The Journal *of* Wealth Management

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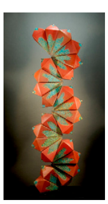
ON THE COVER



Kimono Tower, 2016
Blown and Cut Glass
54 × 11 × 17 inches
Image Courtesy of Richard Royal Studio

***Richard Royal** (American, born 1952) is a Northwest-based artist who began his glass sculpting career shortly after the beginning of the late 20th century, during a time when working with glass was considered a new artistic form in America. After developing his talents, the artist earned the rank as one of Dale Chihuly's main gaffers, which led to Royal's recognition as a glass sculptor in the art market for nearly 40 years. His works are present in museums, galleries, and private collections throughout the world. This piece and others by this artist are available through Schantz Galleries in Stockbridge, Massachusetts.*
Visit www.schantzgalleries.com to view more works by this artist.

The noise level out of the investment community bad-mouthing so-called *hedge funds* is becoming quite loud. One could expect that people who almost systematically drive with their eyes firmly focused on the rearview mirror would now be abandoning these funds, which have done poorly for an extended period of time. Yet, as always, at least in this writer's opinion, one needs to be careful. In times like the current, it is a lot easier than one thinks to throw the baby out with the bathwater.

We have for years argued, at times almost in a solo formation, that grouping these strategies under a single moniker is the surest way known to man to "jump to the wrong conclusion" in the words of Daniel Kahneman in "Thinking Fast and Slow." In fairness, the quote does not refer to so-called hedge funds but, rather, to the tendency to come to quick judgments without taking the time to ponder a variety of possible additional information. In this context, the additional information relates to the strategies that various managers follow. Indeed, other than the fact that they all use a generally similar fee structure comprising both a management fee and some share of the profits, so-called hedge fund managers follow a variety of different strategies, which should be expected to produce radically different return patterns.

Using a slightly finer comb than we have used in the past, one can generally identify at least four radically different types of strategies, each of which can be and, in fact, is applied to a variety of underlying asset classes.

1. *Market neutral or arbitrage strategies*: Whether absolutely market neutral or simply accepting only a minor net beta exposure, these strategies are based on the belief that is it possible to identify some security mispricing offering a form of pure or hybrid arbitrage. At the most elementary level, one can think of pair trades using underlying securities of the same nature, in the same industry, and in the same country. One can gradually begin to take on some form of arbitrage risk by making the arbitrage less and less pure. Sticking to the pair trade example, one can, for instance, use securities in different countries or even in different industries. At some point, the term "pair trade" becomes totally inapplicable.

   Yet, fundamentally, the concept remains: Whether dealing with a true pair of securities or two subportfolios—one being long and the other short, approximately the same market beta—the idea is to limit beta risk and seek individual security risk. These strategies can be thought of as offering a synthetic cash risk—as being long and short the same risk is equivalent to creating a synthetic cash position—plus some individual mispricing risk/opportunity.

Thus, a reasonable market benchmark for such strategies could be composed of the return on cash plus some security selection alpha. With cash returns having been close to zero—when not negative—around the world for quite some time, it should surprise no one that these strategies have produced low returns. Yet, the point to note is that these returns, effectively comprising only alpha—or manager value added—are in line with historical norms with respect to managers' abilities to generate alpha.

2. *Credit, fixed income, event driven, commodity and "activist" strategies*: Generally, managers accept the market risk associated with various holdings, trying to take advantage of opportunities where some underlying fundamental or technical feature of each investment is felt to be better appreciated by the manager than by the market. In the fixed-income world, this assumed misunderstanding revolves around the likelihood that the credit of the instrument is better than thought. In both the fixed-income and the equity worlds, however, there can be some specific event that the manager identifies that should be the catalyst for the market to change its view of the current valuation of an investment. At certain times, the event would raise valuations; at other times, the catalyst should bring about a decline in valuations. Note that certain managers hedge some of the market risk tactically from time to time, whereas others do not.

   Here, one must create a benchmark that represents the actual risks that are being taken and, hopefully, rewarded. It must therefore comprise some measure of market risk in addition to the added value expected from the manager. Because of the different nature of each of the strategies, benchmarks must be customized, and it is thus harder to see the whole industry in one single graph or chart. Suffice it to say, however, that these strategies, particularly but not solely in the credit and distressed space, have generated material alpha even in the recent past. Equity-based strategies have had a harder time, in part because equity markets have been substantially liquidity driven, and the tendency has been for the tide to lift or lower all boats at the same time. Statisticians have a measure for this: They look at cross-correlations among individual securities within a given market. Yet, it is interesting to note that people are talking of walking away from several of these strategies at precisely the time when these cross-correlations are falling, an indication that there could be more value added looking ahead.

3. *Directional equity long–short*: These strategies generally maintain some variable, but set within a range, net exposure (either long or short), and the two subportfolios (long and short) each have their own set of factor exposures. Although risk control processes might limit certain net factor exposures, making money from both the long and the short sides of the portfolio is the goal.

   Such strategies are generally easy to benchmark. The portfolio can be thought of as comprising some basic equity exposure equal to the typical, stated or average, net exposure taken by the manager; some exposure to a risk-free asset equal to the complement of the net equity exposure; and security selection alpha, which may incorporate industry and geographical factors as well. This has been the area within the so-called hedge fund industry where returns have been, by far, the poorest. A number of commentators agree with the idea that managers have produced negative alpha ever since the recovery from the 2008 financial crisis. Several factors have been mentioned to explain this development, ranging from more efficient equity market pricing, the liquidity-driven nature of many developed equity markets since the onset of global quantitative easing, and the observation that former tenors of the industry retired to focus on their own wealth, leaving the mantle to less experienced or inspired managers.

4. *Trading strategies*: Whether discretionary or systematic, these strategies involve taking conscious exposures to certain factor risks, with no intrinsic strategic preference to being long or short. Discretionary traders typically are called *global macro managers* and employ a variety of trading strategies to capture insights into the likely price behavior of factor risks, which can be narrowly or

broadly defined. A narrow theme might focus on beneficiaries of higher oil prices, whereas a broad theme might be anchored to currency or interest rate views. Systematic traders, usually classified under the *managed futures* header, employ algorithms to determine the direction and the size of the exposures they might take. While global macro managers often employ quite strict drawdown controls to avoid substantial losses, managed futures managers tend to build risk controls into their mathematical models.

Fundamentally, these strategies can be thought of as cash-based plus some trading value added. The rationale behind such a statement is that managers do not have a preference for any sort of directional factor risk: They are just as likely to be short or long. Thus, there is no natural capital market asset that can be viewed as representing some sort of a default position. In fact, for managers for whom a drawdown control exists, the typical approach to dealing with too large a loss is to reduce the exposure, which can be viewed as selling some of the risk for cash. On the other hand, one should note that the value added that is generated by these managers can rarely be analyzed as security selection because the focus is on buying exposure to some beta (although, in fairness, in the global macroworld, instrument selection can and quite often does affect both risk management and alpha). These strategies tend to do best when markets are trending and worst when markets are gyrating because they frequently involve some measure of exposure to momentum factors. Thus, although they have not necessarily produced large losses, these strategies have failed to generate returns of the magnitude that investors generally expected both because cash rates were virtually zero and gyrating markets reflected one of the worst possible trading environments.

In short, although it is fair to observe that many so-called hedge strategies have not generated returns that were commensurate with the expectations of investors, it is probably an intellectual shortcut to argue that they have been disappointing. Quite a few disappointments reflected misplaced or misunderstood expectations. Indeed, a more detailed analysis of the implicit value-added of managers—rather than their absolute returns—suggests that, with long–short equity managers being the notable exception (and this, particularly, in developed markets), quite a number of managers produced value-added patterns that were broadly in line with what should have been anticipated.

This brief analysis does not take into consideration certain factors that represent head winds that the industry has faced and that persist. For instance, with a few exceptions, alternative managers have tended to be particularly tax inefficient. However, note that the end of the 10-year deferral period afforded managers in 2006 has now run out, raising the possibility that managers will henceforth have to face the same tax burden as their limited partners. Should that not create an incentive for them to focus more on after-tax returns? Other issues also persist, such as complexity, at times only partial liquidity, frequently limited transparency making overall portfolio risk analysis difficult for investors, and high fees. Note that the returns analyzed in the various industry databases—as well as published by managers—are typically reported net of all fees. Yet, the old adage still holds: Fees are a certainty, but returns are only expectations. Thus, the higher the fees (which, to make matters worse, cannot always be deducted for tax purposes by certain investors), the more difficult it might be to generate positive after-fee and after-tax returns.

On balance, one is struck by the fact that comments with respect to this segment of the asset or wealth management industry continue to be so superficial and to rely so much on generalities and sound bites. Labeling and sound bites may make communication easier, but they often obscure rather than illumine reality. Although it would certainly make a great deal of sense to revisit one's commitment to these strategies in light of what has been learned over the last 10 years or so (one cannot think of circumstances in which it would not make sense to revisit assumptions periodically), one needs to keep a cool head and, in Daniel Kahneman's words, to use our deliberate but more accurate thinking processes to reach sensible conclusions.

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The Journal *of*
Wealth Management

The Summer 2017 issue of *The Journal of Wealth Management* remains as diversified as usual, although it contains fewer articles than usual, owing to the decision to publish two unusually long pieces. Any feedback from readers as to their appetite for such pieces would be welcome, as it will guide our selection of pieces to publish for further issues.

The first three articles broadly fall in one group that we view as focusing on individual investors and the wealth management services they receive. The first, by Franklin Parker, analyzes which portfolio management attributes should be of most concern to the practitioner in a goal-based setting. The second, by Hsiu-I Ting, is dedicated to understanding the key factors that affect the decision processes of consumers when hiring a wealth management service provider, concluding that investors have changed their priorities after the recent global financial crisis, whereas financial advisors have not yet caught up with the changing patterns because they still generally emphasize the quality of service as the most important element of their offerings. The third, by Michael Faloon and Bernd Scherer, focuses on robo-advisors, which assign risky portfolios to individual investors using web-based investment algorithms with minimum human interaction, and seeks to better understand the current state of personalization and to help users of robo-advice to better evaluate the services provided.

The next four articles constitute a second group with central attention paid to investment management issues. The first, by Stephen Christophe, is certainly both topical and controversial because it focuses on the role of international diversification in equity portfolios and concludes that there is evidence to suggest that a globally diversified portfolio underperforms, on average, a U.S.-only allocation. The next piece, by Bryan Foltice, tests whether high-income earners can earn excess risk-adjusted returns by annually exploiting the asymmetric U.S. tax treatment of long-term capital gains and losses using at-the-money options and finds that call options can provide increased annual performance returns for all income levels. Foltice concludes that these strategies also provide excess risk-adjusted returns for high-income earners in the 28% and higher income tax brackets. Our next two pieces focus on emerging markets. First, Raj Dhankar and Kunjana Malik, look at equities in India, studying the relative earnings quality of private-equity (PE)-backed firms and non-PE-backed firms. Finally, Akash Dania and Ramin Maysami look into the diversification opportunities for investment and portfolio management purposes offered by frontier markets, modeling the dynamics of volatility transmission from the mature global stock markets of France, Germany, the United Kingdom, and the United States to the frontier markets of Africa and the Middle East. The authors conclude that frontier nation stock markets are not yet fully integrated with the global economy.

Our next group of papers deals with the mutual fund world. First, Anthony Loviscek asks whether preferred stock funds, despite their lack of attention from Wall Street, academia, and the financial media, might be preferred in mutual fund portfolios and concludes that a preferred stock fund allocation in the range of 5%–15% can reduce portfolio risk while at least preserving portfolio return, thus providing a cushion for portfolio managers of balanced funds and for income-seeking investors. Second, frequent contributor John Haslem proposes what may well be the longest article we have ever published: a discussion of the economies of scale, nature, and sources in the mutual fund industry, discussing and listing 14 factors that we hope our readers will find quite insightful.

Our final article stands on its own. It is by Jordan French who presents a new method for calculating beta through a back-solving process, which assumes the capital asset pricing model (CAPM) to be absolute, also contributing to the literature that the market proxies used are inefficient and adversely affect the results used in other studies to discredit the CAPM.

Jean L.P. Brunel
Editor