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RISK: A MATTER OF PERSPECTIVE

Diverse systematic and active factors mean not all alternatives are equal.

There has been much discussion about the risks of alternative investments, both in isolation and relative to traditional investments. Risk, however, is all a matter of perspective.

According to A.W. Jones, whom most credit with coming up with the idea of hedge funds in 1949, a hedge fund combines long and short positions with leverage to outperform the market in good times and limit losses in bad times. Yet today there are hedge funds that don't even hedge, while there are mutual funds that employ hedge fund strategies. The result is the vehicle is no longer the determining factor in deciding what is or is not an alternative investment; rather, we must look inside the vehicle to see the type of strategy being employed and determine the types of risk the strategy possesses.

Generally speaking, a strategy's risk can be broken down into systematic and active components—all alternative strategies possess both types of risk. Some strategies, such as market neutral and fixed income arbitrage, are predominately driven by their active risks, while others such as convertible bond and event-driven strategies are dominated by their systematic risks. The systematic portion of risk consists of such things as equity market risks, which come from the broad market, the value and small cap premiums, and volatility; fixed income market risks, which stem from exposure to default, maturity, and interest rate volatility, and; currency market risks. Meanwhile, active risks consist of those arising from security selection and active asset allocation. With this as a framework, we can use regression analysis to determine the sensitivity of a strategy to any of the risk factors. This is not only useful to help us understand a particular strategy, but also to compare strategies. For example, we can compare the interest rate risk of each strategy and see that market neutral and market-timing strategies might slightly suffer from credit spreads narrowing, while convertible bond and high-yield strategies are likely to benefit the most. Alternatively, we can examine the risks of a single strategy like fixed income arbitrage and see that this strategy tends to be most sensitive to changes in interest rates, credit spreads, and the volatility premium. The benefit of this type of analysis is that alternatives can be seen as a combination of traditional strategies and active risks.

Although it can be informative to decompose a strategy's risks, many believe that the only real risk is the risk of losing money: there are certainly some glaring examples. There have been well-publicized hedge fund losses in Long-Term Capital Management, the Quantum Fund and the Tiger Fund. However, there have actually been larger losses due to poor management within traditional mutual funds. In fact, some mutual funds have lost their shareholders billions not because of market declines, but because the fund's managers underperformed the market over periods (for example, the Vanguard U.S. Growth Fund underperformed the S&P 500 by more than 40% from 2000 to 2002). And, dollar losses are not the only indication of greater risk: even when we compare strategy volatility, we see that most alternative investments have lower volatility than most traditional benchmarks.

> "TODAY THERE ARE HEDGE FUNDS THAT DON'T EVEN HEDGE, WHILE THERE ARE MUTUAL FUNDS THAT EMPLOY HEDGE FUND STRATEGIES."

Risk is simply a matter of perspective. Consider the following question: which is riskier, jumping out of an airplane with or without a parachute? The obvious answer is jumping without a parachute, but that is wrong. If one jumps with a parachute the outcome is actually uncertain, because the person may land safely, or may not if the parachute fails to open properly. On the other hand, jumping without a parachute is essentially riskless, because the outcome is certain. It's all a matter of perspective. ■