1. Introduction

Recently, alternative investments have grown sharply among investors in Europe and the U.S. According to a survey by TASS Investment Research, a leading authority in the field, the alternative investment market reached $550-600 billion at the end of 2001. Amid ultra-low interest rates, a quiet boom is also occurring in Japan among some individual and institutional investors. In pension fund management, the Pension Fund Association revised investment guidelines in August 1999 to include investment in venture businesses and real estate derivatives. And as demand grows, major securities firms and investment companies are hastening to enhance their alternative investment divisions.

Japanese investors tend to equate alternative investment with hedge funds. However, hedge funds actually comprise only one category of alternative investment. Thus in this paper, we discuss hedge funds in the general context of alternative investments.

2. Defining Alternative Investments

People sometimes use the term alternative investment to mean investments other than in traditional asset classes such as domestic and foreign stocks and bonds. Actually, however, alternative investments often involve stocks and bonds; the difference lies in the use of non-traditional methods.

Broadly speaking, alternative investment strategies consist of hedge funds, private equity, real estate investment, and natural resource investment. Institutional investors use various strategies to invest in some or all of these areas (Figure 1). Although many alternative investment products help institutional investors diversify risk, the products generally have a high-risk, high-return characteristic.
Hedge funds generally engage in speculative investments, relying on financial engineering techniques and short-term trades. Private equity entails a long-term investment in unlisted shares for a period of at least five to eight years before cashing out, and is thus an asset class characterized by low liquidity. Real estate investment includes properties and securitized products, while natural resource investment targets oil, gas, and forest resources. No strategy consistently outperforms the others, as each depends on timing and market environment. In addition, wide disparities exist in the performance of funds with the same strategy. Thus each alternative investment is unique in nature.
3. Features of Alternative Investment Strategies

(1) Advantages and Disadvantages

Advantages of alternative investment include: (1) a low correlation with traditional asset classes, (2) risk diversification through diversified investment, (3) diversification of return sources across commodities, futures, unlisted shares, etc.

On the other hand, there are disadvantages as well: (1) disclosure is inadequate regarding investments, (2) market value cannot always be determined due to low liquidity, (3) holdings cannot be quickly redeemed for cash (one month’s prior notice is often necessary), (4) extensive credit research is needed for each fund, and (5) a common benchmark does not exist.\(^1\)

(2) Characteristics

While alternative investments (primarily hedge funds) resemble investment trusts in being funds that invest customers’ assets, the similarity ends when it comes to disclosure requirements and fund manager evaluation method (Figure 2).

![Figure 2  Comparison of Hedge Fund and Investment Trust](image)

<table>
<thead>
<tr>
<th>Investment trust</th>
<th>Hedge fund</th>
</tr>
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<tbody>
<tr>
<td>Strict regulatory supervision</td>
<td>Lax regulatory supervision</td>
</tr>
<tr>
<td>For large number of unspecified investors</td>
<td>For small number of specified investors</td>
</tr>
<tr>
<td>Detailed disclosure requirements</td>
<td>Disclosure requirement is very lax</td>
</tr>
<tr>
<td>Benchmark is often market index</td>
<td>Benchmark is often absolute return</td>
</tr>
<tr>
<td>NAV is calculated daily</td>
<td>Monthly or quarterly performance evaluation</td>
</tr>
<tr>
<td>Compensation is rarely performance-based</td>
<td>Compensation is usually performance-based</td>
</tr>
</tbody>
</table>

Source: Compiled by NLI Research Institute

1 Many benchmarks exist for the overall hedge fund market, such as the HFR Index (Hedge Fund Research, Inc.), CSFB/Tremont Hedge Fund Index (Credit Suisse First Boston), Hennessee Index (Hennessee Group), and EACM 100 Index (Evaluation Associates Capital Markets, Inc.). However, they are inadequate from the perspective of institutional investors because: (1) the benchmarks include issues that are closed to investment, (2) investment performance has not been audited, (3) survivorship bias exists (performance of failed funds is omitted), (4) performance calculation is not uniform, (5) funds included in each benchmark differ, and (6) registration with the benchmark data provider is voluntary, so that only well-performing funds report results. Detailed indexes for different strategies have also been released, but these too are inadequate for the same reasons.
are privately subscribed. That is, unlike an investment trust, which targets a large number of unspecified investors, they target a small number of specified investors.

According to TASS, approximately 90% of alternative investment fund managers reside in the U.S. This can be attributed to the fact that the development and growth of alternative investments has been centered in the U.S. On the other hand, alternative investment funds are registered not only in the U.S. but in various offshore tax havens (Figure 3). Funds are registered offshore to ease regulatory and tax restrictions, thereby enhancing their freedom to invest.

The funds need not file an application with the SEC, and are subject to almost none of the mutual fund regulations. Moreover, due to lax disclosure requirements, close regulatory supervision is difficult, and investors are often not protected in cases of fund failure or fraud. However, in the case of limited partnerships, which are privately subscribed funds aimed at U.S. investors, the SEC does have limited regulatory power.2

Figure 2  Registration of Alternative Investment Funds

![Pie chart showing distribution of alternative investment funds](source: Compiled from TASS Investment Research data.)

2. Performance Evaluation and Compensation

Alternative investments are characterized by high levels of compensation. For example, the

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2 Under the Securities Act of 1993, securities issuance requires registration with the SEC and detailed disclosure. However, Regulation D of the act exempts hedge funds and other privately issued securities from these requirements when: (1) investors are institutional investors or certified individual investors with sufficient funds, (2) the subscription is private, (3) the number of investors is limited to 99 or less. However, they still must follow minimum disclosure requirements and obey SEC regulations regarding fraud. In addition, the Investment Company Act of 1940 and Investment Advisors Act of 1940 contain rules on margin transactions, derivative transactions, and performance-based compensation. However, like the Securities Act, they contain provisions to exempt private investment companies, so that many hedge funds need not register with the SEC. Moreover, investors must disclose whether they have adequate ability and financial strength to invest in hedge funds (see the first condition for exemption above).
average hedge fund charges an annual management fee of 1-2%, plus a 10-20% incentive fee paid to the manager. However, such performance-based systems generally include qualifications such as: (1) a hurdle rate (no compensation unless a prescribed excess return is obtained), (2) high water mark (no compensation unless the present record rate of return is surpassed), or (3) a requirement for the manager to invest in the fund so that excessive risks are not taken.

(3) The Alternative Investment Process

1. Primary Screening

The number of domestic and foreign alternative investment funds is said to be around 4,000 to 5,000 companies. Selecting a fund out of this massive group requires that some broad screenings are performed. Specifically, the first step is usually to use data from data providers to perform a superficial screening based on: (1) track record and funds under management, and (2) analysis of investment methods and other fund characteristics.

However, problems can arise since classifications vary by data provider, and since many funds do not even provide data. While such quantitative data is important, for alternative investment, the following types of qualitative data are more significant.

2. Qualitative Research

After the initial screening, the next stage is to perform due diligence, or in-depth qualitative research of each fund. This stage is particularly critical, and ordinarily may take several months to over half a year before reaching a decision. Specifically, based on discussions with management and outside assessments, each prospective fund must be examined on the following points: (1) the fund's investment philosophy, (2) investment process, (3) risk management method, (4) crisis management system, (5) administrator and custodian systems, (6) manager's background check, including family, acquaintances, lifestyle, etc., and (7) accounting, tax, and legal framework.

3. Investment Monitoring

Having conducted due diligence and decided to invest, investors need to monitor the fund on an ongoing basis. The fund's circumstances may change in time as the investment climate evolves. Investors thus need to monitor the fund for major changes in investment policies or investment climate by reading the periodic investment status reports from the administrator, who is independent of the fund, and having discussions with the fund manager.
**Ways to Invest in Hedge Funds**

1. **Investing in Existing Funds**

The form of a hedge fund varies depending on the fund’s country of registration. For example, many domestic funds in the U.S. take the form of a limited partnership for tax purposes, so that investors are owners of the partnership. On the other hand, many offshore funds (such as in the Cayman Islands) are organized as companies, so that investors buy shares and earn a return based on share price fluctuations.

2. **Investing in a Fund of Funds**

An increasingly popular type of fund in Japan is the fund of funds, which invests in a portfolio of several hedge funds (or investment trusts). These funds diversify risk by combining various investment strategies, and seek stability of performance. Companies that conduct research and manage the fund of funds are called “gatekeepers,” and at present number approximately 400 worldwide. Compared to investing directly in a fund, these funds offer conveniences such as professional management by the gatekeeper and small lot purchases. On the other hand, investors must pay an additional cost to compensate the gatekeeper (management expense plus performance bonus).

3. **Setting up a Segregated Account**

Instead of buying holdings or shares in existing hedge funds, investors can set up a segregated account, which is legally recognized as being the investor’s personal assets, and managed as a tailor-made fund at the discretion of a hedge fund manager. Such accounts are distinct from separate accounts, which are separate only for accounting purposes, and do not enjoy the same level of safety because they may legally be pooled together with other accounts. This was the case in the recent Princeton Funds case; supposedly separate accounts were actually mingled into another account. Thus the type of account and actual management arrangement are a critical consideration.

With a segregated account, investors can negotiate many aspects of the fund including fee schedule and redemption conditions, while the transparency of investment is also high. On the down side, not only are hedge fund managers difficult to find, for the segregated account, but once found, charge high management fees due to the individual attention that the account receives. In addition, the minimum investment amount is large.

4. **Investing in CFOs**

A new type of security has emerged called hedge fund collateralized fund obligations (CFO), which are corporate bonds backed by a diversified pool of hedge funds. Advantages include:
(1) exposure to a diverse collection of hedge funds, (2) ability to invest in small lots, and (3) enhanced financing opportunities for the issuer. However, one disadvantage is the use of a complex arrange involving special purpose companies (SPC), making it difficult to grasp the condition of each fund.

4. Risks of Alternative Investment Strategies

Alternative investments are exposed to a variety of risks (Figure 4). Market risk pertains to the risk of price fluctuation. Liquidity risk is the risk that the fund encounters panic selling, in which case efforts to raise cash can drive down the fund's market price. If a fund has adequate disclosure and transparency, these risks can be roughly calculated beforehand from financial statements.

Credit risk is the risk of failure of the fund manager or a related company. Fraud and negligence risk relates to the fund manager's personal reliability, while legal risk has to do with encountering unforeseen problems in the investment contract. Systemic risk involves tax, regulatory and accounting issues. Operational risk relates to system breakdowns and other administrative matters. These risks, being quantitative in nature, require adequate time to investigate.

Figure 4  Alternative Investment Risks

(1) Market risk
(2) Liquidity risk
(3) Credit risk
(4) Fraud, negligence risk
(5) Legal risk
(6) Systemic risk
(7) Operational risk

Source: NLI Research

The risk of fraud and negligence is particularly important, as illustrated by the Princeton Funds case, which involved collusion between the prime broker and administrator. Investors must perform the difficult but necessary task of investigating for possible collusion between the fund manager and auditor, prime broker, administrator, etc., as well as risks such as potential conflict of interest with investors over excessive fees. (Figure 5).
Figure 5  Participants in an Alternative Investment Fund (Flow Chart for a Purchase)

Respective functions of participants are as follows:
- Auditor inspects investment reports, etc.
- Custodian safeguards securities and manages funds
- Administrator records transactions and calculates gain or loss
- Prime broker executes securities transactions

Source: NLI Research Institute

In the Manhattan Investment Fund case, most participants were prominent companies: Deloitte & Touche was auditor, an affiliate of Ernst & Young was administrator, and Bears Stearns the prime broker. However, the exception was an unknown executing broker (FAM), whose tacit consent of fund improprieties led to the fund’s demise. Thus investors cannot afford to be complacent simply because most of the participating companies are respected names.

5. Conclusion

As we mentioned earlier, alternative investment in Japan generally refers to hedge funds. This is because of the low level of interest in private equity, real estate investment, and natural resource investment.

In private equity, for example, the rush of venture investments under the IT boom has subsided, while recently, acquisitions by foreign investors have gradually increased, as showcased by the Ripplewood Fund’s acquisition of Shinsei Bank and Miyazaki Seagaia. Still, new market listings and public offerings remain much less active than in the U.S., and private equity investment is puny compared to the vigorous investment activity of pension funds in Europe and the U.S.
Meanwhile, exchange trading of J-REITs (Japanese-style real estate investment trusts, in which real estate properties are securitized, and rental income is allocated to investors) began in September of last year with great fanfare. But because of the small number of listings and small lot size, trading has been modest.

In sharp contrast, hedge funds have been performing well recently. According to the Hennessee Group, hedge funds have outperformed the S&P500 by 10% annually for three straight years since 1999, and are attracting considerable attention from institutional investors.

However, hedge funds carry a wide variety of risks that are not immediately visible. The Princeton Funds and LTCM are just two of many reported cases involving large losses from investment in hedge funds and derivatives.

Yet hedge funds have gained a prominent place in pension fund portfolios. Under ERISA in the U.S., pension fund fiduciaries such as directors and managers are at little risk of fiduciary duty even if massive losses from hedge fund investments, as long as they exercise the utmost care and choose funds with an appropriate decision making process. On the other hand, if the duty of care is neglected and a large loss results, fiduciaries can be held personally liable for damages. In Japan, the issue of fiduciary duty has grown in importance with the implementation of the Defined Benefit Corporate Pension Law in April 2002.

In any case, when engaging in alternative investment strategies, investors must remember not to be distracted by immediate high returns, but to carefully research all potential risk factors based on the fundamentals described above. The adage that an ounce of prevention is worth a pound of cure is particularly true of risk management.

Moreover, we also need to remember that as alternative investments attract more investors and funds, expected returns will diminish.

References


*(In Japanese)*


**Relevant Web Sites**

* Alternative Investment Management Association (AIMA), (www.aima.org)
- TASS Investment Research (www.tassresearch.com)
- Hedge Fund Research (www.hfr.com)
- Global Fund Analysis (www.globalfundanalysis.com)
- VAN Hedge Fund Advisors (www.vanhedge.com)
- Managed Accounting Report (www.marhedge.com)
- Asia Hedge (www.hedgefundintelligence.com)
- Evaluation Associates Capital Markets, Inc. (EACM), (www.eacmalternative.com)
- Hennessee Group (www.hedgefnd.com)
- National Venture Capital Association (NVCA) (www.nvca.org)
- Money Tree (www.pwcmoneytree.com)
- Venture Economics (www.ventureeconomics.com)
- Venture Japan (www.hedgejapan.com/index.asp)
- Venture Enterprise Center (www.venture-web.or.jp/vec)