INTRODUCTION

AN ALTERNATIVE ROUTE TO ABSOLUTE RETURNS

Recent market turbulence has seen clients increasing their allocation to alternative investments, particularly in sophisticated markets. But some investors still perceive them as a risky allocation, writes Elisa Trovato

Although it is quite common for industry practitioners to refer to alternatives as one, monolithic group of asset classes, this expression is just a shortcut to address a very diverse group of investment opportunities, ranging from hedge funds, private equity and real estate to infrastructure and structured notes; these are considered an alternative option to the traditional investment vehicles for most investors: equities and bonds.

Lack of correlation or low correlation with equity markets is a necessary condition for a product to be defined alternative, says Ravi Bulchandani, head of alternatives at Barclays Wealth. And this attribute is strictly associated with the absolute return concept, even to the extent of being identified with it.

Barclays Wealth has recently developed a "different" approach to wealth management which makes the decision between traditional or market returns on one hand, and absolute returns or alternative investments on the other, much more rigorous, says Mr Bulchandani. The new investment philosophy considers risk as a multi-dimensional factor; investors' attitudes and financial personality are identified through a thorough profiling process and matched with a range of investment styles to create an individual investment strategy which delivers performance that really suits the investor.

For example, an investor with strong preference for stable returns and no great regret if his portfolio is not returning as much as the market in positive cycles, is a candidate for a significant proportion of absolute return or alternative investments, he says.

"For our absolute return portfolios, we use funds of hedge funds, but we also supplement them with some liquid traded arbitrage strategies, such as funds that trade in the currency market or in the fixed income market," says Mr Bulchandani.

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But investing in alternatives also means adding value in investors' portfolios by getting access to different sources of returns. For example, by investing in private equity the investor gains access to the ability of a skilled management team that affects changes at the corporate level, which might have not been possible in the full glare of the public market, explains Mr Bulchandani. Unlike algorithmic trading strategies or hedge funds, private equity and real estate are not as easily "modellable", he says. Therefore they are not included in pre-constructed discretionary portfolios, but tend to be recommended to clients on a one-time basis.

The lines between traditional and alternatives are getting blurred because traditional investments are now using some of the freedom that alternative managers have, such as derivative leverage.

"On the other hand, there are funds that describe themselves as alternative investments, but in fact are just leveraged plays on the equity market. For example, in emerging markets certain funds that describe themselves as hedge funds, because of the difficulty of going short, are actually just leveraged longs on the market," he says.

"ALTERNATIVE INVESTMENTS ARE BECOMING MORE OF A CORE INVESTMENT"
PAUL WHARTON, DEUTSCHE BANK

CORE VERSUS SATELLITE

Alternatives used to be considered as the satellite, riskier and alpha generating part of a portfolio, but things are changing in that respect too. "Alternative investments are becoming more of a core investment" says Paul Wharton, investment director at Deutsche Bank, the German heavyweight that strengthened its presence in the UK private wealth management market by acquiring independent private bank Tilney at the end of 2006. "A combination of commodities, hedge funds and structured notes are now becoming more and more regarded as mainstream investments, in the sense that they give portfolio managers more flexibility to manage risk and opportunity on behalf of their clients," he says.

Beyond any semantic discussions on the definition of alternatives, Mr Wharton says the point is that all these instruments increase the level of asymmetry, aiming to maximise upside potential and at the same time minimising risk downside, so that portfolios exhibit a low level of correlation to the underlying markets. "We look to allocate between 25 and 30 per cent of clients' portfolios to alternatives, which include commodities, structures and hedge funds," he says. But, as structured notes can be in any part of the portfolio, alternative exposure could comprise nearly 40-45 per cent of the portfolio, adds Mr Wharton.

Alternatives in general have benefited from the change in clients' asset allocation made as a consequence of market turbulence. At Deutsche, "for a reasonably stable long term portfolio with a key to control the volatility on an annualised basis" this has lead to double the exposure of commodities to 10 per cent, in addition to increasing cash and reducing exposure to long-only equities. Given the long-term supply squeezing developments, commodities look attractive for potential profits but also to hedge inflation problems, according to Mr Wharton. And the wider range of instruments available today has eased the investment process.

"In recent years, we have been investing in commodities through a long exposure to the ETF (Exchange Traded Funds) markets and ETC market (Exchange Traded Commodities) in combination with structures. There is also a growing interest in CTAs and commodities based hedge funds," he says.

Overall exposure to hedge funds has also strongly increased. "Where 2-3 years ago we would be looking at maybe 12 per cent exposure to hedge funds, now we are looking to 20-25 per cent," says Mr Wharton. One of the key variables that any hedge fund investor should look at is the level of correlation of the hedge fund with the stock markets. While most hedge funds managers follow market trends and it is not surprising that correlation tends to increase in stronger markets, in bear markets the ability to reduce correlation can discriminate a real hedge fund from, for example, a simple levered unit trust, he says.

"We would now expect hedge fund managers to move into more neutral positions; in the next 12 months we would be looking for correlation to start to fall quite dramatically with the main developed stock markets," says Mr Wharton. "We don't use single strategy or single manager hedge funds because we think that there is too high concentration of risk. Wealth management is not an unconstrained profit maximisation exercise, but a risk management exercise in order to achieve acceptable rate of return."

At EFG Bank allocation to alternatives has gradually increased at the expenses of long-only equities. "Over the last 12 months we have become increasingly concerned about the outlook for economic growth and resulting corporate earnings," explains CIO William Ramsay. "We therefore progressively reduced exposure to equities and increased exposure to alternative assets.

"A Swiss managed balanced account now has 36 per cent of its assets invested in hedge funds [of funds], structured products and commodities." These products have together played a key part in confining risk and variability, explains Mr Ramsay. Direct equity exposure, which is now accounting for only 27 per cent, has more than halved during the last 12 months, down from over 50 per cent before the subprime crisis broke, he says. The remaining exposure of 37 per cent is invested in short duration bonds and cash.

Other types of alternatives, such as real estate and private equity do not seem to enjoy the favour of private bankers at present. "Property, having been so strong, is unlikely to perform well for some time," says Mr Ramsay. "A major part of the private equity market will be adversely affected by a much more difficult environment for IPOs."

Infrastructure on the other hand is a theme that investors would like to follow, says Mr Wharton at Deutsche, but the opportunity set is stilly fairly limited, with a very few funds listed in the UK market, for example.

DEVELOPING FULL POTENTIAL

If in sophisticated markets such as Switzerland and the UK, private banks tend to allocate a high percentage of clients assets to alternatives, in other less mature countries the employment of alternatives has still to develop to its full potential. "We think that our clients are still underinvested in alternatives as a broad asset class, and that goes for most of the underlying constituents," says Thomas Ericsson, global head of private banking at SEB Wealth Management.

This may be due to clients' perception that alternatives are too risky. "A couple of years ago alternatives were perceived as an additional spice in clients' portfolio," he says. "But investors have now started to be aware that employing alternatives is really about seeking alpha, diversifying the portfolio and having better return characteristics in their overall investments. But every new development takes a while before it starts moving in a more rapid space."

The strong long-standing equity culture of the Nordic investors can also explain the longer time that it is taking to embrace this concept of portfolio diversification, says Mr Ericsson. SEB private banking aims for a level of approximately 10 per cent in allocation to alternatives in clients' portfolios and a good part of this would be represented by funds of hedge funds. "We think that (10 per cent in alternatives) is a good level for our clients, but we are moving from a lower level," he says.

SEB's recent acquisition of Key Asset Management (KAM), a London-based fund of hedge funds manager is an important step in the Nordic firm's strategy to grow its alternative investments business and attest to the importance of hedge funds as a key asset class for clients to invest in, says Mr Ericsson.

Today there is cooperation and discussion with KAM in the hedge fund space, but SEB private bank, as well as the institutional and retail segments of the SEB group, rely on the in-house multi-manager research unit, which analyses and selects funds in both traditional and the alternative space for clients.

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When adding any asset in investment portfolios, it is important not to exclusively focus on the impact of diversification on risk, but to consider the effect of the new addition to the expected return of the portfolio, which may go down, says William De Vijlder, global CIO at Fortis Investments. The marginal contribution to risk reduction will get lower as the investor's portfolio gets more diversified, up to a point where it is difficult to diversify further, because all the de-correlation has already been squeezed out, he says.

"Another important consideration to keep in mind is really how dynamically you manage the portfolio. Diversification raises the bar in terms of the information that you need to collect to manage all these positions dynamically, should you wish so," he says.

New assets affect other key statistical portfolio variables, which need to be taken into account to estimate risk; these are the higher moments, such as the skewness and kurtosis which affect the shape of the distribution.

In private banking clients' portfolios, factors such as the investor's source of income also have an impact on asset allocation and use of alternatives. "When you build a portfolio for a private banking client, you have to factor in his income risk." To find the optimal asset of a firm's owner, who is looking to sell in the future, it is important to consider that in his business portfolio there is already some cyclical volatility connected to the equity risk, says Mr De Vijlder.