

ALTERNATIVES: what CIOs really think

Alternative investments, the darling of the super fund landscape for the past several years, have recently come under fire for everything from lack of liquidity to questions over their correlation to 'traditionals'. Notwithstanding their track record of strong lowly correlated returns, befitting the new style of asset allocation involving alpha/beta separation, questions are being raised about what happens in a crisis, such as a run on a fund. MICHAEL BAILEY, GREG BRIGHT and SIMON MUMME asked a cross-section of asset allocators for their definition of 'alternatives', and their thoughts on how much a super fund should ideally have.



What are alternative assets and how many of them should a super fund have in its portfolio?

It's an argument complicated by the fact that many asset allocators disagree with the need to define 'alternatives' at all.

"Alternatives is a stupid term," one head of investments for an insurance fund says.

"We have a variety of different assets and we look at the fund as a whole. Australian funds have too many buckets."

The chief investment officer of NSW State Super, Martin Drew, is more diplomatic but gives himself plenty of latitude with his approach to the 'a'-word: "Alternatives is a broad term with no strict definition. I view alternatives as anything that isn't equities, bonds, property or cash. So that leaves infrastructure, private equity, hedge funds, et cetera."

The founder of Sovereign Investment Research, Ray King, says that regardless of the semantics, viewing 'alternatives' as an asset class in itself – no matter how broadly defined – can harm returns.

"A common market practice is to broadly group alternative investments," he says.

"Sovereign's view is this diminishes the scope to exploit investments with very distinct properties – we believe asset allocation analysis of these investments must be relatively disaggregated and study specific characteristics."

That's not a view completely shared by an asset consultancy which has become synonymous with 'alternative' investments by Australian super funds, Access Capital Advisers.

While Access certainly assess each sub-asset class on its individual merits – how else could it not recommend any hedge funds to clients – director David Chessell finds it helpful to step back and view the investment landscape in black-and-white, or in his case traditional and alternative.

"When we run strategic asset allocation modelling, we run it in terms of the main listed asset classes, what we call the market portfolio, and for alternatives as a single asset which we call the target return portfolio," he says.

"We have to make the same assumptions about expected return, standard deviations and correlation as we do for listed asset classes. Why we



David Chessell ...
better handle on assumptions if alternatives viewed as a group

lump unlisted assets together is because we think we have a better handle on assumptions than if we looked at them separately."

A new survey of super funds by UNSW Associate Professor John Evans would appear to prove Ray King's assertion that a broad grouping of alternatives is common market practice in Australia.

Sponsored by Swiss private equity fund-of-funds Adevq, the survey was particularly interested in how the \$250 billions' worth of respondents categorised their private equity allocation.

Just 40 per cent put private equity in its own bucket – for 24 per cent it was lumped in with 'non-traditional' assets, 18 per cent filed it under 'private markets', 12 per cent thought they had defined alternatives well enough to put private equity in a bucket of that name, while 6 per cent classified it as part of 'total equity'.

Preferring to remain anonymous, our aforementioned insurance fund CIO says that many investments which are referred to as 'alternative' or a variant on same are "just mainstream... Why is property development considered 'alternative'?"

His fund separates unlisted from listed investments because of the way they are selected and their different time horizons. Unlisted trusts may have a five, seven or 10-year lock-up: "that makes them a different ball game".

Just as blunt is the chief investment officer of MLC Investment Management, Chris Condon, who calls the 'what are alternatives?' debate "a crock... I'm concerned that many into investors equate 'alternative' with 'illiquid' and are loading into these things with no clear understanding of the risk to which they are exposing their funds, particularly now that we have fund choice," Condon

says.

"My view is that unlisted infrastructure, property and private equity are not truly 'alternative', they just have a different method of price discovery, and in fact are not being priced properly in many instances."

Condon walks his talk. MLC's Long-Term Absolute Return Portfolio (LTAR) is about as different as they come in terms of investment objective – a 5.5 per cent real return (after inflation, fees and tax) over a genuine 20 year horizon, with 'neutral' long-run target allocations overlaid by strategic tilts based on five-to-eight year intermediate outlooks.

Yet a glance at the fund's investment strategy reveals surprisingly little in the way of what one might immediately think of as 'alternative' investments.

If we take JANA chief executive Ian Patrick's elegant definition of alternatives as "anything that's not a straightforward investment at arm's length in a security listed on a public market", then



Chris Condon ...
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the only MLC LTAR exposure that really seems to fit the bill is its global private markets allocation, at only a 'neutral' 10 per cent.

The emphasis elsewhere is on unconventional approaches to tradeable securities, such as a 7 per cent exposure to insurance-related investments like catastrophe bonds and weather derivatives.

In Condon's view, the truly "different" aspect of the MLC LTAR is its method of portfolio construction, which is approached "on a scenarios basis rather than the typical mean variance analysis", according to Condon.

"We don't have the skills to guarantee a successful TAA program over three years, we don't think that's possible. If you'd taken a negative view

on equities in 1997, in three years you wouldn't have had a business left but in a fund like ours you're there. The LTAR is the dream portfolio of my team... we model 40 different scenarios for the future, select a cohort of the most likely scenarios and manage the portfolio around tolerances toward those."

Jeff Rogers, the chief investment officer at ipac, agrees with Condon that "it doesn't have to be illiquid to be an alternative", but contends that the reality of packaging products, particularly in his milieu of the financial planner market, does make definitions helpful.

"You've got to remember that in the US, any kind of property is considered an alternative asset, simply because there's no tradition of investing in it as there is here," he says.

Rogers has been thinking a lot about alternative assets lately, as his team overhaul the portfolios it offers to clients to include an "alternative markets" portfolio and an "alternative alpha" bucket.

The "alternative markets" bucket will make up 3 per cent of ipac's core diversified portfolio, and will include what might be termed the 'alternatives usual suspects' of private equity, infrastructure, distressed debt and commodities. Rogers says these exposures should be moderately correlated to equities, but less volatile, and have the propensity to deliver higher returns.

There are some other intended inclusions in the "alternative markets" bucket which further stretch the already loose definition of the 'a'-word.

For example, Rogers says the bucket will include "public market long-only mandates with no benchmark focus but a superior risk-return trade-off".

He cites as an example of this the Morgan Stanley Global Franchise Fund, which selects stocks from a universe of approximately 150 listed 'big brand' names around the world, which in Rogers' words have "built a moat around themselves" thanks to

- Possession of dominant intangible assets
- Repeat business or recurring revenue
- Disciplined management
- Organic growth potential
- Sustainable high return on capital employed

Rogers says that long-only funds based around stocks with strong intellectual property and patent stories



Jeff Rogers ... agonising over whether life settlements is alternative alpha or beta

as well, even though the funds typically only cover a few thousand elderly Americans.

More clear-cut is what will constitute the core of the "alternative alpha" bucket, which like the alternative beta portfolio is earmarked for 3 per cent of ipac's flagship diversified portfolio.

Last month, ipac seeded the US-based hedge fund-of-funds, Prisma Global Multi-Strategy Fund, with \$160 million. It was the first fruits of its relationship with specialist alternatives placement agency, Brookvine.

By short-selling the beta exposures

would also be classifiable as 'alternative'. JANA's Ian Patrick suggests another 'alternative' approach to long-only equity investment might be where a consortia of like-minded institutional investors, "who weren't afraid to be business owners", could take a majority position in a poorly managed, fundamentally sound listed company, and run it on a genuine 20-year vision.

This approach could be a good way of combining a long-term horizon with an "ongoing, third-party derived valuation" - that supplied by the 30 per cent free-float listed component - according to Lachlan Douglas, a director at private equity placement agency Principle Advisory Services.

Maintaining a daily market valuation would help tackle a problem common to many less liquid alternative asset classes, whereby managers are tempted early on in the life of a fund to over-emphasise positive aspects of their holdings to third-party valuers - who as Douglas says "can rely to a great extent on what they are told by management" - in order to bring forward payment of their performance fees.

The possibility of including long-only equity investments in an 'alternative markets' fund is not the only foreign ground being trod by the ipac investment team. Jeff Rogers and his colleagues have also been "agonising" over where to put an intended exposure to life settlement funds - which purchase life insurance policies from people who are typically over 65, and typically are expected to die in less than 10 years.

The manager skill involved in selecting the most lucrative underlying policies would seem to make life settlements a candidate for ipac's "alternative alpha" bucket, but Rogers says there is an argument for the funds containing a "demographic-driven insurance beta"

of underlying managers, the Prisma fund-of-funds aims to have low correlations to equities, be as volatile as bonds and deliver similar returns to those earned by equities. It has recently invested in fixed income, volatility arbitrage and distressed credit strategies, and in the past year sought managers who were short subprime securities and financial companies.

While ipac's "alternative markets" bucket will broadly be characterised by underlying economic exposures and be more suitable for end-clients who are in the accumulation stage, Rogers says that alternative alpha is risk-reducing and more suited to decumulators.

"The anchor is a well-diversified hedge fund-of-funds with strong risk management, but any manager who can demonstrate repeatable skill to us belongs in there too," Rogers says.

Asked to think about his ultimate unconstrained alternatives portfolio



Mark Sainsbury ... length of liability profile What matters when weighing alternatives

aimed at maximising 20-year returns, JANA's Ian Patrick agrees there is a place for hedge fund-of-funds to "provide some liquidity and flexibility in case new opportunities arose", but not a significant allocation because they "fail the fee test".

Patrick believes the potential universe of alternatives should be broad enough to exploit global themes, particularly around changing demographics and globalisation, which to his mind means "private equity and property in emerging markets".

Agricultural investments are attractive as governments in developing nations seek to secure future food supplies.

"Prime farming land in Zimbabwe is the ultimate value play at the moment, if I can make a tongue-in-cheek comment."

Asian currencies are another



Ray King ... monitor illiquidity, but not at expense of its premium

favoured alternatives play, given the upward revaluation "that one anticipates is inevitable", with the position achieved through a combination of assets domiciled in the region and a "raw currency play".

Many investments which are referred to as 'alternative' or a variant on same are just mainstream... Why is property development considered 'alternative'?

HOW MUCH?

If it was not for Mark Sainsbury, the chief investment officer of NSW-based First State Super, the answer to 'how much alternatives should a super fund have?' would be as vague as the attempts to define what they are in the first place.

Asked for the optimum level of exposure that the average fund should invest in unlisted or less liquid alternatives, and globalisation, which to his mind means "private equity and property in emerging markets".

Sainsbury says that the liability profile of the fund is the wrong thing for a CIO to be considering when he or she is determining an allocation to less liquid alternatives.

"It's not the length of the liability profile, it's the length of the liquidity profile. Super funds are like banks, we 'borrow short/lend long' but super funds do not have the fall back of a lender of last resort facility if there is a liquidity squeeze. APRA is quite right to be concerned," he says.

"Super funds have an obligation to meet member roll-out requests, which means they must be able to cope with a 30 day liquidity requirement, irrespective of the length of working life of individual members. This misunderstanding of the fundamental business task of superannuation is why some of the more illiquid funds arguably could not meet reasonable solvency standards."

Sainsbury is hardly the only asset allocator concerned by illiquidity at the moment.

The investment team behind Colonial First State's Firstchoice master trust are understood to have been calling on many of their underlying managers, asking them how they would go about liquidating 25 per cent of the value of their portfolios if asked to do so within

a three-month period.

According to Ian Patrick, JANA is presently testing its super fund clients against a liquidity scenario in which listed markets dropped 20 per cent and ongoing contributions halved.

Sovereign's Ray King says there has never evidence of a 'run' on any Australian super fund, and that CIOs should not allow over-cautiousness to cost their funds the illiquidity premium, which depending on the asset class he calculates can be worth between 0.5 and 3 per cent a year.

However, he acknowledges liquidity would come into focus under a number of more likely scenarios, such as the need to rebalance strategic asset allocation (SAA) if listed equities severely underperformed, or adjust for members retreating to investment choices with lower allocations to alternatives.

In the unlikely event of a quick and sharp decline in fund assets, King recommends that funds, among other things, allow the alternatives allocation to increase to the upper band of the SAA range.

"If the SAA to alternatives is 15 per cent, then a reduction of 25 per cent in total fund size would increase the alternatives allocation to 20 per cent. This is a conservative level for the upper band of the allocation," King believes.

Depending on the severity of the run, or shift away from riskier investment choices, King says funds could redeem assets where permitted, take periodic distributions from their alternatives managers rather than reinvest, impose a freeze on any new commitments to alternatives, sell on the secondaries markets where viable and sensibly priced, and even purchase options to put securities to various counterparties at pre-specified valuations (King warns this could be expensive).

Access' David Chessell, whose clients are well known

for their 50 per cent exposures to illiquid assets, does not think a run on a super fund is likely either.

"I don't think the world changed when choice of fund came in. After three years, the experience that I'm seeing is that members don't change funds at the drop of a hat. COF isn't a watershed for the industry," he says.

Chessell also points out that alternative assets create their own liquidity.

"Our clients get cash back at an average of 14 per cent per year on their unlisted asset portfolios, yield and return of capital," he says.

The ideal allocation to alternatives for the end-investor will of course change according to their age and circumstances,

but ipac's Jeff Rogers says a reasonable spread for the average 30 year old would be 80 per cent in the core diversified portfolio, 15 per cent in 'alternative markets' and 5 per cent in 'alternative alpha'.

"The important thing is to educate and really manage clients' expectations around alternative investments," Rogers says.

"We'll be saying to clients, 'if you're going to sack us in a year's time on the performance of that 15 per cent, we need to have another conversation.' The beauty of unbundling the alternatives pieces the way we have is that it allows you to have that conversation in the first place." ■

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