# alternative investments 101

## The Evolution of Portfolio Management

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Prior to the mid 1970's, most professionally managed portfolios consisted of blue chip US stocks, bonds, and US Treasury Bills. While smaller capitalization stocks were held in some portfolios, they were considered speculative and the percentage weighting was typically quite small. Beginning in the latter part of that decade, a few of the large endowment funds in the US made initial forays into Non-US stocks, real estate, and private equity which were followed in the 1980's and thereafter by allocations to hedge funds, distressed securities, real assets such as timber and energy investments, and many other categories. Today, the average endowment in the US is invested as follows:

| | % OF PORTFOLIO |
|---|---|
| US Equities | 13% |
| International Equities | 17% |
| Fixed Income | 5% |
| Alternative Investments | 58% |
| **TOTAL** | **100%** |

*SOURCE: NACUBO / COMMONFUND ENDOWMENT STUDY*

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And, many foundations, pension funds, and high net worth individuals have followed suit by meaningfully shifting the emphasis in their portfolios away from the traditional asset classes. So, what are Alternative Investments, why have so many investors allocated capital to them, are there difficulties investing in them, and what should we expect from them going forward?

## alternative investments defined.

Unfortunately, there isn't a universally accepted description of Alternatives which has resulted in the default definition that this category consists of all investment classes with the exception of stocks, bonds, and cash. This is not a very satisfactory construct because it includes both liquid and illiquid investments, strategies that use leverage and others that do not, strategies that are offered in the partnership format and others that are delivered via separate accounts or mutual funds, and so on. In other words, "Alternatives" represents an amazingly broad universe of investment strategies with widely varying characteristics including considerable divergence in risk and return. So, while we will discuss the generic pros and cons of Alternatives, it is critical to evaluate each specific strategy on its own merits. The three most commonly held broad categories are: private equity, real estate, and hedge funds, although each of these consists of a large number of sub-categories and many underlying strategies.

Private equity consists of two broad sub-categories. Venture Capitalists invest in relatively young companies with the expectation that they will grow rapidly allowing either a sale or public offering at a very attractive multiple of cost. Buyouts represent the purchase of more mature companies, frequently employing leverage, with the expectation of material operational and financial improvements and a successful exit. As will be discussed in more detail in the next section, the rationale for including them in a portfolio is primarily return enhancement.

While real estate is superficially relatively straightforward, it is important to realize that there are many sub-strategies including sector or geographically focused funds, core property funds, "valued added" funds, distressed property funds, and so on. Real estate should provide attractive returns, diversification, and potentially, an inflation hedge.

Finally, the Hedge Fund category is actually a catch-all that includes many, many actual strategies. In most cases, hedge funds both buy and sell securities short which limits their sensitivity to broad market movements and instead focuses on the skill of the manager in exploiting discrepancies between the valuations of similar or related securities. This category is typically included in a portfolio in order to reduce volatility.

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## why invest in alternatives?

### Return.

The first reason to consider an investment in the Alternatives space is that many strategies have historically delivered higher returns than the traditional asset classes, and it is reasonable to expect them to continue to do so. The following table provides return data on several broad categories over the past twenty years:

| | ANNUALIZED RETURN | |
|---|---|---|
| Private Equity | 15.5% | Cambridge Associates Private Equity Index |
| Hedge Funds | 9.5% | NCREIF Index |
| Private Real Estate | 9.3% | HFRI Index |
| "Traditional" Portfolio* | 7.8% | |

*50% US STOCKS/10% INT'L. STOCKS/35% BONDS/5% CASH

As you will note, replacing a portion of the traditional asset classes with any or all of the three broad alternative categories would have materially enhanced return over this time frame. It is important to note that the indices in each category represent the average return of a large number of managers. There is significant dispersion across each manager universe which suggests that good manager selection provided the opportunity for returns considerably in excess of those depicted here.

Why should an investor expect these categories to deliver higher returns than the traditional asset classes? As a backdrop, it is important to remember that many of these strategies require a lock-up of capital from one to as many as ten or more years. Therefore, any reasonable investor should demand what is known as an illiquidity premium in return for losing ready access to her funds. But, in addition to the illiquidity premium, there are several specific reasons as to why these strategies should deliver excess return. First, some of them are relatively complex or simply not accessible to most investors which creates the opportunity to earn outsized returns for those with access and the necessary skills. Second, some strategies, such as leverage buyouts, real estate, and some hedge fund strategies, use leverage which magnifies returns on the upside although it has the same impact on the downside. Third, managers in some of these categories are able to gain what is known as an information advantage. In the public markets (i.e. stock exchanges), all

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investors basically have the same information due to insider trading laws and other regulations. In contrast, a leverage buyout manager considering the purchase of a private company typically gets access to all of its financial records as part of the due-diligence process. This should result in better decisions and a more accurate sense of valuation. Most important, managers in many of these categories can materially impact the returns they earn. It is worth remembering that most stock and bond investors have little influence on the companies in which they own securities, and if dissatisfied, their only option is to sell. In other words, they are passive owners. In contrast, because it controls a property, a real estate manager can implement a number of operational and financial strategies such as changing management, making cosmetic improvements to the building, upgrading the tenant roll, developing outparcels, and refinancing any outstanding debt. Each of these should enhance returns if executed successfully. And the same principle holds true for many other alternative categories including private equity, activist hedge funds, and so on.

## volatility and correlation.

One of the core principles of modern finance is that it is desirable to get from Point A to Point B with as little volatility as possible. In other words, we strive to structure a portfolio for each client that meets the target rate of return with the lowest possible level of volatility or fluctuation as measured by a statistical term known as the standard deviation of return. The volatility of a portfolio is a function of the standard deviation of each of its components as well as the extent to which they move together. Therefore, in order to decrease the volatility of a portfolio, one must include individual asset classes with lower volatility and/or those that do not move in sync with one another.

As it turns out, many of the alternative categories have lower volatility than stocks, and they tend to have low or even negative correlation with the traditional asset classes. The following table depicts the volatility of selected asset classes over the past twenty years:

| | STANDARD DEVIATION |
|---|---|
| US Equities | 17.0% |
| International Equities | 18.9% |
| Real Estate | 4.6% |
| Private Equity | 16.0% |
| Hedge Funds | 8.0% |

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As you will note, all of the Alternative categories are less volatile than stocks, and real estate and hedge funds are particularly stable.

The extent to which investments move in tandem is measured by a statistic known as the correlation coefficient which ranges between -1 and +1. A coefficient of -1 means that two investments move in exactly the opposite direction whereas +1 indicates they move in tandem. So, the goal in portfolio construction is to include investments that have low or even negative correlation with the other asset classes held. The following table depicts a few of the correlations between alternative and traditional asset classes over the past twenty years:

| | CORRELATION |
|---|---|
| US Stocks vs. Private Equity | 0.75 |
| US Stocks vs. Hedge Funds | 0.68 |
| US Stocks vs. Real Estate | 0.20 |
| US Bonds vs. Private Equity | -0.29 |
| US Bonds vs. Hedge Funds | -0.16 |
| US Bonds vs. Real Estate | -0.09 |

As you will note, addition of any of the alternative categories to a traditional portfolio provides a diversification benefit because their correlations are less than 1, but Real Estate and Private Equity are particularly effective diversifiers versus stocks and bonds, respectively.

Later in this paper, we will look at the behavior of a traditional portfolio versus one that includes material allocations to Alternatives. But, to tie together the discussion of volatility and correlation, one has historically been able to create a portfolio including alternative assets that had the same return as a traditional stock/bond mix with something like 25% less volatility.

In summary, inclusion of alternative investment strategies in a portfolio should either enhance return or lower volatility, and it may well accomplish both objectives. Of course, this sounds "too good to be true" so it is appropriate to discuss the risks and difficulties of investing in them.

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## Issues with Alternatives.

The most significant issue with respect to some alternatives has already been mentioned; illiquidity. Real estate and private equity funds typically have lives of six to eight and ten to twelve years, respectively. Once an investor has committed to one of these vehicles, it is very difficult and potentially quite expensive to exit. Similarly, many hedge funds entail a one year lock up and also require notice of three to six months to redeem. However, for those for whom hedge funds are not appropriate, we frequently recommend very specialized mutual funds that offer daily liquidity and have risk and return characteristics that are designed to achieve the same goals as hedge funds.

Second, there are a number of operational issues that make investing in alternatives more difficult than the plain vanilla traditional categories. First, many of the top funds are simply not accessible to investors that do not have established relationships. Second, with respect to tax reporting, many of these strategies involve a K-1, and some alternative managers are unable to deliver them until after April 15th which requires the investor to file for a tax extension. Some alternative classes entail periodic cash calls and distributions which require each investor to have an active cash management program.

Third, alternative strategies are often complex and opaque, and some entail specific risks such as the use of leverage or derivatives. For example, many hedge funds are unwilling to provide their investors with a list of portfolio holdings. In the case of private equity and real estate, while there are regulatory guidelines, periodic valuations are influenced by the manager's judgment so an investor really can't assess the return on a fund until the end of its life. Finally, investors have very little say regarding the management of a fund including the opportunity to impose guidelines or restrictions on the manager. In other words, many alternative categories are very much of a "trust me" investment.

Finally, manager fees are quite high. They generally include an annual base fee of 1-2% of committed capital plus a share in the profits of the fund. The manager's profit participation varies by strategy and manager, but is on the order of 20% of profits after achieving a minimum rate of return that is known as the hurdle. It is important to note that the return data shown herein are net of all manager fees.

These drawbacks are certainly significant and need to be assessed in the case of each alternative strategy. But, in the next section, we hope to demonstrate that including them in a portfolio is very worthwhile for many investors.

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## Important Notes And Disclosures

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## Portfolio Comparison.

In the investment world, a mix of 60% stocks and 40% bonds is often described as the classic ''balanced'' portfolio, so let's compare it with one that includes a healthy dose of alternatives. For the purposes of this illustration, we will once again use return and volatility data over the past twenty years.

## Portfolio Weightings.

| | TRADITIONAL PORTFOLIO | DIVERSIFIED PORTFOLIO |
|---|---|---|
| US Stocks | 50% | 20% |
| Non-US Stocks | 10% | 10% |
| Bonds | 40% | 25% |
| Real Estate | 0% | 10% |
| Private Equity | 0% | 15% |
| Hedge Funds | 0% | 20% |
| **TOTAL** | **100%** | **100%** |
| Compound Annual Return | 7.9% | 9.2% |
| Standard Deviation | 9.86% | 7.79% |
| Growth of $100 | $498.87 | $622.38 |
| Worst Calendar Year Decline | 11.1% | 10.3% |

As you will note, the diversified portfolio experienced incremental annual return of 1.3% while also experiencing 21% less volatility. (7.79% vs. 9.86%) In other words, you earned more return with less risk! Now, that is what most people would call a great deal!! These numbers are probably somewhat abstract so we have also included the actual growth in a portfolio that was initially valued at $100, and you will note that the diversified portfolio enjoyed cumulative growth that exceeded the traditional portfolio by approximately 25%.

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## looking ahead.

All of the historical data that we have provided make a compelling case for Alternatives which raises the question of whether we should expect similar future behavior. There are those who argue that Alternative returns will not be as robust because non-traditional asset classes have been discovered by many investors. We certainly acknowledge that the Alternative space has become much more crowded, and that there are a large number of managers in each of the major categories. But, for the reasons mentioned above, we believe that these strategies should deliver superior returns as compared to the traditional asset classes, and their inclusion in a portfolio should enhance diversification. Our crystal ball is always fuzzy, so it may well be that absolute returns are lower than history would suggest. But, in a world that is likely to be characterized by modest returns on many asset classes, we believe that even moderate incremental returns derived from alternatives will meaningfully impact overall portfolio returns. And, as discussed, there is considerable dispersion across the manager universe which provides an opportunity to further enhance returns through good manager selection. So, while investing in Alternative asset classes is certainly not without complication, we believe they absolutely deserve an allocation in the portfolios of investors with longer time horizons and the ability to give up some portfolio liquidity.

However, in order to successfully invest in Alternative asset classes, one must have access to top managers and specialized expertise. In particular, it is important to maintain a diversified portfolio which requires a deep understanding of each strategy, and the ability to combine strategies in the optimal proportion. So, while it is certainly self-serving, we strongly recommend that experienced professionals with the requisite expertise, experience, and relationships be employed to manage this portion of a portfolio. ■