



# Boutique Investing

**Wealthy investors are cashing in on commodities, real estate and hedge funds.**

MUCH HAS CHANGED IN THE investment landscape over the last year, what with the credit market turmoil, the threat of recession and inflation worries. Given this altered environment, now seems like a good time to step back and reassess three of the hot investment areas

... favored by high-net-worth individuals over the past few years: commodities, real estate and hedge funds. After all, whenever there are problems, there are also opportunities.

First, take commodities, which have been on a years-long bull run, thanks

to the red-hot economies of China and India. These economies have helped push up costs for everything from metals to cement to lumber for construction and wheat to feed a growing urban population. But with such a long run-up in prices and global growth now coming under pressure, are commodities still a good bet?

## OIL IS POWER

Yes, says Michael Black, a financial planner in Scottsdale, Ariz., who says at least one type of commodity—energy—will continue to be an important investment for his high-net-worth clients. He argues that the credit crisis and the cost of energy are the two macro economic events that threaten to cause a recession, and that's reason enough to own energy. "If energy is causing risk to the economy, than I want to own energy as a risk hedge." It's only logical, he says: The best way to benefit from rising inflation is to own whatever is causing it.

Rank-and-file investors can use natural resources exchange-traded funds (ETFs) to tap this opportunity. But potentially more lucrative opportunities exist for wealthier investors who can tie up more capital for longer. One of Black's favorite's is Ridgewood Energy in Ridgewood, N.J. Founded in 1982, the firm raises money from wealthy individuals and then partners with large oil and gas companies to explore and develop oil and gas wells in the Gulf of Mexico.

The firm has raised \$2.2 billion from 12,000 individuals for more than 20 funds in the past 25 years. The minimum investment is usually \$150,000 and the payoff is several years away since finding wells and building the apparatus to make them operational and profitable takes time. But the payoffs are often several hundred percent, so it's little wonder that 80% of investors are repeat investors. "It provides an institutional platform for high-net-worth individuals to participate in exploratory drilling with major companies in the Gulf of Mexico that would require billions to do on their own," Black says.



Another such investment is Atlas Energy, based in Moon Township, Pa. Atlas looks for natural gas primarily in the Appalachian Basin. Black explains that the public company allows nonaccredited investors to participate for as little as \$10,000, but more sophisticated accredited investors can participate in different private partnerships set up by the company for \$25,000 or more. "It usually takes three to five years to recoup the investment, so you really must commit to a process of investing," Black says.

### CASH IN THE ATTIC

Another type of investment, real estate, has hit serious headwinds of late given the subprime meltdown. But Black also sees opportunities for HNW individuals. In part due to the meltdown, as well as demographic

The other hot topic in investment circles is hedge funds. These remain shrouded in mystery for many investors, in part because there are so many kinds of hedge funds. But it's also important to distinguish between implementing a hedging strategy and investing in a hedge fund. A bespoke hedge strategy is appropriate—perhaps critical—for people who receive large blocks of one stock as executive compensation or from the sale of their business. These investors need to hedge their exposure to a single stock to reduce risk and preserve their wealth.

A typical hedging strategy for a concentrated stock position is a "cashless" or zero-premium, collar, which protects against price moves without having to sell shares. An investor purchases a price floor (a put option) for the concentrated stock

mergers, liquidations and spinoffs; convertible arbitrage, when managers buy underpriced "options" embedded in convertible bonds to purchase the underlying stock; fixed-income arbitrage in which managers seek to exploit mispricings and inefficiencies in fixed-income markets and their derivatives through arbitrage in anticipation of a return to "normal," or correct, pricing; equity market neutral managers who match long and short positions in stocks or stock sectors to profit from a change in their prices relative to one another; and global macro funds, a broad term used to define managers who trade stock, bond, currency or commodity markets using a top-down approach guided by macroeconomic research.

As useful as each of these hedging

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trends, there will be renewed demand for rental properties, he says.

These forces are strong incentives for wealthy investors to participate in limited partnerships, such as Philadelphia-based Resource Real Estate, to own apartment complexes. Black cites an article in *The Wall Street Journal* in August that quoted William Wheaton, a professor of economics and real estate at MIT, as saying: "The U.S. housing boom over the past decade turned 5 million renters into homeowners. But many of the loans that made that possible have proved unsustainable." Wheaton expects two-thirds of those people, or about 3.35 million, to go back to renting.

What's more, says Black, the "echo boomers" will be leaving home en masse in the next few years. This enormous generation, second only in size to the baby boomers themselves, will drive demand for apartments, particularly in big cities.

and finances the cost of this protection by selling a price cap (a call option) on the same stock. In effect the investor locks the stock price into a range based on the floor and cap levels, which reduces the downside price risk to the floor but forfeits any upside potential above the cap.

Implementing this kind of hedging strategy to preserve wealth is quite different from investing in hedge funds, of which there are now around 8,000. And given today's volatile global market, and the wide range of hedging strategies, these funds might seem like they'd be integral to any HNW portfolio. There are: long-short equity funds, in which managers buy stocks expected to outperform the market, and short stocks expected to underperform; event-driven funds in which managers seek to profit from "extraordinary" events in a company's life, such as takeovers,

strategies can be, the trouble with hedge funds, says Black, is the cost, and the fact that with so many managers now pursuing similar strategies, the returns are not as great as they once were. Most actively managed hedge funds have what's known as a 2/20 fee structure, which translates into 2% fee for assets under management and 20% of profits. "That's way too rich for my investors," says Black. Most hedge-fund managers simply do not generate high enough returns to warrant such lucrative fees. A better option, he argues, is a new group of low-fee mutual funds that use established hedging strategies. Some of his favorites are the Diamond Hill Long-Short Fund and some of the Calamos funds, which keep fees to between 1% and 2%. **BIC**

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