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As the global impacts of the financial crisis of 2008 enter their fifth year, perhaps it is time for a rethink of the alternative investment's place in the investment firmament. In one of the most famous of children's books, *The Velveteen Rabbit* (Margery Williams, 1922), a stuffed bunny is a little boy's most cherished plaything. The rabbit is the boy's constant companion through sickness and health. To the boy, he is real, so real that the rabbit convinces himself that he is also real. Of course, the real rabbits know that the toy rabbit is not real and regard him with a little disdain. The stuffed rabbit, while sensing that something is wrong, holds true the boy's vision of himself as being real. All the other toys warn the rabbit that sometime in the future, he will be tossed aside for some new toy. Still, the "toy rabbit" feels real and comes to believe that he is like the real rabbits he sees in the forest. In fact, while he started out as a toy, the rabbit has become real in some ways (although he will need to take it to a higher level to become truly real), but that gives away the story.

When I look at alternative investments and the articles in *The Journal of Alternative Investments* over the past 15 years, I realize how far we have come from being somewhat of a toy in the minds of traditional asset managers to becoming a "real" investment that traditional asset managers see as an essential part of the investment landscape. Today, alternative investments have grown to include an increasing number of new investment strategies and return/risk opportunities, as well as an increasing number of security and investment forms.

So where do we go from here? I feel a little like the boy who is halfway up the stairs and halfway down. I know I cannot go back down the stairs to where I once was; that is, a relatively small set of players with a relatively limited view by investors of the operational and trading issues underlying many alternative investments, as well as a somewhat limited view of the sources of risk and return of many alternative investments. I also know that many players in the investment world are not yet ready to see the toy rabbit as a full competitor in the investment space.

The articles in this issue of *The Journal of Alternative Investments* reflect some of this ambivalence. The first set of articles in hedge fund performance and nontraditional alternatives may be regarded by some as more in the rarefied air of empirical analysis, stressing our continued efforts to understand the sources and the processes of alternative asset return. These articles may, to some, seem a little unreal to their daily investment decision process. The last two articles bring us back to the real world of investments. These articles

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remind us that we cannot go back down the stairs to a time when equity and fixed income dominated the endowment and pension fund world and in which traditional approaches to representing some of their underlying investments hid more than they made transparent.

HEDGE FUND PERFORMANCE

In "A Fund of Hedge Funds Under Regime Switching," David Saunders, Luis Seco, Christofer Vogt, and Rudi Zagst investigate the use of a regime-switching model of returns for the asset allocation decision of a fund of hedge funds. In each time period, returns follow a multi-variate normal distribution from one of two possible regimes, corresponding to periods of "normal" and "distressed" markets. The prevailing regime in any given period is determined by the value of a two-state Markov chain. The case where serial correlation is absent and returns in different time periods are i.i.d. Gaussian mixture variables is also considered. The models are tested on empirical data and compared to a benchmark, assuming i.i.d. normally distributed returns. The results show that in a mean–variance framework, the use of regime switching can improve risk and performance measures. The importance of the sensitivity of optimal portfolio weights to the estimate of the probability of the distressed regime is discussed, and methods for calculating sensitivities are presented and illustrated on market data.

While the first article emphasizes a regime-switching model to describe hedge fund return processes, in "Hedge Fund Benchmarking: Equity Correlation Regimes and Alpha," Jerome B. Baesel, José F. González-Heres, Ping Chen, and Steven S. Shin analyze the effect of realized cross-sectional correlations of the S&P 500 Index on hedge fund alpha by proposing a unified model that extends the Fama–French five-factor model by adding a momentum factor and a dichotomous cross-sectional equity-market correlation factor. The use of dichotomous variables to isolate cross-sectional equity-market correlation regimes reveals factor exposures that would otherwise not be detectable using a continuous-time period analysis. The model achieves a robust forecasting efficacy rate. The authors find strong empirical evidence of idiosyncratic manager-based investment decisions (e.g., security selection, sector rotation, leveraging skills) during low correlation regimes, as evidenced by materially higher alpha, with the converse effect during high correlation regimes. The proposed model can be used as a practical benchmarking tool for hedge fund allocators, particularly when applied to equity-oriented hedge fund strategies.

NONTRADITIONAL ALTERNATIVES

"On the Tracking Performance and Return Deviation of Real Estate Leveraged ETFs" studies the performance and return deviation of real estate leveraged exchange-traded funds (RE LETFs) tracking the Dow Jones U.S. Real Estate Index (DJUSRE) and Morgan Stanley U.S. REIT Index (RMZ) from their inception to March 2011. Hongfei Tang and Xiaoqing Eleanor Xu find that relative to the broad-market LETFs tracking the S&P 500 Index, the RE LETF market is marked with greater daily market inefficiency, less-predictable management tracking error, and much more pronounced negative compounding deviation. To avoid sample-specific bias, they also simulate the target performance of RE LETFs using the entire history of the DJUSRE index from 1992 and show much less severe negative compounding deviation along with a consistent set of determinants. While the introduction of RE LETFs has provided investors with innovative financial instruments to leverage their long or short exposure to the traditional illiquid real estate sector, this article suggests that the behaviors, sources, and determinants of the return deviation on RE LETFs should be taken into consideration when formulating effective asset allocation strategies.

Several authors have stated that put options on the S&P 500 in a particular moneyness and with a particular maturity seem to be systematically overpriced and that, therefore, certain put-write strategies outperform signifi-

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cantly. Motivated by these claims, Gerhard Larcher, Lucia Del Chicca, and Michaela Szölgyenyi studied a large class of put-write strategies on the basis of historic option prices and under realistic trading conditions. Their article, "Modeling and Performance of Certain Put-Write Strategies," reports on the performance and best parameter choices of these strategies for the period 1990 to 2010, as well as several sub-periods.

ISSUES IN INSTITUTIONAL INVESTING

When applied by the largest investors, the endowment model has created impressive returns over the past 20 years. However, this style of portfolio management comes with a special set of risks. In "Risk Management for Endowment and Foundation Portfolios," Keith H. Black outlines several. First, portfolio managers need to be concerned about the interactions among spending rates, inflation, and the long-term asset value of the endowment. Second, a portfolio with as much as 60% invested in alternative assets raises concerns of liquidity risk and the ability to rebalance the portfolio when necessary. Finally, portfolios with high allocations to assets with equity-like characteristics and low allocations to fixed income require the portfolio manager to consider how to protect the portfolio from tail risk, which is a large draw-down in portfolio value during times of increased systemic risk. Those wishing to replicate the results of the most successful endowment and foundation investors need to consider the risks to inflation, liquidity, and extreme market events, while adding value through rebalancing and the successful selection of active managers. A focus on alternative investments also requires a greater degree of investment manager due diligence, evaluating both investment and operational risks.

For nonpublic companies, the Global Investment Performance Standard recommends using a since-inception IRR to report performance. In "Yale's Endowment Returns: Case Study in GIPS Interpretation Difficulties," Ludovic Phalippou shows that such a figure can be misleading. The return of the Yale Endowment in private equity is taken as a case study. It is shown that an investor with a long and "average" track record in venture capital computing its return following the GIPS recommendations would display a 30% return over a long horizon and that this number would hardly change in any year from 2000 to 2010, which is similar to what is shown in the annual reports of Yale Endowment. The results imply that it may be worth reconsidering the performance metric advocated by GIPS.

As reflected in these articles, we have only one choice, and that is to keep on climbing. Later on in *The Velveteen Rabbit*, one of the characters points out the fact of the matter.

> "It doesn't happen all at once," said the Skin Horse. "You become. It takes a long time. That's why it doesn't happen often to people who break easily, or have sharp edges, or who have to be carefully kept. Generally, by the time you are Real, most of your hair has been loved off, and your eyes drop out and you get loose in the joints and very shabby."

No one ever said the climb would be easy. As we end our 15th year, I want to thank our many authors, editors, and reviewers who are all now a little older, a little wiser, and a little more real. As we enter our 16th year, I continue to look forward to climbing the stairs together. Please keep your ideas, comments, and articles coming. While you may not feel it, you are not the only toy in the basket.

Thomas Schneeweis
Editor

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