ALTERNATIVE INVESTMENT STRATEGIES

Boosting diversification, reducing downside risk

Hedge funds, which provide both portfolio diversification as well as superior risk-adjusted performance, are becoming increasingly popular, making them one of the fastest growing areas of investment management. Carl Dunning-Gribble explains

Among the spectrum of asset classes targeted by high net-worth individuals, institutional investors, pension funds or private banks, alternative investments are becoming popular offering more diversification to investors' portfolios. The benefits of such diversification have been demonstrated by Harry Max Markowitz (1990, Nobel Prize in Economics) in the Modern Portfolio Theory. He proved mathematically that an investor can reduce portfolios' risks simply by holding instruments which are not perfectly correlated – a correlation coefficient not equal to one. By holding a diversified portfolio, investors should be able to reduce their exposure to individual asset risk.

Amid topsy-turvy global equity markets and poor returns over classical bond markets in recent years, interest in alternative investments and especially hedge funds have swelled. The number of hedge funds increased by nearly 76% between 2002 and 2006, reaching 9462 while the hedge fund universe recorded $1400bn (€1000bn) in asset under management (HFR 2006 industry report).

If investors are attracted by alternative investments in their quest of alpha, it is because allocating to alternative investments offers advantages compared with traditional asset classes and diversification to a portfolio – though involving a certain level of risk.

As investors have become more concerned about their risk-adjusted returns, especially in bearish market environments, interest in alternative investment strategies gained momentum.

Dunning-Gribble: 'attractive risk/reward profile'

Alternative investment strategies allow investors to invest in asset classes responding in a different manner to market factors from traditional assets – stocks and bonds.

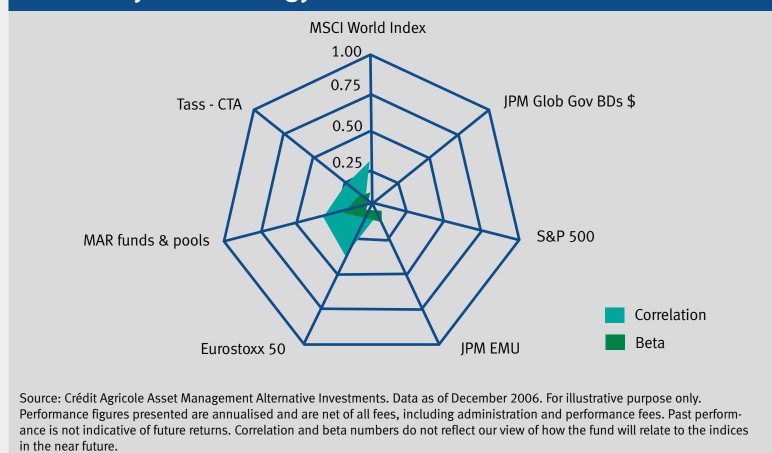
Therefore one of the benefits of allocating to alternative investment strategies is investing in non-correlated or low-correlated asset classes.

NON-CORRELATED ASSET CLASSES

By investing in alternative investments, a portfolio manager or a given investor aims at obtaining performance from the relationships between securities. A non-correlated asset class behaves independently from other securities composing a portfolio. Such investment vehicles allow investors to hedge the risk that an asset falls in value and avoid any snowball effects. One of the main benefits of alternative investment strategies lies in the fact they minimise downside risk.

Cleverly planned funds of hedge funds offerings can deliver on the long-run returns uncorrelated to traditional assets. The objective of a flagship fund should be to return positive performance, irrespective

Figure one: Correlation and beta since inception of Green Way multi-strategy fund



Source: Crédit Agricole Asset Management Alternative Investments. Data as of December 2006. For illustrative purpose only. Performance figures presented are annualised and are net of all fees, including administration and performance fees. Past performance is not indicative of future returns. Correlation and beta numbers do not reflect our view of how the fund will relate to the indices in the near future.

of markets conditions. Figures one and two illustrate the low correlation of a multi-strategy fund.

Among the tools used in alternative investment strategies to obtain uncorrelated performance, the short selling appears as a mean to cancel out market risk and generate absolute return.

ABSOLUTE RETURN

Absolute return funds seek to make positive returns whether the overall market is up or down. Investors are attracted by such opportunity to obtain positive returns in different market conditions.

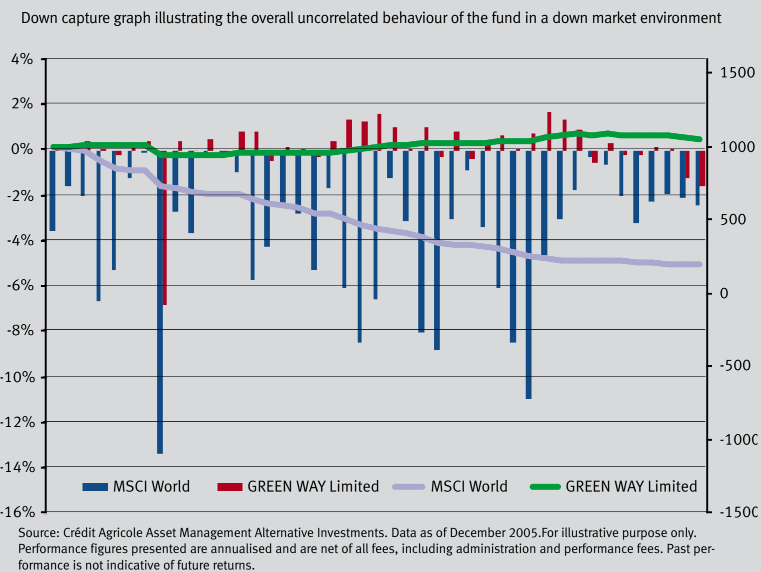
Hedge funds as an asset class offer an attractive risk/reward profile. Managers of institutional and high net worth investment portfolios are currently faced with a combination of low interest rates, correlated global equity markets and increased market volatility. Hedge funds, which provide both portfolio diversification as well as superior risk-adjusted performance, are becoming increasingly popular, making them one of the fastest growing areas of investment management.

Hedge fund performance is characterised by the focus on absolute returns rather than index-benchmarked returns, as well as low volatility. A well-diversified portfolio of hedge funds should be able to add value at all stages of the economic cycle, irrespective of whether equity and bond markets are rising or falling.

The primary steps for a fund of hedge funds aiming to achieve absolute returns consist of selecting thorough underlying funds. Therefore a strong process of due diligence and monitoring of funds closely on an on-going basis is essential.

Directional underlying funds (long/short equity, macro global/CTA) are required to offer judicious stock picking and significant market outperfomance (by making gains both on their short and long books). The goal is to

Figure two: Down captures a Green Way multi-strategy fund since inception



Source: Crédit Agricole Asset Management Alternative Investments. Data as of December 2005.For illustrative purpose only. Performance figures presented are annualised and are net of all fees, including administration and performance fees. Past performance is not indicative of future returns.

achieve positive returns both in upward and downward markets. Arbitrage underlying funds (convertible bond arbitrage, credit arbitrage, fixed income arbitrage), aim to achieve absolute returns by taking advantage of inefficiencies that are inconsistent with market moves.

The second step is the portfolio construction. Strategic allocation provides diversification benefits. Some strategies compensate others (such as distressed and event-driven that were historically generally negatively correlated). The correlation levels between strategies and also between underlying funds are closely monitored. Fund managers aim at being uncorrelated to traditional assets and benefit from diversification irrespective of market conditions.

Through thorough analysis, due diligence and monitoring of these hedge funds and judicious diversification between strategies and managers, we aim to produce a high and consistent absolute return, relative to the portfolio's volatility, which exhibits low correlation with "directional" market indices.

The risk-adjusted returns objectives set up at the fund of fund level take into consideration the risk taken by underlying managers. Higher returns often implied more risks obtained through the use of leverage by underlying managers.

LEVERAGE

The leverage technique is defined as the use of various financial instruments or borrowed capital, such as margin, to increase the potential return of an investment. The use of leverage by hedge funds increases the magnitude of returns. LTCM collapse highlighted the need for risk management to be an integral part of the investment process.

As part of the managers' selection and follow-up, investment professionals are involved in monitoring closely risks through due-diligence, monthly phone calls and regular meetings.

Portfolio managers work closely with risk management professionals in order to ensure that risks are proportionate to expected returns.

Position level risks include risks associated with the underlying assets on which the managers trade (such as liquidity, leverage and systematic market exposures). Position risk is managed foremost by the selected managers. Risk is controlled at various levels.

Alternative investments versus traditional investments

Alternative investments
- Depend on the manager's expertise
- Absolute return
- Flexible exposure
- Low beta/high alpha
- Flexible style constraints
- Low liquidity and performance fee

Traditional investments
- Depend on market conditions
- Return relative to a benchmark
- Long bias
- High beta/low alpha
- Strict style constraints
- High liquidity and no performance fee
- Access to a wide array of markets and trading strategies

Returns, drawdown, liquidity, leverage, assets under management, volatility, correlations are a few metrics considered when managing risk.

The objective is to monitor at individual manager level any negative evolution of these criterions.

These guiding principles offering the perspective absolute returns, uncorrelated to traditional asset classes and monitored by risk guidelines justify investors' interests for alternative investment strategies. Some of the others often cited benefits of alternative investments are the following:

- Hedge funds are investment funds or companies, which are generally subject to less regulation than their mainstream counterparts. This enables them to take a flexible approach to taking positions in publicly traded securities markets with the ability to go with both long and short markets, to use derivatives and to alter leverage in order to reduce risk or increase returns.
- Hedge funds look to exploit pricing inefficiencies on a short, medium or long-term basis through the application of sophisticated trading techniques and risk capital. This enables them to create absolute returns uncorrelated with markets in general.
- Hedge funds tend to be specialist boutique trading firms staffed by former successful investment bank traders or fund managers. They have highly specialist expertise in particular segments of the capital markets, using a consistent strategy and approach to make profits, such as equity market stock picking with a focus on US technology, or the arbitrage of the pricing within specific segments of the fixed income and equity markets.
- Hedge fund performance tends to be very skill-based, dependent on the expertise and investment process and discipline followed by the managers. It is much less dependent on market direction, making hedge funds an important source of diversification for long-term investors such as pension funds.

ADVANTAGES OF FUNDS OF HEDGE FUNDS

Funds of Hedge Funds managers invest in a selection of hedge fund managers in order to both diversify performance and to create portfolios which are uncorrelated with other asset classes. They operate much closer to the hedge funds industry and carry out ongoing due diligence and analysis of the hedge funds marketplace. In doing so, they are in the best position to understand the various managers' approaches and strategies. It is important to combine such 'proactive' manager allocation with dynamic hedge fund style/asset allocation, in order to produce higher returns with reduced risk.

Due diligence is another important role carried out by the funds of hedge funds manager. Rigorous analysis of manager processes and investment methodology, combined with third-party information, enables fund of hedge fund managers to avoid hedge fund meeting accepted investment criterion but unable to demonstrate consistency of returns or are potentially fraudulent.

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- $18.8bn AUM September, 2006
- 15 years' experience
- A highly successful and transparent track record since 1992 (among the longest and most consistent in the industry)
- High degree of diversification both at strategy and hedge fund levels
- CAAM AI closely monitors the exposure of its funds to equity and bond markets in order to maintain low correlations with performances of traditional asset classes
- Global coverage of the hedge fund universe. Presence in the main financial centres: Chicago, London, Paris, Hong Kong, Tokyo, Milan
- Ranking among the top nine global FoHF managers in terms of assets (InvestHedge – December 2006)
- Over 90 employees worldwide
- Team of 31 investment professionals worldwide
- Over 400 institutional investors worldwide