"Protection" offered by alternatives uncertain and costly

If markets zig and zag over the next year, hedge funds may seem attractive. But it's crucial to understand their structure

By Yan Barcelo

If an economic downturn occurs this year, damaging stocks and bonds, where can investors take refuge?

Almost no one is predicting a recession, but many say the odds of a recession occurring are significant. One good place to take refuge is in hedge funds or principal-protected notes linked to hedge funds — asset categories generally classified as "alternative" investments.

But investor beware. "You still have to be very selective with linked notes," says Benoît Blondin, an investment advisor in the Montreal area with **RBC Dominion Securities Inc.** "You mustn't let the principal guarantee throw sand in your eyes. In the long term, some notes will do very well, but I don't expect [them] to be the majority."

The alternative investment sector exploded in the first years of this century. When **Investor Economics Inc.** in Toronto began tracking what it calls "market-linked instruments" in 1999, assets in PPNs totalled $100 million, excluding the more traditional market-linked guaranteed investment certificates. By mid-2005, that total had exploded to $6.2 billion, says Investor Economics analyst Jimmy Chu. In almost the same period, hedge funds rose from $2.5 billion in 46 funds in 1999 to $5.4 billion in 200 funds by December 2004.

Hedge funds and PPNs linked to them have suffered in the wake of the Portus Alternative Asset Management Inc. scandal. "That situation put a significant chill on the whole category of hedge fund-linked notes," says Earl Bederman, president of Investor Economics.

At the same time, returns for most hedge funds have dropped, coming down to earth from the average 17% returns they exhibited in the 1990s. As Robert Schulman, CEO of **Tremont Capital Management Inc.** in New York, notes, they produced a 5%-6% average return in the first 11 months of 2005.

There are exceptions, such as Dynamic Power Hedge Fund, which returned a sensational 52% in the year ended Nov. 30 and an average 60% over three years. But, with a minimum investment of $150,000, it is accessible only to the wealthiest investors.

Most investors have to be content with PPNs linked to funds of hedge funds — the only ones that have low minimum investments, starting at $1,000. According to the CSFB/Tremont hedge fund index, funds of hedge funds saw a return of only 8.4% over the past 12 months.

Should investors put some money into these products to protect themselves in case there is an economic downturn? There is no simple answer.

On the one hand, many categories of hedge funds — convertible arbitrage, event-driven, risk arbitrage and global macro — exhibit little correlation to the stock and bond markets. They also tend to have a more consistent performance over time. In 2002, the CSFB/Tremont hedge fund index was up 3%, while the S&P 500 composite index fell 22.1%. In 2003, the CSFB/Tremont rose 15.4%, far short of the S&P 500's 28.7%.

On the other hand, hedge funds need financial market volatility to do well. They thrive on market swings, positive or negative. "If they didn't do well in the past few years, it's not because of inherent weaknesses but because market volatility was at historical lows," says Pierre Novak, managing director of the Montreal office of **BluMont Capital Inc.**

So the question for the next few quarters concerning hedge funds is not whether the economy and markets will swing south but rather, if they do drop, whether they will wobble a lot on the way down. If they drop consistently, with few hiccups as they dive, hedge funds will not stand out. If markets zig and zag, then hedge funds will zing.

One also has to take into consideration the high fees of hedge funds, to which funds of funds add an extra layer of management fees. Typically, total fees for funds of hedge funds run between 5% and 7%, Novak admits, and that doesn't include the fee for protecting the principal.

So manager quality and expertise are critical. When an investor chooses a multi-fund manager, he or she is betting on that manager's talent in picking the few among the more than 8,000 hedge funds in North America and another 8,000 worldwide that will do very well.

With PPNs, the capital guarantee ensures the investor is at least sure of getting that back. But can he or she get some return over and above that, even if markets and the economy tank?

One major drawback of most PPNs is that they have very short histories. "They are vehicles offering prospective rates of return," Bederman says diplomatically.

Everything hinges on the PPN's specific structure and on the underlying asset that it tracks. If a PPN is linked to hedge funds that plunge, there will not be any extra return.

However, some have done quite well, such as BluMont's Man Multi-Strategy Note of 2000 that has delivered an average annual return of 9.5% since inception, while the bond markets have delivered an annual return of 8.7% over the same period.

BDC China Dragon Index Notes 1, only two years old, has delivered an 8.98% annual return, but its reference MSCI index brought in 21.11%.

There are also some new products that provide extra upside potential. In late 2005, **One Financial Corp.** launched one of the most imaginative structures, the PLIN 10-note series. This is the first time PPNs have been offered as a family — in this case, 10 linked notes with maturities of 8.75 years tracking diverse underlying assets; the investor can switch among these linked notes at any time without incurring charges. Furthermore, the PLIN (which stands for Profit Lock-in Notes) ensures that the investor will receive the highest return the underlying asset reaches during the 8.75 years. If the underlying index reaches its highest return of 25% only eight months after a purchase and then goes into negative territory for the remaining eight years, the investor still receives a 25% return at maturity. <= simple return, NOT per annum
Note from JAP

It is crucial that an investor clearly understands the structure of the PPN being bought. For example, the PLIN structure seems easy to sort out on the surface, but deciphering the mechanism that allows the investor to lock in the highest return can prove challenging. If an investor can't wrap his or her mind around the more complex aspects of PPNs or hedge funds, he or she should steer clear. The alternative is to buy a lot of sleeping pills.

Many investors are attracted to PPNs for the capital protection and choose conservative structures tracking low-risk indices. But others consider the capital guarantee as icing on the cake and resort to PPNs as a means of entering alternative investment territory.

Some notes mix highly diverse baskets of hedge funds and futures contracts. **Tricycle Asset Management Corp.** 's notes, for example, give access to baskets of commodities in every area: energy, precious metals, currencies and derivatives.

That's why specialists typically advise an investor to limit hedge funds and PPNs linked to hedge funds to 10% of a portfolio. But others, more on the fringe, don't see why such asset classes cannot occupy 25% of a portfolio, as are seen in institutional portfolios, or even 50%. "In theory, an individual could replicate identical allocations," says Blondin. "But not in practice. Average investors don't understand these vehicles as well and will get more emotional over them in hard times than they will over a dip in Royal Bank of Canada stock, for example. In a pension fund, emotion doesn't run as high." **IE**