

Alternative Investments A through Z[®]

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The year 2003 should be remembered as “The Year of Alternative Investments” because of the vast amount of attention given to this topic. It’s only fitting, therefore, that 2003 conclude with an article that classifies all the alternative investment products, discusses their growth and risk profiles, and offers the experts’ viewpoints.

This research report for the condensed article with the same name that appears in the November/December 2003 issue of *Financial Engineering News* encapsulates sources that when printed created over a six-inch deep pile of paper. Many of these sources’ conclusions were redundant and supportive of each other. Therefore, for this research report the first source visited is quoted while for the condensed article, the conclusions of all redundant sources were summarized without specific note.

THE PRODUCTS, PROS AND CONS

Alternative investments are catching the public’s notice because investors are increasingly considering them as a way to diversify their traditional stocks and bonds portfolios because most of these products have a low correlation with stock market performanceⁱ.

The defining characteristics of these hot products are that they tend to be more privately held and illiquid than traditional stock and bond investments.ⁱⁱ There are four primary categories of alternative investments (see Table): debt-based offerings, hedge funds, private equity, and real estate.

Debt-based Offerings: Credit Derivatives and Distressed Debt

Debt-based offerings are either credit derivatives or distressed debt. **Credit Derivatives** (CDs) consist of contracts linked to the credit performance of an underlying reference asset.ⁱⁱⁱ

The two largest CD markets are *Credit Default Swaps (CDS)* and *Collateralized Debt Obligations (CDOs)*.^{iv} A CDS is when the protection buyer pays a fee for receiving a contingent payment by the protection seller following a specified credit event occurring to a specified asset over a certain time period. A CDO is a contract covering a security that’s backed by a diversified pool of assets that can be loans, bonds, or a synthetic.^v CDOs require multiple classes of notes being issued so that credit risk and expected return is allocated according to the investors’ risk-return preference.^{vi}

Joe Rizzi, Managing Director, Structured Products Risk, for ABN AMRO, considers the growth in CDOs as directly attributable to banks now attempting to offload risk (rather than their previous buy/hold strategy) to a neglected niche that’s been interested in the underlying products but had limited ability to access the more desirable derivative products. Despite initial investors being burnt by inaccurate modeling/pricing due to the products’ newness, lack of transparency, and a razor thin secondary market that caused liquidity and agency problems, Rizzi foresees all varieties of credit derivatives growing in the future because the models and transparency are improving. Also interested parties have expanded to non-bank products, creating customized synthetic securities using financial engineering constructs.

The three primary drivers of CDO returns are the performance of the underlying collateral securities, the CDO structural features, and the asset manager’s actions.^{vii} The asset manager’s decision as to whether they will protect the rights of the debt or equity holders is so critical that of all CDOs that

were recently downgraded or placed on watch by Fitch, 84.6% were managed rather than static. By contrast, all upgraded CDOs were either static in nature or provided for some type of pay down of the upgraded class during the revolving period.

Issuers of newer CDOs commenced correcting these problems with more conservative CDO structuring and innovative excess spread diversion techniques, which when coupled with the recent strong U.S. residential housing market performance are resulting in a more attractive investment product.^{viii}

Rizzi says that with \$1 trillion in credit derivatives already released globally and the performance issues addressed, there's plenty of room for new entrants to join without impacting the leaders, who are ABN AMRO, Deutsche Bank, Merrill Lynch, Lehman Brothers, and Citigroup.

The **Distressed Debt** sector involves the acquisition (at extremely cheap prices) of corporate bonds of companies that have either gone into bankruptcy or are about to go into liquidation so as to profit from the capital gains of these firms when the company is restructured. The U.S. distressed debt sector's more liquid than its international counterpart because of the large U.S. junk bond market. In fact, in many other countries this product's considered a private equity investment because of its illiquidity level.^{ix} However, in the first six months of 2003 there was so much U.S. fascination with this product because of the peaking default rates, low interest rates, and a less volatile equity market that distressed debt shops vied with event-driven hedge funds for this line.^x

The risk level in the distressed debt field is high as it's quite cyclical in nature due to a host of economic, corporate structure, and technical factors such as asymmetrical information, firm-specific event risk, increase in overall correlations with market-related risks (such as interest rates and the state of the equity market) in times of severe overall market stress, judge track record risk, mechanic operational risk, claim liability risk, disputed/contingent claims risk, holding period risk, liquidation risk, agency and tax issues^{xi}.

Hedge Funds

A hedge fund is a private investment conduit organized as a limited partnership where investors' assets are pooled.^{xii} Most U.S. hedge funds aren't registered under the Securities Act of 1933 and so don't need to concern themselves with the Securities and Exchange Act of 1934, although they're still subject to the anti-fraud provisions of that Act. The way current regulations now read, SEC has no monitoring or fraud prevention authority over hedge funds until fraud has occurred.

One of the contentious issues is whether this industry needs more regulations. Some industry followers think that the SEC will revamp the current system so as to more closely model the U.K. system.^{xiii} However, most experts interviewed for this article think that what changes, if any, will be tiered to reflect the needs of this industry's three investor profiles: institutional, the high-net-worth individual (HNWI)^{xiv}, and the less wealthy than the HNWI retail individual.

These professionals recognize that hedge funds are in a growth stage that will lead to minimally a two-tier, and possibly a three-tier, structure suited to these three investor types. Regulation, transparency, and disclosure appears slated to become the highest for the institutional and retail investor markets with hedge funds financed by HNWI market retaining more freedom and flexibility in choosing what level of dialogue they want to have with their investors.

Some of those changes will be made voluntarily, as evinced by the growing number of hedge fund managers registering their funds of funds as a way of increasing their institutional investors' appeal.^{xv}

Of course, there's also a real probability that no changes will be implemented, especially given that the regulation discussion today is the same as it was when Long Term Capital Management blew up in 1998^{xvi} and also way back in 1970, when Fortune magazine published an article entitled "Hard Times Come to Hedge Funds" where it was predicted that the "SEC was moving in" on those firms^{xvii}.

Although the word "hedge fund" is commonly used, it's essential to understand that there are **MANY DISTINCT HEDGE FUND TYPES**, says Dr. Izzy Nelken, President of Super Computer Consulting, Inc. and author of the forthcoming book *Hedge Funds and Investment Management*. Dr. Nelken insists that this distinction is necessary because, unlike traditional equity fund investments where all perform well in a bull market to varying degrees, different types of hedge funds generate returns that can be quite dissimilar in the same market. The ten types of hedge funds are: *Convertible Bond Arbitrage*, *Emerging Markets*, *Equity Market Neutral*, *Event-Drive* (with its three sub-sectors: *Risk (Merger) Arbitrage*, *Distressed or High Yield Securities*, and *Regulation D*), *Fixed Income Arbitrage*, *Global Macro*, *Long/Short Equity*, *Managed Futures*, *Multi-Strategy* (with its two sub-sectors: *Single Manager* and *Funds of Funds*), and *Short Sellers*.

In addition to the many types (which will be reviewed shortly), within those types there are **FOUR ADDITIONAL ASPECTS** that differ from partnership to partnership. First, there is the *ASSET CLASS*: about 60% of the hedge funds are involved primarily in equities, 8% in fixed income, 7% in convertibles, 3% in currencies, and 1% in commodities. Another 21% of hedge funds diversify by following several of these asset classes. *GEOGRAPHY* is another consideration: although 46% of hedge funds are primarily working with North American investments, 33% on funds spread their investments across the world, while only 13% focus mainly of European-oriented strategies^{xviii}. Also some hedge funds are located domestically and others offshore so the tax ramifications and legal rights of all parties can vary extensively^{xix}. The third aspect, *INVESTMENT STYLE*, also diverges significantly^{xx}, with managers choosing different levels of leverage and product mix to generate a desired return within a certain risk spectrum.

The final feature's the *DELIVERY METHOD*, i.e., how the investment decisions are formed and then implemented. The delivery method can be discretionary, systematic, or a combination of those two techniques. A classic example of a *discretionary or a "guru" investor* is Warren Buffet^{xxi}.

The *systematic approach* involves the use of computers to create and then execute buy/sell quantitative trading strategies. Tanya Styblo Beder, Managing Director and Head of Strategic Quantitative Investments for Caxton Associates, LLC defines quantitative trading as using the systematic approach to generate trade signals where the same information always creates the same signals and the signal may never be ignored.^{xxii}

Systematic trading historically performs outstandingly in a bear market, has low correlation with traditional assets, and many systematic trading strategies work through all market environments. These characteristics coupled with falling volatile equity markets, low fixed income yields, and difficult emerging markets make systematic trading strategies attractive.^{xxiii}

The **TEN TYPES OF HEDGE FUNDS** are based upon the dominant strategy they employ. **Convertible Bond Arbitrage** depends on convertibles being issued, which isn't happening much this

year. “The level of new convertible issues, rising Treasury yields, and declining volatility in this sector has caused returns to slow, says Mike Scotto, Director, Alternatives Research, Hewitt Associates LLC. Scotto conducts independent third party research on alternative investments for large pensions and endowments. Helix Investment Partners, LLC and Creedon Capital Management LLC are a few of the firms in this sector^{xxiv}.

The **Emerging Markets** strategy works much like a traditional long only strategy because most emerging markets around the world don’t permit short selling, futures, or derivatives. The world’s an unpredictable place currently so future prospects in this sector are hard to forecast. Pacific Century Insurance Holdings and Dalton Investments fit this sector’s profile^{xxv}.

Equity Market Neutral means a strategy where long and short positions are used to generate positive returns in any market by maintaining a net exposure equivalent of zero dollars, zero beta, or zero sector; i.e., no bets on market direction so as to protect the portfolio from those risks. Although this strategy’s theoretically sound, overall market volatility’s made it difficult to establish. Pennoyer Capital Management and First Quadrant LP are representative of the firms in this sector, which does attract institutional investors because of the low risk approach^{xxvi}.

An **Event-Driven** shop focuses on capturing the price movements that occur when consequential corporate events occur, such as merger and acquisitions that are caught by *Risk (Merger) Arbitrage*, the formation of *Distressed/High Yield Securities*, and investments to micro and small capitalization public firms raising money in private capital markets under *Regulation D*. The recent economy’s resulted in not many small cap firms raising monies so Regulation D strategies are slow^{xxvii}.

Unfortunately, for the last three years mergers and acquisition have also been minimal, resulting in little activity in the Risk Arbitrage sector, comments Scotto of Hewitt Associates LLC. On the other hand, Scotto says that because of the record number of defaults in this same time period, Distressed/High Yield Securities has been a very busy segment, producing some of the highest returns.

Fixed Income Arbitrage looks for price incongruities between related global interest rate securities. This strategy was employed by the infamous Long-Term Capital Management, Askin Capital Management LP, and most recently, Beacon Hill Asset Management LLC – all three spectacular hedge fund collapses. Both convertible bond arbitrage and fixed income arbitrage hedge funds have convergent thinking managers, explains Mark Rzepecynski, President and CIO, John W. Henry & Co. Inc. (a managed futures hedge fund). For instance, “a convertible bond arbitrageur waits for markets to get out of line,” clarifies Rzepecynski, “so that he/she can make money when the markets for whatever asset converges to its real value. A risk with arbitrage styles is that if there’s a large dislocation or divergence, the market will trend and won’t converge to the arbitrageur’s expectations. Unstable and uncertain markets will lead to trends or divergences that aren’t what convergent traders expect.”

Gregory H. Sachs, Chairman and CEO, Deerfield Capital Management (a fixed income arbitrage hedge fund) confirms that “over the past decade, the Fixed Income Arbitrage field has been repeatedly tested several times by severe market dislocations.” He holds the typical short convexity of a fixed income arbitrage portfolio as the root cause primarily responsible for the reactions to catastrophic events. “The challenge for the sector has been and always will be to find ways to protect the returns from the downside,” comments Sachs, “and there are a lot of ways to construct trades that do well during market dislocations that can result in a well-balanced fund.”

Rzepecynski from John W. Henry & Co., commenting on the **Global Macro** sector with its global capital market and derivatives viewpoints, reminds investors that all U.S. based or trading in U.S. futures contracts may also be legally required to register as Commodity Trading Advisers (CTAs - see Managed Futures section below). Their style, however, is different from other Managed Futures hedge funds in that they tend to be “guru” shops, stock pickers, convergent managers with some systematic trading elements. Rzepecynski continues by stating that their portfolios contain greater exposure to the equity markets and individual stocks than a managed futures firm; thus an analysis may indicate that their returns are more highly correlated to global stocks and bonds. “Although many Global Macro hedge funds originated from the Managed Futures area”, says Rzepecynski, “nevertheless, the majority of Global Macro managers are more likely to have come from the long only global fixed income and equity side.” Moore Capital Management, Caxton Associates, and Tudor Investment Corporation are all major global macro CTAs.

Long/Short Equity hedge funds take bets on the direction of whatever market they’re interested in by employing all available techniques^{xxviii}. As for performance, data on European long/short equity funds showed these funds appreciably out-performing other investments in the recent bull market and then maintaining all their gains during the bear portion.^{xxix}

John W. McDonnell, Chairman of The 6800 Capital Group (a single manager multi-strategy hedge fund), is concerned that going forward perhaps this type of strategy may have grown too large because of the amount of capital it’s attracted. “HNWIs find this concept easy to understand so they’re more comfortable placing their funds in this area. With that much capital in one strategy, however, it could become too crowded if everyone’s in the same trade. It’s that old saying, “The last thing you want to do is come up with a strategy that becomes famous.” because when that happens, it’s harder to maintain high performance at the same level of risk.”

Systematic trading developers for long/short equity hedge funds are working hard to develop higher frequency trading styles, more complex intra-day volatility and correlation strategies, and new definitions for “macro” and “arbitrage” to correct system weaknesses that can also cause performance issues for this sector.^{xxx}

Managed Futures traders are also usually systematic traders, to the point that the computers are automatically generating the buy/sell orders, continues McDonnell. He thinks that this managed futures world’s a critical investing component because “it adds unbelievable stability to funds as a whole through its neutral correlation to the S&P500”. “When the markets are in a tizzy,” says this 20+ years “in the trenches” expert, “it’s managed futures that keeps drawdowns low.”

Mark Rzepecynski, President and CIO, John W. Henry & Co., explains that all managed futures and many global macros hedge funds domiciled or trading U.S. products must be registered as CTAs with the Commodity Futures Trading Commission if they actively use futures for trading. Because U.S. managed futures and global macro hedge funds have different approaches to the market, Rzepecynski feels that the word “CTA” isn’t descriptive enough except in a regulatory sense. “Many managed futures hedge funds follow a divergent style,” he says, “which results in significant returns when market dislocations occur. Additionally, managed futures will have a low correlation with equity markets because of their active trading from both the long and short side of fixed income, currency and traditional commodities markets. Managed futures offers investors a diversification opportunity with firms that often have extremely disciplined and systematic trading styles. The level of discipline

through the use of models is unparalleled relative to many other managers. This mitigates many of the behavioral biases found with less systematic forms of decision-making.”

As for CTAs, McDonnell adds that “it’s CTAs that enable global investment in currencies, industrial, metal, bond indices, energy, precious metals, coffee, and cocoa, just to name a few.”

One other managed futures’ product, *Single Stock Futures*, debuted in November, 2002. Peter Borish, Senior Managing Director for OneChicago, sees this product has being the fastest growing entry in futures for some time. “For the active trader holding for short time periods, single stock futures are the low cost efficient provider. They can be traded from either a futures or securities account, require no up tick or borrowing cost, offer transparency in electronic trading/pricing, and ease portfolio adjustments.” OneChicago and NQLX are the leading exchanges for this product.

One of the reasons hedge funds are so popular is their performance track record. Over the last five years **Multi-Strategy funds of funds** overall have delivered on their promise of absolute returns of 10-15% per year, although they achieved that return by slightly beating those rates during the bull market and slightly missing those rates in the bear market^{xxxii}.

Scott Schweighauser, Partner and Portfolio Manager, Harris Alternatives, LLC, believes that funds of funds offer investors:

- An opportunity to have a group of investment professionals with the necessary experience, infrastructure, commitment, and understanding in accessing the wide variety of hedge fund strategies and managers on their behalf
- Instant diversification given the comparatively small amount of capital needed to invest in a funds of funds versus the substantially greater amounts needed to achieve the same level of diversification by directly investing in hedge funds
- Active portfolio management with attractive returns, low volatility, and no dependence on the direction of the markets for those returns.

Schweighauser says that while most funds of funds use a combination of quantitative and qualitative methods to formulate their investment allocations, “the qualitative aspects of manager evaluation are, far and away, the most important to consider.”

Kay Torshen, President, Torshen Capital Management LLC (a funds of funds hedge fund) thinks that the most important service a funds of funds provides to the investor is having an expert working for them who understands the hedge fund strategies and performs on-going due diligence. “Hedge funds can employ complex investment strategies so having a third party there watching your interests is extremely helpful,” articulates Torshen.

Concern about the additional layer of fees that funds of funds costs is lessening as entrance fees are declining for all types of hedge funds.^{xxxiii} Mike Scotto, Director, Alternatives Research, Hewitt Associates LLC, has certainly seen this effect in the fund of funds catering to institutional investors. He thinks that the dropping fees are a sign that competition is increasing in this sector in response to the inflow of institutional capital. Goldman Sachs, Blackstone, Ivy Asset Management, and JP Morgan, to name a few, all offer funds of funds.

Schweighauser of Harris Alternatives, LLC thinks that **Short Sellers** are “good at doing careful, independent, and original research, and uncovering overvalued securities because that’s what their mandate is and what their monetary incentive encourages them to do. In the process, short sellers

enhance overall market efficiency by helping to bring equity valuations to more realistic levels and to ‘get the story out’ in instances where traditional street research may overlook problems or be biased, which is definitely good for the health of the global capital markets.”

In fact, the consensus among the professionals interviewed for this article is that:

- Hedge funds absolutely help the overall stability and health of global capital markets as they’re a main provider of liquidity. McDonnell, Chairman of The 6800 Group, gave this example: if a corporation needs recapitalization because it’s in a distressed financial condition, it’s the hedge funds that are able to provide the necessary liquidity for the recap when banks can’t provide those funds. Hedge funds provide sources of capital, i.e., liquidity, to firms that have different strategies because they can take sizeable quantifiable risk where they have the ability to manage that risk so as to afford their investors a positive return.
- The top priority of hedge funds is, as Derrick Grava, First Vice President and Divisional Director for the Alternative Investment Group at UBS Financial Services, affirmed, “wealth preservation with reasonable growth”. Grava also said that hedge funds have advantages over their traditional counterparts because:
 - Hedge funds can use cash to linger in when unfavorable market conditions prevail whereas traditional asset managers are typically limited to 10% cash in their portfolios.
 - Hedge funds can engage in short selling and use derivatives to capture market inefficiencies whereas the traditional money managers are limited or prohibited from engaging in either of these products.
 - The compensation structure for hedge funds is more directly aligned with rewarding staff/management by how well they perform in increasing/protecting their investors’ funds than traditional money management compensation structures so the hedge funds are attracting “incredibly bright people with interesting strategies that they want to pursue”, enabling hedge funds then to offer the “best active management”.
- A major reason for the interest and flow of capital to hedge funds is the decline of the stock market. “The typical investor now knows more about risk through their experience with this bear market than they did previously. The losses that they may have experienced in the last three years have significantly changed the lifestyles of many to the point that now their major goal is wealth preservation with a reasonable return, which is nicely aligned with what hedge funds provide,” says Kay Torshen, President, Torshen Capital Management LLC.

HNWIs’ interest in hedge funds has been growing annually, bringing the total assets invested in hedge funds to a record \$665 billion as of June 30, 2003^{xxxiii}. One international region where hedge fund demand’s huge is Japan because of HNWIs’ need to sustain returns in challenging conditions. Investment growth in hedge funds is expected to continue and reach \$1.5 trillion by the end of 2010. HNWIs currently account for approximately 60% of total hedge fund assets under management but the number of institutional investors is rocketing forward^{xxxiv} with \$480 million in institutional monies as of June 30, 2003^{xxxv}. There are an estimated 7,000 hedge funds in the world today and those declining entrance fees are making them more accessible to more investors.^{xxxvi}

There are a number of **Risks**, however, **in Hedge Funds**. One risk is the **FAILURE RATE**. In Europe and Asia the failure rate is estimated to be about 8 -10% with the U.S. having a slightly higher rate. The ease of entry’s the reason for the spike in U.S. failures versus the rest of the world; no regulatory approval to start a hedge fund is necessary, there are no capital requirements, and the start-up costs are low. Starting a hedge fund overseas, however, often involves meeting significant

regulatory and capital requirements. What's most interesting to note is that both in the U.S. and across the world, the number of hedge funds opening exceeds the number of hedge funds closing their doors^{xxxvii}

Another risk is **PERFORMANCE MEASUREMENT** shortcomings generated by applying traditional performance measurement techniques to hedge funds. Hedge funds are usually evaluated using the same tools as the traditional investments, namely by comparing their risk-adjusted returns using the Sharpe ratio. This ratio uses the standard deviation of the return distribution as indicative of the investors' total risk profile, which assumes that investors are indifferent between upside and downside risk. Investors, however, do care about downside risk, which is why they're investing in hedge funds that try to manage the downside risk.

To counter the *Sharpe Ratio's limitation*, new risk measurements are being developed, including the Sortino ratio, the Omega measure, and the Stutzer index.^{xxxviii} Hilary Till, Principal, Premia Capital Management LLC, also recommends the Bernardo-Ledoit Gain-Loss Ratio, the Bavar Ratio, or adjusting the downside deviation calculation in the Sharpe Ratio, in addition to several other techniques described fully in her chapter entitled "Risk Measurement of Investments in the Satellite Ring: Traditional versus Alternative Approaches" in the forthcoming book *The Core-Satellite Approach to Portfolio Management*.

Another performance measurement issue relates to the *Proper Benchmarking* of hedge fund investments. Because hedge fund strategies vary widely, a one-size-fits-all benchmarking approach isn't appropriate. Institutional investors are becoming aware of this benchmarking problem and are refining their benchmarks accordingly^{xxxix}. Furthermore, there are questions as to whether benchmark-based management resulting from using the traditional asset viewpoint of asset allocation as the dominant performance driver is even the correct approach to use for an industry that values absolute returns from each investment^{xl}.

In addition to the **Operational Risks** of key person risk, settlement risk, and compliance/IT/legal/infrastructure risk that hedge funds (and many other businesses) face^{xli}, there is also **Liquidity Risk**. Because an investor's capital is typically locked up in a fund for several years before it can be retrieved during which time the manager could change his style^{xlii} or exercise his incentive fee call option on the fund's earnings by increasing the volatility of his returns^{xliii}, or the hedge fund could collapse, investors face liquidity risk. Fortunately, Hari Krishnan and Izzy Nelken have devised a liquidity haircut to compensate for such exposure^{xliv}

Private Equity

Private equity is the most common form of alternative investing behind hedge funds. It covers pre-seed funds (which tend to be launched through government initiatives), early stage funds, expansion stage funds, later stage funds, management buy-outs/ins, and leveraged buy-outs.^{xlv} Venture capital and mezzanine investing is also included under this "private equity" label.

Primarily private equity is a wholesale investment vehicle^{xlvi} with the risk/return profile of each type of fund varying depending on investment type and lifecycle stage.^{xlvii}

Scott Meadow, Professor of Entrepreneurship for The University of Chicago's Graduate School of Business, who has 20 years previously in venture capital, most recently for The Sprout Group, sees this field's growth drivers arising from two factors. The first cause is the straight venture capital effect where "funding innovation and working commercialization of those innovations results in

capital gains from selling the adult firm at a high price”. The second growth driver is financial engineering, done via “later stage investing in buyouts using leverage and stability of existing cash flows combined with optimization of the cost structure”.

Meadow says that the major private equity firms are KKR, Welsh Carson, Anderson & Stowe, Clayton Dublier, Madison Dearborn, Texas Pacific, Hellmann & Friedman, and the Carlyle Group with the more regional venture capital giants being Greylock, Venrock, Northbridge, APAX, Sprout, Austin Ventures, Kliener Perkins, Mayfield Fund, and Sierra, to name a few.

HNWIs’ interest in market-linked private equity has been falling in recent years.^{xlviii} Although Professor Meadow does see this sector contracting for awhile as capital does a flight towards quality and private equity overreacts to trends, he thinks that opportunities for future growth are being created for those funds with blocks of capital and a willingness to “pick through” those discarded projects now abandoned by other venture capitalists.

Real Estate

Real estate consists of listed and unlisted properties in two arenas: infrastructure and natural resources. **INFRASTRUCTURE** investing, as the name implies, involves the returns from financing of public facilities, airports and other transportation methods. **NATURAL RESOURCES** is composed of properties containing timber, oil, gas, and/or other commodities innately generated by or located in the ground. This product line can also include the more traditional real estate investments in hotels, buildings, shopping malls, etc., which is why there is some confusion as to whether this asset class should even be considered an alternative investment.^{xlix} However, because of its illiquid and mostly privately-held nature, the majority of analysts have deemed real estate an alternative investment vehicle. HNWIs’ interest in real estate as been growing as a result of their new found interest in diversification, coupled with low interest rates, and comparatively attractive returns in this field.¹

IN CONCLUSION

Alternative products appear to offer substantial value to individual investors, institutions, and global capital markets despite the risks, which in most cases appear to be manageable now or in the near future. This article, however, has so far neglected to mention one area that the alternatives product development has created and is providing significant growth for: the service providers to this field.

To put this topic into perspective, remember that during the California Gold Rush the largest body of people who got rich from the rush weren’t the miners – they were the manufacturers and stores who supplied the shovels. Lawyers, software developers, system designers, accounting services, brokers, etc... - the revenue generating from the alternatives product field is significant.

For example, Frank Franiak, Executive Vice President, for Customized Accounting Solutions (CAS), a company that provides hedge funds and private equity with fund administration assistance, accounting systems and other tailored services, says “business has grown very dramatically over the last few years”. Client demand 15 years ago led to the initial development of their software that assists managers with multiple funds, investor categories, and/or multiple strategies. This most recent growth of hedge fund complexity and the need to offer special features and independent administration to institutional investors has resulted in new functionalities being developed and fund administration services perfected.

One key factor supporting this growth is the increase in information and data available.

CSFB/Tremont indexes, Hennessee, HFR, InvestorForce, Van Hedge, and Zurich Capital Markets' MAR reports and others have helped to increase the knowledge of investors regarding alternative investments^{li}

Just like the Kennedy space program resulted in side effect products that tremendously benefited society overall, it appears that the alternative products rush is creating side effect products that reduce costs, improve efficiency and transparency, while increasing GDP through enhanced revenue generation... and all these side effects are good for the health of the global capital markets.

ⁱ "Increased Interest in Alternative Investments, Hedge Funds & Real Estate, Finds *World Wealth Report*", 6/23/03 Merrill Lynch web site, www.ml.com/about/press_release/06232003-1_increased_interest_pr.html

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^v "Credit Derivatives and CDO's as Alternative Investments: Goldmines or Landmines?", J.V. Rizzi, Power Point Presentation, University of Chicago Graduate School of Business Finance Roundtable, 2/12/03.

^{vi} Phillips, C.. "inside the alternative investment universe", *Money Management*, www.moneymangement.com, 9/1/03.

^{vii} "U.S. Structured finance CDO Performance", FitchRatings Credit Products Special Report, September 10, 2003.

^{viii} "U.S. Structured finance CDO Performance", FitchRatings Credit Products Special Report, September 10, 2003.

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^{xiii} Richard, J. and S. Berwin, "SEC Investigation into the Activities of Hedge Funds, *AIMA Journal*, June 2003.

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^{xvii} Loomis, C., "Hard Times Come to the Hedge Funds", *Fortune*, January 1970, 28.

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