Trends in Alternative Investments

February 2017
The Role of Alternatives in Investor Portfolios

Institutional investors and consultants are struggling to meet historical returns figures through traditional investments such as equity and fixed income and so have increased their allocations to alternatives. The percentage of the allocations in a portfolio to alternatives has nearly tripled over the last 20 years, and continues to be an area that clients are looking to diversify into in search of these return objectives.¹ For example, the state of New Jersey has increased their alternative exposure from basically zero ten years ago to over 30 percent today.² And the state of Massachusetts has over 40 percent of their portfolio in nontraditional investments.³

There are of course many different types of alternative investments. How are consultants and investors thinking about each of the specific options? Hedge funds as a collective actually had positive returns for 2016, but they also experienced net outflows as investors tended to be withdrawing assets as opposed to putting more in. A few examples: The Orange County Employee Retirement system is recommending eliminating hedge funds and GTAA asset classes from their portfolio.⁴ New York City employees are looking to drop hedge funds from their portfolio and the Illinois State Board of Investment looking to reduce their hedge fund allocation from 10 percent to three percent.⁵

2. eVestment Public Plan IQ, NJDOI
3. eVestment Public Plan IQ, Massachusetts PRIM
4. eVestment Public Plan IQ, Orange County Employee Retirement system
5. eVestment Public Plan IQ, Meketa, Maryland State Retirement System
Expert Panel

To really dig deeper into how investors and consultants are considering the role of alternatives in portfolios as we enter 2017, eVestment held a recent panel discussion three distinguished members of the institutional investment community.

Joining us were Arno Kitts, CIO of Perspective Investments, who before founding Perspective had a lengthy career in the insurance and asset management area, including acting as the managing director of Blackrock’s UK institutional business; Dan George, CIO of Ellwood Associates who oversees both the traditional and alternative manager research for the firm and who has a particular focus on endowment and foundation clients; and Bryan Mullin, Head of Alternatives for RBC, responsible for advising the firm’s high-net-worth advisors on alternative investing.

Topics covered during this discussion included:

- Asset Allocation and Target Returns
- Hedge Funds
- Private Equity
- Real Assets
- Fees

Panelists:

Arno Kitts
CIO
Perspective Investments

Dan George
CIO
Ellwood Associates

Bryan Mullin
Head of Alternatives
RBC
Asset Allocation and Target Returns

**Arno:** In trying to sustain historical levels of portfolio returns, it's going to be very difficult with or without alternatives. There’s going to be increased competition to find the right assets to make decent returns. Challenges and risks facing investors with alternatives actually might be quite attractive relative to the challenges and risks investors face with conventional assets.

If you look at fundamental characteristics; expected return, distribution, volatility, liquidity, and you take a three-to-five-year view, then it’s high school math that conventional assets such as equities, particularly in the U.S., are in a bubble. History tells you that there’s likely going to be a significant correction at some point. So our models have a mean expected return of traditional asset of nil at best for three-to-five years with considerable downside.

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**Bryan:** I think manager selection is going to be imperative in terms of a summary point. You will be able to still find some value here, but returns are going to be challenged and really episodic. Alternatives are really not a discrete asset class, but you’re seeing investors begin to break them apart and change their asset allocation frameworks into more factor-based exposures and thinking about how you can really provide better risk assessments and better measures of what your real risk exposure is. I think that's where the market is heading overall. You’re seeing different managers react to that differently. Some may change their strategy to better position themselves for some of these changing dynamics.

**Dan:** Our asset allocation modeling is strategic with a 10-year outlook. We have capital market assumptions oriented towards that planning horizon. We also use dynamic asset allocations with a much shorter lens, a two- to three-year outlook. We don't consider week-to-week or month-to-month adjustments. For us, tactical is two to three years.

One example of dynamic asset allocation that we are using right now is a low-duration fixed income strategy in a rising rate environment. Like everyone else, we were early on that, but it's an example of a position with just a 2-3 year outlook rather than a full ten years and how we moved capital as a result of a relatively high level of conviction on that dynamic view.
Hedge Funds

**Arno:** We believe that for hedge funds, the focus should be on how do they actually make money. Then you might be able to pick things that are actually going to make money in the next few years. For example, it’s very hard to predict when systematic will or won’t work. But if you’ve been invested in systematic for a very long time already, you’ve had decent returns, and there is no reason why those returns won’t continue in the next three to five years.

And as far as distressed, I would caveat that there isn’t actually a lot of distress out there right now. I would wait and have some money earmarked for distressed and when there is distress, that is the time to invest in that segment. We do believe that hedge funds will disappoint most investors most of the time, as will the typical active manager. My view would be that for the next five years, you’re going to struggle. You’re going to have to pick the top quartile hedge fund to get a positive return.

**Dan:** I think the term disappointed is a key way of approaching hedge funds. We really need to look at what we are expecting to get out of this asset class. We’re not expecting hedge funds to outperform equities. We break hedge funds into two categories: directional and low volatility. We view low volatility as a capital preservation strategy and have used these hedge funds to replace a healthy portion of our fixed income portfolio.

From a directional standpoint, we’re expecting these hedge funds to have relatively low beta, low correlation, and be that third asset class between stocks and bonds, producing a return slightly below stocks. When hedge funds are added to a diversified portfolio, we really do see a pickup in portfolio efficiency in terms of sharp ratios, downside protection.

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So I think managing expectations is key when going into hedge funds. Along with everyone else, we’ve been disappointed with the performance. But it’s been a very choppy macro environment. Between crowded trades and the low interest rate environment, the asset class has had some significant headwinds. We are not surprised to see cash outflows, but at this point we would say that’s probably healthy for those investors remaining in the asset class. One of the criticisms has been there is too much
capital in the hedge fund space. We’re staying the course, but we are monitoring our managers very closely.

I think the sentiment is against event driven hedge funds, as there have been so many surprises and so many broken deals. But again, that may be an opportunity. We watch each fund closely to make sure they don’t run out of cash from investor outflows. But if there’s a general trend of capital out of the hedge fund space, that can actually remove some of the efficiency in the asset class.

There’s a bit of a contrarian view that can be taken with respect to the headlines we’re reading and this negative sentiment towards hedge fund managers in general and event driven managers specifically. These are very smart investors that have been very successful in a variety of different environments, just not in the most recent environment. The question is, do we expect this current challenging environment to continue and if so, for how long? And if we don’t expect it to continue indefinitely, then maybe we are more comfortable going against the negative sentiment.

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**Bryan:** When you look at what’s going on specifically with hedge funds, you see three broad dynamics happening. You certainly had an influx of managers and new people setting up shop, and this is eroding the talent base broadly. Not everyone can produce alpha. You have to really focus on the top tier groups.

Secondly, you’re seeing changing market conditions. There is a decreasing number of stocks, for example. A lot of participants point to this as a reason why some managers have been struggling finding sufficient differentiation to provide some alpha. There’s a growing number of stocks outside U.S., so that is helping to offset it. I also think lower interest rates is really showing its toll on managers that have historically used that as ballast in their portfolios in terms of returns in cash. Third, there is more structure, more complexity added into the market and that’s helping.
Private Equity

Dan: Our expectations for private equity are to achieve a return premium over public equities of several percentage points. We definitely think there’s an opportunity for additional value-add from this allocation. But because it’s illiquid, it requires robust cashflow modeling and vintage year diversification.

We’re excited about private equity, especially in the current environment. With active managers and public equities suffering as much as they have, we do think that there’s some credibility to the barbell approach where you buy cheap beta on the public equity side and then reach for alpha in this type of asset class.

Bryan: Private capital is really embracing structure and understanding that locking up your capital is a better way to invest long-term and capture that premium. I think this is most pronounced when you look at balances and unrealized values across private capital funds, where that’s continued to increase. There has been an enormous amount of capital raised and I see this as part of a shift in investor preferences. For many years, the speed and pace of the allocation of capital across capital markets has increased.

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I know a lot of investors look at the penetration rate of private capital raised relative to GDP, for example, and for the U.S. and developed markets, it’s generally pushing three percent. But when you look at what unrealized values are, that’s been on a steady climb for the last decade from what was roughly five percent of GDP and upwards, about 15 percent or more. This recognition and willingness to provide structure around your investments to capture that illiquidity premium and provide real active management is just a growing trend. Manager selection is really important.

Arno: Manager selection is going to be critical. So I think I’d make three points. The first is, what are the characteristics of private equity? I encourage everyone to spend more time looking at the academic research that’s been done. So a characteristic that we like a lot is the illiquidity of premium. It’s unfortunate that some people value liquidity such that the illiquidity premium is what it is, but if you can afford to harvest that premium, that’s great.
That said, there’s also academic evidence that private equity returns are essentially leveraged equity a lot of the time. Not all the time. And so you really need to understand whether if you are getting leveraged equity at high fees or if you could just leverage out the public equity portfolio with a passive manager.

The second point is, what are the exceptions? Where is the private equity manager is doing something particularly different with the assets? Be that strategic by bringing together a portfolio of companies that are going to be stronger together or operationally improving the efficiency, and consequently the returns of a company.

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Thirdly, is there a niche you can find? In Europe, more companies are private than public, and you have a very interesting theme in the market in the next 10 to 15 years, which is that many people who set up business 30-40 years ago are now hitting their late 50s, early 60s and some of them are handing the businesses to the children. But many are essentially going to be looking for some sort of exit to get out of their businesses. So there are some very interesting niches that people can find.

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Real Assets

Bryan: Investors are always looking for something different, something special they can get. I think sometimes that’s how real assets are thought about. Here is something special that’s going to diversify our portfolios and help us with returns and really solve our problems from an inflation hedging standpoint. I think it can help in a lot of ways, but again it’s not going to be the perfect solution.

I think you need to be very careful about what the total allocations are for real assets. In most environments you can get plenty of inflation hedge from traditional equities and other growth assets. So the necessity to have this as a really large portion, meaning 25 percent plus of your portfolio, I think is just a fallacy. We would still be proponents of broader diversification and certainly try and persuade clients to think carefully about concentration.

Arno: I think the place to start would be, what is the three-to-five year view and why on some of these asset classes. I preface that with, we look at the world from a very unconstrained basis, so it doesn’t matter if we have a zero allocation or a large one. But never to lose diversification. I’d say currently the portfolio I run actually has more than 50 percent in real assets, and that’s commodities and real estate – and a lot of real estate. We find it extremely attractive. And you get an inflation hedge thrown in, as has been pointed out.

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I think real estate is very interesting. And history tells us if you get surprising inflation, while equities do provide a hedge in the long run, there’s an adjustment period which is quite painful. Real estate is very interesting across Europe. There’s been huge recovery. There’s a lot less at attractive prices than there was six or seven years ago, so you have to dig a bit more. Currently my firm is looking at a number of opportunities where the expected return is in double digits, and that’s the kind of thing people want. Therefore, that’s the kind of thing that you need to find.

Dan: We would actually elevate real estate out of the real asset category. We have dedicated research committed to identifying best-in-class investment managers across a couple different real estate strategies. We do not use public REITs. We only focus on private real estate. Public REITs are part of public equities and have too high of a correlation there and have been driven by a search for yield lately.
Within private real estate, we are currently, with very few exceptions, avoiding core real estate and focusing on value added and opportunistic strategies. We’re treating value added real estate as a fixer-upper where you’re getting part of your return from income, but part from capital appreciation based on some value add the manager is applying.

Opportunistic real estate is an extension of value add in some cases, but includes development and some single strategy or geographically focused types of investments. These strategies tend to produce a quicker return of capital, with an average hold period of 3-5 years, plus you get a little bit of cash flow in between. By following that vintage year diversification we were talking about earlier, we would group real estate in the barbell category along with private equity as a way to pursue some value add, some alpha, with the benefit of a diversified inflation hedge.

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**Fees**

**Dan:** While we are seeing a downward trend on fees, we don’t have a great deal of leverage when we are contemplating approval of a manager and subsequent recommendation of them to our clients, because they tend to be top quartile managers. Many best in class firms have a line at the door in terms of investors willing to commit. That said, we have seen some managers coming back to market with lower fees or more investor friendly fee structures. And we do have some situations where we’ve been able to negotiate lower fees. But again, there’s that selection bias. The best in class managers are the ones that need to cut fees the least.

**Bryan:** Overall, you get what you pay for. The premium managers are not having to really adjust fees. I think even for those that do, maybe they adjust top level numbers as there are other nuances to the structure and to the terms that you can pay attention to as are they becoming more GP or LP friendly, as it were. Adjusting hurdle rates, is it a hard hurdle or a soft hurdle? The crystallization frequency of fees, all these other nuances to the terms really need to be evaluated.

**“Overall, you get what you pay for. The premium managers are not having to really adjust fees.”**

**Arno:** There is a trend for fees and it’s down. I would encourage investors absolutely to dig deeper and push harder than they have for many years about the value they’re getting and understanding the fees both from a cost plus perspective and a value added perspective. But it’s absolutely right that if a manager continues to justify high fees, then eventually you get the point I’ve been making throughout, which is that finding things that will actually make money is going to be quite hard. And if you find a manager that can consistently do that, then maybe they deserve high fees.

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**About eVestment**

eVestment provides a flexible suite of easy-to-use, cloud-based solutions to help the institutional investing community identify and capitalize on global investment trends, better select and monitor investment managers and more successfully enable asset managers to market their funds worldwide. With the largest, most comprehensive global database of traditional and alternative strategies, delivered through leading-edge technology and backed by fantastic client service, eVestment helps its clients be more strategic, efficient and informed.

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