Over the last two quarters, I have had the privilege of starting to present ideas about so-called "hedge funds" to a number of local societies of the CFA Institute. Though the topic is far from new, the receptivity of audiences to the broad principles we discuss convince me that it is important to restate its two major conclusions: the so-called hedge fund universe is too heterogeneous to be viewed as singular, and we need to expand the scope of traditional optimization tools to deal with the non-normality of the return distributions often observed in that space.

The first fundamental conclusion is that the world of hedge funds is so heterogeneous that it is a gross disservice to use a single label to describe such a wide range of strategies. A simple look at the dispersion of all the various strategies on a risk/return scatter graph makes that point, as the spread in the observed risk of the least and most risky strategies is almost the same as the spread between the risk of a two-year government bond and emerging market or NASDAQ equities! Note that this remains true whether one looks at recent or longer-term data.

In fact, it seems considerably smarter to consider the universe as composed of at least two meaningfully different sub-universes. The first comprises strategies that evidence mostly fixed-income type risk characteristics, while the second relates to strategies whose risk seems more akin to equity-type risk. Interestingly, empirical as well as theoretical insights converge. Empirically, strategies whose principal feature involves the manager being equally long and short the same fundamental market factor tends to have fixed-income type risk characteristics. This converges with theoretical findings, as Finance 101 tells us that being equally long and short, the same market risk amounts to creating a synthetic cash investment. Thus, most arbitrage, market-neutral or event-driven strategies naturally fall in that category, as would strategies that involve residual, fixed-income market risk. By contrast, strategies that involve some residual equity risk belong to a different group, though that group incorporates a wide variety of risk levels. These indeed range from long/short strategies that retain only a modest net-long or net-short exposure, to those that really have a significant and intentional directional bias.

The practical portfolio implication would seem to be that, rather than thinking in terms of traditional versus alternative assets, it might make more sense to think in terms of a two-by-two matrix that breaks the universe into fixed-income or equity risk categories, these in turn being both broken down between predominantly market- or predominantly manager-driven risks. This framework would thus lead one to allocate between traditional fixed income and the part of the alternative universe that has a similar risk profile, or between traditional equities and the part of the alternative universe that contains residual directional equity risk.

The second major conclusion is that one should be very careful when using traditional optimization tools with alternative assets, because of non-normal return distribution characteristics, a point which a couple of the articles in this issue of *The Journal of Wealth Management* make as well, thus joining quite a significant body of research. More specifically, strategies that involve limited sets of potential opportunities are often negatively skewed, while those that have some significant concentration—which simply means that they substantially deviate from commonly accepted benchmarks—tend to have excess kurtosis.

The presence of these non-normal distribution attributes makes it somewhat perilous for anyone to consider using a standard mean-variance optimization tool. Indeed, efficient market theory would suggest that there should be some offset for the presence of negative attributes such as negative skew or excess kurtosis. This would typically happen, as Harry Kat so eloquently suggested, through some increase in return, or decrease in volatility, either or both of which would work to raise the Sharpe ratio. Thus, a mean-variance optimization model that ignored the two negative attributes could be "fooled" into a preference for strategies with higher Sharpe ratios, even though these higher Sharpe ratios might simply be an offset for negative skew or excess kurtosis. Prior research has indeed shown that traditional mean-variance models tend to seek as much of an exposure to these non-traditional strategies—at the expense of the

traditional asset classes—as the set of constraints allow. Thus, mean variance models will almost always prefer absolute return, fixed-income, risk-like strategies to a straightforward bond allocation, and long/short equity programs to traditional, long-only equity allocations. Intuition clearly tells us that this cannot make sense. There must be a better alternative that accepts that these nontraditional strategies do have significantly attractive attributes, but also notes that there are unattractive features as well, both from a quantitative and a qualitative standpoint.

A model exists that was developed by Davies, Kat and Lu [2004], but it is currently probably too cumbersome to be used in the context of a balanced portfolio that includes traditional as well as nontraditional strategies. An alternative requires dividing the portfolio risk drivers into a two-by-two matrix, creating four eventual main categories of risk. One axis would divide the world into fixed-income and equity type risks while the other would recognize that certain strategies principally comprise market risk (or beta), while others have a considerably greater share of total risk attributable to manager risk. Then, one could quantitatively or qualitatively assess what balance between manager and market risk is appropriate, recognizing that concentrated, long-only traditional strategies do involve a significant quotient of manager risk, while a number of significantly net directional alternative strategies might involve a similar or even lower share of market risk. This forces us to allocate our manager risk budget across the full spectrum of traditional and nontraditional strategies rather than constraining based on the "legal" structure of the program, assuming that all traditional strategies should be viewed differently from all nontraditional alternatives.

In conclusion, while it does seem to make sense for investors to look to own some balance between traditional and nontraditional strategies, one needs to be careful as to how one constructs the portfolio. First, it is important to recognize that non-traditional strategies ought to be appropriately allocated among fixed income and equity like risks, rather than thinking of these nontraditional strategies as a

separate asset class or category. Second, it is equally impor-tant to remember that nontraditional strategies come with some "statistical" baggage, which suggests that one should see both what they bring and what they cost.

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This summer 2006 issue of *The Journal of Wealth Man-agement* returns to a good balance among several topics. Our first three articles focus on broad investment policy issues. Lisa Gray offers further perspective on family governance and dynamics, discussing the wealth-related perspectives of living generations, and ultimately making the critical connection between such perspectives and wealth management deci-sions involving goal-based asset allocation. Gordon Fowler and Vladimir de Vassal propose a framework and an opti-mization technique that solves for a unified asset allocation taking into account a private investors, multiple asset loca-tions, and multiple goals. Finally, Charles Jones and Leonard Lundstrum show that the growth rates in the P/E ratio and real earnings, as estimated over long periods and reported in the literature, have tended to obscure some important changes in the growth rates of these two variables.

The next article revisits an issue that was covered a couple of years ago. Maretno Harjoto and Frank Jones examine stocks and bonds portfolios under volatile market conditions. They find that some measure of portfolio rebal-ancing add value and propose an optimal rebalancing size rule.

Our last three articles delve more specifically into issues related to the hedge fund universe. First, Douglas Rogers investigates the issue of the definition and measurement of hedge fund risk, principally illustrating the notion that there are several measures that are appropriate and that quantita-tive measures are only a part of the answer. Then, David Lee, Kok Fai Phoon, and Choon Yuang Wong introduce a prac-tical approach to analyzing the risk and performance of Asian hedge funds from the viewpoints of U.S. and Asia-Pacific based equity investors, focusing on the impact of including Asian hedge funds in these portfolios and examining their effects on down market protection, upside capture, and volatility reduction during extreme events. Then, Renato Staub investigates considers a levered equity fund as an alter-native to investing in a hedge fund and an index fund, but finds that he must relax the long-only constraint to gain increased portfolio efficiency. Our final article is by Gary Greenbaum who introduces "APACS" (Alternative Pooled Asset Class Service), a new service that wealth management firms can offer to high net-worth clients, including alterna-tive asset classes in their diversified investment portfolios.

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Editor