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At its core, alternative investments centers on those asset investment strategies that provide unique return and risk properties not easily accessible through traditional stock and bond investments. In the first section, the articles emphasize two alternative approaches to investment management that provide what can best be categorized as alternative beta, that is, assets whose return is based on risk factors beyond those driving long-only stock and bond returns. Lars Jaeger, Stephan Müller, and Samuel Scherling identify insurance-linked securities (ILS) as a source of alternative beta in their article, “Insurance-Linked Securities (ILS): What Drives Their Returns?” With ILS, investors assume natural catastrophe and other insurable risks against the payment of a risk premium. Not only is the ILS risk premium relatively generous in comparison to the probability of loss, but more importantly the occurrence of an earthquake or hurricane event is independent from financial market events. The trade offers attractive opportunities for diversification. The source of the diversification benefits (return and risk) requires additional research as to the precise identity and characteristics of ILS return drivers. The aim of the article is to address this and related questions, decompose ILS returns into various return sources, distinguish between their alpha and beta parts, and analyze each in detail.

Although bear market funds may be regarded as simply the inverse of traditional asset investments, they do offer return opportunities not easily accessible in traditional asset markets. In “On Understanding Bear Market Funds,” Nelson Lacey and Qiang Bu explore the performance attributes of bear funds. They find that bear market funds exhibit timing ability, but surprisingly this does not translate into enhanced return performance. They also find that bear funds tend to be risk seeking at times when market volatility is high. The results are consistent with viewing these funds not in the more traditional context of return maximization, but instead in the context of risk management. In other words, bear market funds decrease return volatility of the fund family at the cost of a slightly lower fund family return.

Given the alternative beta nature of alternative investments, their benefits are often focused on the ability of the the resulting portfolios to offer relative return-to-risk benefits in down equity markets, while capturing the return and risk benefits experienced in rising equity markets. In “Risk Control through Dynamic Core–Satellite Portfolios of ETFs: Applications to Absolute Return Funds and Tactical Asset Allocation,” Noël Amenc, Felix Goltz, and Adina Grigoriu draw on dynamic risk-budgeting techniques to

emphasize the importance of risk management in making decisions to allocate to ETFs. Absolute return funds are an initial application of ETFs to allocation decisions. Absolute return funds can combine low-risk government bond ETFs and conditional allocations to riskier equity ETFs to obtain portfolios that—beyond the natural diversification between stocks and bonds—provide upside potential, while protecting investors from downside risk. A second application of absolute return funds is the risk control of tactical strategies. Dynamic risk budgeting is used to provide risk-controlled exposure—taking the manager's forecasts as a given—to an asset class. Goltz and Grigoriu show that, even if the manager is an excellent forecaster, this approach yields intra-horizon and end-of-horizon risk-control benefits considerably greater than those of standard tactical asset allocation.

In contrast to the use of various liquid investment vehicles to create return-and-risk opportunities consistent with investment in alternative assets, in “Optimal Portfolios with Traditional and Alternative Investments: An Empirical Investigation,” Edwin O. Fischer and Susanne Lind-Braucher empirically investigate the diversification effects on a traditional portfolio by introducing alternative investments, such as hedge funds, managed futures, real estate, private equities, and commodities. The authors analyze two portfolios—the portfolio with the lowest risk, which they call the *minimum risk portfolio*, and the portfolio with the highest (modified) Sharpe ratio, which they call the *maximum relative performance portfolio*—over the period April 1999–April 2009. This article describes the first attempt to incorporate a variety of risk measures—volatility, Value at Risk (VaR), and Conditional Value at Risk (CVaR)—as the objective function for portfolio optimization and for different estimates of the expected return (historical estimates, robust Bayes–Stein estimates, capital asset pricing model estimates, and Black–Litterman estimates). Furthermore, the alternative risk measures are additionally modified for the skewness and the kurtosis: modified VaR and modified CVaR. The influences of the higher moments on asset allocation are also examined in connection with different risk measures and various estimators of expected returns.

The use of historical data to illustrate the potential benefits of traditional investments and alternative investments depends, of course, on assumptions as to their corresponding return processes. Previous researchers have argued that there is no empirical evidence in support of contagion between equity markets and hedge funds. Using kernel density estimation, Jan Viebig and Thorsten Poddig show that the volatility spillover effect between equities and hedge funds is significant at the 99% level of confidence for several hedge fund strategies in their article, “Does a Contagion Effect Exist Between Equity Markets and Hedge Funds in Periods of Extreme Stress in Financial Markets?” Unlike previous researchers, the authors assess whether extreme increases in volatility transmit from equities to hedge funds. Conducting tests for correlation asymmetry and applying vector autoregressive (VAR) models, Viebig and Poddig find evidence confirming a contagion effect exists between equity markets and several hedge fund strategies and that the impact of financial crises on hedge funds varies substantially across hedge fund styles.

In the final section, the authors provide their own perspectives on the assets or investment vehicles that may offer unique return opportunities in contrast to those often regarded as central to traditional asset markets. The 2008 crisis offered another look at how emerging market stocks have behaved relative to developed markets. In “Emerging Markets During the Crisis,” Jennifer Bender, Frank Nielsen, and Madhusudan Subramanian take a fresh look at emerging markets to explore the following questions: Have emerging markets matched growth forecasts? Which segments have performed well? How have emerging markets behaved relative to developed markets? In the aggregate, emerging market stocks were not immune to the crisis, but some clear differences between emerging and developed markets came to light in the performance of particular sectors and styles.

Economic and financial events over the past two years have reminded investors that additional return opportunities are often accompanied by additional risk factors. In a current market environment in which the risk premia for traditional risk factors may be low, investors increasingly need to focus on alternative risk-and-return

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opportunities. The articles in this issue return to some of the basic elements of alternative investments: the return and risk characteristics of stand-alone alternative investments as well as the return and risk characteristics of portfolios constructed to have characteristics that differ from those commonly associated with traditional stock and bond investments. The dynamic elements of financial markets ensure that, as markets evolve and new financial regulation drives new structures of risk and return, new alternative investments will emerge to take advantage of additional return opportunities. We look forward to your submissions on new products, new ideas, and new approaches to return and risk management especially as they enlarge those available in traditional market environments.

**Thomas Schneeweis**  
**Editor**