A TRUSTEE'S GUIDE TO ALTERNATIVE INVESTMENTS, PART II

For many years during the 1990s it was conventional wisdom for plan sponsors, big and small, to follow a certain pattern for investing. Generally, trustees took a traditional approach whereby 60% of investments went into stocks and 40% went into bonds. But the times are changing for pension plans and they are increasingly looking to separate skilled managers from the beta herd as they look to maximize their investment portfolios and decrease liability. This guide to alternative investments is the second in a series of guides to help trustees better understand the world of investments available to them.

The wheat from the chaff

Separating the skilled managers from the beta herd is increasingly on the minds of plan sponsors as they look to maximize their investment portfolios.

By Scott Blythe

Between the Caisse de dépôt et placement du Québec's recent purchase of a share in a Midwest pipeline, the Ontario Municipal Employee Retirement System's (OMERS) sale of part of its real estate portfolio to the Canada Pension Plan Investment Board, and the Ontario Teachers' Pension Plan's high-profile investment in hedge funds, alternative investments are very much in the news.

Over the past few years, many of the largest pension funds have explicitly turned to alternative strategies and away from the 60% stock and 40% bond portfolio that constituted the model portfolio for the 1990s.

Indeed, research from a variety of consultants confirms that it is pension plans, rather than the traditional endowments or high-net-worth individuals, that are pushing hedge fund investments to record levels, and contributing to a revival in private equity, especially in leveraged buyout firms. While pension funds have, back to the 1980s, had involvements in real estate, over the past decade it has become a tidal wave. In the interim, infrastructure investments in pipelines and toll roads, as well as commitments to timberlands, are in fact blazing new trails in the world of inflation-protected instruments.

So far, the trail points ahead with promise. Alternative investments contributed significantly to the bottom line in 2004 for some plans, with the Caisse's real estate portfolio up 22% and its private equity holdings up 20%. OMERS' infrastructure portfolio earned 31% in 2004. At Teachers', the hedge fund or absolute return portfolio contributed one-quarter of the portfolio's $3 billion excess return and real estate accounted for one-third.

Pension plans have little choice but to seek alternative sources of return, while leveraging off their relatively long liquidity horizon—that is to say, taking advantage of investments that may take a few years to mature. The key to that, says Ron Mock, vice-president of alternative strategies at Teachers' in Toronto, is to seek out relatively uncorrelated managers who have high evidence of skill, which gives some indication of whether a manager can consistently produce an uncorrelated income stream.

No one really expects the major developed markets to generate the double-digit returns they did in the late 1990s. At best, there will be a modest risk premium over bonds, of anywhere from 0% to, at the outside, 3%,—a far cry from the historical 4.7% premium. At the same time, long-dated bonds carry 4% yields—and some mavens think they may go lower, thanks to a world awash in liquidity that has nowhere to go but bonds and real estate. (While many analysts ponder whether there is a real estate bubble, others think the same label actually applies to the bond market).

In any case, a 60/40 portfolio, split among stocks and bonds, might generate enough to match the increase in liabilities, but probably will not wipe out the underfunding many plans face. Teachers' averaged an 11.4% return over the past decade, and 14.7% last year. The benchmark returned 10.6%. However, liabilities grew 17.9%.

According to Canada's largest institutional manager, Quebec's Caisse de depot et placements, or more familiarly, CDP Capital, "the expectation of lower returns on liquid markets and more intense competition for new sources of value will make it increasingly difficult to obtain returns that meet depositors' long-term needs. Faced with the same problems as other institutional fund managers, the Caisse will have no choice but to assume greater relative and absolute risk in seeking returns similar to those it obtained in the past, in an environment where absolute risk is especially high."

Along the way, the Caisse mentions a crowding into hedge fund strategies, and fears real estate has topped out. That, however, doesn't halt the search for alpha. It just makes it more difficult.

WHAT IS ALPHA?

Alpha can be a complex technical term —a way to quantify whether a traditional manager adds value, against a benchmark such as the S&P/TSX Composite Index. As was reviewed in the November 2004 Trustees Guide to Alternative Investments in BENEFITS CANADA, there are various definitions—whether it's an information ratio, or a Sharpe ratio, or simply an excess return over a benchmark.

Alpha is often identified with an absolute return over cash—as opposed to matching or beating a benchmark. "The pursuit is actually deadly—it's very much a flawed theory," says Tom Gunn, former chief investment officer at OMERS and now president of the University of British Columbia Investment Management Trust in Vancouver. "Whether or not one is achieving a benchmark or under-

achieving it, it is all about relative returns. You don't pay pensions with relative dollars. You pay them with absolute dollars. There is a move in the whole investment business towards absolute rate of return targets rather than variable rate of return targets."

Still, the increasing availability of indexes for hedge funds is leading some pension plans to use them as their benchmark. Other plans set explicit cash targets as represented by T-bills, the London Interbank Offered Rate (LIBOR) or CPI (Consumer Price Index) plus 3% to 5%. In private equity, the benchmark is often initially set in accordance with funding requirements, rather than an index.

William Fung, a professor at the London Business School and co-founder of PI Asset Management in London, England, frames the alpha question in a different way: "Alpha is what you are willing to pay 2 and 20 for (2% in management fees and 20% in performance fees). It's that part of the return you can't replicate cheaply. Alpha is where do it yourself ends. If you can't do it yourself, you pay for it."

Mock concurs. As one of the largest money managers in Canada, Teachers' can easily get beta—passive returns earned from stocks and bonds—by purchasing futures contracts based on the main stock exchanges, or by entering into total return swaps. Since futures contracts require small margins or swaps, that leaves a healthy sum, say 10%, that can be invested elsewhere.

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But that only works if hedge funds are uncorrelated with the market; otherwise, a plan sponsor is simply buying expensive beta. Mock concedes, "that hedge fund returns are loaded with beta; you have to really look hard in the business to find the alpha."

There is a growing academic interest in hedge fund betas, or even investable instruments that could replicate hedge fund returns. Fung has conducted one of those studies, using factor analysis with the main factors: large-cap versus small-cap performance, credit spreads and market trends that can help to plot hedge fund returns, even though managers may not be directly making these investments. The factors seem to account for about 90% of hedge performance. But he says, "You still need to pay for that extra bit of skill. The big question is: What is the right balance? Am I paying too much?"

Finding alpha is difficult work. Different skills are needed for different alternative strategies, says Gunn. "In real estate, it has to do with people's demonstrated ability to make transactions in the past. It's the same thing, ideally, in the private equity space," he says.

"Unlike public investing, the record of the manager is usually repeatable. That's because what you're investing in is a management skill rather than just a securities selection skill." The corporate skill, he says, "is buying an asset and figuring out how actually to improve the underlying value of that asset."

By contrast, hedge fund managers, most of whom were trained on the proprietary trading desks of the banks, seek out short-term mispricings, in very narrowly-defined strategies. The skill was really in the execution. "Hedge fund managers should have a recognizable skill and should have a definable skill and be able to explain it," Gunn says. "If they can't explain it, then chances are you may just be investing in luck and that's where you get the confusion between someone who is just hot at picking markets or if you've got someone who actually knows how to make money."

The distinction is important. Researchers have identified market cycles in particular strategies. Some managers simply earn the beta for that strategy—they are paid for showing up for work. Others exhibit skill.

"This gets into the argument of how much capacity there is in the market," says Gunn. There are some very obvious strategies that people can follow and they have been there for a couple of centuries in capital markets. They only have so much capacity and eventually the more players there are, the value that can otherwise be found from market inefficiencies gets arbitraged out."

Capacity has another side to it. If strategies falter because too much money is chasing too few opportunities, hedge fund firms starve. "A lot of hedge funds come in with 1.5% management fees," according to Jim McGovern, chairman of the Canadian chapter of the Alternative Investment Management Association in Toronto. "So take $750,000 on a $50 million pool, let's say you need yourself, probably another portfolio manager, another trader, somebody in the back office—so you're talking four people, four salaries to pay, plus overheads, and nobody's making a good living on that, relative to what you could be offered in the long-only world. Then it's a really an issue of what you can make that $50 million pool do. Can you consistently make it go up 10% to 12%, then you're looking at $5 million in gains, times 20%, that's a million dollars. That starts to look attractive."

Still, he says, most managers aim to reach at least $100 million in assets. That allows for a bigger organization and creates the potential for institutional investments. No institutional investor wants to be a quarter or a third of a single manager's capital. However, many funds never reach that $50 million level, and so may go out of business simply because they're unprofitable for the manager.

In addition, even for successful funds, according to Fung's estimates, alpha, defined as returns in excess of LIBOR—has been compressed to 29 basis points a month now from 63 basis points a month to 1998. Some observers suggest this means too much money is piling into the hedge fund market. Others, like Fung, point out that different hedge fund strategies fall into and out of favour, according to the business cycle. For instance, convertible arbitrage—where managers buy convertible debt and short the stock that the debt will convert into—was in the doldrums even before the major ratings agencies downgraded the debt of two of the major issuers, Ford and GM, to junk status this past spring.

Interestingly, investors seem to know who has alpha and who hasn't. In another study, Fung tracked the performance of funds of funds. Only 15% demonstrated alpha, but at the end of the study, 90% were still in existence. Of the funds that didn't demonstrate alpha, half were closed. What's more, investors keep adding to money flowing into the funds with alpha. Asset growth was flat for funds without alpha. "Investors are anything but ignorant," Fung concludes.

That is confirmed by a July 2005 KPMG survey, "Hedge Funds: A Catalyst Reshaping Global Investment." Institutional investors expect hedge funds to grow —but they don't expect the same returns as the past. But there's a paradox here. Most fund managers are not operating at full capacity: "much of the reported surplus capacity is not capable of generating risk-return characteristics in line with client expectations," the survey finds. Instead, the most successful funds will probably close to new investors; they are at capacity, and KPMG estimates them to be 15% of the universe. Investors will be looking at aspiring managers who do have capacity. But if they don't have alpha, they probably won't last.

For Part I of the Trustee's Guide to Alternative Investments (see BENEFITS CANADA November 2004 issue) go to the alternative investments key juncture in The Resource Centre on www.benefitscanada.com.

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BENEFITS CANADA

Beyond 60/40

There's something to be learned from pension funds that have diversified beyond the traditional asset mix.

By Scott Blythe

When stock markets began topping out in 1999, the Nova Scotia Association of Health Organizations Pension Plan (NSAHO) in Bedford, NS made a call. It sought to reduce the total risk profile of its asset mix by adding two asset classes: high-yield bonds and commodities.

Since then, aware that beta, or market exposure, won't be enough to satisfy future pension liabilities, the plan has further diversified into hedge funds, says Rick McAloney, president of Keel Capital Management in Halifax, which runs NSAHO's portfolio. "Why do people look at them?" he asks. "There is a feeling among many that using just a traditional tool set may not be sufficient to meet the return requirements of pension plans on a go-forward basis."

While some plans are relative newcomers to alternative investments, others have a longer history like The Ontario Municipal Employees Retirement System (OMERS). "When I joined the firm, OMERS had a fair representation in real estate at the time," says Tom Gunn, former chief investment officer at OMERS, and currently president of the University of British Columbia's Investment Management Trust. "While real estate was classified as an alternative at the time, actually it is an almost perfect pension asset. Through time, what we did was build both the real estate and the private equity program, the hedge fund program and then the infrastructure program."

The board should also understand the risks and rewards of all the asset classes the pension fund invests in and be educated sufficiently about these investments.

Along the way, both plans, NSAHO and OMERS have met with success. NSAHO returned 3.12% over its benchmarks. On the other hand, notes Gunn, infrastructure, real estate and private equity programs have helped OMERS to meet the pension promise at times when the public markets simply weren't going to be there. "I think we'll do very well in the future. A pretty solid foundation was made," he says.

FROM LIABILITIES TO ASSET MIX

Typically, boards may worry about the risks of getting into alternatives. Among them are "headline" risk the media reports if a single investment goes awry, or the risk of not keeping up with peers, or the risk of lagging a benchmark. Yet, there is an even greater risk, notes McAloney. He suggests people might confuse familiarity with risk. He says that most people are familiar with the traditional asset mix structure of approximately 60% equities and 40% bonds and might assume that that's a non-risky asset mix. "But if you evaluate that in its proper context," McAloney notes, "there are certain risks inherent in that asset mix."

For that reason, it's important to approach the alternative investment decision in a way that matches the fund's liability structure. "We always did in the strategic sense," says Gunn. He also notes that the desire to diversify into alternatives is a good idea from an asset mix standpoint. The board should always be involved in the asset mix decisions, adds Gunn, because that's the primary decision that affects asset returns. The board should also understand the risks and rewards of all the asset classes the pension fund invests in and be educated sufficiently about these investments.

Alternative investments require work, adds McAloney. "Of course, deciding to look at [alternatives] doesn't necessarily mean that you should invest in it. You should invest the time and resources to evaluate it and still keep an open mind. It can be very resource-intensive." The intensive nature of alternative investments will vary depending on how much is done in-house and how much is delegated to a third-party manager, he adds.

At the Ontario Teachers' Pension Plan for example, it's estimated that due diligence on a single manager costs from $75,000 to $100,000. Some plans, like OMERS can handle that internally. "Unfortunately, when markets are frothy, it's tempting for people to think they can invest without building the necessary infrastructure," says Gunn. "That almost inevitably comes home to

haunt them when times become rough."

Building the infrastructure is no mean feat: it's not just a matter of looking at how returns were generated, though that is certainly a consideration. It also involves assessing the manager, looking at the business model, and setting out risk controls.

Gunn says that one of the hardest questions that gets asked on due diligence on any manager is just to look at their back office and at their system skills. The purpose is to see if they have invested in their accounting controls and proper due diligence of banking controls. "If it's not there, or we can't find it, or people are reluctant to show it to us, we will go and deal elsewhere," he stresses.

NSAHO also built its due diligence and management systems from the ground up. In fact, Keel Capital manages the entire portfolio. "It does the whole balance sheet. That's key because the absolute return portfolio was custom built to be a good complement to the rest of the balance sheet for this typical pension plan—it was typical before we expanded into alternatives," says McAloney.

Boards can also turn to consultants for due diligence who, in turn, instead of selecting a direct investment, may choose from a proven list of funds-of-funds, Gunn says. That "outsources" some of the diligence, but as many in the alternative space note, if you don't have alpha, you have to pay someone else for it. That doesn't, of course, mean buying something a trustee doesn't understand. And ultimately, the board has the decision over broad asset mix, leaving the implementation to the investment staff.

"I've always taken the attitude that it was my responsibility to present a compelling case for the board to consider and then vote upon," says McAloney. "If there was any delay, I always made the assumption that it was my fault and I needed to explain it better. But first, revisit my facts to make sure that they hadn't run up something that I'd overlooked."

And, McAloney adds, context is everything: "You have to frame the analysis and the information in the proper context, as opposed to starting with the assumption that 60/40 is not risky and anything with alternative investments is more risky. That's not so." **BC**

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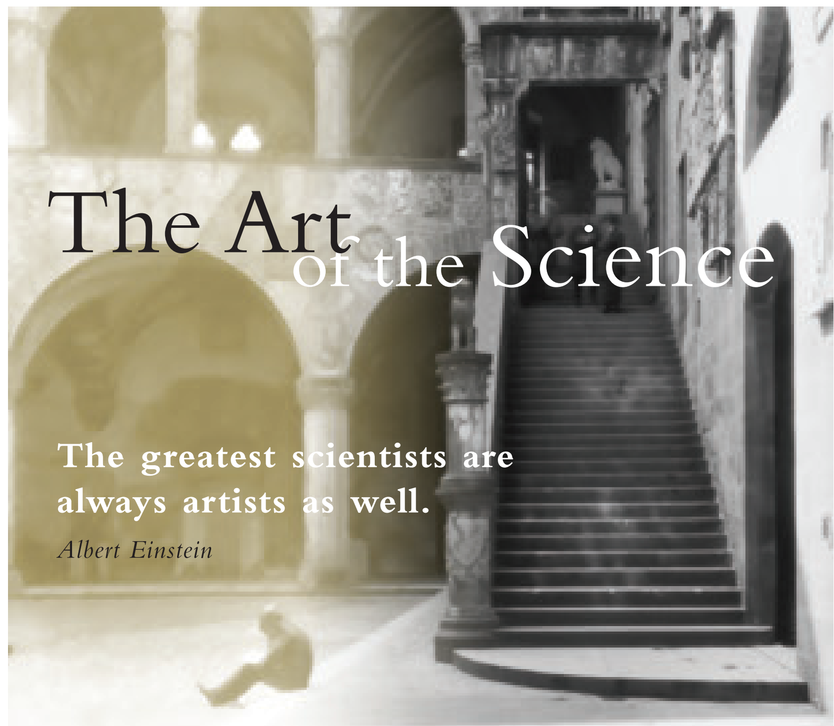

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