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In each past issue of the JAI my comments have been directed solely at the new articles being published in the issue. For this issue I am breaking precedent. As readers may know, the JAI is the official journal of the Chartered Alternative Investment Analyst (CAIA)Association. What some readers may not know is that CAIA is the home for the world's largest professional designation in the area of alternative investments—the CAIA Charter—and was founded just ten years ago. As a co-founder of CAIA, it may seem a bit self-serving to provide my summary observations on the importance of alternative investments or on the role of education in understanding better the role of alternative investments in today's financial world. One could of course, simply roll out many of the 'time worn' clichés' as to the importance of understanding better those areas that are vital to one's personal education or job training. Many of us have stalled in traffic behind the sticker—"If you think knowledge is expensive try ignorance." Over the past several years, the last part of that sticker (ignorance is expensive) has certainly been proven right.

The central reason for the creation of CAIA was the simple fact that ten years ago there did not exist a single educational organization which had the resources or commitment or the separation from potential 'agency' conflicts with either businesses or academic institutions that could focus on the importance of alternative investments and their impact on financial markets, in particular and the economy at large, and provide individuals with a designation which indicated a level of knowledge of alternative markets as well as provide continuing education in the area. The CAIA Association's affiliation with the JAI is of course one area of that continuing education.

If anything the last ten years has proven the importance of both the CAIA Charter and the JAI. In the public press, industry, and academics, questions are still being raised as to the fundamental basis for a wide range of alternative investments and their place in the modern investor's portfolio. Often one reads or hears that many alternative investments (hedge funds, commodity investments, private equity….) are simply too risky or too complicated for either the individual or institutional investor.

In class (yes I still teach)—I try to get two primary points across to all of my students. First, knowing about the process of education is as important as education itself—look at your investment textbook 2012 copyright (10th edition)—written in 2010 based on academic articles published in 2008 which were written in 2006 based on data ending in 2002. In short, textbook knowledge is often ten years out of date by the time you read it. (Moreover, just check any current investment book and see how many complete chapters there are on hedge funds, commodities, or private equity). Second, what you learn today may not be of direct importance in your current world, but could be in many "of the parallel universes." What you want from education is as many 'relatively costless' options in your backpack; ready to be taken out when needed. Survival in the long run is based on knowledge and chance. But chance opportunities without knowledge provide no basis for taking advantage of the optionality in chance.

As for those who know me, it has taken a long time to get to the point; that is, the importance of education in Alternative Investments strategies and the unique role that CAIA provides in obtaining that knowledge.

First, the CAIA program was created to offer a means by which 'a body of knowledge' could be reviewed by both academic and practitioners and made available in a consistent and timely fashion. CAIA is a non-profit educational enterprise. It has no—I repeat no—direct corporate funding. CAIA was in part the outgrowth of the realization that academic investment textbooks fail to fundamentally offer current and timely knowledge as to the underlying characteristics of alternative investments and their role in the modern financial world. In most investment books, alternatives are considered primarily gold, silver and your mother's antiques. Second, practitioners also failed in their role as educators. Fifteen years ago, I and others wrote in the JAI that hedge funds were not 'absolute return vehicles' and were impacted by the same market factors as traditional stocks and bonds. In addition, many hedge funds do not hedge, and many hedge funds hold little or no leverage. Historical private equity returns are often 'accounting' rather than market based, hedge funds are more of a 'legal structure' than a single strategy, and our current measures of 'Alpha' are totally misunderstood. (Many current measures of alpha are merely measures of 'excess returns' and are not necessarily evidence of skill but the ability to provide expected returns not easily available in other forms of investment. In short, the knowledge is there and CAIA provides the avenue for that knowledge.)

Third, if knowledge is the lock that must be broken, then the CAIA program (and its associated material such as the JAI) may help provide the key. To the less informed, I am sure that alternatives seem like magic. As one who performs the show every day, I can assure you that it is not. I can also assure you that every CAIA graduate knows what is happening behind the curtain, that historical data is just that (historical), that 'Simple' VAR is for 'Simple'tons, that in times of crisis (especially credit crises) all assets may fall together, and that the ratings that ratings agencies give are often poor if not worthless as measures of market or price sensitivity.

Lastly, the CAIA program is not the fount of all wisdom. It emphasizes a limited but important part of the investment world; that is, alternative investments. Other professional organizations (CFA, IMCA) offer additional avenues for education in traditional asset markets as well as risk management. Just as CAIA does not provide detailed background on traditional asset management or risk management; those organizations cannot and do not provide detailed information on alternative investment management. What these organizations have in common with CAIA is their long term commitment to knowledge and education. Many other 'for profit' educational ventures (online or otherwise) offer the teacher of the week, or the just fired executive, to provide the educational experience. While these courses have their place, they do not and cannot provide the overall perspective or consistency required by a professional certification.

The goal of education is to change when change is required and to remain steadfast in our adherence to always asking ourselves if we are providing the 'state of the art' as to our current understanding of the markets. The CAIA Charter has been, is and will continue to be the standard by which the level of understanding of alternative markets can be judged. Here is looking forward with you to being continually educated and reeducated in an ever changing world. The articles in this issue of JAI continue this quest.

Performance Evaluation Methodologies

In "Qualitative Hedge Fund Characteristics and Fund Performance: Changes over Time," Rajesh Aggarwal, Jane Buchan, and Pierre Saint-Laurent examine three hedge fund governance characteristics: restrictions on investor liquidity, the presence of a high water mark, and the level of fees charged to investors that have previously been shown to be associated with superior hedge fund performance. Investor liquidity and high water mark provisions, which were found to predict performance in earlier time periods, no longer do so. High fund fees are associated with better fund performance, but only because better managers are able to charge higher fees, not because higher fees make managers perform better. The authors conclude that simple, readily observable characteristics do not reveal superior performance.

The data dependency of empirical financial research is of common concern to both academics and practitioners. This is especially true for hedge funds since no one single commonly accepted database exists and since many of the databases may hold different sets of reporting managers. Each database uses current reporting managers as the basis for the construction of hedge fund indices and these index returns reflect the characteristics of the funds reporting to the relevant database. However, unlike historical returns derived from current databases, historical returns from most major hedge fund indices do not contain backfill or survivor bias. At the same time, performance characteristics may differ between indices since each index is constructed based on a different set of index rules (e.g., equal weighted, asset weighted, and different databases CISDM, HFR, CSFBs). In "Hedge Fund Return-Based Style Estimation," Thomas Schneeweis, Hossein Kazemi, and Ed Szado, conduct a series of empirical tests, similar to those previously conducted in academic studies. Results indicate that return based style analyses, often used as a basis for hedge fund analysis, are impacted both by the period of analysis as well as the hedge fund index used. Moreover, results indicate that the addition of variables beyond those designed to capture underlying equity, interest rate, and credit risk have little impact on explanatory power of these hedge fund universe indices beyond a very low level of statistical significance.

Clones and FoF Performance

Hedge fund clones provide a liquid, efficient and transparent alternative to investing in hedge funds. As a group however, their recent performance has been disappointing, despite the large variation in the replication methodologies used. In "What Drives the Tracking Error of Hedge Fund Clones?" Arik Ben Dor, Ravi Jagannathan, Iwan Meier, and Zhe Xu investigate hedge fund clones' tracking errors and find that contrary to common belief, the reliance on historical data to 'reverse engineer' hedge funds allocation is not the primary cause. Instead, the authors identify two important drivers of tracking errors of hedge fund clones. One is changes in market-wide liquidity levels as measured by the basis between derivatives and cash securities. The second is biases in measuring the returns that arise due to attrition among hedge funds that affect the performance of commonly used hedge fund indices. Together they account for about half of the variation in hedge fund clones' tracking errors over time.

Funds of hedge funds are diversified investment vehicles that provide investors with diversification either across managers within a specific hedge fund strategy or across a wide range of hedge fund strategies. In "Diversification Strategies and the Performance of Funds of Hedge Funds," Na Dai and Hany Shawky contrast the performance of funds of hedge funds that diversify across managers (but stay within a single hedge fund strategy) versus those that diversify across managers and hedge fund strategies. Their empirical results provide strong evidence in favor of the latter. Funds of hedge funds that diversify across both managers and strategies outperform those funds that diversify across managers but stay within a single hedge fund strategy.

Regulation

The growing complexity of financial markets makes it increasingly challenging for institutional investors to manage their asset/liability profile efficiently. This is especially true for financial institutions which are facing their own changes in the regulatory framework and in accounting rules. For example, while the benefits of hedge fund strategies in asset liability management have been documented in the academic literature, the integration of these strategies into the global asset allocation of European insurance companies may be jeopardized by recent developments on the regulatory front. The Solvency II Directive is an EU Directive that

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codifies and harmonizes the EU insurance regulation. It defines the target level of capital that an EU insurance company should hold so that it can absorb significant unforeseen losses and give assurance to policyholders that payments will be made as they fall due. The Solvency II directive is, as of today, due to come into force on January 1, 2014. In "Solvency II: Regulation Change and Hedge Fund Evolution," Mathieu Vaissié argues that a solvency capital requirement of 49% does not reflect the risks inherent in hedge fund strategies. He finds that a capital charge of no more than 25% is appropriate for a diversified hedge fund allocation, and concludes that hedge fund investing is appealing from both a risk-adjusted performance standpoint and a capital efficiency perspective.

"The Impact of European Product Regulations on Global Product Structuring," by Samuel Sender attempts to show how European regulations currently being put in place will modify the fund management industry. It is based on an online questionnaire that was sent to professionals within the fund management industry (UCITS and alternative asset managers, their service providers, external observers, and investors). There are 437 respondents to the survey, reporting assets under management of more than $13 trillion. Regulatory constraints on institutional investors play a large role in the way funds are structured: pension funds, the institutional investors subject to the fewest quantitative restrictions, are, all else being equal, five times less likely than the average survey respondent to ask for hedge funds strategies to be restructured as UCITS. Investment regulations being enforced by the European Commission fail to provide incentives for hedge funds to be structured as AIFMD regulated alternatives, and instead create incentives for them to be structured as sophisticated UCITS called NewCITS. Only UCITS, after all, benefit from a distribution passport. They could thus lead to a wave of NewCITS rather than to hedge funds that comply with the AIFM directive.

Next year starts the next decade of CAIA as well as the sixteenth year of the JAI. Each organization must have done something right to last these many years, but neither could have achieved their goals without the help of many of you. A heartfelt thank you.

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