A brief history of **alternative investments**

While new to some, alternative investments have been around for decades...

While most investors are familiar with traditional vehicles like stocks and bonds, fewer are aware that alternative investments (AI) — hedge, private equity and other funds — have a tradition of their own. For decades, savvy high net worth and institutional investors have benefited from access to various types of AI. Of course, the underlying instruments from which most of these funds are derived (stocks, bonds, futures contracts, etc.) have been around for much longer. It is only in the last two decades that general interest in alternative investments has multiplied, along with the proliferation of AI funds, strategies and the industry professionals dedicated to their study and management.

Once available solely to the very wealthy and well-connected, alternative investments have become increasingly popular as mainstream investors discover AI's unique diversification and market-exposure opportunities. Likewise, AI "funds of funds" provide access with much-reduced minimum investment requirements, further encouraging investors whose net worth is not so high.

Still, some hesitate to explore the potential of alternative investments — even though they may be well positioned to do so — due to a perception that these investments are too new, untested and risky. We believe, to the contrary, that appropriately selected alternative investments can play an important role in improving the risk/return profile of most portfolios. This is particularly true of hedge and private equity funds.

The origin of hedge funds

Hedge funds have come into prominence recently, but they actually date back to 1949, when Alfred Winslow Jones developed the first in New York City. A sociologist, financial editor and U.S. diplomat, Jones became interested in the growing Wall Street consensus that market movements simply could not be predicted. In an effort to protect against such instability, he devised a strategy that would come to be known as the Jones Model. It combined two approaches, with a twist: he sold short significantly overvalued stocks, and purchased undervalued ones using a modest amount of leverage. This hedging approach reduces a portfolio's exposure to market movements, relying substantially on the investment manager's skill at security selection. Initially at A.W. Jones & Co., several managers selected investments for the fund, but this approach is less common today. Jones also instituted two other hedge fund hallmarks: requiring managers to make significant personal investments in the fund, and compensating them with a straight 20% of fund performance profits. Both features help to tie the success of the manager to the success of the hedge fund.

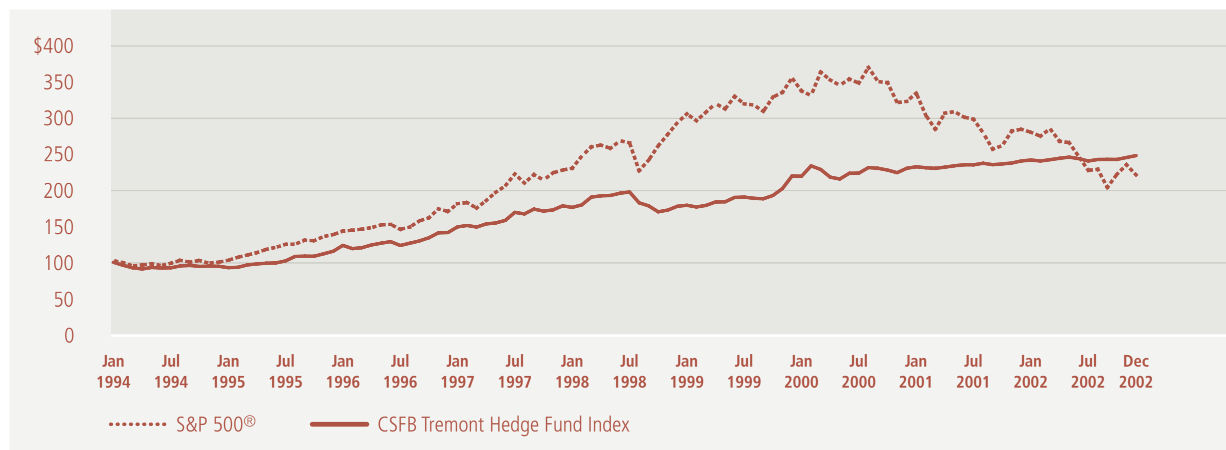
For about a dozen years, the A.W. Jones method was known only to a small circle of sophisticated investors. In 1966, however, Jones revealed in a **Fortune** magazine interview that over the preceding decade, his fund had performed nearly twice as well as the best-performing mutual fund — and with that, the first hedge fund boom was on. The next four years saw the birth of more than 150 new hedge funds.

This flurry of attention dwindled in the bear markets of the early 1970s, as many more-aggressive, highly leveraged funds dropped from the scene. (From the early days, Jones identified this scenario — poorly managed risk combined with excessive leverage — as one to be avoided. It would echo loudly in the late 1990s with the plight of Long Term Capital Management.) By the early 1980s, hedge funds again began drawing interest, and many new strategy variations began to appear in the market. Since then, the industry as a whole has been growing at a rate of approximately 20% per year. Today, roughly 6,000 hedge funds exist worldwide, with total assets under management in excess of $500 billion.

Risk versus returns

While hedge funds offer great flexibility in the pursuit of a specific investment objective, it is important to remember that individual funds differ widely. Depending on the strategy employed, hedge funds may be characterized as either return-enhancers or risk-diversifiers — of course, like most traditional investments, those seeking higher returns typically have the most risk. In combination with the recent highly publicized

Figure 1: Value of $100 invested on January 1, 1994



Source: Credit Suisse First Boston Tremont Index, LLC
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troubles of a few heavily leveraged funds, these qualities have contributed to the notion among some investors that "all hedge funds are too risky." In truth, hedge fund strategies are represented broadly across the risk/return continuum, and it is essential to choose funds based on one's specific investment goals.

Both fund-of-funds and multi-strategy approaches help diversify strategy risk, while a fund of funds also mitigates manager risk by allocating capital among a range of separately managed hedge funds. These risk-diversifying strategies have often proven much less volatile than traditional equity investments, such as an S&P 500 index fund (see Figure 1). In fact, many investors pursue hedge fund strategies to protect their capital during down markets. With the diversity of strategies available today, investors with a wide range of risk profiles can benefit from hedge fund investing.

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Private equity's public debut

Another popular form of AI, private equity, includes investments in companies that are not publicly traded, and takes the form of direct equity investments and loans that are structured to provide equity-like returns. Private equity is generally viewed as a long-term investment, designed to enhance overall return through exposure to high-potential opportunities that typically bear more risk than publicly traded equities. Historically, private equity has shown relatively low correlation to public equity or fixed income returns, so it can act as a diversifier in typical portfolios.

The first venture capital firm, American Research and Development, launched in 1946 with the dual aims of generating profits and encouraging economic development within the United States. (It was not until the 1980s that the broader industry term "private equity" supplanted "venture capital," to encompass just about all equity investments that are not publicly quoted.) Under the direction of founder and former Harvard Business School professor General Georges Doriot ("father of the venture capital industry"), AR&D's early successes included a stake in Digital Equipment Corporation and other now-famous software, biotech and electronics firms. As competitors followed their lead through the 1950s, the modern private equity industry began to take shape.

Through the 1960s and early 1970s, large companies began establishing their own venture capital programs, but many were scaled back or dissolved in the down-market cycle of the mid 1970s. In 1978, the United States eased restrictions on private equity investing and allowed pension funds access to the market for the first time. This influx of capital helped spur a renaissance in private equity investing, for the first time driving the little-known asset class into the minds and portfolios of mainstream investors — at least until the U.S. stock market crash of 1987, when interest and investment flagged temporarily once again.

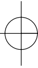
Recently in the United States, total private equity commitments rose sharply from 1991 to 2000, from roughly $8 billion to more than $210 billion,* but have fallen back since then. The reason for this interest is straightforward: private equity historically has generated returns that are greater, on average, than those for listed equities.

AI going forward

Having compiled a significant trade record over the last half-century, the alternative investment asset class is no longer the sole purview of the richest and most-daring investors. Currently, many of the brightest minds in the financial services industry are working in this established but growing field, seeking both professional and personal rewards. Pension funds, endowments, banks, insurance companies and other institutions have been increasing their portfolio allocations to AI, and investors have begun to appreciate the valuable diversification, market-neutrality and/or performance potential of such funds. These trends seem likely to continue. While they may be "new" to some, alternative investments have become an essential part of the asset allocation of many knowledgeable investors worldwide.

Alternative investments are illiquid, speculative and involve a high degree of risk. They may also employ significant leverage and hold illiquid positions. Alternative investment products often involve a high level of advisory and transaction fees, and investors may lose all or substantially all of their investment.

*Source: Venture Economics (TFSD)/NVCA, U.S. Commitments per Fund Raising (by year), All Private Equity, Gross Amount Raised as of 12.31.02.



Investment Managers

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