Investment Planning Answer Book by Jay L. Shein, Alternative Investment Strategies

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Mainstream asset classes are investments such as stocks, bonds, bills, and cash. Alternative investments have no concrete definition. Some definitions suggest that alternative investments include such things as timberland, works of art, antiques, precious metals, commodities, and hedge funds. Many people think of alternative investments as hedge funds. One way of looking at a definition of alternative investments is any investment that is an alternative asset class to mainstream investments or an alternative approach within mainstream asset classes. The important thing from a diversification point of view is that whatever the alternative investment is, it should have an opportunity for positive return and dissimilar patterns of return to the other investments or strategies contained in a portfolio. Alternative assets and strategies should always be considered when designing a portfolio. Recent market turmoil in 2008 in the alternative asset space has caused many to shy away from this asset class. Advisors may find that certain alternative assets or alternative strategies may make sense for many investors regardless of recent history.

Investment Planning Answer Book by Jay L. Shein, Q 9:1, Is real estate an alternative investment?

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Many investors consider any investment that is not in stocks, bonds, or cash an alternative investment. Real estate is considered by many to be an alternative investment and does not typically have a high correlation to the stock and bond market. Investments in commercial and residential property and real estate securities are used in this category. They may seek investments domestically or internationally in the real estate market. Real estate securities have the advantage of being more liquid than individual commercial or residential properties. Many consider real estate to be opportunistic like many other investment strategies and should be included in the portfolio some of the time but not necessarily all the time.

Investment Planning Answer Book by Jay L. Shein, Q 9:2, Are there advantages or disadvantages of holding timber in a portfolio?

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Over long periods of time, managed portfolios of timber have done very well. The volatility of timber has also been lower than stocks. Think about how much timber is consumed each year even in bad times. Timber is used to make desks, chairs, the frames of homes, and paper. Reduced timber harvesting on public land has increased the value of forests that are private. Timber also has tax advantages. Large institutions and endowment funds have increased their allocation to timber. The majority of the timber in the world that can be invested in is in the United States, although countries such as Australia, Brazil, and Canada also have investable timber. There are various methods for investing in timber each with its own advantages and disadvantages. Investors can invest directly in timber and the management of the forest properties. They can buy shares of Real Estate Investment Trusts (REITs) that invest in timber. They can buy shares of publicly traded companies whose main line of business is paper products and/or managing forests, or they can invest in Timberland Investment Management Organizations (TIMOs). TIMOs are pooled funds that invest in timber and forest properties. TIMOs have high initial investments and very low liquidity, and many have lock-up periods of ten years or more. Publicly-traded REITs that invest solely in timber and forestry products provide the most liquidity, but they tend to have higher correlations with traditional stock investments. Companies whose primary product is timber and forestry products are hard to distinguish from other companies in the industry which may be challenging for the investment advisor. Investing directly in timber properties presents its own set of challenges and requires expertise and knowledge of geographic areas, forest management, and forest harvesting.

Investment Planning Answer Book by Jay L. Shein, Q 9:3, What is a typical commodity alternative investment strategy?

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Commodities are sometimes included in portfolios to reduce risk and increase return. Over long periods of time, they have had a low correlation to the stock and bond market. However, like many investments, there are periods of time that they are highly correlated with the stock market. A typical commodity investment used today is a portfolio of managed futures. Commodities such as corn, oil, and grains are traded in the futures market. Managed futures strategies involve going long and short in various commodities on the global market. This strategy takes advantages of uncertainty in worldwide economies. The main driver of performance that provides the opportunities in this strategy is the movement of prices. A money manager who trades mostly futures in the United States is known as a Commodities Training Advisor (CTA). Commodity trading strategies involve risk and should be evaluated as diligently as one would evaluate other alternative investment strategies and hedge funds.

Investment Planning Answer Book by Jay L. Shein, Hedge Funds

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There are thousands of hedge funds that make up the hedge fund universe. Maybe 20 percent will offer real opportunities while many will not, and many are less than five years old. Hedge funds play a role in many portfolios as they can offer diversification benefits. Many individual investors' portfolios are made up of long-only investments. Diversified portfolios will invest so they are not too concentrated in one sector or region. Relying just on diversified portfolios of long-only investments may make sense in a roaring bull market but may be inadequate in fluctuating or bear markets. Globalization of the world's economies has diminished some of the benefits of long-only investment portfolios. Isolated major events in the United States, China, Asia, or Europe can trigger a major impact on all financial markets. Because of this, some investors feel that diversification is less effective for mitigating risk than it has been in the past.

Although there is no absolute definition of an alternative investment such as hedge funds, Howard Marks in the *Oaktree Client Letter* [April 1998] defined alternative investments as follows: "Alternative investments can be found in markets that are alternative to mainstream asset classes or alternative approaches within mainstream asset classes." There are thousands of hedge funds and fund of hedge funds. According to the 2007 PerTrac Hedge Fund Database Study published in March 2008, there are approximately 21,000 distinct funds that reported performance data in 2007. One of the main plusses of hedge funds has been their low correlation to other asset classes and positive returns at least historically. There are different structures for hedge funds. Some are private partnerships, some are limited liability companies, and some are registered hedge funds that may be structured as a non-traded closed end fund with lock-up periods. Hedge funds may be hedged or leveraged. A 3C7 fund allows for up to 500 investors with an individual net worth requirement of five million or more and an institutional net worth requirement of twenty-five million or more. A 3C1 fund has an individual net worth requirement of one million dollars and can have up to 99 investors. Hedge fund-like strategies are also available in a mutual fund investment vehicle with daily liquidity. The hedge fund-like mutual funds have no minimum net worth requirements. Because of the many different ways that hedge funds and hedge fund-like strategies can be accessed, they can be included in anyone's portfolio.

Hedging risk is becoming a much more important priority for many investors. Using hedge funds to diversify a portfolio has played an important role in the past. Even with less than stellar hedge fund results and problems in 2008, many hedge fund strategies will probably offer diversification benefits going forward.

Investment Planning Answer Book by Jay L. Shein, Q 9:4, What are some hedge funds structures that are available?

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Hedge funds may be structured as partnerships, limited liability companies, registered fund, closed end fund, or hedge fund-like mutual funds. Different structures may offer different liquidity constraints. An example is as follows, a partnership may allow the investor to redeem funds only once every quarter after the first year with at least 45 days notice. A hedge fund-like mutual fund will allow redemption of shares at the end of each day the market is open. A prospectus or offering memorandum should be read for restrictions and caveats relating to redemptions or redemption requests.

Investment Planning Answer Book by Jay L. Shein, Q 9:5, What are some of the advantages of investing in hedge funds?

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Some of the advantages of investing in hedge funds include diversification, hedging, superior consistent performance, high flexibility, and the ability to access modern techniques. The correlation between hedge funds and mainstream asset classes such as stocks and bonds is typically low. This is probably one of the main advantages of investing in hedge funds. While this was a significant advantage in the burst of the technology bubble from 2000-2002, it was much less of an advantage in the financial crisis from 2008-2009. Hedge fund strategies are available as private partnerships, registered hedge funds, and hedge fund-like mutual funds. In a study done by Andrew Clark, head of research for Lipper-North and South America, in the March 9, 2007 Lipper report, [Lipper Research Series, *The Role of Hedge Funds and Hedge Fund-Like Mutual Funds in a Portfolio (Special Edition)*] he states: "for many of the hedge funds and hedge fund-like mutual funds in our study, having them in a portfolio improves diversification and, in all cases, does not add to existing risk. The possibility exists that the addition of a hedge fund or hedge fund-like mutual fund could actually reduce the risk in a portfolio… In this study we demonstrated the efficiency of hedge funds and hedge fund-like mutual funds as diversification tools." A *caveat emptor* when investing in hedge funds and any other investment is that past performance is no indication or guarantee of future performance.

Investment Planning Answer Book by Jay L. Shein, Q 9:6, What are some of the disadvantages of investing in hedge funds?

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Some of the disadvantages of investing in hedge funds are the lack of transparency or understanding of the underlying holdings or strategy, the use of leverage, the high fees, or risks that may not be consistent with investment portfolio objectives. While hedge funds may add value in most any portfolio, there are other issues that concern some investors. These issues include the following:

- *Lock-up periods.* An investor may have to wait a year or more before they can request a redemption from a hedge fund after contributing money. Even after one year, hedge funds require advance notice to request a redemption, typically 30-60 days before the beginning of the next calendar quarter. Some hedge funds have lock-up periods that are longer than a year and some may have lock-up periods less than a year. Even after a lock-up period has ended, a hedge fund may suspend redemptions especially if management and the board of directors feel that liquidating some or all of a portfolio may have adverse consequences for redeeming and remaining investors. This has been common in 2008 and 2009. Investment advisors and investors who invest in hedge funds should be comfortable with redemption restrictions that a particular fund that they are considering may have. Advisors should be clear on the limitations for redeeming hedge fund shares and when or if redemptions can be suspended.
- *The fees are high.* Typically, the fees for hedge funds are higher than other types of investment strategies such as long-only stock or bond managers. Typical hedge fund fees can range from 1 to 3 percent of the assets under management plus 20 to 30 percent of profits. While in some cases these fees may be justified by risk adjusted performance, other times they are not. One argument that these high fees are justified is that many hedge funds have high absolute returns but have low fees relative to their alpha (added value).
- *Taxes.* Because of the trading strategies used in most hedge funds, they are tax inefficient so much, if not all, of the income will be taxed at the investor's marginal income tax bracket. But as mentioned previously in another section of this book, the focus should be on after-tax risk adjusted returns and how addition of a hedge fund to the portfolio benefits the whole portfolio. Another tax issue for tax exempt entities or IRAs is Unrelated Business Taxable Income (UBTI). Income generated in a tax exempt investment entity that is subject to UBTI will cause income to be taxable. This is probably not a problem for U.S. investors that use offshore hedge funds. Investors should check with their tax advisor if putting hedge funds in their tax deferred or tax exempt portfolio.
- *Data on hedge funds may be sketchy.* Since hedge funds, in general, are not totally transparent it may be difficult to find all of the information needed. It is recommended that advisors only use single strategy hedge funds or fund of funds that are registered with the Securities and Exchange Commission. While this does not guarantee the validity of any information on a hedge fund, it does hold the hedge fund to some level of accountability. Many advisors will find it valuable to get copies of hedge funds audits and confirm directly with the auditing company that they were in fact the auditor. Preference should be given to hedge funds that have audited returns. Many hedge funds report their own returns to various databases, and there is no verification of this information. Therefore, return information that is procured from databases may or may not be accurate.
- *No indexes or universes.* Since hedge funds are absolute return strategies, it would be very difficult to find a benchmark or index to measure their performance against. Although their strategies may be similar to a certain hedge fund peer group or index, their process may be different enough that these would be an inadequate relative return measurement.
- *Low correlation.* Because hedge funds may have a low correlation to everything, it is much harder to attribute where performance is coming from.

- *Risk of total failure.* Because of the strategies some hedge funds use, they may be susceptible to total failure. While fraud is a possibility which could cause an investor to lose all of their money, some of the risks that hedge funds which are not fraudulent incur can cause a significant loss of principal. Hedge funds that in normal financial markets may be lower risk may have large declines in value when unprecedented dislocations in the financial markets occur such as in 2008 and 2009.
- *Leverage.* Some investment advisors and investors may be averse to borrowing money to invest. Borrowing money is not necessarily a negative element in portfolio management as long as it is not excessive. Purchase of real estate is typically done with borrowed money which is similar to margin on an investment portfolio.
- *Skill may be difficult to find.* While there are thousands of hedge fund managers, it is difficult to find the ones that are truly skillful and not just lucky. The important thing is to look for smart hedge fund managers with a sensible approach.
- *Volatility.* hedge funds can experience a very high volatility as many of the investment techniques employ leverage and derivatives (such as futures, options, commodity contracts, and short sales).

Investment Planning Answer Book by Jay L. Shein, Q 9:7, What are some of the considerations or questions to ask when evaluating a hedge fund?

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Before someone invests in a hedge fund, he should understand the investment process and whether that process is repeatable. Past investment performance should not be relied on as an indication of the future. Many advisors and investors make the mistake of putting large emphasis on historical returns only to be disappointed going forward. There are many factors that affect hedge fund performance in the future. The volatility experienced by the fund on a monthly basis is very important. When looking at past returns, the advisor should inquire whether those returns were generated by any large gains in a one, two, or three month period, or are the gains dispersed more evenly across the period of time being measured. Looking at the funds' worst months, quarters, and years will help the advisor determine if the strategy meets the tolerance for risk that is acceptable for inclusion in the portfolio. Because hedge funds typically have a low correlation to other assets in a diversified portfolio, this should be taken into consideration how total portfolio risk is reduced by adding a particular hedge fund to the portfolio.

Advisors should understand how the hedge fund manager deals with risk. To help assess this, an advisor can ask the following questions regarding the hedge fund manager: What is his highest and lowest market exposure since he began and in the last twelve months? What percentage of his portfolio can he have in any one single investment? How many positions does he typically hold? What does he consider the largest risk in his strategy and how does he gauge it? The advisor should also have the manager discuss his overall risk management strategy.

Advisors should read the hedge fund's offering memorandum or prospectus and all other materials such as marketing materials that are available from the manager. A lot of good information, especially regarding strategy and risk, is included in these documents.

Hedge funds have latitude in how they value securities. They may invest in securities that are highly illiquid and may be hard to value. Ask the manager how she values the various securities in the portfolio and how much she relies on independent sources to value the securities.

Since fees can be very high in hedge funds, it is important for the advisor to understand the fee structure. Hedge fund fees from 1 to 3 percent of assets under management and performance fees of 15 to 30 percent are common. One disadvantage of performance fees is that a hedge fund manager may be tempted to take on greater risk in order to obtain greater return which in turn would increase their performance fees. Those that use fund of funds for diversifications will incur an additional layer of fees.

It is important to look into the background of the hedge fund managers you are considering. Because advisors are looking for people that qualify to manage the money in the particular strategy, they should look heavily into their experience, be very specific, and ask detailed questions on how long they have run the strategy and previous investment experience. The advisor should ask about the people who started the firm and if these people are still with the firm. If these founders are no longer active in the firm, the advisor should ask why this is the case. They should also ask how the firm is structured and how the principles are involved on a day to day basis and whether the principles are involved in any other activities outside of managing the fund.

Investment Planning Answer Book by Jay L. Shein, Q 9:8, What are some of the summary sources of return and risk for various hedge fund strategies?

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Arbitrage strategies may include fixed income, equity, convertible, and merger arbitrage. Fixed income strategies have mispriced fixed income investments as their primary source of return. Some of the risks in fixed income arbitrage are hidden such as embedded optionality. It may be hard to identify opportunities since fixed income strategies can be a very efficient market. The overall risk is considered moderate unless leverage is used. Equity arbitrage strategies look for mispriced equity investments with one of the primary sources of risk being spread widening. The risk and return potential is moderate unless leverage is used. Like many hedge fund strategies, there may be limited capacity in this investment space. Convertible arbitrage strategies are strategies in which convertible bonds are purchased long and the equity of the same company is sold short and are usually of moderate risk. Some of the risks inherent in these strategies include credit, liquidity, and spreads. Merger arbitrage may have a moderate to high return and risk depending on the opportunities.

Market neutral strategies include equity and relative value types. Long short equity portfolios have a moderate to high return potential. They tend to have high turnover. The mathematical models used to make decisions are one source of risk in these strategies. Relative movements of the long equity positions versus the short ones are also a source of risk in this type of strategy. Relative value fixed income strategies which include long and short fixed income investments have a moderate to high risk and return potential. They may be very complicated and are exposed to risk caused by unfavorable spread movements.

Directional alternative investment strategies can include sector funds, distressed securities, short selling, equity/hedge, event driven, macro, market timing, and managed futures. Sector funds typically have a narrow focus and are long only investment strategies which are highly dependent on the manager's skill. The risk and return potentials are high. Securities of bankrupt and/or unrated companies, both domestic and international, are purchased in distressed securities strategies. Sources of risk of distressed securities strategies include credit, liquidity, lack of information, and the manager. They have a moderate to high risk return potential and can be intricate in nature. Short selling involves selling short various securities or markets. The risk and return potential ranges from low to high. Equity/hedge strategies are long equities with some short selling or hedging and are usually fairly directional in nature. Their risk and return potential is moderate to high. Event driven strategies, which are discussed in this publication, invest in special situations such as mergers. The major source of risk is that the event must unfold as planned. The risk and return potential can be moderate to high. Macro strategies take investment positions both domestically and/or internationally based on economic outlooks. Their sources of risk can include making the wrong decision and investing in the wrong direction and the manager's skill at macro investing. This can be a very volatile strategy with a low to high risk and return potential. Market timing strategies depend a lot on manager's skill where the manager takes long and/or short positions depending on particular speculations of market directions. These strategies can also have a low to high risk and return potential. Managed futures strategies are directional and rely heavily on the manager's skills and the mathematical models employed. Managed futures are usually long and/or short various futures markets frequently using commodities futures. Most of these strategies are trend following and have a low to high risk and return potential.

Other alternative investment strategies include private equity/leveraged buyouts, venture capital, international or emerging long and/or short currencies strategies, and real estate. Private equity involves direct ownership in an operating company, usually a private one. Buying the right company in the right market relies heavily on the manager's skills. These investments may use leverage and be illiquid. Their risk and return potential is moderate to high. Venture capital companies involve direct ownership in new companies such as technology or biotech. They typically are illiquid and may involve leverage. The risk and return potential is high and may take significant time to realize profits. International or emerging market currencies strategies involve purchasing long and/or short positions in currencies in different countries. They have a low to high risk and return potential and may have liquidity constraints depending on what currencies are used. Real estate strategies involve investing in property and have a low to high risk and return potential. They can be complicated and illiquid, and they depend highly on manager skills.

Investment Planning Answer Book by Jay L. Shein, Q 9:9, What is a 130/30 strategy?

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A 130/30 strategy is a long short strategy that is sometimes referred to as a short extension fund. It is not quite a hedge fund, but it takes some of its methodology from the hedge fund world. These strategies can go short and leverage up the portfolio. They tend to be quantitative models. These strategies have become popular in the last couple of years. The track records of these funds are short and many of them are simulated. The objective of the strategy is to maintain a 100 percent net market exposure. This alone may be difficult to do. The proponents of this strategy claim that they can unlock additional alpha by allowing long only managers to also short stocks. Short extension strategies invest in a basket of stocks such as the S&P 500 index. They would then short a certain percentage of those stocks, commonly 30 percent. Besides 130/30 strategies, advisors can find 120/20, 140/40, and 150/50. The stocks the manager shorts are the ones they feel are overvalued, and then they use the proceeds from the short sale to invest in the equivalent amount of long stocks that the manager thinks are undervalued. This strategy can be appealing over a long only strategy since the manager has more funds to invest in their belief by making active bets that are bigger underweight and overweight relative to the benchmark such as the S&P 500. The advantage of this short extension structure is to improve the efficiency of the information over long only portfolios. While extension strategies may add alpha, they appear to be higher risk than traditional long only funds. If their long and short stock picking goes wrong, they can take a large hit.

Investment Planning Answer Book by Jay L. Shein, Q 9:10, What is a hedge fund replication strategy?

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Hedge fund replication strategies are also known as beta strategies. Hedge fund returns typically come from the sum of traditional beta, alternative beta, and alpha. Many have observed that much of the returns of hedge funds come from alternative beta rather than the alpha component. Return derived from exposure to systematic risk factors such as liquidity risk, volatility risk, and credit risk is alternative beta. Alpha is the excess return that comes from the unique skill set and ability of a manager. These alternative beta strategies attempt to replicate the average beta exposure of the average hedge fund. While there is some evidence that they may be able to replicate this exposure, it is doubtful that they will be able to replicate the exposure of the best and consistent hedge funds. One of the purported advantages of hedge fund replication strategies is that they can offer similar exposure to the average hedge fund for a lower fee.

Investment Planning Answer Book by Jay L. Shein, Q 9:11, What is maximum drawdown?

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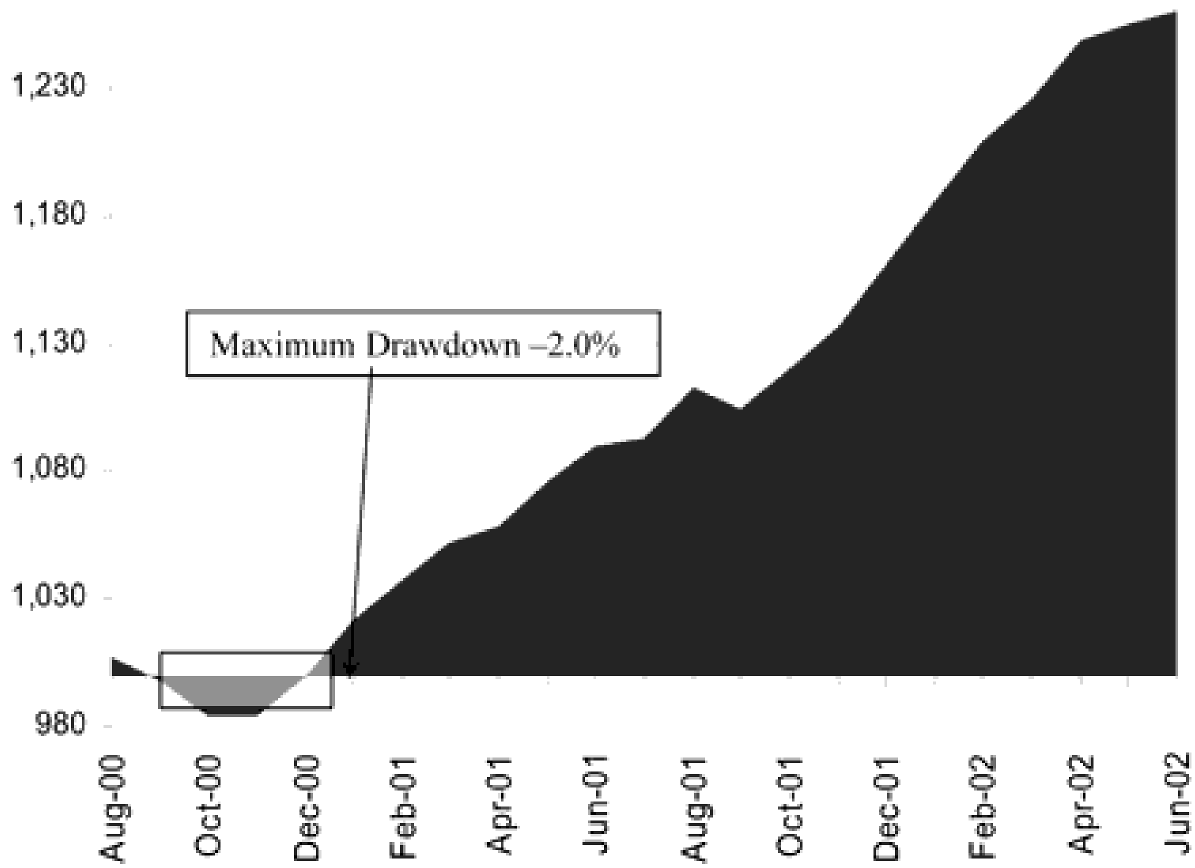
Maximum drawdown is a statistical measure that can be used to determine an investment's risk. Maximum drawdown can be defined as the measurement of peak-to-trough decline over a specific period of time for an investment. It demonstrates the worst period of time an investment or hedge fund had. It is usually quoted in percentages and can be determined by locating the largest drop from a high point to a subsequent low point in the investment portfolio. The losses do not need to be concurrent.

Hypothetical Example of Maximum Drawdown in a Hedge Fund

The maximum drawdown in this example is −2%.



One of the uses of maximum drawdown is to have a subjective view of the risk of the hedge fund. If the financial advisor or investor is uncomfortable with the maximum drawdown, then this investment should be avoided. The maximum drawdown does not tell the advisor how bad it could be. It only tells him how bad it has been. The Sterling and Calmar ratios use the maximum drawdown in their calculation to measure an investment's reward to risk.

Investment Planning Answer Book by Jay L. Shein, Q 9:12, How can maximum drawdown be used?

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An advisor could apply this concept to get an idea how bad a client's portfolio could be down during the life of the portfolio. Of course it can always be worse. If the advisor and client are uncomfortable with what has happened, then the portfolio may be too risky for the client. For example if an investor is willing to accept a drawdown of −10 percent then a portfolio with a drawdown of −15 percent would be inappropriate for that investor. It is important to understand that this is a backward looking statistic. The value of this measurement depends on the length of time that was used to compute the statistics. Drawdown will not help predict the future especially since market dynamics will change in the future. Drawdown can be valuable when comparing the risk that is inherent in different portfolios.

Investment Planning Answer Book by Jay L. Shein, Q 9:13, How do strategies using leverage work?

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Leverage is a strategy that seeks to increase return by borrowing funds. Typically, this money is borrowed on margin to purchase more securities than would otherwise be possible. If the investment goes up, that security could be sold, the brokerage company could be repaid the loan plus interest, and the investor could keep the profits. In this case, the investor is assuming greater risk by borrowing money which allows the investor to seek returns on that investment without having to commit additional funds of their own.

EXAMPLE 9-1

A portfolio manager buys 5,000 shares of IBM at $91 per share and only pays for 500 shares (or $45,500) out of pocket. The manager borrows the $409,500 for the additional 4,500 shares. If the value of IBM stock increases to $100 per share, the portfolio manager can sell the 5,000 shares for $500,000. The manager would then repay the $409,500 borrowed (plus interest charged), and the portfolio would have a profit of $45,000 (less interest) on the transaction. The reverse of this scenario would be that if the IBM stock declined to $80 per share, the stock would only be worth $400,000 but the portfolio would still owe $409,500 plus interest. The loss would be $55,000 plus interest.

Investment Planning Answer Book by Jay L. Shein, Q 9:14, How are derivatives used?

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A derivative is a term that is generically applied to a wide variety of financial instruments that derive their value by reference to some other underlying asset, rate, or index. Call and put options are examples of derivatives.

> **EXAMPLE 9-2**
>
> If XYZ stock traded at $40 per share, an investor could buy a four month call options on 100 shares of XYZ stock at $45 per share at a cost of $100 (the premium). If XYZ stock rose to $50 per share, in three months, the investor could exercise her option to buy the 100 shares at $45 per share. She could then immediately sell the shares for $50 per share, making a profit of $500 minus the $100 she had to pay for the option. If XYZ stock fails to rise in value, the call option would expire, and the investor would lose the $100.

The use of derivatives in hedge funds can be much more complex and may include strategies combining the sale and purchase of options and other derivative strategies simultaneously.

Investment Planning Answer Book by Jay L. Shein, Q 9:15, How can arbitrage be described?

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Purchasing a security in one market and the selling of the same security or derivative of it in another market simultaneously in order to profit from the differentials in price of the two markets is an arbitrage strategy. For example, a group of stocks sells for $200,000 in the futures market. The individual stocks that make up the group in the aggregate are priced at $204,000. The portfolio manager who wants to take advantage of this arbitrage opportunity would purchase the futures contract and sell short the individual stocks in the group. If the price of these two positions converges, the portfolio manager would make $4,000 on this arbitrage opportunity.

Investment Planning Answer Book by Jay L. Shein, Q 9:16, How do event driven strategies work?

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One of the primary uses of event driven strategies is for portfolio diversification. The objective of event driven strategies is to capitalize on events such as corporate mergers, bankruptcies, reorganizations, spin-offs, and takeovers. The uncertainty of the outcomes of these event driven strategies causes many securities to be mispriced which is the main source of returns for this hedge fund strategy. An event driven manager tries to profit by correctly anticipating the resolution to a corporate event. One type of event driven strategy is merger arbitrage. This corporate life cycle event involves investing in an announced corporate event where the final outcome is uncertain. A merger arbitrage manager would analyze an announced transaction in an attempt to predict its likely outcome and determine whether the acquirer and takeover target stocks are correctly priced relative to each other. If the manager feels the stocks are mispriced, he would sell the overvalued stock short and buy the undervalued one long. The manager would expect the prices to converge once the merger is completed. If the manager analyzes the transaction incorrectly, it could cause the portfolio to lose on its long side or short positions or both. The returns from these event driven strategies are not predominantly related to broad market moves. They attempt to make money from uncertainty and the mispricing of securities that comes with major corporate events.

EXAMPLE 9-3

An event driven manager hears that ABC company is buying XYZ company, and the price of ABC is currently $80 per share and the price of XYZ is currently $40 per share. The manager might feel that ABC, the acquirer, is paying too much for XYZ while the acquisition may benefit the price and shareholders of XYZ. The event driven manager might sell ABC short and buy XYZ long with the expectation that the prices of ABC and XYZ will converge somewhere between $40 and $80 per share. This strategy should allow the manager to make money on the shorting of ABC stock and the purchase of XYZ stock while still reducing the volatility of this pairs' trade versus only shorting ABC stock or purchasing XYZ stock. The event driven manager will do this with multiple pairs of securities to keep the risk of the overall portfolio low while taking advantage of these corporate events.

This strategy is sometimes referred to as merger arbitrage or a risk arbitrage strategy. Event driven strategies require specialized knowledge over the whole range of corporate events. These managers must also be skilled at correctly determining the final outcome of these events. If there are not enough of these events occurring or the manager does not have consistent skill, these strategies will not provide acceptable risk adjusted returns.

Investment Planning Answer Book by Jay L. Shein, Q 9:17, What is a long-short strategy?

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A long-short strategy is a relative value strategy which tries to take advantage of relative changes and the prices of securities instead of the broad changes within a particular market. A relative value manager would invest in securities that are undervalued relative to other securities and take short positions in securities that are overvalued which are off-setting positions. This combination of long and short positions attempts to hedge or at least reduce the impact of broad market changes on the return of the overall portfolio. The long positions can profit in a market that is rising, and the short ones can profit in a market that is declining. The returns of this long-short strategy are more closely tied to the manager's ability to choose pairs of stocks then whether a particular market is going up or down. This relative value of long-short strategy is directional in nature. The objective is not to be market neutral. These managers can change from growth to value, from large to small capitalization stocks, or become net short or net long. They may use derivatives such as futures and options to hedge their positions and their focus may be global or more regional such as a specific sector (e.g., being long technology stocks and short financial stocks). While many long-short managers have had stellar long-term returns, they can be faced with declines that are unexpected such as those that happened to statistical arbitrage long-short strategies in August 2007. Long-short strategies are sometimes referred to as directional or opportunistic strategies.

Investment Planning Answer Book by Jay L. Shein, Q 9:18, What are some other opportunistic strategies?

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Opportunistic strategies are used to increase portfolio returns. They benefit from wide changes in market conditions that can result from speculative bubbles or governmental intervention. Global macro, an opportunistic strategy, attempts to capitalize on major events affecting global economies. For example, a government shifts its policies regarding interest rates which then affect other financial instruments such as currencies, stocks, and bonds. A global macro hedge fund manager attempts to anticipate these events and make appropriate investment policy changes and investments that are directly influenced by these new trends. Many times, they use leverage and derivatives to accentuate the effect of these market moves. Because they use leverage to make these directional decisions, they often are not hedged which is one of the large reasons why many macro managers experience high volatility.

Another opportunistic strategy which is highly directional in nature is that of short sellers. These strategies attempt to find stocks of companies that are overvalued and sell them short anticipating the value of the stocks will decrease and the manager can buy them back in the future at a lower price. In a short sale, the manager borrows the stocks and then sells them with the hope of buying them back at a lower price. This strategy does better in declining markets.

Another opportunistic hedge fund strategy is a long only manager. A long only manager looks for stocks that are undervalued or that have a high growth potential. The difference here between a portfolio of long stocks only and a typical stock mutual fund is that a long only hedge fund manager will use leverage to amplify the returns.

An opportunistic strategy that has provided high returns during high global emerging market growth is one that focuses on buying and selling stocks and bonds in emerging markets. These markets tend to have higher volatility and more unstable economic decision. It is the opportunity for substantial growth in these less developed countries that it attempts to capitalize on. These strategies can be very high risk since they may have limited liquidity, no hedging ability, and the inability to sell short in many emerging markets. Emerging market opportunistic strategies usually require successful market timing to navigate and succeed. Major political changes in emerging market countries or legislative changes in those countries can have significant detrimental effects on investment positions with this strategy.

Investment Planning Answer Book by Jay L. Shein, Q 9:19, What does a distressed hedge fund manager attempt to do?

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A distressed securities manager invests in company securities that are experiencing financial or operational problems. High quality securities selling at distressed prices are sometimes also referred to as a distressed security strategy. This discussion will be limited to the former not the latter.

When the markets seem not to understand the true value of highly discounted securities, event driven managers will take advantage of this inefficiency and will buy debt or equity in companies that may be facing bankruptcy or reorganization. Distressed securities strategies tend to be cyclical.

Investment Planning Answer Book by Jay L. Shein, Q 9:20, What are relative value strategies?

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Relative value strategies can be good portfolio diversifiers. They attempt to make money by buying undervalued securities and selling overvalued securities short. The reason they are called relative value is because the returns are largely due to relative changes in the price of securities that are similar.

A relative value strategy investing in long and short equity positions that seeks to remove market risk from its portfolio is referred to as an equity market neutral strategy. This strategy would involve investing in two similar stocks by buying stock that is most likely to increase in value and shorting the one that is more likely to decrease in value. The idea of this strategy is to profit by having the stock that is invested long outperform the one that is shorted. This way the manager can profit regardless of movements in the market. The returns of this type of manager should be uncorrelated with broad equity market returns.

Fixed income arbitrage, another relative value strategy, tries to take advantage of the pricing anomalies in the fixed income markets. A fixed income arbitrage manager looks for potential changes in the interest rate spreads between related fixed income investments. For example, fixed income arbitrage managers might invest in a high yield fixed income investment and sell short an investment on a lower yielding instrument. This could be done by investing in different fixed income investments with different maturities on the yield curve. This strategy may also invest in different types of fixed income investments such as government bonds or corporate bonds with different yields and/or maturities. This type of strategy will typically employ leverage to increase the returns.

Another relative value strategy is convertible arbitrage which seeks inefficiencies between two different types of investments, stocks and convertible bonds. For example, a convertible arbitrage manager would buy the convertible bond of a particular company and at the same time short the underlying stock of the same company. A rising bond market and a falling stock market provide ideal opportunities for this type of strategy. Like many investment strategies, cyclical market and economic conditions can have a significant effect on this strategy. Convertible bonds tend to be of lower credit quality and tend to drop in value when investors shun lower quality credit investments.

Strategies that are considered market neutral are long-short strategies. Market neutral strategies go long many securities and short many others in a proportion that attempts to remove market risk. While they may not be attempting to have a beta of zero, strategies that are market neutral usually have a beta close to zero.

Investment Planning Answer Book by Jay L. Shein, Q 9:21, What is statistical arbitrage?

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Statistical arbitrage is a relative value strategy which uses the equity market neutral concept. This type of hedge fund manager will typically hold a large number of stock positions and offset them with a large number of short positions. Their methods use sophisticated, quantitative, and qualitative systems. These type managers attempt to balance picking stocks using their statistical advantage while at the same time reducing their exposure to systematic risk by investing long and short across various market factors. They use large amounts of data to capitalize on these factors. They are trying to keep the portfolio neutral to the market or at least to a minimum market exposure. A simple way to calculate their exposure to the market is as follows:

$$\text{Exposure to market} = \frac{\text{Long exposure to stocks} - \text{Short exposure to stocks}}{\text{Capital}}$$

These statistical arbitrage models employ leverage and are highly dependent on the mathematical models used to make the decisions. These types of strategies have high turnover and may incur large drawdowns if the risk management is ineffective. This happened in 2007.

Investment Planning Answer Book by Jay L. Shein, Q 9:22, What is a fund of funds?

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A fund of funds hedge fund allocates capital between various single hedge fund strategies. The general partner or manager allocates the capital and determines how much is invested with each hedge fund manager. Fund of funds may invest with a large number of single strategy managers (twenty to forty) or may concentrate on just a few managers. Fund of fund offers diversification because typically the capital is allocated between various hedge fund strategies and is not dominated by any one single strategy. Fund of fund managers may have access to hedge funds that may not be available to investors directly or would require very high minimum investments for individuals. For instance, an investor could put one million dollars in a fund of funds which would then invest the money in twenty different individual hedge fund managers. Fund of funds have many advantages of single strategy funds such as a lower correlation with many other investments and a focus on absolute returns. Hedge fund of funds can be structured as a partnership, a limited liability company, a registered hedge fund, or a hedge fund of funds like mutual fund. Because of the various structures available, probably all investors regardless of the size of the portfolio can access hedge fund of funds strategies. One of the disadvantages of using a hedge fund of funds is that they incur an additional layer of fees. The fund of funds manager charges a management fee and possibly also a performance fee. These fees are on top of the asset management fees and performance fees that the individual hedge fund managers are receiving. Some incorrectly assume that the purpose of the hedge fund of funds manager is to select the high performing hedge funds. While this is important, there are many other advantages of using a fund of funds manager. Fund of funds managers combine the various hedge fund strategies to provide the appropriate risk and return metrics. Their functions include selecting the appropriate managers and nonperformance based duties such as operational risk management and anti-fraud analysis. The fund of funds manager is responsible for constructing the portfolio, monitoring the portfolio, and managing it on an ongoing basis.

Investment Planning Answer Book by Jay L. Shein, Q 9:23, What are some questions to ask a fund of funds manager?

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The following are some of the questions that should be asked of a fund of funds manager. It is not an all inclusive list, but it covers the basic issues to discuss with a fund of funds manager.

- Ask the fund of funds manager to discuss the type of transparency he has with the underlying hedge fund managers and their portfolios.
- Ask how much leverage is used and how it is monitored.
- Ask the criteria that are used to select the individual hedge fund managers. The advisor should have the fund of funds manager explain the process that is used for selecting these managers. Ask the fund of funds manager to take you through the process and reasoning behind the selection of a recent manager.
- Ask the manager about the criteria that are used to terminate an underlying manager. Have the fund of funds manager take you through the process and reasoning behind the termination of a recent manager.
- Ask the fund of funds manager what his policy is regarding how many managers he uses, the sectors and industries he allocates to, and his geographic distribution.
- Ask the fund of funds manager to describe the structure of his research team. He should explain the teams' individual responsibilities and specialty areas of each person on the team. Ideally, there are both specialists and generalists on the team.

Investment Planning Answer Book by Jay L. Shein, Q 9:24, Where can one find information on hedge funds?

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Advisors can find information on hedge funds from various sources. They can speak with other advisors and hedge fund investors. They can subscribe to various databases such as TASS. They can purchase research from Morningstar. Information on hedge funds is also available at www.hedgefund.net and www.hedgeco.net.

Investment Planning Answer Book by Jay L. Shein, Q 9:25, What are absolute return strategies?

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The objective of an absolute return strategy is to generate positive returns in all types of market conditions. There is no guarantee that any particular strategy or group of strategies will achieve this objective. Performance of traditional investments is evaluated on a relative basis as against a benchmark such as the S&P 500, some combination of benchmarks, or the manager's peer group. Managers who have an absolute return objective seek strategies that make money in both up and down market environments. To accomplish this, they may use a broader range of investments than typically used by a money manager, employ leverage and/or use derivatives to enhance a specific strategy, or sell short to capitalize on markets that are declining and/or invest in more illiquid investments or strategies. These absolute return strategies have been around for years.

Investment Planning Answer Book by Jay L. Shein, Q 9:26, What are tactical and timing alternative investment strategies?

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Tactical and timing strategies may be part of a hedge fund methodology or portfolio management. They are typically a top down approach to investing which looks at the macro environment worldwide and makes decisions where to allocate capital based on economic and/or mathematical models. A timing strategy may be more focused such as being more invested in stocks or cash and moving between those investments when deemed appropriate.

Investment Planning Answer Book by Jay L. Shein, Q 9:27, What are music copyrights?

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A copyright is as a bundle of exclusive rights. The exclusivity means that only the copyright owner may exercise those rights in that music, or authorize others to exercise them. A valid copyright is created as soon as the original song or sound recording is fixed in a tangible medium of expression, which means that the song or sound recording must be written down or recorded. Registration with the U.S. Copyright Office is not required in order to have a valid copyright, but it does provide additional protection in the event someone infringes the owner's work.

Investment Planning Answer Book by Jay L. Shein, Q 9:28, What are some of the characteristics of music copyrights as an investment?

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Music copyrights have the ability to provide reliable, “high coupon” cash flows. This income stream is derived from the rights to be paid for the use of these songs. While these assets are difficult to price since they are not traded on a regular basis and do not have precise comparables, they generally have low volatility returns and low correlations to most assets classes. Because of the low correlation, they can be a portfolio diversifier. Potential capital appreciation of the copyrights exists though revenue enhancement and expansion into new markets. For example, the ease of access to purchase music via the internet and other media sources has expanded the ability to gain users in otherwise remote or unsaturated areas that can further enhance revenue growth. Music copyright assets generally require minimal reinvestment to maintain useful lives, and have extensive legislative copyright protection (in the United States, typically the life of the last living writer plus seventy (70) years).

Investment Planning Answer Book by Jay L. Shein, Q 9:29, What are some of the caveats or risks of music copyrights?

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Music copyrights are exposed to liquidity and marketability risks. Copyrights are not traded on an exchange, so the ability to sell a position in a timely and efficient manner may be difficult. Determining a value for these copyrights may also be difficult since there may not be a readily comparable valuation. The ability for the copyright to continue producing a steady stream of income is also a risk since the music may fall out of favor over time. Piracy is another risk that can negatively impact a copyrights income stream, even though the risk of piracy is reduced due to some statutory infringement fines. The addition of music copyrights may add an element of diversification to the portfolio, but an investor should also diversify within the music copyright portion of the portfolio to manage the risk associated with any single copyright. While there are ways to manage some of these risks, an investor should be aware of the risks to determine if the expected return is sufficient to compensate them for this exposure.

Investment Planning Answer Book by Jay L. Shein, Q 9:30, What are insurance linked securities (ILS) and how can they fit into a portfolio?

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Wealth managers, investment advisors and investment consultants are always looking for ways to improve a portfolio's risk-adjusted return. This goal can be attained by optimizing the portfolio to either reduce the portfolio risk without taking away from a portfolio's expected return or to increase portfolio returns without increasing the portfolio's risk. In order to accomplish this objective, the advisor looks for assets that have positive expected returns and are uncorrelated, or have low or negative correlation to their current portfolios. An asset class that potentially fulfills that objective is some Insurance-Linked Securities (ILS).

ILS can transfer insurance catastrophe risk that can be produced by natural events to the capital markets. Insurers, reinsurers and governments sponsor these securities. By doing this, they get more reinsurance capacity. The most liquid ILS are catastrophe "cat" bonds which at least historically have produced returns similar to those of the equity risk premium while still having a low volatility as measured by standard deviation. Additionally, they have had a low correlation to more traditional asset classes such as stocks, bonds and real estate. Cat bonds that insure different events, such as earthquakes, hurricanes, tornadoes, and floods, also have low correlations to each other. Cat bonds have grown to over a 16 billion dollar market and represent about 5 percent of the overall reinsurance market. Another type of ILS is quota shares. Quota shares exhibit higher risk and higher expected returns than cat bonds, but also have low correlations to traditional asset classes.

Investment Planning Answer Book by Jay L. Shein, Q 9:31, What are Catastrophe (Cat) Bonds?

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In 1992, Hurricane Andrew hit Florida causing losses that were much higher than expected, and 13 insurance companies went bankrupt as a result. This led to an increased demand for protection from catastrophes. In 1994, the first cat bond was sponsored by Hannover Reinsurance. There were 5 cat bond transactions that took place in 1997, and many consider that year to be the establishment of the market for cat bonds. From then on, the demand for cat bonds has continued to increase, including new demand from large loss events such as 2005 Hurricane Katrina. Insurance companies are typically focused on a specific region of the country (i.e. Florida) or on a specific line of business (i.e. property). Because of this emphasis, some insurance companies are exposed to more catastrophic, systematic risk that could bankrupt them, such as hurricanes in Florida or tornadoes in Kansas. Since this lack of diversification brings a large risk to the insurance companies, they turn to reinsurers to provide relief. Large catastrophes, such as the hurricanes in 2005, and more recent natural disasters like the 2011 Christchurch earthquake in New Zealand that severely damaged New Zealand's second largest city, the 2011 Tohoku earthquake in Japan, or the 2012 Hurricane Sandy have emphasized the reinsurance market's need for more capacity. Reinsurers provide assistance to insurance companies by allowing them to spread out their concentrated risk exposure.

Reinsurance companies sponsor ILS for various reasons. To begin with, it is an inexpensive way for them to protect themselves against genuine catastrophes. The reinsurance companies may also improve their financial results from issuing ILS which can increase their Return on Equity (ROE), increase total profitability and smooth earnings. In addition, the issuance of these securities can diversify large concentrated risk and lessen pressure from rating agencies and regulators.

Cat bonds have some advantages for reinsurers or insurers versus purchasing traditional reinsurance. These include locking in annual costs for 3 to 5 years instead of 1 year contracts. They also have very little risk from a credit point of view since cat bonds are collateralized with U.S. treasuries or similar money market instruments even though typically rated below investment grade.

Both corporate bonds and cat bonds are rated by bond rating companies, but cat bonds have what is known as jump-to-default risk. Jump-to-default risk is the risk for an event that is unforeseen by a company that would cause large changes in the bond's value. In other words, jump-to-default risk is the risk that the natural catastrophe occurs and triggers payment by the insurer. Because of this risk, cat bonds generally have higher yields than corporate bonds that have a similar rating. The return component of cat bonds comes from a combination of the reinsurance premiums and the yields on the treasuries/money market instruments. Because the yield on treasuries or other money market instruments typically adjust quickly with inflation, cat bonds can also have an element of inflation protection.

When yields are low in the capital markets, advisors and investors typically look for ways to enhance returns by increasing yields. The uncorrelated returns and track record can make cat bonds an attractive addition to a diversified portfolio.

Does the historical record of cat bonds bear out some of the purported benefits? From a historical perspective and being mindful of the fact that past performance is no guarantee or indication of future results, cat bonds do have favorable historical attributes. The historical average risk premium of the Swiss Re Global Cat Bond Index is comparable to the historical average risk premium of equities and has a higher spread than corporate bonds with a similar rating. Since cat bonds usually have a floating rate, they exhibit low duration risk (interest rate risk). These bonds are less risky as measured by standard deviation or drawdown risk than more traditional asset classes. When cat bonds are diversified in a portfolio, they have a low correlation to each other. Furthermore, cat bond portfolios have had a low correlation to other asset classes even in times of economic/financial crisis. This makes them a great portfolio diversifier. Historically, cat bonds have been held by buy-and-hold investors giving them an asymmetric liquidity characteristic which has made them hard to buy, but easy to sell. Even though these bonds tend to have below investment grade credit ratings due to their event risk, they appear to have very little credit risk since they are collateralized with U.S. treasuries or similar quality money market instruments.

Investment Planning Answer Book by Jay L. Shein, Q 9:32, What are Quota Shares?

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Quota shares are another type of Insurance Linked Security (ILS) where an investor is investing alongside a reinsurance company. The quota shares provide the investor exposure to a segment of the reinsurer's insurance portfolio. This may be limited to a specific portion of a reinsurer's book—such as the natural disaster component of the reinsurer's portfolio. This segment may include, but is not limited to, a reinsurer's wind (hurricane and tornado) insurance, earthquake insurance, flood insurance, terrorist insurance, marine transportation, satellite, agricultural and aviation risk insurance. By taking on this risk, the investor receives a fixed proportion of the premium. The investor's loss is limited to the amount invested by an investor and the reinsurance company retains the exposure to the excess loss amounts. Quota shares have higher risk and higher expected returns than cat bonds. This is due to the leverage contained in their construction. Other features of quota shares such as their typical 1 year contract, specified date of maturity, and a modeled risk and return profile make them a coveted investment by many investment advisors and investors.

Quota shares have been private transactions which are by invitation to investors. They have advantages to the reinsurers and the investors alike. Some advantages for reinsurers are:

- More potential for revenue
- Smooth out their earnings
- Gives them access to another flexible source of equity capital

Some advantages for investors:

- Correlations that are low to other financial assets
- Greater diversification when added to an investment portfolio
- Quota shares are a very diversified ILS
- Good expected returns

Quota shares have historically been more volatile than cat bonds but have exhibited higher returns. Dislocations in the financial markets have shown quota shares to have less propensity for depressed pricing than cat bonds as seen in 2008, as multi-strategy hedge funds liquidated cat bonds because of their need for liquidity. Quota shares did not experience this due to their smaller number of investors that are more focused on the long term.

Investment Planning Answer Book by Jay L. Shein, Q 9:33, Are insurance linked securities (ILS) appropriate for all portfolios?

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Advisors, consultants and investors might be well-advised to review and study the benefits and disadvantages of ILS to better determine if they make sense for inclusion in client portfolios. The most likely place for this type of asset in an asset allocation framework is in the alternative asset class category. This is mainly predicated on their risk, return and correlation parameters. To some investors, ILS might sound like a nearly perfect investment short of their event risk. However, like all investments, there are pros, cons and risks, including the risks that cannot be quantified or even identified. In the search for portfolio diversifiers with positive expected returns, advisors might be well considering a diversified basket of ILS within their diversified investment portfolios.

Investment Planning Answer Book by Jay L. Shein, Q 9:34, What is alternative lending?

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Alternative lending is used to describe a variety of loan options to consumers and business owners that are often obtained without the involvement of a bank. These loans are often made by investors that are providing credit to the borrowers. The early adopters of this form of lending often referred to the structure as “peer-to-peer” lending or sometimes “marketplace lending” because of the matching of individual borrowers with individual investors. This type of lending has expanded through various platforms that emerged to facilitate this lending process and is becoming a growing part of the overall credit market. While individual investors were the primary source of capital in the earliest stages of the alternative lending development, institutional capital has since become the primary source of funding for these alternative loans. Along with the substantial resources that institutional investors are able to provide, they also have the professional expertise to better monitor and enforce underwriting discipline.

Investment Planning Answer Book by Jay L. Shein, Q 9:35, What type of borrower would consider alternative lending as a source of credit?

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Individual consumers or small businesses that are looking for capital may turn to a traditional bank to obtain the financing or may instead elect to use their credit card. However, in order to obtain financing from a traditional bank, borrowers are subject to what can often be a time-consuming process with only a modest probability of obtaining a loan. While credit card debt is often a very expensive way to obtain financing, it is a common solution for those who have either been unable to obtain a traditional loan from a bank or do not want to go through the loan process with the traditional bank because of the length of time often required to obtain the loan and the uncertainty of whether the bank will actually approve the loan.

Alternative lenders provide an attractive solution to borrowers and investors by incorporating technology into their operations and underwriting process, which allows them to function with less overhead than the traditional banks and an increased speed of underwriting loans. The period of time it takes to determine whether a loan can be made by an alternative lender is often measured in days, rather than in weeks or months when comparing to a traditional bank. The savings is passed on to both the borrowers, who can receive lower rates than they would be paying on credit cards, and to investors, who benefit from the operating cost advantages inherent in the alternative lending structure. Borrowers may use an alternative lender for a variety of purposes including debt consolidation, credit card financing, home improvement, major purchases, vehicle financing, business–related expenses, vacation, moving and relocation, medical expenses, and other needs.

Investment Planning Answer Book by Jay L. Shein, Q 9:36, What are the mechanics of the alternative lending process?

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Unlike a traditional bank, which takes deposits and then makes loans to borrowers, an alternative lender acts as the middle party between borrowers and investors. The alternative lender takes on the responsibility of originating, underwriting, and servicing the loan. While the alternative lender is not actually taking any deposits, they are still going through the underwriting process somewhat like a traditional lender would to determine a borrower's credit worthiness and their ability to repay. Alternative lenders incorporate both traditional methods of underwriting, such as review of credit scores and income verification.They also incorporate financial technology to leverage a broad range of sources to include a complete credit picture. This could include accessing additional financial data to assess the borrower's cash flow, as well as web-related information regarding the consumer or business, and even social media information.

A borrower typically initiates the loan process through an online application. The alternative lender will then begin the process of determining eligibility and analyzing the applicant's information and any third-party data. Once the alternative lender has approved the loan and determined the interest rate based on the borrower's credit picture, the lender will review the terms of the loan with the borrower and simultaneously match the borrower with an investor that is funding the loan. The alternative lender also establishes the schedule of payments and usually requires that the payments be set up through some automated electronic payment method, which helps to reduce the likelihood of borrower defaults.

The alternative lender receives a fee for their responsibility of originating, underwriting, and servicing the loan. While fees vary depending on the alternative lender, if a borrower is charged a rate of 14 percent for a loan, the alternative lender may take a fee of 1 percent, so the remaining 13 percent would pass through to the investor.

Investment Planning Answer Book by Jay L. Shein, Q 9:37, Should an investor consider alternative lending as part of a diversified investment portfolio, and what are some of the risks that an investor should be cognizant of?

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Alternative lending provides attractive yield opportunities and low duration relative to traditional fixed income. The term of the loans, which are typically fully amortized loans, is usually five years or less, and the interest rates often exceed that of even high-yield and lower quality corporate bonds. Because there is not an established secondary market for these loans, the investor should understand the illiquidity of the loan during the life of the loan.

The largest single risk to the investor is that the borrower will default on the loan and the investor will not receive full repayment. Because there are currently hundreds of alternative lending platforms around the world, the investor should carefully evaluate the alternative lender(s) they are using. This could include due diligence on the alternative lender's underwriting and origination process, the legal and regulatory framework as well as their compliance management the alternative lender has in place, and the transparency they provide to the investor both regarding the loan details and the servicing and administration costs charged by the alternative lender.

Even with a quality underwriting process facilitated through a robust legal and regulatory framework, a borrower's credit picture could significantly change during the life of the loan and leave an investor with losses because of defaults. One way to mitigate this risk is for an investor to own hundreds, or even thousands, of loans that are diversified across different geographies, alternative lending platforms, and loan types so that the investor is gaining access to a diversified portfolio of loans and no single default will have a significantly adverse effect on the loan portfolio. Advisors and investors can access diversified pools of these loans through private placements and hedge funds. While a significant pool of globally diversified loans would remove the concentrated risk exposure, the loan pool would still be exposed to risks associated with rising level of defaults on the loan portfolio due to deteriorating economic conditions. In other words, even with a diversified loan pool that is spread out geographically around the world, if there is a significant rise in unemployment on a global level due to deteriorating economic conditions, this will likely result in a higher than average level of loan defaults on the loan portfolio.

While a pool of these loans could be impacted through conditions that increase the loan default rates as described above, the loans generally have a low correlation to traditional asset classes like stocks, bonds, real estate, and even a low correlation among the loans themselves if adequately diversified. For example, a loan to a business owner in Australia who is financing some new business equipment is not necessarily correlated to a loan to an individual borrower in Germany that borrowed money to finance his daughter's wedding. Additionally, neither of these loans are necessarily correlated to funds borrowed by an individual in California for medical expenses. Fluctuations in stock, real estate and bond markets would also not typically impact these borrower's repayment schedules. While the loan values would have some sensitivity to changes in interest rates, because of the typically low duration of these loans, that impact is usually relatively small. Overall, when weighing the risk-return trade-offs of alternative lending as an investment, this can be an attractive complement to investment portfolios for investors who are able to invest in this strategy through a broadly diversified portfolio of loans spread out over different geographies, alternative lending platforms, and loan types.

Investment Planning Answer Book by Jay L. Shein, Q 9:38, What are royalties and, more specifically, what are healthcare royalties?

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A royalty is a payment to the owner for the use of a product or service. Royalties can be acquired for a broad variety of products or services. Some examples of royalties include book publishing royalties, music and art royalties, computer software royalties, patent royalties, and healthcare royalties. As its name implies, healthcare royalties are royalty income streams derived from the healthcare industry. Healthcare products, including pharmaceuticals, medical devices, biotechnology, and diagnostics, are often initially invented and developed at research institutions, universities, and small to mid-sized companies and then licensed to large healthcare companies that promote and sell the products in markets around the world. The stage at which the healthcare royalties are created from can range from discovery, to development, to mature commercial-stage products or services.

Investment Planning Answer Book by Jay L. Shein, Q 9:39, What is the structure of a healthcare royalty?

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Royalties are often structured so that the acquiring party receives a percentage of revenue of the owner's product or service. A license agreement is prepared to outline the terms under which royalties are based. The license agreement will address the parameters and limits of the royalty income stream, including how long the royalty income stream will last, any restrictions on territories for which the royalty incomes apply, and the specifics of any products or services included under the agreement. In addition, it will define the rate or participation in the royalty income stream, which is usually determined based on a number of factors, such as, but not limited to, the stage of development of the product or service and the risks involved, the supply of alternative products or services, the demand for the product or services, and the exclusivity of rights that the royalty provides.

Investment Planning Answer Book by Jay L. Shein, Q 9:40, What are some of the types of healthcare royalties?

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Traditional royalties give the acquirer the rights to streams of cash flows based on the variables outlined in the licensing agreement. Purchasers of traditional royalties generally take a passive role, where after investing in the royalty income stream, the investor has no ongoing role in the product's commercialization. Structured royalties are financial arrangements derived from, including, or structured to function as royalty interests. These structures can include revenue interests, performance milestones, and royalty-backed securities such as royalty monetization bonds and loans against royalties. An example of a performance-based healthcare royalty structure could be where an investor provides capital to fund clinical trials for a new pharmaceutical drug in exchange for milestone payments combined with royalties and/or revenue interests. An example of a royalty-backed security would include an investor's purchase of a bond that is collateralized by royalties. In these cases, a special purpose vehicle is typically set up, and then the product assets, including patents and license agreements associated with the product, are transferred into the special purpose vehicle. The royalties received by the product assets are then used to pay the interest and principal payments of the bond. Some hybrid structures may include a combination of traditional debt or equity along with royalties or revenue interests.

Investment Planning Answer Book by Jay L. Shein, Q 9:41, What are some of the potential benefits, drawbacks, and risks of investing in healthcare royalties?

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Revenues from healthcare products that target areas of medical necessity have historically been largely uncorrelated with traditional debt, real estate, and equity indices. Depending on the stage of the product or service, the royalty income streams can provide attractive yields comparable to traditional fixed income or equity investments. Depending on the structure of the royalty income stream, the license agreement can be set up to minimize downside risk via a series of negotiated contractual provisions while preserving upside potential. These provisions could include the use of guaranteed minimum payments, guaranteed return of principal, put options, safe tiers of revenues, staged funding, senior secured collateral positions, and a variety of additional protective covenants.

Investors typically gain access to these investments through private placement agreements. Because of the structure of these investments, liquidity is often limited or nonexistent for long periods of time, typically ranging from 7–10+ years. Management fees are typically high in these structures, and it would not be uncommon to see an investor pay a management fee of 2 percent of the committed capital plus a percentage of the profits.

Investors who want to gain exposure to healthcare royalties should seek to create a diversified portfolio of these revenue streams that include a variety of different product types, therapeutic areas, and geographies in order to mitigate the risk associated with any single product, transaction counterparty, or marketing institution. Successful healthcare royalty investing requires a deep level of understanding of the broad dynamics of the pharmaceutical, biotechnology, medical device, and diagnostic sectors, as well as the ability to evaluate the strength of intellectual property protection, the regulatory environment, the drivers and barriers of the revenue streams, and the various manners in which the deals can be structured. In addition, investors or private-placement managers will need to be able to have the necessary connections with small and mid-sized companies, healthcare experts, and key opinion leaders in order to effectively access any available royalty income streams. Investors without the skill set and contacts could consider investing in a private placement managed by people who have the ability and contacts to invest in these royalty income streams. Advisors and investors should perform due diligence on any manager they hire with an understanding that all investments have a downside element to them, and past performance is no indication or guarantee of future performance.