



Image sourced from **Convergence and Divergence: Forces shaping the investment universe**. Co-authored by Prof. Amin Rajan, CEO of CREATE-Research, and Anthony Cowell, partner at KPMG in the Cayman Islands.

Explosive growth in alternative investment has sparked transformational shifts in the investment universe. Investment managers have diversified on a scale which has initiated a convergence in strategies, structures and cultures. Regulatory changes have encouraged this.

Active long-only managers are getting closer to the alternatives sector, which is itself witnessing the convergence of hedge funds, private equity, real estate, infrastructure and structured products.

Thus far, convergence between long-only managers and hedge funds has been largely tactical in nature. Each has modestly ventured into the other's area without major changes to their business model. Now a whole new class of products is emerging that sits somewhere between hedge funds and active long-only.

One in every three alternatives managers and two in every five long-only managers report strategy convergence over the past three years, according to a new study by CREATE-Research and KPMG International.

The report shows that long-only managers have attempted three things when entering the alternative investment world. Firstly, using a regulatory device like UCITS III, they have offered hedge fund-like products for retail investors.

Convergence and Divergence: How investment managers will evolve

By **Amin Rajan** and **Anthony Cowell**

Was the switch to alternatives a triumph of hope over experience?

Secondly, using hybrid products like 130/30 and global tactical asset allocation (GTAA), they have increased choice for institutional clients. Thirdly, via M&A, they have aimed to acquire alpha-generation skills. Hitherto, many had suffered a talent drain into alternatives.

Those hedge fund managers and private equity houses which have done IPOs, or aspire to, have responded by venturing into the long-only space to secure stable revenue streams. So far, the most extensive convergence has been between hedge funds and private equity, some of which has spilled over into investment banking activities.

Those leading the way are redefining the contours of their sector. But there is another group – the purists – who are doing old things better, causing divergence. They see diversification as a dysfunctional distraction. For them, focus is the name of the game. A majority of them are in the long-only space where they have survived and thrived.

That does not detract from the fact that convergence has delivered mutual benefits. For clients, it has delivered better returns and access to all-weather portfolios. For fund managers, it has delivered improved profitability and enhanced ability to attract, retain and deploy talent. Improved returns have been delivered by managers who have focused on three structural factors: a deeper talent pool, enhanced quant capability, and better ability to manage transitional issues.

RECOVERING BREATH

That said, the pace of convergence is likely to slow down over the next three years. From a fund manager perspective, the shift towards alternatives may well continue, so long as clients are convinced that they will deliver higher returns with lower risk than traditional long-only funds. More notably, the level of interest in hedge funds is likely to be as high as the long-only high alpha products. But fund managers also

CASE STUDY: THE CIO OF A UK PENSION FUND

“Our journey towards absolute returns investing started in 2000, when the equity bear market wiped out 48% of our portfolio. Overnight, we switched a large slug into bonds only to find two years later that our funding levels were getting worse as interest rates continued their downward slide...

“We first diversified into private equity, which was easier for trustees to swallow. The same cannot be said about hedge funds, since the memories of the LTCM disaster were still vivid in people’s minds. So, it took two years to make a decision and another year to make the first allocation. Currently, around 5% of

our funds are in alternatives.

“We have also looked at structured products and concluded that they are a step too far for us. Our research shows that, along with private equity, structured credit is a rare corner of finance where managers enjoy wide discretion over valuing the assets. Many risk takers have taken their profit and gone. The originators of risk are not in the business of holding it. That job falls on investors who have to be prepared for the long haul. Investment banks have done a huge damage to themselves and others. Any innovation from them is now seen as the latest con trick.”

harbour doubts about the viability of some alternative investments, in the aftermath of the recent sub prime débâcle. Most investment managers see convergence slowing down – especially in the long-only sector – for three reasons.

First, clients have switched to alternatives because the traditional long-only returns had all but evaporated in the 2000–2003 bear market. The switch had more to do with the failure of the old rather than the success of the new. It was the triumph of hope over experience. Now that alternatives such as hedge funds and structured products are being truly stress tested, we shall soon know how good they are at generating uncorrelated returns.

Second, within the long-only and alternatives sectors, there are managers who have eschewed any diversification in the belief that the borrowing binge of this decade will potentially result in a worldwide recession in 2008, leading to a large scale flight to quality and simplicity in the long-only space.

Third, any judgment on convergence has to be provisional: markets are cyclical, strategies are adaptive, and people chase returns, not asset classes. The fact that managers in different sectors have diversified says more about their ability to adapt to changing client needs than about radical departures.

WHAT DO CLIENTS THINK?

Pension funds have been at the forefront of the convergence process. Hence, it is instructive to highlight their perspective.

Since the onset of the last bear market in 2000, pension funds worldwide have started an incremental diversification of their asset base. Most of them have moved away from their traditional 60:40 equities-bonds balance and gone into alternatives. Alternatives now account for 31% of the allocations of pension funds surveyed in our study. The actual diversification is not as dramatic as the one implied by this number, however: a significant part of investments in alternatives has been made with long-only managers, indicating both the blurring of

boundaries and the convergence of strategies. The goal is consistent risk-adjusted absolute returns.

The path to diversification has been cautious for two reasons. **First**, the new accounting and regulatory rules in Europe and, to a lesser extent, Japan have enjoined pension funds to: be at least 100% funded within a specified period; avoid smoothing of assets and liabilities; and have all investments marked-to-market. Similar rules are now being implemented in the US. **Second**, most pension funds have always had severe reservations about illiquid or opaque strategies that have been implemented by hedge fund managers, private equity firms and investment banks. The recent collapse of the sub-prime market and the effect on world financial markets, if anything, has reinforced their reservations.

Although pension funds have diversified into alternatives, the weight of money has benefited long-only managers via two routes: mimicked hedge fund-type strategies on the back of superior governance and operational structures; and diversification into classes such as real estate, infrastructure and forestry. Pension funds have been chasing returns, not asset classes, thereby blurring asset boundaries.

CONCLUDING REMARKS

Clients had notched up good returns until the latest credit crunch. Most of them were on paper rather than realised. Actual outcomes are uncertain at present. Doubtless the crisis has decisively turned sentiment against some structured products. The risks associated with illiquidity and leverage in some hedge funds and private equity strategies have come to the fore. At the same time the number of new hedge fund registrations in Grand Cayman has soared, as managers are launching new vehicles to capitalise on distressed assets. Hence the pace of convergence between long-only and alternative investments from here on will be slower, at least until the health of the global economy returns. But it is unlikely to be reversed. **TFB**

AMIN'S ADVICE

Tips and checklists for CEOs, CIOs and COOs:

After the recent crisis, if convergence is to enhance the benefits for end clients and their fund managers, ten issues need to be addressed because they bring with them unintended consequences. Many investment managers have added complexity in business models on a scale that has raised the cost income ratio and lowered the operating leverage. These are:

- **Convergence has increased dysfunctional rivalries within firms: how do you guard the existing revenue stream when creating a new one?**
- **Clients report that some products look as if they are being created on the fly: is the value proposition defined sufficiently for clients to understand what it says on the tin, and what it costs?**
- **People in distribution channels are not au fait with new products: do you have product specialists within the channels who straddle the gap between investment professionals and their end clients?**
- **Investment professionals have not had sufficient autonomy to generate high conviction ideas and to be accountable for them: are the relevant structures and systems in place?**
- **Operational issues have had lower priorities: what is being done to improve operational excellence in the back office in order to mitigate the various risks that worry clients?**
- **The biggest risk is the one we don't know: do your risk systems cater for the so-called 'fat tail' risks?**
- **Skills for absolute returns have been scarce and constantly re-priced: what are you doing to recruit, retain and deploy talent?**
- **Incentives need a clear alignment between managers and clients: how are you achieving this alignment?**
- **Brand image has taken a back seat in the search for alpha: what are you doing to ensure that the brand reflects 'a promise kept'?**
- **Internal rivalries have frayed business cultures: what are you doing to promote a 'one company' mindset?**