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I was reminded when writing this introduction that this is the last issue in the 14th volume of *The Journal of Alternative Investments*. I was taken aback not only by how fast 14 years can pass, but also by the quantity of articles and issues addressed during that time. The alternative investment industry has certainly grown over the past 14 years, and the JAI, I hope, has been a major asset in that growth. But growth is often about change, and in a world of change, one cannot claim to have consistency of thought without being a hypocrite. We must constantly reexamine what we think and what others have written. Education is all about constant re-education. The articles in this issue address many concerns resulting from recent market events. The dynamics of the marketplace require our constant reappraisal of the place of alternative investments in the investment world. As I have maintained in many cases, if it were easy, one would simply hire a monkey and feed it bananas.

In the first article, “Defending the ‘Endowment Model’: Quantifying Liquidity Risk in a Post-Credit Crisis World,” Sheikh and Sun set forth the proposition that liquidity risk may be optimized in an attempt to forestall or minimize the impact of a liquidity crisis. For a generic (but typical) endowment asset allocation, the authors find that liquidity levels between 6% and 14% are optimal, all other things equal, because 95% of the time, an allocation in this range would obviate situations in which a portfolio’s payout rate exceeds its liquidity pool. The framework also provides insights for tail-risk events involving a particularly severe liquidity crisis. For a generic endowment portfolio, the analysis indicates that in order to reduce the severity of a liquidity crisis to zero (i.e., eliminate risk completely), the allocation to fixed income would have to be around 35% (close to seven times the payout rate of 5%). Such an allocation would entail a very significant opportunity cost in terms of forgone returns based solely on a desire to mitigate extreme liquidity events (the proverbial “100-year flood”). In the authors’ view, reducing the likelihood of a liquidity crisis to below 5% may be undesirable for all but the most risk-averse and least return-sensitive endowments.

The volatility of equity returns generally exhibits an asymmetric reaction to positive and negative shocks. Economic explanations for this phenomenon are leverage and a volatility feedback effect. In “Asymmetric Volatility in the Gold Market,” Baur studies the volatility of gold and demonstrates that there is an inverted asymmetric reaction to positive and negative shocks—that is, positive shocks increase volatility by more than negative shocks. The author argues that this effect is related to the safe-haven property of gold. Investors interpret positive gold price changes as a signal of future adverse conditions and uncertainty in other asset markets, which introduces uncertainty in the gold market

and, thus, higher volatility. The empirical results hold for gold bullion and gold coins denominated in different currencies and for different return frequencies, sample periods, and distributional assumptions. Finally, the author shows that the inverted volatility effect of gold can lower the aggregate risk of a portfolio for specific correlation levels.

In “Volatility and the Cross-Sectional Performance of Emerging Market Hedge Funds,” Cao and Jayasuriya use an augmented Treynor and Mazuy model to analyze the cross-sectional performance of a large sample of hedge funds operating in different regions of emerging markets. The performances of these funds are benchmarked on the relevant regional capital market indices and option-based risk factors. They find that the realized volatility of emerging market stock indices generally has a negative impact on fund performance. For some of these funds, they find evidence of an ability to generate alpha and time the market. Furthermore, they provide information on how certain fund characteristics are related to the performance and ability of fund managers.

Of course, alternative investments may be as much about making investment decisions to maximize return as they are about minimizing or managing risk. In their attempts to maximize investor return, hedge fund managers are largely free to pursue dynamic trading strategies, and standard static performance appraisal may be insufficient for evaluating hedge funds. “On the Dynamics of Hedge Fund Strategies” by Cai and Liang presents some new ways of analyzing hedge fund strategies by following a dynamic linear regression model. Statistical residual diagnostics are considered to assess the appropriate use of the model. The authors unveil dynamic alphas and betas for each investment style during the period of January 1994 to December 2008. They examine the in-sample goodness-of-fit and out-of-sample predictability on hedge fund performance. By simulating a hypothetical trading strategy, they demonstrate that the model-based predictability helps to implement a profitable fund selection process. Finally, timing skills can be directly examined with a dynamic model; they find significant evidence of market, volatility, and liquidity timing, which is

consistent with the timing literature about hedge funds.

Substantial losses suffered by several multibillion dollar fixed-income hedge funds have brought attention to the risks involved in what has been advertised as a leveraged municipal bond arbitrage strategy. Brokerage firms marketed these hedge funds to investors as higher-yielding alternatives to conventional municipal bond portfolios with little, if any, additional risk. In “Leveraged Municipal Bond Arbitrage: What Went Wrong?” Deng and McCann explain what the strategy really was, why it was not an arbitrage, and why it failed. Sponsors of these hedge funds portrayed the failures as the result of unprecedented and unforeseeable market events operating on a fundamentally sound strategy. The authors show that, instead, the funds failed because of the confluence of flaws in the strategy: ineffective hedges; high leverage; poor incentives created by management fees; leverage limits based on portfolio acquisition costs, not market values; and the mismeasurement of within-horizon risk, which differentiates strategies operated on proprietary trading desks and in retail hedge funds. Fundamentally, the strategy was simply a highly leveraged bet on the value of short call options, interest rates, and liquidity and credit risk. Events in late 2007 and early 2008 revealed the fundamental flaws in this hedge fund type, which is now effectively extinct.

But as in any set of readings, it is often best to return to where one starts. Expected return cannot be accomplished without a level of expected risk (however defined). While modified value-at-risk (or Cornish–Fisher value-at-risk) has been quite extensively used by practitioners and academics since its introduction, Cavenaile and Lejeune show that it can be consistently used only over a limited interval of confidence levels. In “A Note on the Use of Modified Value-at-Risk,” they illustrate that confidence levels below 95.84% should never be used if one wishes to be consistent with investors’ preferences for kurtosis. In addition, the use of higher confidence levels is restricted by the value of the skewness. Failure to respect these restrictions on confidence levels could result in the misassessment of risk and potentially overweight assets that exhibit undesirable properties in terms of higher moments.

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So there it goes, the end of Volume 14 and onto Volume 15. In the next issue, I plan to remind readers of the articles and issues first addressed in Volume 1, way back in 1998–1999. Each year, as we introduce a new volume, I look forward to reflecting on the articles and issues raised almost 15 years earlier. I hope the readers of the JAI find this “return to the past” both interesting and informative. If nothing else, it will remind all of us of the footprints we step in as we move forward. I again wish to thank all of those who have made this journey possible and look forward to seeing where this journey will lead in the future. It cannot be done alone, however. As always, I look forward to your submissions and comments.

**Thomas Schneeweis**  
**Editor**