A Study Of Investing Principles For Alternative Investments

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Abstract - Investments are a major area of study in the financial world. The role of an investment agent or portfolio manager is being scrutinized for following the unsaid principles laid in the industry and henceforth known as Investing principle. This paper will introduce what, for many investors, may be a new way to think about portfolio construction. It will start with basic precepts, discuss common tools for asset allocation and some of their weaknesses, especially with respect to alternative investments, and then discuss the emerging practice of grouping assets by their economic role in the portfolio.

Index Terms - Investments, portfolio, alternative investments, financials , assets, long term investments, risk management, liquidity, quality, ethics.

ALTERNATIVE INVESTMENTS: THE PRINCIPLES

Management of alternative investments is characterized by two principles, which we identify as best practices in alternative investment portfolio construction. Both principles have three important subsets:

1. Collect quality partners opportunistically
    a. Listen to and learn from our managers
    b. Be contrarian when appropriate
    c. Innovate
2. Risk management is a key to success
    a. Diversify among asset classes, strategies, and managers
    b. Maintain enough liquidity to stay the course
    c. Accept and plan for the eventuality that we are wrong

Collect Quality Partners Opportunistically Unlike traditional investments, the quality of the manager matters more than the asset class in making decisions about alternative investments. Build portfolios from the bottom up by opportunistically identifying and allocating to quality managers, and only quality managers. While in search of quality managers, we must "stick to our knitting." That is to say, stick to our mission and objectives, stop looking at what our neighbor is doing, and don't chase returns that might have risks inconsistent with our basic strategy.

Traditional investment managers work under the disadvantages of investing in the most efficient markets and long-only constraints. The best domestic fixed-income managers add merely 20 basis points compared to the median while assuming considerable market risk (i.e. most of their return is beta, not alpha). The same could be said of the best managers of U.S. large cap equities which add not quite 1½%.6 Even in international equities, the value-added for top quartile managers is little more. Most results can't exceed passive indexation. Contrast this with alternative investments. Allocation and access to top-tier illiquid alternative investment managers is the primary difference among top-performing funds even after adjusting for the additional risks and illiquidity assumed. The spread between top quartile and median managers in most alternatives is very large, and the spread between even second and third quartile is huge on a raw return basis. It is often better to have zero invested in an alternative strategy than to have the target allocation invested with a mediocre manager.

What is quality and does it Matter? One answer to "What is quality?" paraphrases the late U.S. Chief Justice Potter Stewart's 1964 opinion on obscenity ("I know it when I see it"). But the answer to the second question is much more concrete: Does quality matter? Yes! The Greenwich Roundtable's first three *Best Practices* publications examined the question of ascertaining what quality is for hedge fund managers. The capital asset pricing model holds that returns can be broken down into passive market exposure (beta) and active management (alpha). Mathematically, "quality" therefore means high and consistent alphas. Applying this definition mechanically, however, ignores the possibility of the alpha being the result of simple mis-measurement or parameter misspecification. There is considerable academic and practitioner work suggesting that many alternative investments contain exposures to both traditional and nontraditional betas as well as to other risk factors. These include size and style exposures, interest rate term structure, momentum, short volatility, corporate events, liquidity, and leverage.8 Nor does it answer the question of whether the returns were luck or genuine skill.

The process of investment manager selection evaluating people, culture and business structure, operations, value proposition, and identifying skill—applies to all asset classes and sectors, not just alternatives. For liquid alternatives, the three previous *Best Practices in Hedge Fund Due Diligence* publications offer some practical guidance at not only finding but doing the hard work or ascertaining whether real skill is present.

Ultimately, after all the due diligence and reference- checking is done, the decision boils down to investor judgment and intuition regarding whether the person or team is a money maker who can maintain a durable competitive advantage, possesses

integrity, is personally invested and motivated, is a fair partner, and offers a reasonable value proposition. Past performance is a clue to quality, as are other markers such as time spent at proven firms and academic success. But how managers achieve their results is more relevant to answering the main questions: is it probable that they will replicate their past success, and do I get to keep a sufficient portion of it to justify committing capital and bearing the inherent risks?

How do we get Quality? Access to quality is neither democratic nor egalitarian. Whom we know and, more importantly, how *we* are known, matters. If we as long-term investors want excellent managers to work hard for us and offer their insight, we need to make a commitment and demonstrate "staying power"—that we are able to stay the course.

Since quality is scarce and has historically been difficult to access, it is often best to allocate opportunistically when capacity becomes available regardless of our particular view of the asset class, sector, or strategy. The most successful investors willingly rebalance their portfolio by selling liquid positions in the associated or proximate asset class or use derivatives to stay reasonably within their Policy Portfolio.

How do we keep Quality? Quality managers are in high demand and can extract better economics for themselves—either through higher fees or less liquidity for investors. Typically, such funds are closed to new investors or are adjusting liquidity provisions to attract only investors that have staying power. Both the supply of investment talent and the demand for it fluctuate over time. Between 2003 and 2008, demand outstripped the supply and investors had to give up larger and larger portions of the economics to managers. Starting in the fall of 2008, this balance began shifting increasingly in the investors' favor.

How do we gain confidence that the manager's interests are aligned with ours? First, we prefer a fee structure that is more biased toward the performance fee. This aligns incentives more strongly. Among other advantages, it can lead the manager to be more responsible in raising costs. Second, a manager's principals should demonstrate their commitment by having a meaningful portion of their personal net worth invested in the fund. While this is often difficult to verify, the general partner's or fund manager's capital commitment should represent a meaningful commitment. Terms should also provide a key person clause9 and other "investor friendly" provisions. Third, a manager should be building an investment culture that encourages cooperation, competition, mentoring, and a climate of mutual respect.

Listen to and learn from our managers hiring a manager is like getting married. Both are characterized by the seriousness of the decision to say "I do," the need for work and time to build a relationship, and the pain of parting company. Getting to know our managers is a two-way street requiring plenty of communication. We need to understand how they are going to think or react to certain circumstances. They need to know some of the same about us. It is best to treat the due diligence process as never-ending. We should be constantly verifying that the managers are playing the role in the portfolio that we expect.

We must understand the risks they are taking since these will change over time. A balance between trust and skepticism is needed. Managers in certain strategies may see what they do as highly proprietary and confidential and may be reticent to be as sufficiently transparent unless they understand our need to manage the whole portfolio of which an individual manager is only one part.

Preparing well for the meetings, offering honest and forthright feedback, are all components of building this kind of relationship. It is more important to listen, listen some more, and continue listening. The manager will likely be examining us as well. If we set the standard high during the due diligence phase by being open and forthright, we have a better chance of building a strong overall relationship.

Some managers can be original thinkers, and others may be early warning indicators. Some are ahead of investment trends, expert in spotting untapped opportunity. Listening to our managers and understanding the quality of information and the accuracy of their predictions will go a long way in helping us build our own portfolio and make the whole greater than the sum of the parts.

Be contrarians when appropriate Great long-term track records are not built by being like everyone else. They are the result of purchasing high quality assets at favorable prices, often when others perceive them as low quality. The appeal of alternative investments is the lack of consensus. There is more room for non-consensus thinking within the investment structures they employ. A best practice in portfolio construction is, selectively and when appropriate, to be contrarian.

The only way to "pay a little/get a lot," is to buy when others are selling and vice versa. While a value bias is part of being contrarian, it is not the whole story. Being a true contrarian is not

about reflexively betting against the consensus. It's about betting against the consensus when our assessment of fundamentals differs materially from those priced into the markets. The 2007-2008 success of shorting the subprime asset-backed securities index was about a divergent view of home equity borrowers.

The consensus held that residential mortgage borrowers represented little credit risk because the underlying collateral—their houses—always went up in value. But small disturbances in the rates of house price appreciation, not even requiring actual losses, would result in material default risk. At any given time, there are hot asset classes sporting high valuations while other sectors languish with cheap or distressed pricing.

Alternative investments are no different. An area is undercapitalized, with few investors showing interest, so participants within it have to attract investors with high yields and/or low prices. Capital then flows in, the opportunity becomes less attractive until it becomes the new hot area and should be avoided. Venture capital was a great investment in the early 1990s but it was terrible in 1998-1999.

Convertible arbitrage in the late 1990s was great while in 2005 it was terrible. Talking to managers across a wide range of sectors, geographies, and strategies gives institutional investors a unique vantage point. It helps us understand the differences in pricing, fundamentals, and ultimately opportunities. The key is to use this information to our advantage.

Innovate

The success that some institutions enjoy through alternative investing is a result of the institutionalization of a culture of innovation. Strong results at the leading institutions are the result of reaping what was sown a decade or more ago. We should

not invest in what these institutions are investing in, but rather invest *how* these institutions are investing. That is to say, remain open-minded and innovative.

Earning great returns means being invested when the idea or market is cutting edge and riding the compression of risk premiums until it reaches mainstream. Take for example the heavy use of alternatives by endowments. Hedge funds were on few people's radar screens in the 1980s when these investors began allocating to them. Returns to the now-mainstream strategies like merger arbitrage or convertible arbitrage were sometimes in the 25%-30% range. Timberland was bought with 12%-15% yields.

Like a contrarian benefiting from shorter-term dislocations, executing on this practice requires an investment culture supportive of innovation and long time horizons (especially the ability to lock capital up over a decade or more). It also requires a way to source fresh ideas. Listening to our best and brightest managers is a good place to start. And it requires an acutely tuned appreciation for where the idea is in the spectrum.

Innovation in investment management is about moving to areas rich in opportunities and poor in capital. While alternatives currently offer some of the best chances of meeting acceptable return levels, most of the strategies and sub strategies are relatively well understood and no longer cutting edge. There may be a time when most alternatives could be too widely owned and become unattractive.

Risk Management

Effective risk management is crucial to successfully managing a portfolio. It is often viewed as a distinct responsibility, but it's executed most effectively when it's an integral part of the investment process. The best practitioners consider risk management and portfolio management as two sides of the same coin. Successful investors are good at assessing the relationship between potential return and downside risk. To make solid investment decisions, it's impossible to ignore risk. Successful investors understand and manage risk in several ways:

1. **At individual decisions:** They integrate risk analysis into individual investment manager selections or terminations.
2. **At the portfolio level:** They manage their portfolio to a risk target or constraint. Based on their objectives and risk tolerance, they determine a specific amount of downside they are willing to suffer. They then construct a portfolio that optimizes the mix of opportunities within that risk limit. The most effective investors work to adjust their portfolio risk as a function of the quality of investment opportunities available and their outlook for the markets. This approach limits excessive leverage and manages liquidity so the investor isn't forced to sell assets at an inopportune time.
3. **As a feedback loop:** As events unfold, investors can determine if their *ex ante* risk expectations were accurate to the given market conditions. If assumptions are off, they can recalibrate them to improve the process should the delta be considered nonrandom. The more turns of this process, the better investors can deal with future risks and opportunities.

Caveats about Applying Diversification:

The principle that some risks can be diversified away applies equally to traditional and alternative investments, but it needs to be approached differently with alternative investments.

For most alternatives the data are infrequent (monthly or quarterly) and lack a standardized calculation methodology (net vs. gross; IRR vs. cash return). Also, the performance indexes are less robust because of smoothed pricing, voluntary reporting to indexers, and relatively recent inception dates. Investors cannot form statistically robust conclusions with the index data, especially across asset classes. We should be cautious about relying too heavily on quantitative measures.

The opportunistic nature of most alternative investment managers further complicates the analysis. Managers seek opportunities wherever they may arise, leading to varying exposures over time.

Investors must therefore deal with the possibility of an unintended concentration in market risk exposures. For example, many different managers currently view distressed credits and companies as an attractive opportunity. Hedge funds of marketable alternatives (event strategies), fixed income (distressed debt), private equity (turnaround/distressed companies), and even real estate portfolios (distressed sellers and properties) are all likely to be developing highly correlated distressed exposures. Compounding this problem are changes in markets where globalization and financial innovation have increased correlations among asset classes. The result is less diversification with increased exposure to certain sectors. The way to achieve true diversification with alternative investments is to develop a deep qualitative understanding of the managers what, how, and why they are making their investment decisions—and form conclusions based on reasoning and judgment. This applies equally to initial and ongoing assessments. How managers are currently thinking and positioned is often far more important than historical factors.

A hedge fund may have demonstrated an historical beta of 0.9 to the S&P 500 Index. But knowing that the manager is now bearish and lowered the fund's net exposure to 15% is relevant to the risk profile of our portfolio. Recently, for example, many multi-strategy or equity oriented fund managers, who several years ago had zero allocation to credit, may now have portfolios dominated by credit and minimal equity exposure. The strategy change was driven by market conditions and opportunities. Once we understand these fundamentals, we then understand more about the total portfolio risks and can decide to either retain them or hedge appropriately.

Portfolios generically contain three levels: the asset class (the "bucket," such as equities or growth as we will see later), the strategy (publicly traded equities, hedged equity, or private equity), and the individual managers selected. All three should be diversified. We achieve diversification in two ways: by selecting uncorrelated investments and by sizing them appropriately. While an uncorrelated position helps, even at 1% weighting, it does not materially influence a portfolio's overall risk profile. The same position sized at 25% changes it dramatically.

Position Sizing: How then do we size alternative investments? Successful investors must make judgments based on their knowledge of markets as well as the risks associated with various strategies and individual managers. Differences in sector and manager weightings should always reflect demonstrable differences in characteristics. Because it is difficult to demonstrate clear quantitative differences among managers, equal weighting is often a reasonable first step because it focuses the investment team on what will make a difference in the portfolio.

For example, assume we have access to three hedged equity managers, each with a different investment philosophy and process, all of whom meet our quality standards. A logical starting point would be to give each one-third of our hedged equity allocation. Investors should look to roughly equal-weight both in terms of capital and risk in the portfolio. Judgment is used in determining the balance between the two. This allows us to avoid the false sense of precision generated by statistical risk measures while benefiting from the insights they can provide.

There are three caveats to an equal-weighting scheme:

1. Since manager capacity may be limited, we may not be able to get to equal weighting in all investments. In those cases, we take what we can get.
2. As we gain confidence in our managers over time, we may have a greater sense of the managers and a stronger sense of their return characteristics. Having a higher weighting for established, long-term investments and a lower weighting for less proven investments may be wise. Also, some thought should be given to half positions in especially volatile managers or strategies.
3. Most institutional investors use some sort of Policy Portfolio to size allocations among strategies. Policy Portfolios serve two vital yet distinct roles: they establish a risk target and they represent our passive asset allocation. Risk tolerance should be set independent of how risk is obtained (i.e., what investments are selected). Alternative investments allow us to squeeze more return from the same level of aggregate risk. Maintain Enough Liquidity the best long-term investment performance is earned by those who not only survive market crashes but have the "staying power" to maintain fundamentally sound positions and the liquidity to invest when others cannot.

Liquidity means having an unfettered ability to deploy capital to an opportunity. No matter how correct we are in our views on the long term, our ability to stay in the trade when the going gets rough ultimately decides whether we had adequate liquidity to make the investment in the first place. History is replete with sad tales of investors who were forced to sell into turmoil but who, if they had just been able to hang on—had staying power, would have realized gains consistent with their objectives.

It is ironic that during the 2001-2002 routs in stocks, investors who were locked-up often did better because they were unable to heed the emotional desire to sell. Staying power, of course, is more than staying in the investment it is the ability to adhere to the long-term investment objectives and not abandon those objectives to meet shorter-term needs. Ultimately, investors have two sources of liquidity: internal and external.

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