

RETHINK THE WAY YOU INVEST

Alternative Investments: Risky Business

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An excerpt from the National Best Selling Book, *The Empowered Investor: A Guide to Building Better Portfolios* by Keith Matthews (www.empoweredinvestor.ca).

Hedge funds and other forms of alternative investments have been around for decades. They were traditionally marketed to the super-rich and often have glamorous reputations. Pitched as a way for wealthy private investors to ride the performance wave of the best active money managers, hedge funds and other alternative investments have increasingly made their way into the mainstream with—as we will see—varying results.

There is an intriguing rationale for including these alternative strategies in your asset mix. In theory, investors should obtain better levels of diversification with less overall risk by adding specialty assets that are not correlated to a traditional, publicly-traded asset mix. In practice, however, many individual investors find that including specialty assets leads to frustration and less-than-stellar portfolio returns.

Alternative strategies are marketed and sold to investors with an underlying investment story that appears straightforward and credible and can often be quite convincing. More often than not, alternative strategies are marketed and sold during periods of high public market volatility. They are definitely marketed and sold during equity bear markets—when our emotions and fears are at their peak. At times like that, the message of better portfolio diversification and higher absolute returns can be very soothing and enticing.

You may be wondering how and when to include these strategies in your portfolio. Well, I have good news and bad news. First, the bad news: I strongly recommend that you do not include any of these alternatives in your long-term investment mix. The good news is that there are lots of asset classes¹ that—in many cases—have achieved the same or better rates of return as alternative

investments, often with less risk and less cost. These asset classes are much more transparent, easier to understand, accessible to you at great prices and, most importantly, do not bear high rates of manager inconsistency or performance risk.

Alternative strategies have long been known to sophisticated investors for their less-than-transparent operations. Investors and advisors alike have struggled to obtain timely and clear information regarding many of these investment holdings, historical returns, or risk-management techniques. In this white paper, we review a few of the most common types of alternative strategies and introduce some evidence-based research to help you understand why you should steer clear of these vehicles.

Hedge Funds

Hedge funds are perhaps the best-known of the “alternative strategies.” A hedge fund is most often a private investment fund charging a performance fee that is typically open to only a limited range of qualified investors. Because of this restriction, hedge funds are often exempt from any direct regulation by the security regulators or other regulatory bodies. A hedge fund’s activities are limited only by the contracts governing the particular fund, so they can follow complex investment strategies such as long or short assets and entering into futures, swaps, and other derivative contracts (Wikipedia 2007).

Hedge fund managers are the ultimate active managers and we are told that they can deliver these results with lower volatility. Their marketing materials inform us that this is an easy and efficient way to preserve or increase your expected portfolio return while at the same time decreasing your risk or portfolio volatility. Simply allocate 5–15% of your

portfolio to these types of strategies and you will be a more satisfied investor. Sounds interesting, doesn't it? Not so fast ...

In 2005 Burton Malkiel and Atanu Saha published research findings that highlighted the investment risks of hedge funds.² These risks include: biases in historic returns, wide dispersion of returns, a lack of performance persistence, and high levels of fund demise. We will examine each of these risks separately.

Biases in Historic Returns

There are many published databases that show the historical returns of the performance of hedge fund managers. These databases typically report returns and standard deviation of existing hedge fund strategies which, at first glance, can appear very appealing. In other words, good returns with less volatility than many traditional equity asset classes. Malkiel and Saha's analysis, however, demonstrates that these published returns are heavily biased upwards, as does other credible research. "Backfill"³ and "survivorship"⁴ biases lead to published databases that can contain very misleading information.

Malkiel and Saha concluded that "the use of backfilled returns to judge the effectiveness of hedge fund management significantly biases the returns upwards" and that this backfilling activity can inflate the group's average return by up to 500 basis points. Their analysis on survivorship bias was not the first to be done on the hedge fund industry, but it may be the most thorough. They found that "the average return of the surviving hedge funds was 13.74 percent for the 1996–2003 period, whereas the average return for all hedge funds (including those that did not survive and were dropped from the

database) was only 9.32 percent—a 442 basis point difference."

Why is it so important to understand these biases? Simply put, the historic returns presented in these published databases are typically the first argument used to persuade investors and advisors to consider including hedge funds in their portfolios. Be aware of these biases. The numbers you may be shown could be wildly optimistic and your portfolio could very well be the loser in this equation.

Wide Dispersion of Returns

Average returns for hedge funds tell you one thing; dispersion tells you another. Evidence-based data quite consistently shows that alternative strategies have a higher than usual dispersion of returns compared to managers of traditional asset classes. Dispersion of returns is a measurement of the gap between the returns of the top-performing funds and the returns of the worst-performing funds. A report by Bernstein Wealth Management Research⁵ found that the average U.S. long/short equity hedge fund had an average return of 1.5% in 2001, but that individual funds had returns ranging from -50% to more than +60%.

The alternative strategies available to Canadian investors also have a short-, medium-, and long-term history of wide dispersion of strategy returns. As of 31 August 2007, over forty retail alternative strategy funds—with total investments of \$3.3 billion and with a five-year (or more) track record—were available in Canada. Table 1 (see next page) shows the wide gap between the best- and worst-performing alternative strategy returns. As you can see, the gap between the "winners" and the "losers" is quite significant. Are you prepared to accept this level of dispersion within your portfolio?

Table 1: Dispersion of Canadian Hedge Fund Returns

ALTERNATIVE STRATEGIES	1 YR	3 YRS	5 YRS	10 YRS
Highest in Alternative Strategies Group	57.2%	71.7%	59.2%	19.8%
Median in Alternative Strategies Group	4.2%	7.9%	10.8%	7.3%
Lowest in Alternative Strategies Group	-78.9%	-40.2%	-17.9%	-22.9%
S&P/TSX Total Return	16.0%	20.2%	18.0%	9.4%
Median Canadian Equity Manager Rtn.	15.1%	17.9%	15.0%	8.1%
BMO Nesbitt Burns Cdn. Small Cap Index	7.9%	18.8%	18.9%	9.4%
Median Small to Mid Cap Canadian Equity Manager Rtn.	11.6%	16.3%	15.3%	9.4%

Source: Globe Fund, 31 August 2007

Lack of Performance Persistence

To complicate matters, it appears to be just as difficult to find the winning managers in advance in the hedge fund universe as it is in the traditional active manager universe. Since the difference in returns between the winners and the losers is so great, the selection process seems to be critical to an investor’s investment experience. The rewards of selecting the top-performing funds are no doubt spectacular—but the dismal experience of selecting the worst-performing strategies can be extraordinarily painful.

So how persistent are the winners? And can investors and advisors select winners in advance? Again, Malkiel and Saha’s analysis is revealing. Table 2 illustrates the challenges of selecting winners based on past performance. In this analysis, a “winner” was a manager who had realized a return larger than the median hedge fund return for that year, while a “loser” realized a below-median return.

Apparently, hedge fund managers are not as consistent as they would have you believe. On average, slightly more than half (54.74%) the

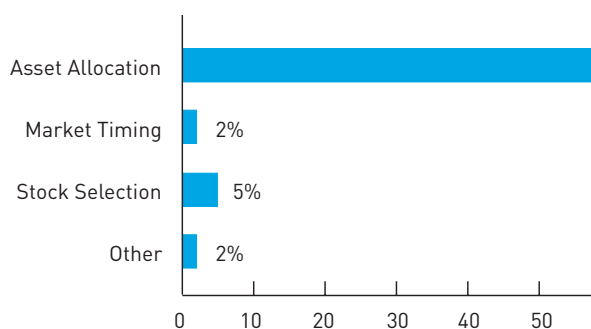


Figure 1: Lonely at the Top

Source: Altvest and Bernstein Wealth Management Research Report

managers returned as “winners” from one year to the next. The numbers in figure 1 show the records of the top-performing U.S. long/short equity hedge funds just as the market was transitioning from a bull market to the difficulties experienced in the 2000 and 2001 equity sell-off. Is identifying the next winning hedge fund manager a sure bet? Far from it. The wise investor remains focused on keeping

Table 2: Persistence in Hedge Fund Returns 1996–2003*

YEAR	WINNER TO WINNER	WINNER TO LOSER	TOTAL	% REPEAT WINNER
1996	11	5	16	68.75%
1997	70	54	124	56.45%
1998	113	104	217	52.07%
1999	124	140	264	46.97%
2000	142	181	323	43.96%
2001	226	150	376	60.11%
2002	275	144	419	65.63%
2003	298	380	678	43.95%
Average				54.74%

* This analysis does not include funds that were dropped from the database. If these numbers were included, the average would decrease to 51.56%

Source: Burton Malkiel and Atanu Saha, "Hedge Funds: Risk and Return," *Financial Analysts Journal* 61, no. 6 (2005). This report highlighted findings of a study on hedge fund results from 1995 to 2003, using a database provided by TASS, a unit of Tremont Capital Management. This database covers between one-third and one-half of the total number of hedge funds in existence. Malkiel and Saha obtained TASS data not only on currently existing funds but also on so-called dead or defunct funds.

a well-diversified portfolio—and avoiding this rollercoaster ride.

High Level of Hedge Fund Demise

The managers of a poorly-performing fund will find it difficult to attract new assets. And if the managers fail to reach their (often unattainable) performance benchmarks, they will not receive their performance pay (bonuses). What happens in this situation?

The management team will voluntarily shut down the fund—and start another one. Although this frequently occurs with all poorly-performing funds, hedge funds have a higher probability of being shut

down by their own management teams than regular mutual funds.

In their analysis of hedge funds, Malkiel and Saha showed that average attrition rates during their study period (1994–2003) ranged from 13–20% per year. Attrition rate is like a “drop out” rate. This means that approximately one out of every five or six hedge funds closed during each year of their study. These rates are three to four times greater than the dropout rates for mutual funds. Being in a fund that opts to close down is not a particularly rewarding experience for investors. In fact, it is probably one of the most frustrating experiences that an investor can live through, and usually happens when a fund significantly underperforms or is simply not performing well.

A Final Word of Warning

David F. Swensen gets the final word on hedge funds. Swensen is the chief investment officer of the Yale University Endowment Fund, a fund with a legendary investment following.⁶ He had

one of the best performance track records in the U.S. endowment industry and his fund was known for its successful inclusion of alternative strategies. In his second book, *Unconventional Success: A Fundamental Approach to Personal Investment* (2005), Swenson argued that, while some sophisticated asset management groups might be able to exploit alternative strategies for superior returns, the non-pension plan investor has a slim chance of finding true success with any of these strategies. Swenson did not mince his words, clearly stating that retail and individual investors have a much higher risk of prospective failure when investing in hedge funds due to their materially higher level of fees. He simply does not feel that the odds are in your favour. Referring to individual investors (anyone other than a pension fund), he says that a “casual approach to hedge fund selection leads to almost certain disappointment.”

Private Equity or Buyout Firms

Private equity or leveraged buyout partnerships involve private owners buying mature companies, adding debt to magnify their returns, and then restructuring the existing assets in a more streamlined fashion. The general partners of these buyout funds argue that their abilities to restructure the firm and to find, create, and release value in the underlying assets will generate returns far in excess of the ongoing management fee and their 20% stake of profits. We are told that public equity markets are tired, boring, and just not as interesting as these private markets. We are told that pension plans are turning to private equity to enhance their pension returns. We hear that private equity funds are ballooning on a global basis and that they are in the process of buying up all the good investment opportunities in Canada and abroad.

We again appeal to Swenson who writes that “for the twenty years ending June 30th, 2003, a group of 304 buyout funds tracked by Cambridge Associates produced a pooled mean return of 11.5%. Over the same period the S&P 500 returned 12.2%.” In his book, Swenson notes research that appears to provide evidence that smaller buyout funds (under \$1 billion) have generated returns superior to larger buyout funds over a long period; however, he is quick to point out that these smaller buyout funds typically invest in smaller companies (which have higher levels of operational risk) and should therefore provide higher rates of returns for the heightened risk. He goes on to suggest that this small buyout fund premium can disappear quickly with a large influx of new capital.

Given his legendary status and his reputation as the master of including private equity funds in the total asset mix of a foundation, Swenson’s findings and recommendations carry a lot of weight. In a nutshell, he feels that “the large majority of buyout funds fail to add sufficient value to overcome a grossly unreasonable fee structure.”

Venture Capital

The appeal of venture capital for investors is easy to understand: invest in a fund or partnership whose sole purpose is to discover start-up operations, provide them with financing, and help them develop into profitable enterprises; or, find and invest in ground-breaking technology, incredible medical discoveries, or revolutionary trend-changing brands. This strategy is all about trying to discover the next Microsoft or Google and to invest in it before it sells to the public markets—with handsome rewards. Everyone has heard of someone (rarely someone you know personally) who has cashed in beyond their wildest dreams in

this fashion. It is by far the most exciting investing concept—if you happen to be one of the lucky few (the very lucky, very few) who hit the jackpot. Venture capital investors invest at very high risk in the hope of achieving very high returns. You may think this sounds appealing and you believe you can handle the risk, but there are a few things to consider before you sign on the dotted line.

Investing in small companies can be a rewarding experience for investors with patience and discipline. Investors who want higher returns and are prepared to take on higher levels of risk, can diversify their portfolios to include diversified holdings in Canadian, U.S., and international small companies. There is a big difference, however, between small companies that trade in the public markets and “start-up operations” that need venture capital. While they might seem similar, they are two very different investment asset classes or asset strategies.

Let’s not forget that entrepreneurs and small business owners are a key engine of the world’s economies. Running a small business and delivering goods and services to market is a very different activity to launching a start-up operation. Start-ups are generally just that: operations that start with nothing and dream big. They often have difficulty obtaining financing (either equity or bank financing), so they turn to venture capitalists. And, yes, once in a while, one of these companies will break out of the pack and succeed wildly. But the majority of our great new inventions and discoveries continue to come from larger and better-financed companies that do not need your money to bring their ideas to market.

Investing in venture capital opportunities is a unique concept: it is the act of investing in an idea or vision. That idea or vision is owned by an

individual or small company that lacks the capital it needs to commercialize its idea and bring it to market. Unfortunately, by and large, Canadian investors have only had access to a small group of venture partnerships and their performance has been less than impressive. The larger and best-known venture pools of capital have always been in the U.S. market—the marketplace and home of many discoveries and innovations. Opportunities (including those found in Canada) are often seeded from U.S. venture pools of capital.

So how have Canadian venture capital funds done? Table 3 shows the results obtained by investors in retail venture capital funds over the past ten years. From the 2.1% ten-year median venture capital return (as of 31 August 2007), it is clear that Canadian investors have not been rewarded for taking on this additional venture risk.

As of 31 August 2007, more than twenty-eight retail venture capital funds—with total investments of \$2.3 billion and with track records of five years or more—were available in Canada. Unfortunately, the increase in the number of these new funds has not improved the returns experienced by investors. As of 31 August 2007, the five-year median return of these twenty-eight funds was a mere 2.2 percent, whereas the S&P/TSE Total Return and the BMO Nesbitt Burns Cdn. Small Cap Index were 18.0% and 18.9%, respectively.

The U.S. institutional venture capital market has obtained better relative returns, but nowhere near the numbers needed to justify the added risk. In its authoritative 2001 report on investment benchmarks, Venture Economics stated that, for the twenty-year period ending 31 December 2000, a sample of nearly 950 venture capital funds produced a rate of return of 19.6% (as opposed to a rate of return of 20.2% for the S&P 500). We again turn to

Table 3: Canadian Venture Capital Mutual Fund Performance

FUND NAME	ASSETS (MILLIONS)	MER	10-YR RETURN
B.E.S.T Discoveries 1	69.4	5.72%	2.7%
Canadian Med Discoveries Sr. 1	200	3.00%	-5.6%
Dynamic Venture Opportunities Sr. 1	66.2	3.99%	6.8%
Dynamic Venture Opportunities Sr. 2	68.8	4.74%	6.7%
Growth Works Canadian	231.5	4.90%	-2.9%
Vengrowth Investment Fund Cl. A Sr. E	126	3.98%	0.2%
Working Opportunities Balanced Sr. 1	162.4	2.63%	2.1%
Median in group for Retail Venture Capital			2.1%
91-Day Treasury Bill Index			2.7%
Canada Savings Bond Index			3.8%
5-Year Average GIC Index			3.9%
S&P/TSX Total Return			9.4%
BMO Nesbitt Burns Cdn. Small Cap Index			9.4%

Source: Globe Fund, 31 August 2007

Swensen for guidance, “Over long periods of time, venture investors receive no more than market-like returns with demonstrably higher levels of risk. The promise of venture capital fails to deliver.”

Stay Focused on Your Portfolio Strategy

While many financial institutions market alternative investing as a reasonable thing to do with a small portion of your portfolio, the odds do not appear to be in your favour. The guaranteed winners are the firms and managers that charge the high fees. And while some investors (both institutional and individual) may have done remarkably well with their alternative strategies, the long-term evidence simply does not favour the individual investor.

NOTES

1. Asset classes such as REITs, Canadian, U.S., and international equities, broad market equities, and value and small company equities

2. Burton Malkiel and Atanu Saha, “Hedge Funds: Risk and Return,” *Financial Analysts Journal*, 2005. This report highlighted findings of a study on hedge fund results from 1995 to 2003, using a database provided by TASS, a unit of Tremont Capital Management. This database covers between one-third and one-half of the total number of hedge funds in existence. Malkiel and Saha obtained TASS data not only on currently existing funds but also on so-called dead or defunct funds.

3. Often called “incubation bias,” backfilling occurs when hedge funds submit historical results of a strategy only once they obtain favourable results. Contrary to the mutual fund industry, hedge funds provide information to database publishers only if they choose to do so.

4. A database has survivorship bias when it does not include all the “dead fund” performance numbers. Most published databases only include funds that existed as of the reporting date and typically do not include the returns from hedge funds that existed at some point in the past but are not in existence as of the report date.

5. Bernstein Wealth Management Research, *Hedge Fund Myths and Realities*, 2002. The report examined returns for the four years from 1998 through 2001 for long/short U.S. equity hedge funds and absolute-return hedge funds reported by the Altvest database.

6. The Yale Model was characterized by relatively heavy exposure to alternative strategies such as private equity compared to more traditional asset classes. The endowment fund’s two decades of great success came primarily from investing in these very types of alternative asset classes. The Yale Model was developed by David Swensen and is described in his first book, *Pioneering Portfolio Management*. He also teaches economic classes at Yale College and finance classes at Yale’s School of Management.

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A Guide to Building Better Portfolios

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