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Over the past several weeks I have had the opportunity to review past issues of *The Journal of Alternative Investments* in search of a series of articles that explored particular issues in the area of alternative investments. I would hate to ruin any individual's weekend, but if you have the opportunity to look at some of the past issues of the Journal, especially as they relate to a given topic, I think you will be pleased with the insights they offer up. I know I was.

There is always a tradeoff between ideas expressed in past articles, which were written in part to answer questions of the day, and current articles that focus on more recent topics and economic conditions. Yet we should be careful, not to simply reject or forget past efforts in favor of more recent ones. Things change. And still, the articles of the past provide, at the very least, a sense of the staircase that led to the current approaches to the current concerns.

I welcome you to several articles that deal with the current concerns in commodities, strategy replication, and methodological issues in risk management. Each section provides new insights and approaches to the questions with which we have been grappling in previous months and previous Journals.

## COMMODITIES

In "Collateralized Commodity Obligations: *Modeling and Risk Assessment*" authors Svetlana Borovkova, Hidde Bunk, Willem-Jan de Goeij, Dimitar Mechev, and Dirk Veldhuizen address the risk characteristics and rating of Collateralized Commodity Obligations (CCO). These are recently devised structured products similar to the Collateralized Debt Obligation (CDO). Commodities as an asset class have garnered investors' attention for the past decade. CCOs, which are fixed income instruments, provide fixed income investors an exposure to commodity markets. The underlying assets of a CCO are Commodity Trigger Swaps (CTS). These are similar to Credit Default Swaps, but a "trigger" occurs when a commodity price reaches a certain pre-set level rather than when there is a default. Rating agencies have developed CDO evaluators to rate CCOs, however particular characteristics of commodity prices and an abundance of historical price data for commodities render their approaches questionable. For example, S&P recently withdrew its ratings for CCOs, perhaps due to some concerns regarding their rating approach. The authors examine the historical performance of CCOs and propose two novel approaches to their rating. The first

is a flexible multivariate parametric model for commodity prices: a mean-reversion model with correlated trends. The second approach is close in spirit to the historical simulation method for risk management and is based on the block bootstrap technique. The authors apply both approaches to an example of a CCO and compare the results to the ratings provided by the rating agencies. They find that simulated ratings are sensitive to the model assumptions; the default probabilities resulting from the agencies' ratings underestimate both historically observed and bootstrap-simulated default probabilities; and the non-parametric approach most closely matches the historically observed probabilities of default. The results demonstrate the benefit of a data-driven, non-parametric modeling approach to rating CCOs.

In "A Conditional Assessment of the Relationships Between Commodity and Equity Indexes," David P. Simon models the conditional relationships between the Goldman Sachs Total Return Commodity Index and Sub-Indexes and the S&P 500 index from January 1991 through June 2011 within a bivariate GARCH framework that uses instruments to model time-varying conditional correlations. His results indicate the presence of important spillovers between the conditional means and volatilities of commodity and equity index returns. The findings also indicate that conditional correlations increase from roughly zero to about 0.4 during the sample period, consistent with an increased integration of commodity and equity markets. The results also indicate that conditional correlations rise when the conditional volatility of equity returns increases and when business-cycle conditions deteriorate. The greater integration of these markets is also reflected in the increase of conditional betas from around zero to roughly 0.6 over the sample period. Overall, the results indicate that while the diversification benefits of commodities have diminished over the sample period, the estimated conditional correlations remain low enough for commodities to provide meaningful diversification benefits to equity investors.

## REPLICATION

Carol Alexander and Dimitris Korovilas provide the first comprehensive study of VIX futures ETNs. This empirical research into their statistical characteristics motivates the development of a sub-class of these notes based on static and dynamic differential roll-yield trades. Results in their article "Volatility Exchange-Traded Notes: *Curse or Cure?*" show that such notes provide very attractive risk and return characteristics, plus a new source of diversification for non-speculative investors. Moreover, scenario analysis demonstrates that banks may control ETN issues so that profits are virtually guaranteed net of hedging costs. However, the authors note that there is a dark side to ETNs currently in issue, which stems from a few sub-optimal terms and conditions concerning early redemption values. These conditions underpin: i) the speculative front-running of hedging activity, which has very negative consequences for issuers; ii) a moral hazard problem, which is induced by the one-day notice period for early redemption, and iii) large-scale spill over activity to VIX futures trading, which is a potential new source of systemic risk.

In "Replicating the Investment Strategy of Buyout Funds Based in the United Kingdom with Public-Market Investments," Oliver Gottschalg, Leon Hadass, Eli Talmor, and Florin Vasvari assess whether it is possible to emulate the risk-return profile of buyout funds with comparable public market investments, and conclude that the buyout fund sample used demonstrates a "performance delta" over mimicked public market investment. The performance of a sample of buyout funds is replicated by mimicking the risk characteristics of their transactions with public index data by timing precisely the funds' cash inflows and outflows net of fees and carry, matching the investments by industry sector and taking into account the effect of additional leverage replicating the typical financial risk of buyout transactions. The authors measure the returns of four investment strategies:

the buy-and-hold return on the broad public stock market index; the return on the broad public stock market index based on matched investment timing; the return on the broad public stock market index based on matched investment timing and with additional superimposed financial leverage; and the return on industry-matched public stock market indexes based on matched investment timing and with additional superimposed financial leverage. The authors compare the returns on these four investment strategies with the actual IRR performance of the buyout funds in the sample, which invested predominantly across Europe and through both rising and falling markets. They select sample funds that were raised before 2001 to minimize the measurement error associated with residual NAVs. This research shows that the mimicked public market investments fail to generate the same level of performance as the buyout funds in the sample. The buyout funds achieve performance 11.51% higher than the mimicked public market investments—a gap that the authors call “performance delta.”

## MOMENTUM AND RISK MANAGEMENT

Replication products strive to offer investors some of the benefits of hedge funds while avoiding their high fees, illiquidity, and opacity. In “Send in the Clones? *Hedge Fund Replication Using Futures Contracts*,” Nicolas P.B. Bollen and Gregg S. Fisher test whether a replication algorithm can deliver the diversification and high Sharpe ratio that investors seek. Their procedure constructs monthly clone returns out-of-sample using fully collateralized futures positions held for one month, with position sizes determined using rolling window regressions. Clone returns have high correlation with their hedge fund targets, indicating replication is possible. Clones also have high correlation with a buy-and-hold investment in stocks, however, and neither the targets nor their clones demonstrate successful time variation in factor loadings.

In “Evidence of Momentum in Newsletter Recommendations,” George Crawford, Alex Krause, and Jim

Kyung-Soo Liew study a database of investment newsletter performance since 1980, and find that the top newsletters persistently outperform the bottom newsletters when a one- to six-month look-back period is employed. They find that dynamically allocating to “winning” newsletter recommendations and shorting “losing” newsletter recommendations is both economically and statistically significant. The long/short quintile sorted portfolios employing prior monthly returns from newsletters generate a gross-of-cost annualized returns of 11.1% with *t*-statistics of 2.94. Notably, this positive performance comes packaged with a negative and statistically significant CAPM’s beta—the “holy-grail” investment strategy. Moreover, this relationship of negative CAPM’s beta coupled with positive Jensen’s Alpha has persisted over many years. These results extend the growing body of momentum literature to include newsletter investing.

Each of the above articles offers a new perspective on its area of research. One might think that after 15 years of *The Journal of Alternative Investments*, after more than 60 referred articles and a host of practitioners, comments, and reviews, we would have run out of new ideas and new ways of understanding the alternative investment universe. But of course we still have much to learn. The alternative investment area is itself changing, with new areas of investment, new regulations, new demographics, new technologies, new means of trading. Fortunately for all of us, the opportunity and challenge also remain always new.

I look forward to hearing from all of you, by letter, by email, and by article. *The Journal of Alternative Investments* is about those who read it, write in it, and discuss the issues it raises, rather than those of us who merely repeat the ideas you send us.

I continue to look forward to hearing and reading how all of you view this ever-changing world of alternatives.

**Thomas Schneeweis**  
Editor