

Hedge funds and managed futures programs have added much needed diversification to many portfolios since the stock market topped out in March 2000, but they have been perceived as being only for high net worth and institutional investors despite often exhibiting lower volatility than long-only equity funds.

Excerpts from

Alternative strategies for everyone?

BY DANIEL P. COLLINS

As increasingly more people are becoming aware of alternative investment strategies, we are hearing dire warnings from the traditional investment community as to the risk of these strategies. But are these warnings legitimate or just a case of the traditional investment community trying to protect its turf from competitors who have outperformed it in recent years? The answer is probably the latter, seeing that many of the traditional investment providers are beginning to offer alternative strategies to investors.

Traditional long-only mutual funds could not help but make money in the go-go 1990s and could not do anything but lose money the last three years (see "Bad stretch," right). Many investors have avoided the ravage of the bear through alternative investments in hedge funds and managed futures, though both, with few exceptions, are products catering to high net worth individuals and institutions. While large established commodity trading advisors (CTA), such as John W. Henry & Co. and Campbell & Co., have offered public commodity pools

to the retail public for nearly a decade, higher regulatory barriers haven't allowed them to compete for the retail dollar with well known mutual funds.

At the heart of the problem is the myth that alternative strategies are riskier than traditional investments despite utilizing hedging mechanisms that by their very nature make them less risky. Add to that a lengthy bull market that has caused a generation of investors and managers alike to forget the gravitational realities of the market and believe there was no reason to seek out alternatives. But as the broad market indexes approach their third consecutive negative year, investors are realizing that it might not just be a short-term correction and are looking at alternative places to put their money. With the public once again learning the lesson that markets can also go down, some managers are offering, and some investors are demanding alternative strategies.

A BAD STRETCH

Mutual funds have taken it on the chin since the end of the endless bull market.

Largest 10 funds	Net assets	3-year return	YTD return
Fidelity Magellan Fund	\$58.056	-11.90%	-20.81%
Vanguard 500 Index Inv	56.226	-11.99%	-20.15%
American Funds ICA A	45.299	-3.77%	-14.58%
American Funds Wsh A	41.423	-3.17%	-15.65%
SPDR Trust 1	40.398	-12.08%	-20.13%
PIMCO Total return Inst (Bond fund)	39.255	9.52%	7.97%
American Funds Gro A	30.948	-4.95%	-18.98%
Fidelity Contrafund	28.013	-6.42%	-9.03%
Fidelity Gro & Inc	26.677	-8.16%	-16.51%
American Funds EuPc A	22.423	-10.22%	-14.55%

Source: Barons/Upper

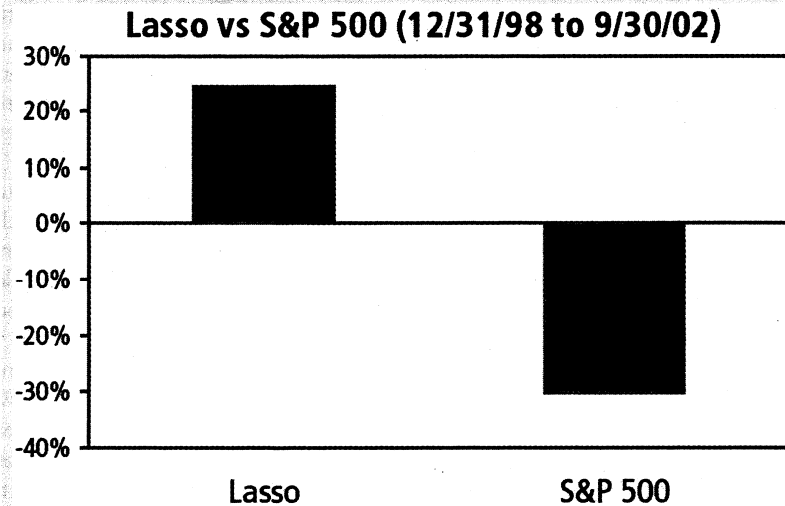
hedge funds," Strachman says. He sees it more as the creation of a new asset class and not as much retailization of hedge funds, noting that the growth will come from the traditional investment world because few managers will reduce their minimum investment from \$1 million to \$50,000. Though traditional managers are slowly moving toward offering alternative style investments, he questions whether people trained in the long-only world can successfully trade hedge funds. "Going short is counterintuitive to everything they are taught," Strachman adds.

He sees the move as overdue, noting there is no reason why any investor, particularly those with less to lose, should be locked into only one side of the market. "Hedge funds are not risky. All investors should have hedge funds in their portfolio. Any investor who thinks [he] can make it through high volatility markets with long-only [investments is in for a surprise]," Strachman adds.

Leaders in the alternative investment field say the biggest challenge to the expansion of alternative strategies to the larger investment world is the

ADVANTAGES OF HEDGING

Lasso, a pool of hedged mutual funds has avoided being bitten by the bear.



THE GRASS IS GREENER

"The real question you have to ask is, Why is this happening?" says Daniel Strachman, president of Answers and Co., a New York based fund management firm. His answer is that Wall Street can't sell their products and are looking for something new. "Wall Street is scratching its head and saying, 'What should we do?' The answer is

HOW THEY STACK UP

Alternative strategies outperform traditional strategies in good times and bad.

	YTD	2001	2000	1999	1998	1997
Van hedge fund index	-2.80%	5.60%	11.00%	40.60%	11.70%	20.90%
S&P 500 index	-21.80%	-11.90%	-9.10%	21.00%	28.60%	33.40%
Average equity mutual fund	-20.80%	-12.60%	-5.20%	28.40%	10.70%	15.70%
Average bond mutual fund	3.20%	5.50%	5.20%	0.50%	6.10%	7.30%
Barclay CTA index	8.74%	0.84%	7.86%	-1.19%	7.01%	10.89%

Sources: Van hedge funds/Morningstar/Barclay Trading Group

myth that these products are not appropriate for retail investors and the regulations that support that myth.

"The SEC is still biased against hedge funds being offered to retail investors," says John Van, chief financial officer of Van Hedge Funds. The SEC is in the midst of an investigation into the hedge fund universe and has voiced concerns over cases of fraud and its expansion into retail. While a diligent regulator is a good thing, the SEC did not appear to show as much concern over corporate governance and auditing issues involving public companies until a dearth of implosions thrust them on the front page. "Investors lost more in fully transparent public vehicles than any hedge fund," Van says. "The only way you are really going to have change is if investors demand it," he adds.

Though traditional managers are adopting some hedge fund strategies, Van says that the only registered hedge fund for the retail market he has seen is the Quadriga Superfund.

THERE ALL ALONG

The Quadriga Superfund for all intents and purposes is a publicly offered commodity pool, something that has been available to retail investors for a while, albeit under extremely restrictive regulations. Offering managed futures products to retail investors is nothing new for Campbell, which has been doing it since 1994. Campbell CFO Terri Becks says they actually would like to see a little more competition in the field for more people to know about the products. "We want to see our industry grow," Becks says. Key to having more choices in publicly offered commodity pools is reform of burdensome often

duplicative regulations, Becks says.

George Crapple, co-chairman of Millburn Ridgefield, a CTA that also offers public commodity pools, says that it takes approximately \$50,000 to start a mutual fund compared to about \$500,000 for a publicly offered commodity pool. He says that the added start-up expense is not the only disadvantage pools face. Public pools are required to deliver their complete prospectus before making any solicitation of customers, are restricted from advertising and have greater disclosure requirements than mutual funds. "The barriers to entry are enormous," Crapple says.

He says the industry's reputation for high risk is a problem. "It is a total myth. Now that we had a bear market the mutual fund industry has done worse than [managed] futures ever did...now that these lessons are sinking in, I expect alternative investments to get more exposure," Crapple says.

He believes that growth of alternative investments offered to retail will continue though it will need regulatory reform to really take off. "The SEC has said that [these strategies] are incongruent with retail; in fact, hedge funds and managed futures programs will help any portfolio in any market. People will be better off [invested in alternative strategies]," Crapple says. He expects the climate to change as investors become more educated and market forces take hold. "Forty years ago you couldn't put stocks in a trust," he says.

Mark Rzepczynski, president and chief investment officer of John W. Henry & Co., says the industry's performance relative to the equity markets over the last five years will lead to growth in public pools despite the reg-

ulatory disadvantages it faces. (see "How they stack up," above) He notes that beyond the added expense and multiple agencies they report to, public pools have to provide maximum draw-down information, something not required of mutual funds. That is a factor in keeping alive the myth that futures are inherently riskier than traditional investing, Rzepczynski says. He notes that if mutual funds had the same disclosure requirements as public commodity pools, "people would have concluded that mutual funds are riskier than managed futures."

REDRESS OF GRIEVANCES

Representatives of public pools addressed their concerns over burdensome and duplicative regulations to a CFTC forum on CTA and CPO issues in September. Industry reps were heartened by the presence of SEC Division of Investment Management Director Paul Roye because much of the relief they seek is from SEC mandates. "[Roye] seemed to acknowledge some inefficiency in the SEC handling of publicly offered commodity pools," Crapple says.

MLIM Alternative Strategies Chief Administrative Officer Steve Olgin whittled the pool operator's wish list to four main items. Relief from having to deliver entire prospectuses prior to any solicitation, eliminating SEC oversight of commodity pool disclosures (they would continue to oversee the public offering process), exempting public commodity pools from filing reports under the 1934 Act of Registration, and providing commodity pools exemption from state by state review of their offering material, something that both private managed futures programs and mutual funds are exempted from.

Paramount to their argument is that regulations that effectively restrict the offering of alternative strategies to retail investors, far from protecting those investors, have kept them from taking advantage of opportunities to better manage their risk and protect their capital.

Though no guarantees were made at the forum, the CFTC has already acted

in response to manager concerns voiced at the forum, effectively giving exemptive relief from CPO registration to hedge funds for some products. Though the relief did not directly address public commodity pools, the fact that a government agency would respond so quickly has encouraged fund managers. "It is a good sign — I am encouraged," Crapple says.

THE MARKET DECIDES

The biggest factor in the growth of alternative investments is the apparent death of the bull market. If it is truly dead and not just taking a nap, investors will demand products that appreciate in all market conditions.

"No one knows what is going to happen in the market, what [investment professionals] should tell you is to prepare for markets that move in both directions," Strachman says.

Baha points out that both bull and bear markets can last up to 20 years. "To trade equities from just the long side is stupid. What happens if stocks go down for 20 years? Hedge funds will always find trading opportunities," Baha says. He scoffs at the notion of a hedge fund bubble developing that has been bandied about the investment world. "That is for people who don't understand what a bubble is. I will only smile when people say the next bubble is the hedge fund bubble, the next bubble is the equity long-only bubble."

Baha points to the experience in the far East where Hedge fund regulations have been loosened after 13 years of bear equity markets. He says we may have to live through some more pain before we realize markets go two ways.

"When people realize that alternative investments are less risky and produce better returns, that is when pressure [will be brought] for the rules to change," Van says. The strength and length of the bull market has made that a difficult lesson to learn says Van. "Not just a generation of investors [have known nothing but a bull market] but a generation of managers [as well]."

IFM

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