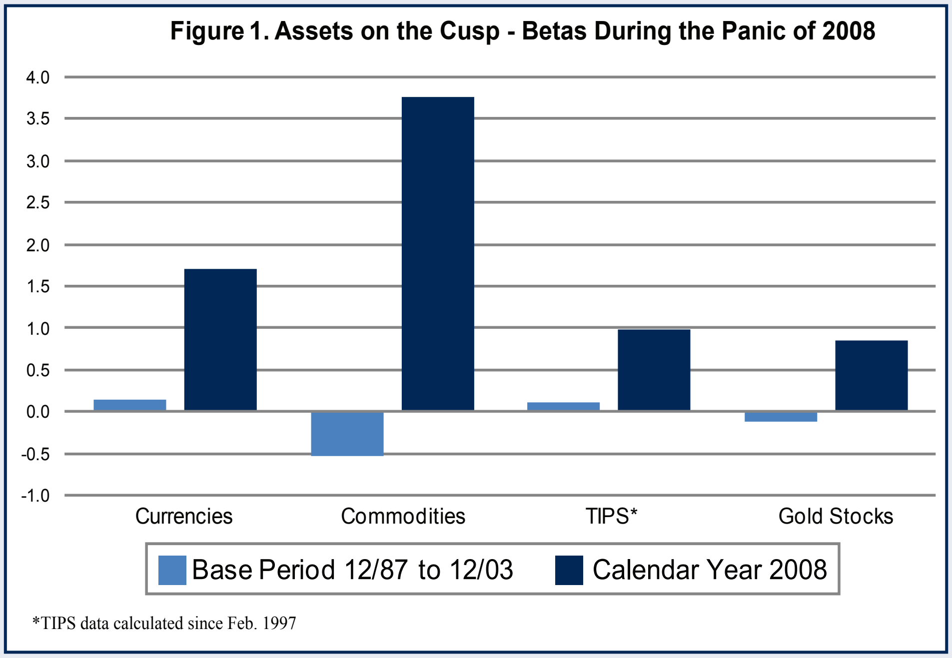
BULLSEYE Highlights

Betas on the Cusp

The investment mantra for years has been to diversify. But how do you achieve real diversification? Nobel Prize winning economist Harry Markowitz became famous for his research in this area during the 1950s as he developed the concept known as Modern Portfolio Theory (MPT), based largely on the concept of combining noncorrelated assets. As investors tried to apply these theories to actual portfolios, the only risk-control method was to adjust the percentage of exposure to asset classes based on long-term historical risk/return averages.

But investors soon learned the pitfalls of long-term averages. That's because noncorrelated assets often move in the same direction over shorter periods of time since they can be influenced by many of the same economic and behavioral factors. In fact, many asset classes are often on the cusp of increased correlation when excess liquidity and the mispricing of credit risk begin to dominate the markets. This type of *"Beta on the Cusp"* behavior was evident during the late 1930s and reappeared again around 2003. Both time frames were credit-bubble periods fostered by the Federal Reserve's generous credit terms, which arguably lead to increased greed on Wall Street and eventual fraudulent activity.



Performance displayed represents past performance, which is no guarantee of future results.

A Historical Perspective

We should consider a historical perspective of asset-class behavior, during a time before the Fed helped to inflate the credit bubble. The foundation for our recent credit bubble actually began in July 1997 with several currency devaluations, resulting in the credit crisis of 1998. This was perhaps the first sign of a future that might look more like the 1930s than the way things looked in the 1990s.

But the credit bubble itself began to inflate after 2003 when the Fed's easy money policies aided credit securitization of mortgages and other credit craziness. The Street took the credit bubble to epic proportions, which blew up the financial system. Their hubris led to peak risk levels for all assets by July 2007.

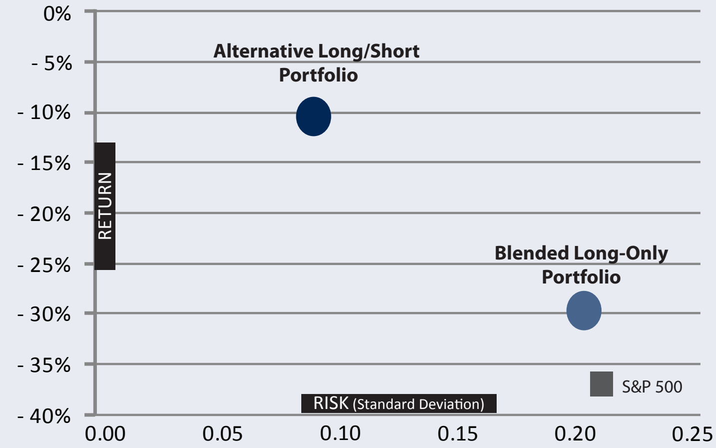
A Minsky Twist To Modern Portfolio Theory

Economist Dr. Hyman Minsky, whose research often focused on the impact of a financial crisis on the markets, anticipated large degrees of "Ponzi borrowing" during credit bubbles—the greater the bubble, the greater his expectation of this occurring. The "Ponzi borrower" borrows money based on the belief that the appreciation in the value of the asset will be sufficient to refinance the debt, as we saw with the sub-prime real estate bubble. Unfortunately, without continued appreciation and refinancing, the borrower eventually can not make the payments. Although Ponzi borrowing is not quite the same thing as a Ponzi investment scheme, they are based on a similar premise of an eventual inability to meet payment obligations. Highly publicized fraudulent Ponzi schemes have led to increased investor skepticism of hedge funds and increasing public demand for more regulated investments, such as those provided by a new breed of alternative mutual funds. This change of view is illustrated by the events of 2008, where we saw hedge fund assets drop in half from $2 to $1 trillion. The hedge fund industry is shrinking dramatically and manager skill is coming into question as investors grow weary of nontransparent "black box" investments.

Dr. Minsky, who graduated from the University of Chicago, rejected many of the Chicago business school's Modern Portfolio Theory axioms. In light of the recent Bernie Madoff fraud and other financial market scandals, more people are starting to consider how Minsky's work could perhaps contribute to the "modernization of Modern Portfolio Theory." When default-deflation fears rule price directions, and the effects spill across multiple markets, a lesson can be learned from Minsky to find a way to complement Modern Portfolio Theory. The image in Figure 2 depicts the beta effect for a blended portfolio of domestic stocks, foreign stocks, bonds and commodities at a weighting of 25% each. This type of traditional long-only portfolio failed to deliver many diversification benefits during the "Panic of 2008" because the performance horizon shifted as we entered the credit crisis. The image also shows another model with exposure to similar asset classes, but with a long/short twist: Hedged Equity (domestic & international equities exposure), Fixed Income Arbitrage (bond exposure) and Managed Futures (commodity exposure).

Figure 2. Alternative Long/Short vs. Blended Long-Only

Risk, Return and Beta (to the S&P 500) for Calendar Year 2008



	Alternative L/S Portfolio	Blended Long-Only Portfolio	S&P 500 Index
Return	-10.08%	-29.96%	-37.00%
Risk (StDev)	0.09	0.20	0.21
Beta	0.19	0.81	1.00

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Weathering The Storm

Asset managers who were well-versed in the idea of *Betas on the Cusp* might have been better prepared to weather the storm by hedging out some of the atypical movements in asset classes that had previously been relied on for noncorrelating diversification. Perhaps real diversification should be less reliant on which asset classes you own and may benefit more from what is done with those assets. Long/short strategies may be used to neutralize some of the volatility and help to reduce the impact of global market declines. Unfortunately for their investors, some hedge funds have been suspected of being beta-driven funds in disguise. On average in 2008, hedge funds returned -21.9% *(HFRI Equal Weight Index)* with risk levels and market correlations more in line with long-only stock & bond portfolios. They did not seem to live up to their moniker of providing a portfolio hedge. Investors are finally "*paying attention to the man behind the curtain*" as the black box investment techniques of hedge funds have come into question. This has resulted in an increased demand for the new breed of alternative mutual funds that actually do what they claim—manage both risk and return with far greater transparency.

Data Sources: Based on original research "Betas on the Cusp" by Arrow Insights, February 2009 (www.arrowinsights.com). Figure 1. Morningstar and Advisory World, with additional calculations by Arrow Investment Advisors. Currencies are represented by the Advisory World Money Fund Index; TIPS are the Advisory World TIPS Average; Commodities are the Goldman Sachs Commodity Index Total Return; Gold Stocks are the Closed-End Fund PM Average. Figure 2. Morningstar, calculated by Arrow Investment Advisors. Long-Only portfolio is comprised of 25% each: S&P 500 for U.S. stocks, EAFE for International Equity, Barclays Aggregate Bond for Bonds and GSCI for Commodities. Long/Short portfolio is an equally weighted blend of CS/Tremont Hedged Equity, Fixed Income Arbitrage and Managed Futures Indexes. Index returns assume reinvestment of dividends and do not reflect any management fees, transaction costs or expenses. The indexes are unmanaged and are generally not available for direct investment.

Definitions: ***Beta*** *is a measure of the relative volatility of a security, asset class or portfolio by comparison, most often, to the market as a whole. In other words, beta indicates the historical tendency of a security to respond to swings in the overall market. A beta of 1.0 indicates that the security has moved with the market., and higher or lower indicates more or less relative movement.* ***Standard Deviation*** *is a measure of risk or volatility based on fluctuations in performance.*

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