount of his own capital, thereby aligning his own interest with those of the other investors in his fund. Sink or swim, they were all in the same boat together.

So, how did he do?

Jones operated in relative obscurity until 1966 when Carol Loomis wrote an article titled "The Jones That Nobody Keeps Up With." His results were nothing short of astonishing: Net of incentive fees of 20%, Jones hedge fund beat the best five-year rate of return fund, Fidelity Trend Fund, by 44%, and beat the best ten-year rate of return fund, Dreyfus Fund, by 87%!

The article led to the initial proliferation of hedge funds, the number of funds growing from a handful to over one hundred in a few years. As time has gone by, many bright money management professionals have developed new strategies using various combinations of arbitrage, short selling and leverage to exploit market inefficiencies. Today's hedge funds are essentially pools of private capital that invest in almost anything including private equity, commodities, currencies and derivatives of all types.

One of the most important attributes of hedge funds is that there is true alignment of interests between the manager and investors. Typically there is a substantial personal financial commitment by the principles and the key employees as co-investors in the fund. When the fund delivers performance the investors do well, and the fund managers do really well because they participate in two ways. In addition to growing their own capital from investment gains just like other "retail" investors, the fund manager also benefits from a performance fee: typically 10% to 20% of profits. By delivering performance to its investors, hedge fund managers can earn a lot of money.

Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments *(continued)*

There is also the concept of a "High Water Mark" which means the manager is only entitled to collect performance fees on net new profits; i.e., if a fund loses money (say the NAV goes from $10 to $9) the manager can't charge a performance fee until the NAV goes north of $10 again.

Remember when being a Fidelity fund manager was the height of prestige? Those days are over!

During recent years, a number of successful "traditional" money managers such as Jeffrey Vinik of Fidelity Magellan Fund fame have decided to make the switch over to the world of hedge funds. The dream of Wall Street's brightest lights today – from superstar money managers to freshly minted MBAs – is to start one of the private, non SEC regulated investment partnerships known as a hedge fund.

Who invests in hedge funds?

Until recently, due at least in part to high minimum investments, hedge funds were once the exclusive preserve of wealthy individuals, family offices, banks, brokerages, insurance companies, endowment funds and large pension funds. These individuals and institutions don't want to expose all of their capital to unpredictable and un-controllable market based investments.

Risk management and capital preservation are of utmost importance to them and long ago they recognized the value of adding hedge funds as a diversifier in their portfolios.

The idea behind hedging, namely moderating risk and preserving capital, is appealing to almost all investors. And I believe there is a place in every portfolio for some form of hedge fund.

Not all hedge funds actually hedge. In fact, today the term "hedge fund" refers not so much to hedging techniques, which these funds may or may not employ, as it does to their status as private and unregistered investment pools. Some long only hedge funds don't make any excuses. They are not using the structure to hedge; they are using it for other reasons such as higher concentrations or investment mandate flexibility.

Another aspect of the hedge fund structure is the typically broad authority a hedge fund manager has. This latitude can lead to trouble; in the 1990's bull market, incentive fees and leverage seduced many hedge fund managers into using high leverage ratios with little, if any, hedging.

The short side of the hedge transaction becomes a drag on performance in buoyant markets, but it will "save your bacon" in a declining market. The logic was, since the manager is paid for performance and everything seemed to be going up, why have any shorts at all? Well, here's why. When the markets tanked, these funds got caught with very little downside protection and many suffered substantial losses.

Hedge funds can be categorized – sliced and diced – many ways. One way is that they are sometimes referred to as either "get rich" or "stay rich" funds. "Stay rich" funds are more of a diversification tool and have the objective of preserving capital and delivering slow, steady, moderate returns. "Get rich" funds will still act as a portfolio diversifier but they tend to have higher risk profiles and hence target higher returns albeit with more volatility.

In my practice I specifically look for funds that manage risk and do actually hedge. Capital preservation is the single most important attribute that I look for in a hedge fund. Beyond that, I like to see steady positive incremental returns month after month. The overall objective is to reduce portfolio volatility and deliver improved risk-adjusted returns.

And above all, I try to avoid negative returns. I try to follow Warren Buffet's two rules of investing:

Rule #1 - Don't lose money.
Rule #2 – Don't forget rule #1.

We will see more of why this is so important later in this presentation under the topic "Mathematics of Losses".

In addition to a focus on preservation of capital, the distinctive features I look for in a true hedge fund are:

Absolute Return objective; If you remember from your school days, we learned that an absolute number is always positive. Hedge funds are always looking to have positive returns. This is NOT a guarantee – but an objective.

Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments *(continued)*

Use of any and all investment strategies – unlike traditional money managers, hedge fund managers are not limited to long only positions whereas traditional managers are. Hedge fund managers can use short selling and any and all other tools available in the marketplace. It's comparable one man trying to build a house with only a hammer and nails versus having a full crew with all of the most up to date tools.

By combining various strategies, each of which have different risk and return profiles, a good manager can, to a certain degree, *control the risk and develop a realistic target rate of return*.

Alignment of interests where the hedge fund manager and the investors are all rewarded when their investment makes money. The money manager actually gets to "double dip" because in addition to having their own funds invested in the fund, they also collect performance fees that can amount to large amounts of money. And if things don't go quite so well, the manager might lose some capital just like other investors and they certainly won't collect any performance fees.

The right hedge funds can reduce total portfolio volatility and risk, and enhance portfolio returns in economic environments in which typical stock and bond investments offer limited opportunities. I believe we are presently in this type of limited opportunity market – the equity markets have been relatively flat, rising interest rates limit the appeal of bonds and even though rates are rising nominal rates are still low so holding cash doesn't pay much either. And with the constant threat of terrorism overhanging everything I think you owe it to yourself and your clients to investigate the hedge fund category

Let's take a look at a chart showing the return attribution in a traditional investment. You can see that the bulk of the return is really based on how the market has fared. Maybe up to 20% of the return can be attributed to the manager's skill

In the hedge fund world this equation is turned upside down by minimizing market influence in favor of the manager's skill.

Here, up to 20% of the return might be attributable to the market and the balance to the skill of the manager. In fact, hedge fund strategies are sometimes referred to as "skill based" strategies.

There are certain strategies known as "market neutral" that can eliminate the effect of the market all together.

Now, I do want to make a point about the market. It's not always such a bad thing to have exposure to the market. In good times you may in fact want to increase exposure to have the wind at your back and take advantage of positive momentum. Take a look at any chart that shows the market's long term performance and you can certainly see that there is a long term upward bias.

Here is the previously referred to discussion on the mathematics of losses. When this concept finally sunk in, I had my epiphany!

A closer look at the simple mathematics of losses shows why they need to be avoided at all costs.

Let's say an investor purchases an investment for $10.00. If it appreciates to $12.50 that's a 25% gain. But what happens if the price retreats by $2.50 to $7.50? True, the investor has experienced a 25% loss. But what's worse is that it now takes more than a 25% gain to break even. In fact, the investment will have to now increase 33% in value to make the investor whole again.

Unfortunately, the way the math works on investments is that the more money you lose, the harder it is to make up. This is especially true in the later part of the period being measured, because the negative effect is on a bigger base and there is less time available to make up the loss.

In this example, the scenario #1 on the left returns a steady 10% each year for three years.

Scenario 2 shows an investment that makes 10% in the first year but loses 10% in the second year. What percentage return does this investment need to achieve to pull even with scenario 1 at the end of the third year?

Most people guess in the 20% range, but the fact is, it takes a 35% return in year three to have the same amount of money.

My conclusion is very simple: successful investing is the result of having stable, consistent, positive returns.

Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments *(continued)*

Better risk adjusted returns always delivers more money at the end of the period.

While both investments in this slide average 10% over a ten year period, the more moderate scenario on the left has over 22% more money at the end.

I want to pause and let this sink in.

Two investments, both averaging the same return over a ten year period and one has 22% more money! All because the overall portfolios risk level was lower. The positive returns weren't as high but more importantly; the negative returns weren't as low.

I have run this spreadsheet many times and although the answers are always slightly different, the concept is always true.

As I mentioned previously, the reason is the impact of losses, especially in the later stages of the period being measured.

The same conclusion: Superior risk management leads to lower volatility and therefore better risk adjusted returns with higher account values.

And you are a lot less likely to get fired by your client!

One company I work with uses a software program that allows it to quantify the potential impact a historical seismic event would have had on their current hedge fund portfolio. And they measure this every day.

Wouldn't it be great to know what would have happened to your client's portfolio if we had a Global Market crash? How about an overnight spike in the price of gold due to some calamitous event? Or a major currency devaluation?

Having an idea of how the portfolio would perform in times of stress, based on historical events is crucial to understanding and controlling risk. This type of risk management gives me a tremendous amount of comfort. And every time I take my client to see this software in action my closing ratio has been 100%!

You should be aware of the various hedging strategies used in the marketplace but don't get overly worked up about this. You don't have to understand each strategy in detail in order to get started.

If you can become familiar with the general categories such as Relative Value, Event Driven, Global Macro and Equity Hedge, you will have a good head start. And you will, in all likelihood, know a lot more than your prospect or client.

I have been very fortunate in getting my hedge fund education. Without exception, the industry people I have dealt with have all been extremely patient and generous with their time. And I suspect you will find the same if you show an interest in learning.

As I mentioned earlier, some hedge fund strategies have more market exposure than others.

A very interesting chart comparing various hedging strategies is a variation on the basic risk/return chart we are all familiar with. The horizontal scale measures risk, defined as standard deviation, and the vertical scale shows rate of return. If you divide the chart into four quadrants, the ideal plot for an investment would be somewhere in what is known as the Northwest quadrant; relatively low risk without sacrificing better returns.

Each circle or "bubble" is a different size. The bigger the bubble, the larger the drawdown. Drawdown is a term we use in the hedge fund world to describe a decline in value of an investment over any period of time. The red bubble, which represents the S&P 500, is quite large meaning that it has had the biggest drawdown relative to the others on the chart.

In contrast, the Equity Market Neutral bubble is quite small meaning that this investment strategy has had to endure only very moderate drawdowns.

As we have already seen, there are many different hedging strategies, each having their own risk/reward profile. Most, if not all hedge fund managers are truly skilled in executing one, maybe two, different strategies and that is how they run their hedge fund.

By far, the lowest risk way of selecting a hedge fund is to use a "Fund-of-funds" which invests with multiple managers through funds or managed accounts. A diversified portfolio of managers is selected with the objective

Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments *(continued)*

of significantly lowering the risk (volatility) of investing with an individual manager. The fund-of-funds manager has discretion to choose which strategies to invest in for the portfolio. A good, active manager will always be adjusting the allocations to each strategy depending on their outlook.

There are fund-of-funds that employ a single strategy using multiple managers like long/short equity and, even lower on the risk scale, is a fund-of-funds that employs multiple managers executing multiple strategies.

There are numerous benefits to using this structure.

By employing a number of managers and strategies that are not only uncorrelated to the markets, but also uncorrelated to each other, we are able to increase overall diversification.

A good Fund-of-funds manager will also provide professional management to monitor and strategically reallocate its funds as various strategies go in and out of favor.

Affordability and accessibility are additional important benefits because individual managers can be accessed with a much lower initial investment than would have been required had the investor invested in each hedge fund individually.

They can also provide investors with access to some of the best managers, and their funds, that would otherwise be closed to new investors due to capacity constraints or because of high minimum investment requirements.

It will also help reduce the risk of relying on the skill of a single manager, and a Fund-of-funds tends to deliver more stable and consistent returns under a variety of market conditions.

The brokerage section of a major Canadian bank published a report stating the following:

"… We believe that fund-of-hedge funds represent the best risk/return option for investors.

Not only do such funds facilitate a diversified hedge fund investment across multiple strategies, but they also offer the service of constant monitoring and rebalancing as various strategies go in and out of favor"

Fund-of-Funds as a category will do a much better job of protecting capital in stressful times or periods of market uncertainty.

As you can see from the chart, past performance in difficult times is quite good BUT things did go wrong in August 98. Losses were more significant but still they performed better than the markets, losing only half as much as the S&P 500 total return.

This is certainly not a panacea – but managing risk is the most important thing. As you can see, the fund of finds index (HFRI) shows excellent downside protection

Your clients have lived through a tremendous bubble in the stock market as seen on this slide; clearly, in the hedge fund space things have been a whole lot smoother and simpler.

Fund of funds offer capital protection especially in down markets. Look at the performance during the massive market declines in 1999 to 2002.

BUT Fund-of-funds are not always perfect.

As you will note, in 1994 and 1998 the Fund-of-funds index suffered relatively modest losses, but losses nonetheless when the traditional markets were positive.

In this traditional efficient frontier chart, the initial portfolio consists of 60% S&P 500 and 40% Lehman Brothers Aggregate Bond index.

As you add a Fund-of-funds to the traditional portfolio you can see the risk level going down and yet the return is going up. Every time a prospect or client sees this chart they inevitably say, "If the all-hedge portfolio looks so good, why shouldn't I put all my money into hedge funds?"

My answer is that we are still only measuring a limited period of time and it is never wise to put all your eggs into one basket. I am advocating the use of hedge funds as a total portfolio risk reduction tool.

There are a number of special considerations for you and your investors to take into account.

First of all, the unit value calculations are done a lot less frequently than in the world of stocks and bonds.

Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments *(continued)*

More often than not, they are done weekly or monthly and sometimes even less frequently. There are only a very few that will publish a daily net asset value.

Liquidity will usually match the valuation frequency but many funds require a notice period which can be as much as six months or more.

In addition, there is sometimes a "lock-up" period of 6 months or more in which you cannot redeem your investment at all.

Part of the reasoning for this is that often a hedge fund manager will hold certain illiquid or semi-liquid positions and they need time to unwind positions without looking like they are dumping investments in a panic.

Additional special conditions are the minimum investment typically required to invest in a hedge fund – which varies from $150,000 to $1 million and more.

So called "accredited investors" can often invest smaller amounts (each fund sets its own amount) but only if they qualify by having a minimum income of $200,000 or $300,000 household - or – have $1 million of net financial assets, not including real estate.

This income threshold still leaves out a very substantial portion of the population. And yet, these are the people who could most benefit from the inclusion of hedge funds in their portfolio.

The industry has recognized this need and over the past couple of years they have developed new products that provide exposure to the return of a hedge fund-of-funds but also with a maturity date and capital guarantee.

I am in favor of using hedge funds for a number of reasons, the most important of which is, the possibility of achieving consistent, positive returns with lower volatility than the equity markets - no matter what is happening in those markets.

Nothing is perfect, not even hedge funds, and there are some limiting factors to consider as well.

In a major bull market, many of these investments, especially fund-of-funds, won't normally keep pace. There are also the previously discussed liquidity limitations - well as potentially higher fees, limited transparency and the resulting due diligence that is required.

I cannot stress enough the importance of conducting due diligence on each and every hedge fund you consider for your clients. This is a largely unregulated industry and buyer beware has never been more appropriate. The managers usually have so much leeway that they are often totally free to invest in anything under the sun.

You have to read the offering documents. Ask lots of questions and if you don't get the answers you're looking for, move on.

If the fund manager and other principals of the firm aren't substantially invested personally, move on. They've got to have "skin" in the game.

Compared to analyzing and selecting mutual funds, it will take a lot more time and effort to do the research needed to find the most appropriate hedge funds for you and your clients.

There are enough really great funds out there with track records of delivering superior risk adjusted returns and who operate in a transparent and ethical manner.

This due diligence is not a one time event where you satisfy yourself that thinks look OK and assume that will continue ad infinitum. You need to be in touch with these managers and companies on a regular basis and continually confirm that all of your evaluation criteria are still within acceptable ranges. In my office we keep a series of charts that measure various risk, return and other factors on a monthly basis. They are an invaluable tool.

I make a commitment to my clients that I will maintain my rigorous due diligence on an ongoing basis.

In addition to the charts I just mentioned, I have regular telephone contact – both directly and through conference calls. I periodically conduct on site visits with the managers and other senior management associated with the funds we are tracking.

One of my primary objectives in giving this presentation was to take some of the mystery out of this asset class and to give you at least a basic understanding of hedge funds.

I also hope I have demonstrated to you that some hedge funds can be extremely conservative and can be used to stabilize portfolios and preserve capital in difficult

Caution: Danger Ahead! Reduce the Risk in Client Portfolios Using Alternative Investments

times. And that exposure to hedge funds as a non-correlated asset class can deliver diversification to just about anyone's portfolio.

I hope I have intrigued you enough so that when you get back to your practice and give serious consideration to making hedge funds a part of your strategic asset allocation models.

In conclusion, I would say that hedge funds are here to stay. Each year they are becoming more and more accessible to the average investor. If you don't talk to your clients about hedge funds, someone else will.