Industry Trends: Alternative Mutual Funds and Hedge Funds

New mutual funds abound while hedge funds capitalize on economic distress

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Alternative Mutual Funds

After a decade of hedge fund proliferation, strategies followed by hedge funds in private vehicles seem to be moving to public format, through mutual funds and exchange-traded funds. Although the more esoteric or leveraged hedge fund strategies may be difficult or impossible to implement in regulated investment vehicles, the most basic hedge fund strategies appear to be much more transferable. The daily liquidity, absence of performance fees, and portfolio transparency make these new alternative funds worth looking at.

Turner Spectrum Fund TSPEX is one of the newest entries on the alternative mutual fund list, having opened on May 7. This fund combines six long/short equity strategies all managed by Turner Investment Partners. Previously, the underlying portfolios were only available through private partnerships and separate accounts. The funds will levy a 2.20% expense ratio in its investor share class.

Also a fund of funds, Aston/Lake Partners LASSO Alternatives ALSOX opened on April 1 as one of the only mutual funds of all alternative mutual funds, although its strategy has been available to private investors and institutions since 1998. This fund's underlying strategies range from hedged equity to long/short bonds, managed futures and currencies, and multistrategy. Charging an expense ratio of 2.85%, Lake Partners tactically allocates among these strategies, generally investing in 10–15 mutual funds.

Quantitative hedge fund manager AQR has moved into the retail arena this year, with AQR Diversified Arbitrage ADANX. Open since January 2009, this fund combines merger arbitrage, convertible-bond arbitrage, and other arbitrage techniques, aiming to generate returns with low correlations to the stock market. The fund has returned 3.5% through May 31 and charges a 1.5% expense ratio.

Permal Group's first foray into mutual funds, Legg Mason Partners Permal Tactical Allocation LPTAX, launched on April 13 and is perhaps the least alternative of these newfangled funds. Permal Group is one of the oldest and largest hedge fund of funds managers, with close to $20 billion under management, but its new mutual fund is a tactical allocation fund, not exactly a new or alternative concept. The fund is novel, however, in that it allocates between long-only and long-short funds, using parent-company Legg Mason's open-end funds as well as outside managers. At an expense ratio of 1.75%, it is less expensive than some fund of mutual fund alternatives.

Older entrants worth mentioning are Direxion Commodity Trends Strategy DXCTX and Rydex Managed Futures Strategy RYMTX, which launched in June 2008 and March 2007, respectively. These funds attempt to track the returns of the Standard & Poors Commodity Trends and Diversified Trends Indicator index, through primarily long/short futures contracts (but also swaps). Attempting to profit from upward and downward trends in commodity and financial futures has long been a private hedge fund strategy, and these strategies tend to be good traditional portfolio diversifiers.

Also tracking index returns, ETF provider IndexIQ now offers two hedge fund replicators in ETF format: QAI, which tries to replicate an index of multistrategy hedge funds, and MCRO, which attempts to replicate an index of global-macro hedge funds. IndexIQ's replication strategy involves trading liquid ETFs in various asset classes. Because its underlying investments significantly differ from those of the hedge funds it tracks, it's difficult to predict the success of these ETFs. But their low fees of 1.09% certainly help. It shouldn't be hard to outperform the new Naisscent Fcube hedge fund, for example, a fund-of-funds-of-funds that charges three layers of fees.

Hedge Funds

After a year as bad as 2008, with poor performance, massive redemptions, and record hedge fund closings, it's a wonder that there are any new hedge funds at all. But there are. New fund offerings continue from managers with past success, as well as new managers coming from banking or other funds. The newest trends seem to capitalize on depressed assets in anticipation of economic recovery.

If prominent investors entering a strategy are any indication, the smart money is on moving to distressed assets. John Paulson and Philip Falcone are among the many managers that are starting distressed-debt funds. Paulson & Company has hired former Lehman real estate veterans for the Real Estate Recovery Fund. Philip Falcone's new Credit Distressed Blue Line Fund marks a return to the distressed-securities space for Harbinger Capital Partners, which began with a distressed focus nearly a decade ago. Dalton Investments, a firm that wound down its original distressed portfolio in 2006 because of a lack of opportunities, has re-launched a distressed strategy to accompany its equity and distressed-mortgage portfolios. Private equity firm Apollo Management is also in fund-raising mode. Instead of structuring LBOs, this firm will be buying distressed debt of defunct LBOs as well as distressed real estate in two new funds.

Startups are joining the distressed-asset-manager ranks as well. Archview, a startup managed by former Citigroup managers, launched early this year with $200 million in capital to invest in corporate credit and distressed assets. Charlotte, N.C.-based Concerto Asset Management opened this year with seed capital of $50 million committed in the fourth quarter of 2008 from French hedge fund incubator NewAlpha.

Some hedge funds are taking up the government's offer to provide liquidity in the assets that suffered the worst of the economic tsunami. The Treasury's Term Asset-Backed Securities Loan Facility (TALF) and Public-Private Investment Program (PPIP) have also spurred a number of fund openings. Private equity firm Colony Capital is looking to acquire bank assets with leverage provided by the announced government programs. Two new funds from New York-based Belstar Group also intend to participate in the TALF. Both fund-of-funds manager Atrevida and Connecticut-based investment manager Paramax Capital Partners have also publicly discussed establishing TALF portfolios.

Other funds are providing liquidity through direct lending. GSO Capital Partners, the hedge fund unit of Blackstone BX, is aiming to raise $3 billion for a Debtor-in-Possession (DIP) financing fund. DIP lending is a way to invest in distressed assets without taking on all of the risk, as DIP lenders have a senior claim in bankruptcy proceedings. Meanwhile, New York-based Golden First Mortgage established Secured Capital Partners in order to finance mortgage underwriting prior to reselling the mortgages to GNMA, replacing short-term debt that has historically funded mortgage operations.

Some hedge funds are falling far from the beaten path in their quest for investment opportunities. Castlestone Management is turning to investments in fine art. The firm believes that fine art will protect investors from inflation in the years to come and debt-laden collectors needing cash may provide some opportunities to buy pieces at deep discounts. Similarly, the Codiam Fund is exclusively investing in colored and exotic diamonds. M

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