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THE RISK OF LOSS IN TRADING FUTURES, OPTIONS AND OFF-EXCHANGE FOREX CAN BE SUBSTANTIAL.  
PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

## Portfolio Component Comparisons

How do stocks, bonds and hedge funds fare as investment vehicles as opposed to stocks, bonds and managed futures?  
Why should I consider adding managed futures to my overall portfolio?

Many investors share the common misconception that hedge funds offer investors the best of both worlds, namely expectations of returns similar to equities combined with risk parameters normally associated with bonds. In 2003, the Journal of Investment Management published an article titled “Stocks, Bonds and Hedge Funds: Not a Free Lunch!” The author of the article, Mr. Harry Kat of the Cass Business School in London, showed that although including hedge funds in a traditional investment portfolio may significantly improve that portfolio’s mean variance characteristics, it can also be expected to lead to significantly lower skewness. Skewness is a statistical term used to describe a situation’s asymmetry in relation to a normal distribution. Later, in the winter of 2003, Mr. Kat published the article “Taking the Sting Out of Hedge Funds” in which he stated, “Although the inclusion of hedge funds in an investment portfolio can significantly improve that portfolio’s mean-variance characteristics, it can also be expected to lead to significantly lower skewness and higher kurtosis.”

In this article, the author shows how this highly undesirable side effect can be neutralized by allocating a fraction of wealth to out-of-the-money put options on the relevant stock index. Roughly speaking, the costs of the proposed skewness reduction strategy will be higher 1) the higher the hedge fund allocation, 2) the lower the expected equity risk premium, and 3) the higher the bond allocation relative to the equity allocation.

In the current low interest rate environment, for portfolios with a more or less equal allocation to stocks and bonds, the costs of skewness reduction are unlikely to be much higher than 1% per annum. For portfolios with relatively high bond allocations, however, the costs could amount to 3% or even more. This confirms that the benefits of hedge funds heavily depend on the portfolio they are added to and that the attractive mean-variance properties of (portfolios including) hedge funds may come at a significant price.

Mr. Kat furthers this research in another report, “Managed Futures and Hedge Funds: A Match Made In Heaven,” from the Journal of Investment Management (2004). He wrote, “We find that allocating to managed futures allows investors to achieve a very substantial degree of overall risk reduction at, in terms of expected return, relatively limited costs. Apart from their lower expected return, managed futures appear to be more effective diversifiers than hedge funds. Adding managed futures to a portfolio of stocks and bonds will reduce that portfolio’s standard deviation more and quicker than hedge funds will, and without the undesirable side effects on skewness and kurtosis. The overall portfolio standard deviation can be reduced further by combining both hedge funds and managed futures with stocks and bonds. As long as at least 45–50% of the alternatives allocation is allocated to managed futures, this will have no negative side effects on skewness and kurtosis.”