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The first article in this issue of the Journal deals with the important topic of comparing hedge funds and mutual funds. On the surface, hedge funds seem to have much higher fees than actively managed mutual funds. However, the true cost of active management should be measured relative to the size of the active positions taken by a fund manager. A mutual fund combines active positions with a passive position in the benchmark index, which can make the active positions expensive. A hedge fund takes both long and short positions and uses leverage, which could make the active positions cheaper, but this can be offset by the expected incentive fees, especially for more volatile funds. In “What Is the True Cost of Active Management? *A Comparison of Hedge Funds and Mutual Funds*,” Jussi Keppo and Antti Petajisto investigate the trade-offs from the perspective of a fund investor choosing between a mutual fund and a hedge fund, examining the impact of leverage, volatility, active share, fees, and alpha for a realistic range of parameter estimates. Their calibration shows that a moderately skilled active manager is approximately equally attractive to investors as a mutual fund manager or as a hedge fund manager, showing that both investment vehicles can coexist as efficient alternatives for investors. Further, their model explains documented empirical findings on the career path of successful fund managers.

In “Hedge Fund Replication Using Shrinkage Methodologies,” Jiaqi Chen and Michael L. Tindall offer a set of new approaches to hedge fund replication. This new set includes stepwise regression, ridge regression, the lasso method, the elastic net, dynamic linear regression, principal component regression, and partial least squares regression. They perform a “horse race” among these approaches and find the method which employ the shrinkage of parameters tend to perform better. These methods reduce the impact of estimation risks on the size of positions and therefore tend to avoid taking extreme positions in various asset classes.

Using data from the Lipper/TASS hedge fund database over the period 1994-2011, in “Liquidity Risk and Economies of Scale in Funds of Hedge Funds,” Hany A. Shawky and Ying Wang examine the effect of liquidity risk on the relationship between size and performance for funds of hedge funds (FOFs). After confirming a significant positive size effect for FOFs, they explicitly introduce liquidity risk and find that this scale effect becomes more pronounced among FOFs with lower liquidity risk. To the extent that

more illiquid FOFs exhibit higher illiquidity risk, the results provide evidence in support of the liquidity hypothesis that size does not erode, but instead helps improve performance, since FOFs do not directly manage portfolios of securities, and thus are less affected by the liquidity costs associated with trading a large portfolio.

The fourth article, “Informed Trading and Price Discovery Around the Clock” by Chan Wung Kim, Timothy T. Perry, and Manjeet Dhatt examines intraday patterns of volume, volatility, informed trading, and price discovery in actively traded Eurodollar (ED) futures contracts exchanged on the Chicago Mercantile Exchange’s (CME) Globex electronic transaction platform between January 3, 2005 and December 29, 2006. This period immediately follows the full integration of Globex into this market. On an hourly basis—and within four distinct intraday periods—the author observes notable intraday market patterns in volume, volatility, informed trading, and price discovery in this around-the-clock setting. Traders have nearly continuous access to this market, and information fundamental to the pricing of Eurodollar futures contracts can materialize at any time of the day. Yet, the vast majority of informed trading and price discovery in this market continues to occur during historical regularly scheduled trading hours, when volume and volatility are highest.

Following large positive returns in 2008, CTAs received increased attention and allocations from institutional investors. Subsequent performance has been below its long term average. This has occurred in a period following the largest financial crisis since the great depression. In “Is This Time Different? *Trend-Following and Financial Crises*,” using almost a century of data, Mark C. Hutchinson and

John O’Brien investigate what typically happens to the core strategy pursued by these funds during global financial crises. They also examine the time series behavior of the markets traded by CTAs during these crisis periods. Their results show that in an extended period following financial crises, trend following average returns are less than half those earned in no-crisis periods. Evidence from regional crises shows a similar pattern. They also find that futures markets do not display the strong time series return predictability prevalent in no-crisis periods, resulting in relatively weak returns for trend following strategies in the four years immediately following the start of a financial crisis.

In “Strategic Allocation to Commodity Factor Premiums,” David Blitz and Wilma de Groot confirm the existence of sizable momentum, carry and low-volatility factor premiums in commodity markets, and argue that investors should consider these commodity factor premiums when determining their strategic asset allocation. They find that a diversified portfolio of commodity factor premiums exhibits a significantly better risk-adjusted performance than the commodity market portfolio and adds significant value to a conventional stock/bond portfolio. The plain commodity market portfolio, on the other hand, appears to deserve little or no role at all in the strategic asset mix. Investors should therefore not postpone the consideration of alternative commodity factor premiums to a later stage of the investment process.

Hossein Kazemi
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