

# The Journal of **Alternative** **INVESTMENTS**

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It has been seven years since the first issue of *The Journal of Alternative Investments*. Much has changed over those seven years. Few, I believe, would have predicted the tremendous growth in the alternative investment area. Today, for some, traditional assets have become the alternative. Still, the fundamental reason for the creation of this publication still holds, that is, to provide an avenue for both academics and practitioners to provide new insights into the functions and economic basis for alternative investments. We need not always agree with the positions taken by the various authors. In fact, healthy debate lies at the core of our better understanding of these markets. The articles in this issue illustrate aspects of that continuing debate: Does leverage really matter? What is the role of CTAs in portfolio diversification? How are new alternative products or new financial instruments affecting portfolio creation? If risk management and compliance are fundamental aspects of fund management, what are the theoretical and practical implications of differing approaches?

The lead section of this issue features articles on asset allocation and investment strategies. In the first article, "The Impact of Leverage on Hedge Fund Risk and Return," Thomas Schneeweis, George Martin, Hossein Kazemi, and Vassilis Karavas analyze the effect of leverage on hedge fund risk and return and present results on the level of leverage used in various hedge fund strategies. Results are also provided on the degree to which leverage above or below the median fund leverage results in superior or inferior risk adjusted performance within a particular hedge fund strategy. Overall their results show that while different hedge fund strategies may use different amounts of leverage, within a particular hedge fund strategy, there is little evidence of a significant difference between risk adjusted performance of funds with above-median or below-median leverage. In the second article, "The Answer to Your Dreams? Investment Implications of Positive Asymmetry in CTA Returns," R. McFall Lamm argues that CTAs possess overlooked performance characteristics—positive skew and excess kurtosis—which are of significant value to investors. Specifically, positive asymmetry in CTA returns serves as an offset to the negative asymmetry of other assets in portfolio construction. Using

portfolio optimization techniques that consider higher-order moments, Lamm shows that the resulting allocations to CTAs are significantly higher. He concludes that investors are well advised to take into account CTA return skew and kurtosis as ignoring those measures can lead investors to the impression that CTAs are more risky than they really are, thereby increasing the likelihood of diminished investment returns in the process. In the third article, “The Risk Profile of Private Equity Funds of Funds,” Tom Weidig, Andreas Kemmerer, and Björn Born illustrate that FoFs significantly reduce risk due to diversification, utilizing a framework that constructs the risk profile of FoFs using fund performance data. Their results show that the risk associated with a FoF investment is significantly smaller than that for a fund investment. The fourth article of this section, “Super Cats as Alternative Investments,” authored by Joseph Calandro, introduces the concept of super catastrophes, or Super Cats, as alternative investment opportunities. Using the recent Pepsi *Play For a Billion* sweepstakes case, he presents a methodology for valuing Super Cats with a reasonable margin of safety. The methodology combines insurance and value investing theory. In addition to the case discussion, he presents general guidelines that could prove useful in future alternative Super Cat investments.

With the increased importance of risk management and numerous developments in recent years, we will present a section on the subject each issue going forward. In the first article of this section, “The Impact of Higher Moments on Hedge Fund Risk Exposure,” Jordan Alexiev utilizes simulation techniques to quantify the miscalculation of exposure to loss for 31 Hedge Fund Research return series. These errors are measured for both end of horizon and within-horizon probability of loss. His results show that HFR return series tend to exhibit distributions that are far different from normal. Risk calculations performed under the assumptions that continuous returns are normally distributed signifi-

cantly differ from the empirical results. However, he notes that if skewness and kurtosis for HFR returns over the period January 1999–May 2003 are calculated, the distributions of the return series are much closer to the normal distribution and the majority of HFR strategies exhibit positive skewness. In the second article of this section, “The Effect of Misestimating Correlation on Value at Risk,” Vasiliki D. Skintzi, George Skiadopoulos, and Apostolos-Paul N. Refenes examine the systematic relationship between correlation misestimation and the corresponding value-at-risk (VaR) miscalculation. Their results show that the VaR error increases significantly as the correlation error increases, particularly in the case of well-diversified linear portfolios. In the case of option portfolios, this effect is more pronounced for short-maturity, in-the-money options. They note that the use of MC simulation to calculate VaR magnifies the correlation bias effect. They conclude that these results have important implications for measuring market risk accurately. In the third article, “Maximum Drawdown: Models and Applications,” Ricardo Pereira Câmara Leal and Beatriz Vaz de Melo Mendes propose a new modeling strategy for maximum drawdown that separates its duration and severity along with suggestions of a flexible distribution from the extreme value theory for modeling the losses. Illustrations using stock market indexes as well as insights on the connection of the fluctuations of the maximum drawdown and the volatility of the underlying return series are provided. This methodology is applicable to various alternative investment strategies as well.

The final section of this issue features articles on regulation and compliance. In the first article of this section, “An Introduction to the Investment Advisers Act of 1940,” Elizabeth M. Schubert discusses a recent SEC ruling regarding hedge fund adviser registration and the impact that it will have on the industry. First, she addresses briefly the initial industry response to the new rule, including speculation



about loopholes and possible legislative and judicial challenges. This is followed by a detailed discussion of the new rule and the Advisers Act while emphasizing items that funds need to address to ensure they meet the SEC's compliance deadline and other requirements. In the second article, "Investment Adviser Compliance Requirements for Managers of Hedge Funds," Jeffrey R. Blumberg, Kelly A. Fetzer, and David M. Matteson examine issues in the context of designing the compliance manual that funds are now required to maintain under the new rules. These include among others portfolio management processes and trading practices including personal trading activities of supervised persons and soft dollar benefits.

The Journal has met another milestone other than completing its seventh year. The Journal's continued efforts to provide a forum for various views on the alternative investment industry has resulted in its being named the official Journal of the Chartered Alternative Investment Analyst Association. We welcome members of that association who are not yet familiar with the Journal. We look forward to your comments and your submissions. I am sure that it is the start of a beautiful friendship.

**Thomas Schneeweis**  
**Editor**