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As the year comes to an end, one has the opportunity of reviewing how the alternative investment industry has evolved during the past year. Commodity investment, often viewed as the poor stepchild of the industry, continued to grow among increased investor interest in reaction to evidence that global growth may insure its long-term profitability as an investment vehicle. Similarly, private equity and venture capital seem poised for a rebound after several years of being on the back page of the alternative investment industry. Hedge funds, of course, have also remained in the headlines. With recent actions at the governmental level as well as the business level one may view the past year as a watershed year for the hedge fund area. In brief, it seems that the alternative investment industry has become a central part of the investment landscape. This position—and the accompanying attention—is not without its drawbacks. The increasing understanding of the underlying factors which drive the seeming somewhat cyclical returns in each investment area make the term "absolute returns" more of a tag line than a central tenet of the industry. In fact, hedge funds themselves have become, to many, so successful that their ability to continue to provide suitable returns is now questioned. The lead section of this issue features articles on hedge fund strategies and asset allocation. In the first article, "Have Hedge Funds Eroded Market Opportunities?" Jan Loeys and Laurent Fransolet discuss whether and how hedge funds erode opportunities in interest-rate, credit, equity, and currency markets. They believe that this erosion will prove temporary, with new active trading opportunities emerging in the near future.

At the same time, the knowledge that both market forces as well as economic factors drive hedge funds may better help investors understand the dynamics of the return patterns inherent in the industry. In the second article, "Active Risk Budgeting in Action: Understanding Hedge Fund Performance," Kent Clark and Kurt Winkelmann propose a framework that identifies the impact of market returns versus active returns, the differences in active returns across hedge fund strategies, as well as the relative confidence that investors place in alternative strategies. They note that hedge funds will continue to play an important role in investors' portfolios and assert that their framework is designed to help investors isolate the key decisions they make.

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One reason for the continued optimism as to the growth of the hedge fund industry is that the investment area itself has shown the ability to evolve and have its own set of dynamics. The third article, "CDO Equity: An Emerging Class of Alternative Investment," by Shanker Merchant, describes CDO equity as an alternative asset belonging to a separate class of alternative investments (structured product), subject to certain qualifications. It discusses CDO equity as an option on the underlying assets, outlines the correlation and other investment properties of both dynamic and static CDO equity, and illustrates such properties through examples. The article uses the option framework developed by Merton and Black and Scholes to determine the valuation of CDO equity as a call option on the CDO assets. Furthermore, it provides a guideline for the investment in CDO equity from an asset allocation perspective. Merchant suggests that CDO equity should serve as a risk-diversifier to alternative portfolios with attractive returns.

The fact that the industry itself is an evolving structure requires that we focus on how both practitioners and academics alike are monitoring that change. The second section features an article on hedge fund practices. In this article, entitled "Taking a Close Look at the European Fund of Hedge Funds Industry: Comparing and Contrasting Industry Practices and Academic Recommendations," Noël Amenc, Jean René Giraud, Lionel Martellini, and Mathieu Vaissié present the results of a survey conducted by Edhec Risk and Asset Management Centre of the practices of European hedge fund multi-managers. This survey focused on examining the following three dimensions that are commonly perceived as the main sources of added value by multi-managers, namely fund selection, asset allocation and portfolio construction, and reporting and investor information. The authors report the results of this survey, and shed some light on the causes of the gap between practitioner and academic perceptions with regard to the approach followed by hedge fund multi-managers. They conclude that the institutionalization of hedge funds, and the move from absolute performance to diversification benefits, cannot simply be understood as a change in scale and client objectives, but more as a profound modification of investor requirements impacting several dimensions of the industry.

Along with review of investment issues which deal with a more macro view of the industry, micro issues which deal with performance at the product level continue to require analysis. The third section features an article on hedge fund taxation. Janie Bouges in the article entitled "Alternative Hedge Fund Product Performance: The Impact of Regulation on Performance" reviews various legal and tax regulations that impact hedge fund and mutual fund after-tax returns and demonstrates that it is possible to employ current tax regulations in such a way as to make hedge funds more tax efficient than mutual funds with similar return patterns. Her results show that for the majority of positive return patterns, mutual fund taxes were greater than hedge fund taxes. She finds a stark difference, however, when returns were negative. When returns were negative, at all levels of volatility tested, hedge fund taxes were higher than mutual fund taxes. The reason for this contrast is a subject for future research.

As discussed earlier, after several years in which the investment area was retrenching, private equity has begun to reemerge as a major investment vehicle. The next section features an article on private equity benchmarking. Andre Frei and Michael Studer in the article "Practitioner's Guide to Private Equity Benchmarking" discuss various benchmarking methods that aim to draw the practitioners' attention to the subtleties of comparing private equity performance with public markets. It concludes that the static spread method—widely used for fixed income investments, but generally unknown in the context of private equity investments—represents the most meaningful methodology. Their results show benchmarking his-

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torical private equity data with the static spread method reveals that private equity outperformed public equity markets by around 5%.

The evolution of the alternative investment area insures that other "less well known alternative investment" media may become part of the investment tool box. The final section of this issue features an article that examines penny stock returns. In this article, entitled "Over the Counter Bulletin Board Exchange: The Impact of Liquidity and Size to Return, Volatility, and Bid/Ask Spread," Carl Luft and Lawrence Levine extend prior research on this market by studying the impact of market capitalization and liquidity to return, volatility, and components of the bid-ask spread. They find that an investment strategy that focuses on the largest OTC-BB firms provides relatively the highest risk-return trade-off in this market during the period January 1996–December 2000. These findings are consistent with an earlier article by the authors that suggests that a trading strategy of OTC-BB securities will not yield an appropriate risk-return trade-off as measured by the Sharpe ratio. In addition, they find that competition appears to be increasing as the relative bid/ask spread for OTC-BB securities declines. Finally, they observe that the behavior of the market participants trading OTC-BB securities ("traders") is consistent with the behavior exhibited by New York Stock Exchange ("NYSE") specialists.

In short, here is the good news: like any long-term successful entity, the alternative investment area is evolving. Here is the bad news: Evolution requires us to adapt to that change. The articles in the current issue are evidence of the industry's attempt to monitor, understand, and adapt to that change. We look forward to your articles and ideas on how we can best continue to evolve and meet your needs.

Thomas Schneeweis
Editor