

## WHITE PAPER

### ALTERNATIVE INVESTMENTS - LOOKING UNDER THE HOOD

by: Seth E. Lipner and J. Boyd Page

\*\*\*The authors of this White Paper are distinguished attorneys. They collectively have over 60 years of experience representing investors who were sold bad investments, successfully battling Wall Street's largest corporations. In this unprecedented piece, they come together to offer their knowledge, experience and guidance about Wall Street's flavor-of-the-month, so-called "Alternative Investments."\*\*\*

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If you invest money, chances are you have been pitched something called "Alternative Investments." You may even have bought some. Or you may be considering buying some. This White Paper is intended to alert the investing public to the pitfalls of Alternative Investments, and to encourage the Financial Services industry to do more to supervise and make more transparent this newfangled type of investment.

The very name - Alternative Investments - suggests that investors are not satisfied with traditional investments - stocks and bonds. And who can blame them? They were twice burned this decade as stocks tumbled after a few years of gains. Wall Street greed first brought us the tech wreck, then it doubled down when the sub-prime bubble burst. And traditional bond investments seem particularly unattractive, with interest rates on safe stuff like Treasuries and municipals ridiculously low. With fears of future inflation and the likelihood that interest rates will soon rise, investors are wary about investing too heavily in the bond markets.

Investors are thus thirsty for alternatives to these traditional categories. That thirst is music to the ears of the wizards of Wall Street who create esoteric investment products. And it is a rhapsody for the salesmen - the Registered Representatives and Investment Advisors who earn their living selling investment services, investment products and investment strategies.

## **WHAT ARE ALTERNATIVE INVESTMENTS?**

A variety of products and strategies are usually included in the Alternative Investment category. In theory, anything that is not a traditional equity investment - common stock and preferred stock - or a traditional bond - coupon and zero-coupon debt, qualifies as an Alternative Investment. Thus, age-old vehicles like precious metals, commodities and commodity funds, and real estate investments, fit the bill.

These other “asset classes,” when added to a portfolio of stocks and bonds, arguably provide diversification and (generally) reduce risk because, historically, they don’t correlate to stocks and bonds in certain economic environments. That doesn’t mean these things are less volatile than stocks and bonds - often they are more volatile. And that extra volatility means they can produce some very bad results, especially if they are defectively constructed, selected poorly or managed improperly.

Today, there are a whole host of new vehicles being sold as alternatives. There are Hedge Funds, Private Equity Funds and Structured Products. There are Leveraged Buyout Funds, Credit Recovery Funds and Managed Futures Funds. There are Principal Protected Investments, Yield Enhancement Strategies and Reverse Convertible Securities.

When it comes to Alternative Investments, the more esoteric the better. Some go long, others go short. Some use options, forwards or futures.

Many use leverage. Almost all have limited (if any) liquidity. There is, of course, little transparency. Most have no available market prices so they are valued to investors at cost of based on guesstimates. Fees tend to be high. For the most part, these investments are unregulated.

The wizards of Wall Street love these last two parts. The fees charged for Alternative Investments usually involve not just commissions for the salesmen, but really big money for the managers and sponsors. A variety of different incentive structures are used, and all of them offer riches to the managers - at very little risk (to them, of course). These fee structures, and their hidden pitfalls, are discussed below.

Strange as it may seem, the unregulated aspect of these investments is in some ways the least troublesome part. That is because securities regulation is itself a joke. The fact that many of these investments are offered as private placements exempt from SEC registration requirements is largely meaningless; the SEC performs no real review of public offerings anyway, either before or after they are sold to the public. And the fact that investment advisors are not (yet) regulated by FINRA makes little difference, because FINRA (which regulates brokers but not advisors) is not much of a regulator.

Making the environment for these investments particularly good for sellers is the fact that most people don't know much about Alternative Investments. Investors are often attracted to the prospect of diversification and low correlation, yet these features are sometimes absent, or achieved only at very high cost. And investors are lured to the mystique of exotic strategies, convinced (often by the seller) that Alternative Investments are special opportunities to make money the way rich folks do. That lure, of course, is usually an illusion.

In the first part of this White Paper, we offer four examples of Alternative Investments gone bad. Each demonstrates, in its own way, some of the

problems with Alternative Investments. The second part of the Paper offers some insight into the questions an investor should ask about Alternative Investments.

## **FOUR CASE STUDIES**

### **Misleading Advertising**

Evaluating Alternative Investments is not easy. Manager track records are hard to know, and the statistics that are offered are often misleading. Take, for example, the Real Estate Investment Trusts offered by the municipal bond firm David Lerner Associates.

David Lerner Associates has been acting as underwriter and exclusive sales agent for a series of hospitality REITs called Apple since 1993. These Real Estate Investment Trusts own extended stay hotels and “other full service and select service hotels.” Lerner claims on its web site that its clients have invested, to date, \$6.8 billion in these vehicles. Lerner’s web site claims wonderful results. The site boasts that two versions of the REITs were bought out at handsome prices:

#### Apple Hospitality Two

We are very pleased to announce that in May 2007, an affiliate of ING Clarion purchased Apple Hospitality Two for a total consideration, including debt, of approximately \$890 million at approximately \$11.20 a share in cash.

Apple Hospitality Two investors received the following (assumes a fixed price of \$10 per share on 4/24/01):

- a) If distributions taken, average total annual return = 11.89%
- b) If the distributions were reinvested into additional Apple Hospitality Two shares

The web site boasts similar results for the Apple Five series of the investment; Apple Three and Four go unmentioned. So does any recognition of the fact that 2007 was the very top of the real estate bubble, and that it will be a very long time before prices get back to even those 4-year-old levels.

The Lerner web site then says that Apple Seven, Eight, Nine and Ten are “no longer open to new investors.” That is scary marketing-speak in the post-Madoff era, designed, in part, to make future investors feel like they are getting in on an exclusive.

In summer 2011, FINRA charged Lerner with making misleading statements about these REITs, and for making unsuitable recommendations to buy them. According to FINRA, much of what is advertised by David Lerner Associates is an illusion. The nice dividends to Apple investors are being subsidized by borrowings. The prices Lerner prints on its clients' monthly statements - pegged at the purchase price of \$11 - do not reflect the fact that real estate valuations are way down. There are, according to FINRA, numerous sales to elderly and retired individuals, and to unsophisticated investors, sometimes in high concentration.

The FINRA complaint paints an ugly picture. David Lerner has been earning huge fees selling this product. The FINRA complaint explains that David Lerner Associates earns 10 percent of the amount of all the offerings of Apple REITs, as well as other fees. It explains that Apple REIT sales have generated \$600 million for Lerner, and that, incredibly, they account for 60% to 70% of the firm's business annually since 1996.

The business Apple is in - hospitality - is notoriously cyclical and risky. These Apple REITs are reminiscent of the Limited Partnerships of the 1980s, where slick brochures and misleading materials were used to sell a variety of real estate investments, including hotels and time shares. The wizards reaped huge fees, and kept up the sales effort during a flagging economy by doing

exactly what Apple and Lerner are charged with - using borrowings to keep up dividends, and hiding the effect of market fluctuations by pricing the investments at "cost" on monthly statements. A lot of folks got hurt.

This is just one example of the problems with even simple Alternative Investments. High fees, exaggerated results, non-transparent pricing, illiquidity. The stories get worse as the complexity of the investments increases.

### **Money Chasing an Investment**

Municipal Arbitrage was a winning strategy in the early part of the last decade. Falcon and ASTA/MAT, a series of hedge funds that Citigroup launched during this period. They were marketed to investors as safe fixed-income alternative funds with little risk of loss. Yet the turmoil in the credit markets in late 2007 and 2008 combined with disregard of the stated investment strategy decimated these leveraged funds. The funds, which later became the subject of a Securities and Exchange Commission investigation, had borrowed at (low) short-term rates and invested in longer-term bonds that paid higher rates. Indeed, the MAT funds borrowed more than \$8 for every \$1 invested, magnifying the risk from even small changes in the bonds' value. Mr. Corzine's MF Global fund was reportedly leveraged 40:1. Even the ex-Goldman Chairman, ex-Senator and ex-Governor cannot defy the laws of nature-including the law that high leverage eventually will kill any investment.

Investors in the early versions of the fund experienced normal, anticipated returns for several years. But then the credit crunch came, and the markets turned against the strategy. The folks at Citi who engineered this strategy - and whose compensation was tied to keeping the train going - knew that the strategy was not working - that an inverted yield curve and rapidly-moving rates were creating large losses. But they had new money to invest from new investors (as well as old), and they couldn't bear to shut the thing down. So the deals went forward, and the results were disastrous. These

investments are examples of money chasing an investment. When markets turn, advisors who see fees will continue to push their strategies anyway. The investments of manager and investor quickly diverge. The manager sets his fees and the investor gets stuck.

### **Who Is Minding My Money?**

Throughout the decade, a prestigious investment manager was selling an investment based on a program called a split-strike strategy. The manager used options to manage downside risk - trading the potential for large gains by selling call options, and using the proceeds to buy puts - to provide downside insurance. Making the thing sound even safer was the fact that the investments were actively managed, and at times of high volatility, the manager moved to treasuries, expertly avoiding the worst of times.

The manager sold his services to several funds, whose managers earned fees. These managers in turn did business with several investment advisors. Retail clients bought the funds from these advisors, who earned sales commissions, and a percentage of the profits earned annually on the funds. The advisors represented to their clients that they would monitor the manager and perform the customary due diligence.

The manager, of course, was Bernard Madoff. The investment advisors who recommended him could not possibly have done their jobs. Madoff refused to let anyone check up on him. If you asked too many questions, you were off the gravy train.

If they had known their business, and asked questions, these managers might have realized it was indeed too good to be true. A short call, long put strategy will produce returns with limited upside and protected downside. But in volatile times (and the last decade has been volatile), one would expect some up years and some down years - not the steady returns Madoff reported

year-in and year-out. Either these fund manager and advisors didn't know what to expect from a split-strike strategy, or they were too thrilled with their fees to notice that the returns didn't correlate. Who is watching the manager? Is he really living up to strategy he promised to execute? Most Alternative Investments are bought on blind faith. And the blind are unfortunately, easy to take advantage of.

### **How Do They Do That?**

Imagine an investment where you make money whether the market goes up or down, so long as it doesn't go up down a lot. If the market does make a big move, you won't lose any money, but you won't make any either.

This investment is a kind of Structured Products. This one is called an Absolute Return Barrier Note with 100% Principal Protection. It sounds safe, and it sounds like the kind of Alternative Investment folks would want to own.

Success in this investment depends on the "barriers" not being broken. And the barriers can sound generous - say 20% either side for a period of 18 months. Sounds like a good deal, right?

Well . . . maybe. First, what are the chances that the barriers will be broken? Don't know, huh? And how would you feel if the market went up 21%, and you got nothing? Not so good, we suspect. But maybe you are willing to take that risk, so you put up your money. And then you find out that you can lose anyway, if the issuer of the security goes bankrupt. But nobody told you that. They just told you about the barriers. We bet that would make you angry.

That is what happened to hundreds, perhaps thousands, of customers of UBS. These investors were sold Absolute Return Barrier Notes with 100% Principal Protection issued by Lehman Brothers. The folks who have



complained about these investments say they weren't told that these fancy securities were, at bottom, the unsecured promises of one company - Lehman.

These investments sound wonderful, but in fact they are quite complicated. They function like complex option combinations, and, as a result, their fairness is impossible for ordinary investors to evaluate. Option investments are not like stocks and bonds. They produce non-linear (kinked) outcomes and non-normal (skewed) distributions. To figure out whether they are fairly priced (in this case, whether the barriers are fairly set by the issuer), you need to be able to do the computations that earned the Black-Sholes model a Nobel prize.

But never mind all that. It wasn't the barriers, or the non-transparent embedded costs, that burned these investors. It was the ever-growing default risk in Lehman. But few paid attention to that. Perhaps because the words "Principal Protection" in the title suggested more than an unsecured debt, but also perhaps because the investment has too many moving parts. While folks are trying to figure out "How do they do that?," they are missing other important stuff that is off to the side.

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These examples of Alternative-Investments-gone-bad are just that, examples. But they vividly convey many of the problems with these esoteric investment devices. In the next part of this White Paper, we offer some suggestions about the important questions to ask about Alternative Investments.

## **QUESTIONS TO ASK; ANSWERS TO BEWARE**

### **Is the risk right for me?**

Returns on Alternative Investments may or may not correlate to stocks

and bonds.

In periods of sharp movements in the markets, historical correlations can be deceiving, because at these times, by definition, investments are not behaving normally. Alternative Investments may thus not prove to be protective. The 2008-2009 time period is a good example.

Before one invests, of course, the suitability of the investment must be considered. Correlation aside, some Alternative Investments are designed to seek out-sized returns, often using derivatives or leverage (or both). These funds may occasionally produce stupendous results, but they are also more likely to produce a disproportionately large number of big losers.

To understand the suitability of an Alternative Investment, one must understand enough about the investment to evaluate not just the variety of potential outcomes but also their likelihood of occurrence. Typical securities offering materials, such as prospectuses and marketing material, are usually good at listing the existence of risks, but rarely do such documents discuss the statistical significance of those risks. The existence of specific risks that exist in the current environment and their significance, are rarely, if ever, provided. Without information about significance/likelihood, these boilerplate disclosures are impossible to evaluate, and they thus frequently go unread.

A good simple question to ask about risk is thus “what is the worst I can do.” A good follow-up question is “how likely is that?” A straightforward answer ought to be forthcoming; if an advisor or seller is not willing to put it in writing, that ought to be a bad sign. A mealy-mouthed or confusing answer is a huge red flag.

Aside from asking what are the potential outcomes, under what circumstances can they be expected to occur, and with what likelihood, the next question ought to be “how does it work?” The answers here can range from the straightforward to the incredibly technical, and often it is hard for ordinary investors to go much farther. They lack the evaluative tools, as well

as the time and ability, to conduct due diligence on managers and promoters. Average investors often cannot evaluate strategies, methods and fees, make appropriate comparisons to other investments, and then make suitable choices among a huge array of investments.

It is a daunting task, and one best delegated to a professional. And therein lies the next question . . .

**Is my advisor able to understand and monitor the manager and/or the strategy?**

No advisor should recommend an investment that the advisor does not fully understand. But understanding how a strategy or investment program works is not enough. The investment must be monitored, and here is a place where many Alternative Investments will fail the test. There is not a lot of transparency in Alternative Investments.

Lack of transparency exists at many levels. After money is raised, an investment fund must acquire assets. Retail investment opportunities in REITs and Private Equity Funds are too often characterized by asset acquisitions that were not done at arm's length, that were based on inflated appraisals or where the assets were acquired at relatively high prices. There is no bigger mark than an investment manager chasing today's hot property with other people's money. The Goldman Sachs/Abacus incident is a reminder of how common it is for brokerage firms and investment banks to be helping one customer sell certain assets favorably even as it recommends that another customer buy them. Fees, of course, are earned on both ends.

After acquiring assets, a fund must then execute an investment strategy. A problem with Alternative Investment monitoring is that little independently-verifiable information is provided to investors about how well the funds are actually doing. Indeed, there may even be a paucity of information about what

investments are being made. Many of these funds are styled to give managers broad power to take concentrated positions, to make fast and large bets, and to act with almost total discretion. It is not clear how anyone can monitor and evaluate such activity.

Hiring strangers to execute strategies that are neither knowable nor controllable does not seem a recipe for success. Most Alternative Investments are conceived as blind pools (i.e. the actual assets to be acquired are not identified at the time the investor puts in his/her money), they are mostly based on blind trust. . . . and reliance on marketing and promotional materials. That leads to another question . . .

### **Is the advertising truthful?**

Alternative Investments need to be sold to investors. Without sales to investors, managers and promoters would have no way to earn money. To be successful, the organizations that create and sell Alternative Investments must not only be good at investing, they must also be good at marketing and selling. The use of these skills can make evaluating Alternative Investments a real challenge.

The biggest problem with evaluating the marketing material promoting Alternative Investments is that there is no credible clearinghouse of information on either funds or managers. Reliable comparative statistics are not available; there is no Morningstar for Alternative Investments. Data about past performances thus comes exclusively from the very promoters who will profit from the sales. In addition, as promoters tout prior successes, there is no mechanism for investors to discover whether there are losers that are being hidden from view.

The limited regulation of hedge funds and private equity funds also creates an environment that is ripe for exaggeration and deception. The

involvement of off-shore entities makes the situation even more ripe for abuse, since suing and collecting from foreign entities is often not practical. Con artists thrive in such spaces.

This combination of the paucity of independently-verifiable data and lack of regulation presents a scary picture. Sellers who are tempted to take advantage also know that by getting investors to sign onerous subscription documents with extensive disclaimers, they may further limit their liability.

**Do the fee structures present any improper incentives to the managers/sellers?**

Every dollar skimmed from the top is a dollar not invested. High up-front sales fees and ongoing management costs are an obvious problem. The higher they are, the less there is left for the investors. When it comes to Alternative Investments, there is often a transparency deficit, and, as previously observed, there is no database or service that collects and compares the fees so that consumers can make intelligent comparisons. And of course, there is little regulation.

One problem we have seen over the years is where a successful manager raises money in a series of syndicated real estate or private equity offerings. There is, necessarily, a lag between the time the investment is conceived, the time the offering is made, when the money is raised, and the time investment opportunities are identified, and fund money is actually invested. During that time, market conditions can change, perhaps to the point where the investment's economics have changed. But the promoters have raised the money, and they need to continue with their plan if they are to earn their fees. Terminating the fund and returning the money is not a good alternative. For the promoters, that is. Falcon and ASTA/MAT is a prime example of how this phenomenon can be deadly.

But the problem of fees runs deeper for Alternative Investments. Often, Alternative Investment promoters and managers are given a share of future profits. While such compensation arrangements would seem to align the interests of managers with investors, that is not always the case. For example, such arrangements can cause to managers to be more prone to gamble, in the hopes of achieving a big win or meeting incentive thresholds.

So-called “high water mark provisions” can exacerbate this problem. In such arrangements, a manager earns no fee if the fund loses money, and he continues to earn no fees until the fund gets back to, and exceeds, its previous high-water mark. Such arrangements seem sound (no profit, no fee), but it can cause a manager with a fund that performed poorly to take big risks to get back to and then exceed previous highs.

### **Are the investments fairly priced?**

You will never know, of course. You will never know if the values printed on your monthly statements are accurate, because there is neither a ready market nor a market-based price discovery mechanism. Years of apparent gains can disappear quickly and without good explanation.

But once again, the lack of transparency creates deeper problems. Consider a real estate or private equity fund. There is no way to know whether the fund is over-paying for the assets it is buying. Appraisals are easily manipulated. Sales to shell companies followed by resales to the fund at higher prices are not uncommon, and very hard to detect. How can such an investment ever be prudent?

### **How illiquid is illiquid?**

A common warning in the legal documentation accompanying the sale of Alternative Investments is that the investment is illiquid. That warning does not

necessarily mean that one can never sell the investment, and salesmen are thus prone to tell clients that there is fact an ability to resell. Of course, the documents will be used against any investor who buys one of these investments, no matter what the salesman said.

Often, Alternative Investments provide liquidity by allowing for periodic redemptions. But the right to redeem is almost always qualified in some fashion, for example by limiting total redemptions for a given period. If too many investors seek to redeem, the fund may only grant each applicant a pro rata share of that investor's request.

Illiquidity is not just a feature, it adds risk. One who buys an illiquid investment will pay dearly to unload it if economic conditions change. And in bad times, illiquid investments suffer the most; nothing is worse for sellers than a mass rush-for-the-exit.

But it is not just a matter of whether the investor "needs" the money. The inability to re-deploy investments when market conditions change is an important benefit. Surrendering that benefit necessarily adds risk.

## **CONCLUSION**

In summary, alternative investments suffer from an array of risks - they are extremely complex (often using advanced mathematical strategies and sophisticated computer programs); they are not transparent but are opaque; they have very little liquidity; they have expensive fee structures; and they are neither understood by nor suitable for most investors. If you are encouraged to purchase an alternative investment, you are urged to tread lightly. Make sure that your investment advisor fully understands the investment and satisfies his or her obligations to fully disclose all important risks and aspects of the investment to you. Make sure that the investment satisfies your objectives and risk tolerance. Otherwise, stay away.

Seth E. Lipner  
Deutsch & Lipner  
1325 Franklin Avenue  
Suite 225  
Garden City NY 11530-1631

J. Boyd Page  
Page Perry, LLC  
1040 Crown Pointe Parkway  
Suite 1050  
Atlanta, GA 30338