Insights on...

WHY DIVERSIFICATION IS SUCH A HARD THING TO DO

A DISCUSSION PAPER PRODUCED IN CONJUNCTION WITH PROFESSOR AMIN RAJAN

Interview quotes from studies by CREATE-Research

BACKGROUND

Since the onset of the bear market in 2000, intentions surveys reveal a paradox: worldwide, institutional investors want to invest in alternative investments as part of holistic solutions to achieve absolute returns; yet their cash allocations to such investments remain small at around 3% currently. There is a yawning gap between aspirations and outcomes, according to two separate surveys carried out by CREATE-Research.*

"Pension funds are in disillusionment mode"

When markets tumbled, interest in alternatives accelerated: they were initially perceived as uncorrelated investments that complemented, not competed with, other asset classes. Since then, however, a number of factors have dictated an incremental approach that is at odds with media headlines which continue to convey the image of investors fleeing long only funds and flocking en masse to alternatives.

Such headlines fail to take account of the fact that most institutional investors do not as yet have governance structures and investment expertise to achieve a radical diversification. Nor do they recognise that the worst funding crisis in living memory has created new sets of internal and external drivers that are shaping investors', most notably pension funds, investment approach.

"Our biggest concern now is our sponsor's ability and willingness to bail us out if the deficit persists"

INTERNAL DRIVERS

The last bear market savagely exposed the scale of the funding crisis and damaged the reputations of many pension funds in every country. In retrospect, some of the things they did in the 1990s seem reckless: like being overweight in equities, relying on their risk premium to take care of long term liabilities, declaring 'pension holidays' when numbers were good, awarding mandates on the basis of past performance of star culture and having total faith in their consultants, to name just a few.

"In the absence of transparency, our clients have taken money away, even with out-performance"

Now, they are understandably cautious; all the more so since the crisis has weakened the strength of the covenant between pension trustees and their plan sponsors. As a quid pro quo for extra contributions towards the persisting deficits, plan sponsors are demanding that further diversification should be targeted at strategies that have been stress tested as well as road tested.

Regulators, too, are demanding a more risk-controlled approach to under-funding (see figure 1). Their impact is especially felt in two areas.

First, under the new mark-to-market accounting rules now being implemented on both sides of the Atlantic, the value of assets have to be expressed in terms of their prevailing market prices, rather than the average of three years to iron out fluctuations. This switch has introduced extra volatility into the balance sheets of plan sponsors which their shareholders find unacceptable.

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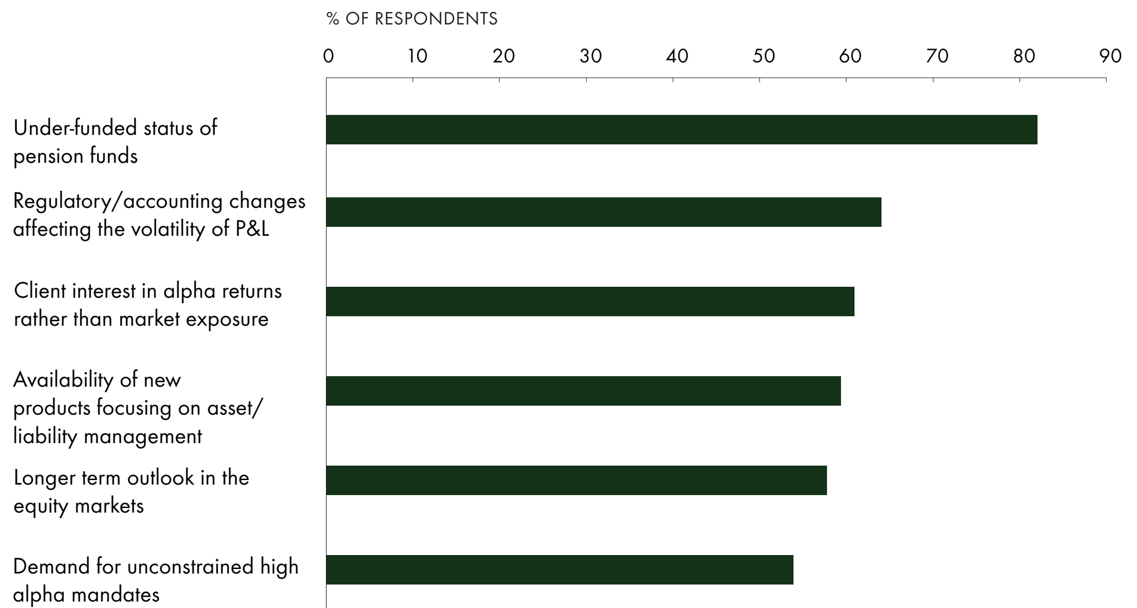
Northern Trust

The second area covers the funding level. Even in the Netherlands, the most sophisticated and successful pension market in the world, the recent accounting rules - *the Financial Toetsingskader* - are forcing Dutch funds to match their liabilities to the market rate, thereby forcing a more conservative approach to asset allocation, as has happened in Northern Europe. The new rules demand 105% funding. The capital and income protection strategies they favour do not necessarily leave enough assets in the classes in which they are invested, since hedging instruments are expensive.

"Pension funds want higher returns without ramping up risk"

FIGURE 1: FACTORS DRIVING THE INVESTMENT GOALS OF INSTITUTIONAL INVESTORS



"We don't succumb to fads"

Accordingly, before making big allocations, institutional investors want to see steep improvements in different aspects of alternatives, as covered by hedge funds, private equity, real estate and commodity funds.

"We have moved into low-risk active investment strategies which give us 'alpha tilts' by beating the target index by 150-basis points"

Specifically they want to see improvements that involve:

- Enhancing risk-return characteristics to a level higher than normal equities and bonds; so that they can clearly assess the opportunity cost of not going into alternatives
- Reducing the opacity of strategies used in alternatives to make them more comprehensible to investors; so that they can address governance and expertise issues
- Making certain asset classes with long time horizons (e.g. private equity and real estate) more liquid; so that they can be considered as credible sources of alpha
- Having a value-for-money fee structure that clearly separates alpha and beta returns on the back of sound business basics; so that they can deliver superior value.

These internal drivers are ensuring that 'sticking to the knitting' is the new mantra for institutional investors. Besides, those institutional investors (which are pension funds) need worldwide average annual returns of around 8% to meet their future liabilities from the existing levels of funding. A majority feel that such returns can be sourced more cost effectively from the mainstream long only asset classes without the need for extra risk and high charges.

EXTERNAL DRIVERS

There are other factors promoting caution as well. These are inherent in alternative strategies and the ways in which they are delivered, as exemplified by hedge funds which now account for 50% of the total value of assets in the alternatives universe, now estimated at US$3trillion.

The focus on hedge funds here is deliberate: they are the biggest component of alternatives; they are very liquid; most institutional investors have actively considered investing in them; and they have a longer history of delivering stellar returns than other alternatives. In any event, they exemplify concerns towards private equity and commodity funds as well.

Most institutional investors have four concerns about hedge funds: high charges, shortage of prime capacity, opaque strategies and absence of governance structures. Such concerns have not deterred ultra high net worth client and family offices whose demand has largely fuelled the extraordinary growth of hedge funds in the past 10 years.

Looking at the hedge fund industry in its totality, our studies found that institutional investors perceive three distinct groups of managers:

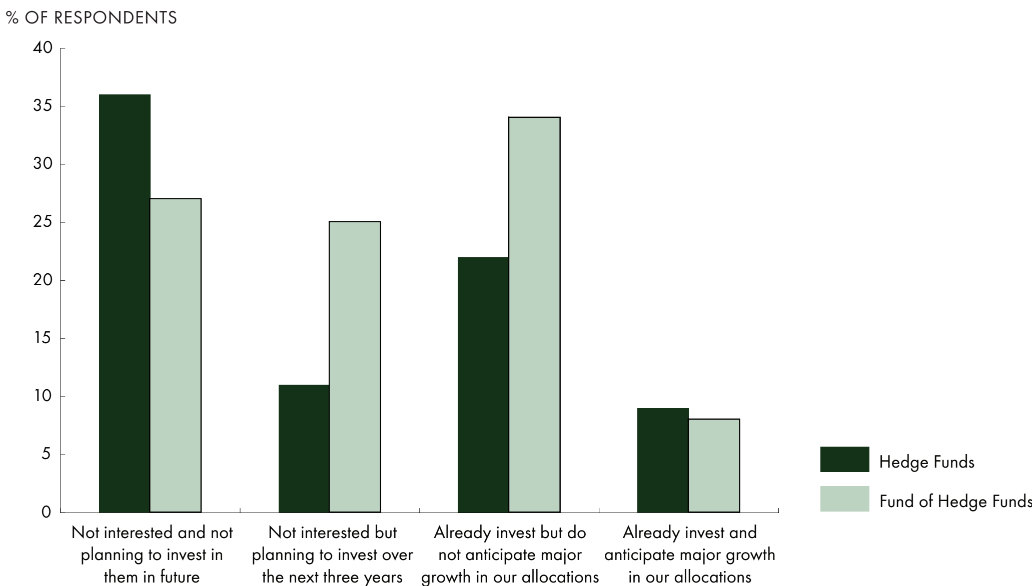
- Around 15% of managers are clear *stars*: they provide the prime capacity that is capable of generating high risk-return characteristics in line with client expectations. Most of them have an investment banking background; with the majority based in the United States.
- A further 55% are *wannabes:* many are second generation long only managers with the right pedigree. All aspire to be *stars* before long; with the majority based in Europe and, to a lesser extent, Asia Pacific.
- The remaining 30% are *has beens*: they are the victims of brutal burn and churn that characterises their universe.

Accordingly, around one in two institutional investors are not in hedge funds and a sizeable proportion of this group intend to stay out (see figure 2). Around one in two is in; but do not expect to increase their allocations substantially. So far, the size of their average allocation is typically less than 3%, being higher in the United States and Japan than Europe. The UK institutional investors are far more cautious than their peers on the Continent and, in many instances, their first move has been typically via the hedge fund-of-fund route.

"For every successful hedge funds boutique, there are at least a hundred who have failed. This is a brutal business"

"Trustees are diversifying into exotic sources of beta which lie between alpha and beta - e.g., infrastructure and commodities"

FIGURE 2: INSTITUTIONAL INVESTORS' CURRENT APPROACH TO HEDGE FUNDS OR FUND OF HEDGE FUNDS



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Furthermore, two in three institutional investors believe that high returns on hedge funds depend upon: a high and rising inflow of new talent; rapid innovation, as strategies go out of fashion; and the ability to commercialise the new strategies. There are widespread doubts on each of these factors. Hence, those investing prefer 100% liquidity, with no lock-ins and with dealings once a month.

Nor are institutional investors convinced that hedge fund managers can scale their business without sacrificing performance; or that regulation can prevent periodic blow ups. Neither of these would be a formidable deterrent if the existing prime capacity was scalable. It is not: there are three approximate scale points, expressed in assets under management:

"The trustee world is in turmoil. We have endless choices and few insights"

- Single strategy managers need a critical mass of US$100 million to break even
- They prefer to go multi-product or multi-strategy in the US$1 billion to 4 billion range to avoid style drift
- Most funds of hedge funds can be scaled up to US$15 billion

These are orders of magnitude and clearly vary between strategies. But they serve to emphasize an important point: namely, growing the businesses in response to rising demand involves transitions that the majority of boutique hedge fund managers are unwilling to accept, because of the resulting dilution of their craft.

"Old money, like old thinking, will remain locked into old asset classes"

Furthermore, they see theirs as lifestyle businesses where profit matters more than growth, scope more than scale, performance more than size, autonomy more than ownership. Like rock stars, hedge fund managers can only work in small bands.

Only a tiniest minority of portfolio managers generate absolute returns consistently for more than three years. Putting more and more money into a given fund soon exhausts its opportunity set: success begets failure, before long.

In the 1990s, the first significant wave of money into absolute returns strategies was driven by high net worth clients and family offices. Many of them earned exceptional returns. Institutional investors want them too. After all, as markets in financial, physical and intangible assets evolve, the scope for exploiting price inefficiencies is always there.

"Currently, 2% of our assets are in hedge funds and the rate will grow. Like all our other assets, we manage them ourselves"

However, they require having talented portfolio managers - mini Einsteins who can devise new strategies and commercialise them at an ever faster rate, akin to a treadmill; in other words, people who have a strong instinct for spotting opportunities and trading them profitably before competitors arrive on the scene.

These are people who need to work in an environment where they have the autonomy and space to generate and implement high convinction ideas. This 'gut' factor separates the stars from the journeymen. It duly echoes the received wisdom in Silicon Valley that 'the geeks shall inherit the earth'.

Not only are such people few and far between; most of them also prefer to work in independent boutiques or pure play fund managers, not too encumbered by the bureaucracy and the quarterly-targets culture of the parent bancassurance groups.

Like their hedge fund counterparts, they prefer to work in small boutiques or teams, with their own restrictive scale points. The rhetoric of absolute returns sits uncomfortably alongside this underlying reality.

THE TWO CAMPS

Not surprisingly, therefore, when it comes to their involvement in hedge funds, institutional investors fall into two groups: *pragmatists* and *fundamentalists.*

The first group perceive hedge funds as but one of many credible strategies for generating alpha. Their view is that the last bear market has created major discontinuities. Indeed, the currency interest in absolute returns is nothing short of the revival of the investment mentality of the 1960's and 1970's, before the rhetoric of relative returns and benchmark hugging blinded so many investors, so many times, for so long.

On this argument, it is better to swim with the tide of absolute returns than go against it. That said, the allocations made by the first group are small: from a tiny base, their growth looks impressive. Outside the United States, they are largely channelled through fund of hedge funds to manage the reputation risk. That said, collectively, the weight of new money has the potential to *'industrialise'* the hedge funds industry on a scale that can make the majority indistinguishable from mainstream funds.

"Many trustees perceive new abolute returns products as old wine in new bottles"

That convergance is already evident, for example, with ever more hedge funds venturing into the absolute long only space. On their part, mainstream fund managers are emulating hedge fund type strategies (e.g. unconstrained investing; 130:30) and boutique structures within a far more competitive pricing model.

In contrast, the second group believes that investor appetite for hedge funds will evaporate as markets continue to recover. After all, many investors chase returns, not asset classes. Beta will remain the main source of wealth creation in the medium term. Many do not understand hedge funds and dislike their '2 and 20' charging structures when they have been used to paying 25-50 basis points for long only funds.

"Hedge funds are a mystical way of redeeming the sins of the past"

Furthermore, there are other ways to achieve absolute returns. In any event, long short strategies can be self-defeating for those pursuing shareholder activism. Finally, for the majority of institutional investors, hedge funds carry huge reputational risk: the charges are high, as are the prospects for low returns. Better education may help to change their attitude. But their resistance boils down to investment basics: opaqueness, fees and performance.

Both groups, however, recognise an interesting paradox: those who can afford to invest in hedge funds, don't need to; those who need to, can't afford to.

REGIONAL VARIATIONS

That said, it is important to underline that institutional investors in North America are most sanguine about alternative investments, followed by those in Asia Pacific and Europe (especially the United Kingdom). It partly reflects these different levels of influence exercised by consultants and partly the prime mover advantage enjoyed by some US institutional investors, notably pension funds.

"If you take the whole funds universe, average returns after fees are near enough zero. So why take on the risk?"

For those one in two institutional investors who are already investing in hedge funds, or planning to do so, the single most important reason is the diversification opportunities which they offer; especially since returns from long only funds have not been so attractive, despite the market recovery. That said, many of them are already questioning the lack of correlation between mainstream and alternatives, particularly over the last 24 months. The data shows significant correlation, if anything.

In North America, far more institutional investors also perceive alternatives in three distinctively favourable roles:

- As an established asset class
- As an effective instrument for bridging the funding gap
- As a smart way of retaining key talent

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"We are dipping our toes in the water: 4% will be our maximum allocation. But the queue for premier capacity is endless in every corner of this planet. The returns so far are a pittance"

"Pension funds want alpha. Today, they think that hedge funds are an answer; tomorrow it may be different. Investment business is cynical"

In contrast, in Europe and Asia Pacific, institutional investors are far less inclined to ascribe these roles to alternatives.

In large measure, the difference is a reflection of two facts about institutional investors in the United States. First, many of them went in far earlier than their peers elsewhere and enjoyed the earlier fruits of high returns; they also believe that hedge funds will become an established asset class in their own right. Second, many of them manage a large tranche of their money in-house and thus have a superior familiarity of hedge funds that enables them to tailor their investments in line with their medium - and long term goals. As a result, their comfort level is far higher.

Not surprisingly, therefore, over the next five years, the biggest proportion of large allocation to hedge funds or fund of hedge funds will be made in the United States. Indeed, the same observation applies to other alternatives.

Outside North America, investment in hedge funds so far is less stategic and more opportunistic: more a matter of dipping a toe in the water than diving in deep. Over time, this may change. Education, history and risks are the key contributory factors.

Doubtless, institutionalisation will professionalise the hedge funds in particular and alternatives in general beyond recognition by 2010.

For example, institutional investors want independent valuations based on transparent pricing models. They also want to receive valuation reports directly from the administrators, not via hedge fund managers. Finally, they want all the regulatory and risk controls in place. Together, these requirements will make administrators a seamless extension of hedge fund managers. Indeed, as hedge fund managers evolve to become multi-strategy houses, they will use multiple prime brokers but perhaps only a single administrator. This will make administrators a focal point for investors.

Hence, the demands of moving from lifestyle boutique to institutionalised investment firm are fraught with paradoxes. Things that made the hedge funds industry great - talent, individualism, enterprise - are the very things that will change. A sustainable business requires scale; but scale is the enemy of alpha. Most institutional investors require discipline; but discipline could be seen to stifle creativity. Only the most adaptive hedge fund managers will survive and flourish in the new world.

For example, only 4% of out performance by hedge funds is attributed to skills of the managers, according to Edhec Risk and Asset Management Research Centre in France. Alpha remains a zero sum game: for every winner there is also a loser, as in a game of poker.

To be fair, this applies to long only funds, too, which have increasingly adopted the rhetoric of absolute returns without delivering them. For example, some 76% of the trading volume in the American stock markets relied on passive investing from 2000 to 2004, accoring to Utpal Bhattacharya and Neal Galpan of Indiana University's Kelley School of Business. The comparable figure was 64% between 1995 and 1999.

Both figures are well above the 'pure' passive funds bought by investors. The implication is that actively management funds are less active than they claim: many may be closet trackers, departing from the index only at the edges of their portfolio in order to distinguish themselves from the herd. Such tendencies also prevail in Europe but with some variability. Belgium, Italy and Sweden have figures just as high as the United States. But the figures for the United Kingdom are 50% and 31% for Germany.

DOES IT MEAN CLIENTS ARE BEING SHORT-CHANGED?

The answer is 'yes' in the sense that they don't necessarily get what it says on the tin; or 'no' when one realises how hard it is to generate absolute returns year after year. Or, as chairman of a large US institutional investor put it to us "when you've seen a successful alpha manager, you have seen one; they are a rare breed inside and outside the hedge funds space."

"The euphoria over the search for alpha is only exceeded by its illusiveness"

CONCLUDING REMARKS

As a result, many absolute returns funds will increasingly be at the mercy of market movements. If they hit their targets, it will be more by luck than judgement. The fund management industry's ability to deliver skills-based returns is far more limited than the weight of currency money in absolute returns implies.

This, at any rate, is what a majority of institutional investors around the world think.

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* Hedge Funds: A Catalyst Reshaping Global Investment (2005)

* Tomorrow's Products for Tomorrow's Clients: Innovation Imperatives in Global Asset Management (2006)

Both reports are available free from amin.rajan@create-research.co.uk

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