This issue of *The Journal of Alternative Investments* deals with three broad topics: regulation, structured products, and hedge fund strategies. Since the 2007–2008 financial crisis, few topics have attracted more attention than financial regulation and its impact on various parts of financial markets. When President Obama signed the Dodd–Frank Act into law in 2010, a new era of financial regulation began. The previous era, which started at the end of the Great Depression, can be characterized as the period of deregulation, as some of the regulations that were put in place during the 1930s were slowly relaxed. All of that came to an end with the bankruptcy of the Lehman Brothers and bailouts of Fannie Mae, Freddie Mac, and American International Group. The Dodd–Frank Wall Street Reform and Consumer Protection Act was the central response to these events. In “What Drives Dodd–Frank Act Compliance Costs for Private Funds?” Kaal assesses the effects of Dodd–Frank Act compliance costs on the private fund industry. The article shows that the cost of financial regulation under the Dodd–Frank Act brings increasing returns to scale.

One of the central functions of financial markets is to allocate risk efficiently. Derivative markets are prime examples of risk allocation innovations that have taken place during the last 50 years. One of the more recent innovations in this area is the introduction of cat bonds. These instruments allow insurance and reinsurance companies to use financial markets to efficiently diversify away their risks. In “Understanding Cat Bonds,” Sterge and van der Stichele provide an excellent review of these instruments. The authors review the diversification and other performance characteristics of cat bonds and study their value in the context of portfolio allocation. They find that cat bonds’ low correlation to equities, fixed income, and hedge fund indexes can make them compelling from a diversification standpoint. Though they provide significant diversification benefits, their historical yields appear to have been too low to compensate investors for their relative illiquidity and complexity.

Option strategies, and in particular those that can generate steady income, have become very popular in recent years. In “Risk and Return of Equity Index Collar Strategies,” Israelov and Klein explain that equity index collar strategies are often perceived as a way for investors, at little to no cost, to exchange some upside exposure for reduced losses on the downside. That perception may be accurate if one considers only the net dollar cost of the strategy’s initial option trades, but it fails to account for the significant drag the collar may impose on returns. The authors decompose the equity index collar’s returns to show that it is expected to have lower returns than its underlying index, primarily because it earns less equity risk premium.
Additionally, collars that are net long volatility exposure may further reduce expected returns because they pay out volatility risk premium.

Cherian, Kon, and Weng analyze the downside risk and loss profiles of hedge funds in North America and Asia in “A Tail of Two Cities: On the Downside Risk and Loss Profile of Asian and North American Hedge Funds.” They attempt to identify any significant differences between the geographic markets and to determine how these differences have converged or diverged over time. They help us understand the performance drivers that differentiate Asian from North American hedge funds.

In “Evaluating the Efficiency of Hedge Fund Replication: Return and Diversification Effects,” Blumin, Hauser, Levy, and Rao study the benefits of adding hedge fund replication products (clones) to an existing portfolio in comparison to adding actual hedge funds as represented by hedge fund indexes. They employ the marginal Sharpe methodology to evaluate the benefit of adding an investment to an existing long-only portfolio. The marginal Sharpe is decomposed into a return component and a diversification component, and they conduct separate tests on the two components and compare clones with hedge fund indexes. Hedge fund clones, which are liquid trading strategies, seem to be able to replicate the benefit stemming from the diversification component. With respect to the return component, the benefits of adding a hedge fund index to an existing portfolio are significantly greater than those obtained by the clones. However, these results are mitigated after accounting for fees and hedge fund premiums.

Continuing with the theme of algorithmic and systematic trading, the article titled “The Structure of a Machine-Built Global Macro Forecasting System” presents an automated forecasting system that provides a macroeconomic forecasting approach that some hedge funds may find useful. Chen and Tindall describe the structure of an econometric forecasting system designed to produce multiequation econometric forecasting models of national economies. They present the functioning of an automatic model-building system that builds the forecasting equation for each series submitted and produces forecasts of the series without human intervention. The automatic model-building system employs information criteria and cross-validation in the equation building process, and it uses Bayesian model averaging to combine forecasts of individual series. The system outperforms standard benchmarks for a variety of macroeconomic datasets. To demonstrate its use, the automatic system is used to build a fixed-income macro trading system.

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