INVESTMENT INSIGHTS

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Alternatives can provide diversification and downside protection if done right

Alternative investments can play an important role if approached in the right manner. Today, with interest rates rising and volatility returning to stock prices as valuations seem somewhat stretched, some alternative strategies can provide investors with sources of return that are not correlated with traditional asset classes and that offer downside protection. But carving out an allocation to alternatives requires deep understanding and thorough due diligence. Biagio Manieri, managing director at PFM, discusses why alternatives make sense and how investors should think about understanding them.

|Pensions & Investments| ***Why should institutional asset owners be thinking about alternatives when traditional asset classes, particularly stocks, have been performing so well?***

|Biagio Manieri| The advantages of incorporating alternatives into a portfolio of traditional strategies is that it broadens the universe of potential strategies and managers from which to select. Expanding the universe of possible investments should lead to better returns over time. Going forward, publicly traded fixed-income returns will be challenged as rates rise and credit spreads possibly widen. Alternative fixed-income strategies such as distressed credit, fixed-income arbitrage and other similar strategies may help returns. If certain segments of the equity market continue to propel higher and valuations become more stretched, strategies such as long/short equity, event-driven, activist strategies, etc., can add to returns and/or help reduce risk and volatility.

|P&I| ***What portfolio/strategy goals can an alternatives allocation help meet?***

|Manieri| Alternatives can improve the overall efficiency of the portfolio in various ways. One, alternative strategies that have low correlation with other investments in the portfolio help to reduce the overall risk of the portfolio. An example would be event-driven strategies that do not correlate highly with traditional long-only strategies. Another way that alternatives can lead to a more efficient portfolio is by enhancing the return of the portfolio or delivering a return stream that cannot be accessed via traditional strategies.

|P&I| ***Within the alternatives bucket, can you discuss the differences — pros and cons — of the various types (e.g., public, private)?***

|Manieri| We don't think "buckets" is the best way to think about it. We think of alternatives in a comprehensive way rather than as a carve-out with investors saying, "I will have X% in alternatives." Questions that investors should always ask themselves include: What are my goals?, What's my risk profile? and What are my liquidity needs? Then they should assess the current economic and market environment, and based on that analysis, construct a portfolio of strategies that are expected to meet those goals in the most efficient way possible. When it comes to alternatives, we do not blindly follow the endowment model, which assumes that alternatives are inherently better than traditional strategies at all times and in all environments. We believe — and a body of research has shown — that asset allocation is the most important driver of investment returns. In our opinion, the important decisions with respect to alternatives are which strategy to include, based on economic and market conditions, and how much to allocate to those strategies.

|P&I| ***Where, typically, do investors fund an allocation to alternatives?***

|Manieri| The funding source depends on the alternative strategy being employed. If it's a fixed-income-oriented strategy, then it should be funded from the fixed-income portfolio; if it's equity-oriented, then it should be funded from the equity portfolio. In some cases, such as real estate, funding should come from a combination of traditional equity and fixed income. This is why it is important to understand the strategy and how it fits in the portfolio, rather than simply saying, "I want X% in hedge funds," for example. When we consider alternatives for our clients' portfolios, we analyze the fundamental drivers of the strategy and its risk-return profile in order to understand its role in the portfolio and where we should source money to allocate to it.

|P&I| ***What are the biggest hurdles that institutional asset owners face when implementing an alternative strategy or allocation?***

|Manieri| The biggest hurdle for most investors is access to top-performing funds. This is important because the dispersion of returns is very large in the alternatives space versus traditional funds. Based on the various databases that we use, we found that the difference in returns between top-quartile and third-quartile core and core-plus fixed-income funds is about 150 basis points; for U.S. equity funds it is about 450 basis points. In the case of private equity funds, for example, the difference is significantly larger; therefore, it is critically important to be able to access and select the right PE fund.

Another issue faced by investors is that there has been a significant increase in the number of firms and assets under management, which we believe will result in lower performance for alternative strategies going forward.

There is also the issue of how best to model alternative strategies for analytical and portfolio construction purposes. Given the illiquidity, fat tails and auto-correlation of alternatives, the use of models, such as mean-variance optimizers, for portfolio construction becomes problematic. Since we cannot simply rely on quant models, we need to understand the underlying fundamentals of each strategy to decide when to include the strategy and how much to allocate to it.

|P&I| ***What about liquidity and fees?***

|Manieri| Fees are always important, and for us the metric that is important is net-of-fee performance: High fees make it much more difficult for any strategy to outperform. In addition, the calculation of carry needs to be well understood by investors. It is important to identify managers that align their incentive fees with the best interests of investors.

Liquidity or illiquidity is also important. While some investors believe in an "illiquidity premium," they typically do not include an "illiquidity cost" in their analysis. While it is debatable whether an "illiquidity premium" actually exists, the drawbacks of illiquidity are easier to show and should be taken into consideration when constructing portfolios.

|P&I| ***How should investors think about performance and performance measurement?***

|Manieri| Some alternative strategies — such as private equity, private real estate, etc. — use internal rate of return, and therefore it's difficult to compare the performance of funds that use IRR with traditional funds that do not. We also know that IRR has a number of flaws and can be easily manipulated. It's possible that a fund with a higher IRR has a lower total return to the investors than a fund with a lower IRR. Investors need to understand how managers calculate IRR in order to understand the performance of the funds they are considering so as to be able to accurately compare them. ■

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