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INVESTING IN ALTERNATIVES, EUROPE 2017

Understanding the evolving role of alternatives and the investment mix

APRIL 2017

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Thomas Weber, Managing Partner, LGT Capital Partners

Pascal Spielmann, Portfolio Manager, LGT Investment Partners

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SECTION 1

THE EVOLVING ROLE OF INVESTING IN ALTERNATIVES

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POINTS OF DISCUSSION

- *Understanding the asset allocator*
- *Managers and overseeing assets*
- *Transparency and fees*
- *Preserving real value of assets*

Maire McGuire: In each of your opinions, what considerations and understanding of alternatives do you need as an asset allocator?

Dinesh Visavadia: From an investor and pension scheme perspective it isn't a well-defined asset class so there is some uncertainty in trustees' minds as to what is included within this asset class which needs to be addressed. From a trustee and pension scheme standpoint you need to look at whether there is a space for alternative investments in there or not and this depends on your liability profile and your portfolio so that you could then come up with what role alternatives would take in there. Areas like diversification, return enhancing, return mitigation or improving the risk return of your portfolios might be factors that trustees would want to address. These aren't easy elements for trustees to understand as you need a lot of education.

Giovanni Fulci: We are in an environment of high valuations and low returns for traditional markets. In that context, the commitment to hedge funds can ideally deliver the objective of an uncorrelated source of return while diversifying the portfolio and mitigating its downside. True alpha-producing alternatives can provide both a non-beta-driven return enhancement and a pay-off that is different from the one provided by classic, traditional, long-only buckets of assets allocation.

The problem is that if you look at hedge fund indices through the lens of drawdown you do not see that hedge funds in aggregate are delivering a drawdown diversification against a traditional balanced portfolio.

Instead, the aggregate industry behaviour mostly resembles a systematic exposure to a leveraged position in an out-of-the-money put sold on equity indices. However, behind the industry indices, there is a healthy dispersion of strategies and managers' return, so from this perspective manager selection plays a very crucial role. It is the search for orthogonality among the bad times of the

opportunity set of each selected manager that is the most important ingredient for maintaining a portfolio of alternative investments.

I think another necessary key element is a proper upgrade of the quantitative due diligence process, in order to adopt a full multi-asset risk factors perspective that is useful to better understand the return drivers of each manager, by filtering out managers that are mainly traditional beta or alternative beta-driven, and therefore raising the bar to clear investor approval and paying the corresponding alpha-fees.

Jack Inglis: You shouldn't go into alternatives if you don't understand what they might deliver for you.

It is important to have a complete understanding of what they are as well as what the various types of alternatives are that exist out there and what you are trying to achieve.

I would define alternatives as anything that is non-traditional and a traditional investment portfolio is 60% stocks in public markets and 40% bond in public markets. The addition of alternatives changes that profile and can do so quite significantly depending on the adoption of alternatives.

Alternatives are hedge funds, private equity, private debt, infrastructure and real estate as the principally distinct main alternative products and strategies that you can buy.

I particularly speak towards hedge funds and private debt because that is the nature of the membership of AIMA so my comments are tilted towards these.

You also need to understand what their various return, liquidity and risk profiles look like but the intention of adding alternatives to a portfolio and therefore moving away from a traditional 60/40 mix is to try and improve the risk and return profile of any given portfolio.

The desire to do so is very much dependent on what the objectives are of the investor. A public pension plan may have a very different objective from that of a family office who may have a very different objective from that of a sovereign wealth fund or university endowment.

Every investor must assess what their own objectives are before they can even contemplate what the role of alternatives should be in the portfolio.

As a starting point, if you are thinking of moving away from a 60/40 portfolio you should ask yourself whether you are looking for a substitute to those stocks and bonds in the portfolio or are you looking to diversify.

There are many different approaches you can take and the decisions you make around allocation towards alternatives will depend on some of those early decisions that you make.

I WOULD DEFINE ALTERNATIVES AS ANYTHING THAT IS NON-TRADITIONAL AND A TRADITIONAL INVESTMENT PORTFOLIO IS 60% STOCKS IN PUBLIC MARKETS AND 40% BOND IN PUBLIC MARKETS

Dinesh: We can still work on the traditional basis of 60/40 but we don't have to call them equities and bonds, we can call them a growth portfolio where you get some return with appropriate risk levels and alternatives can fit into that bucket.

I would ask if it is really necessary for us to call this an alternative asset or should we re label the traditional asset class as growth or matching assets and then within these assets it will then be about return enhancing, diversification whereas within the matching it might be more about risk mitigation and downside protection.

From this you would then just choose a manager and not worry about traditional versus alternative.

I feel this would make things easier from a trustee standpoint as at the end of the day they just want to invest in long equities, developed market equities or emerging market etc. and they all just have different styles of investing in this.

Jack: This is a good answer as in a way it can complicate things as it makes them sound so complicated by calling them alternatives and what we are really trying to get is a set of risk exposures which might be the same as a 60/40 portfolio but might achieve that with lower volatility and that might be what is desired of the outcome.

You are effectively making investments as it is no longer an "either (alternatives)/or (traditional)" decision that needs to be made and indeed sophisticated investors are now looking at the entire portfolio composition from a risk budgeting perspective so with low yield in the fixed income markets what can they get as a fixed income proxy or substitute which they can get by building out fixed income portfolios that might have the same characteristics but higher returns than the traditional fixed income component.

There is a far more sophisticated approach being taken at the moment which moves away from that "either/or" decision that perhaps the term alternative investment suggests.

Maire: How do you strike the balance between tolerance for short-term volatility and long-term need to preserve the real value of your assets?

Jack: It is going to be determined in which type of alternatives you are going into. If you are going into private equity and you get an annual net asset value and your money is locked up from anywhere between 5-10 years short term volatility doesn't really come into it.

Where this question is aimed at is for those funds who are invested in the public markets which provide more regular net asset value updates and indeed liquidity for the underlying investors and so you can see those short-term movements.

Most investors, particularly pension funds whether they be public or corporate, who are perhaps the mainstay of investors across all alternatives at the moment do and should have a long-term view for the preservation of capital as well as an objective of making returns to meet their future liabilities which are long term.

Therefore, should their investment decisions should be altered by near term volatility in the portfolio of funds and assets that they earn.

We are all humans at the end of the day and so we all get affected by what is happening in the near term and in terms of the decision and balancing that tolerance the only way for investors to get tolerant and for managers to be able to manage the portfolios on behalf of their investors towards achieving a mutual goal is that full disclosure needs to be given about what risk measures the portfolio needs to be run on i.e. what drawdowns are acceptable in the short term.

These are discussions that need to be had at the due diligence phase of the investment not halfway through when things start going wrong or the volatility tends to increase.

The objectives and goals should be established and communicated right from the outset between manager and investor. Then throughout various cycles in markets, transparency, risk metrics and frequent dialogue about what is impacting the short-term fluctuations in the portfolio are vital tools in the investor relationship that need to be used frequently.

Dinesh: When you look at pension funds they are very long term investors so it isn't really a question of short-term or long-term as for pension schemes you must preserve the long-term value of capital of the assets. Liabilities are equally long term in nature and there is a huge portfolio of assets there so ultimately what is boils down to is that there will be short-term volatility and plans need to understand where they want to take that volatility and how they manage that volatility because there will be other assets that will give them the benefits of contracting against that volatility.

For pension schemes liquidity is important and because of the long-term nature of their liabilities liquidity is an important issue now that they are getting closer to maturity levels where cash is being required.

Understanding the nature of the investment products that they are going into is very key regardless of there being volatility or not at least they will know how to manage it.

If they believe that there is an investment product that is going to be beneficial in whichever objectives it meets whether it be return enhancing, diversification or even risk mitigation then at least they can manage that better.

I am not sure in my mind if there is a balance to be struck as opposed to just a greater understanding because pension schemes are always long term so the short-term volatility needs to be understood more deeply.

The asset managers can help us understand this much better through transparency and disclosures.

Giovanni: For investors in the public market, the type of risk measure matters because it affects how decisions are made. In that regards the tolerance should be tightly related to the definition of risk that you want to be tolerant to, in order to avoid any unpleasant surprises.

If you use volatility for assessing hedge funds and portfolio construction, you could end up with a reassuring level of volatility but an intolerable level of potential drawdown. Hedge funds deliver a multi-period payoff that could be highly skewed so risk measures

like single-period volatility, expected shortfall and so on, are mostly irrelevant in the hedge fund space.

Instead, risk tolerance should be defined in terms of undiversified portfolio drawdown, that is the potential maximum drawdown of the portfolio if all the assets are experiencing their max drawdown at the same time.

In that way you can navigate multiple, short-term market pressures without being stopped-out during the journey because of a wrong assessment of the potential portfolio risk.

Furthermore, I think that diversification objectives should be deployed by looking at the multi-period downside correlation and not by looking at the conventional-wisdom, single-period, standard linear correlation.

It is better to be prepared for the worst than just sit on standard correlations and volatilities and hope for the best.

Another key element of assessment in an environment of low volatility but high fragility is related to crowding. Too often, we have seen risk-off episodes that are reinforced by short-term procyclical risk reductions.

There are a lot of weak hands that are forced to simultaneously reduce risk at the worst possible time, given the similarity of exposures and very similar risk management and drawdown management approaches.

In this way, the subsequent positive reversals are largely missed.

With regard to crowding, most hedge funds allocators see crowded rates and herd behaviour as one of the most significant potential risk for the hedge fund industry. I think this is only a partial perspective.

While it is true that crowding and herding by portfolio managers create co-movements by supposedly different portfolios and strategies, the real risk is the similarity of risk management metrics and drawdown management approaches used for instigating the process of portfolios' risk reduction.

My view is that the hedge fund allocators should pay much more attention to the diversification of the risk-taking levels and to the drawdown management processes of the different managers.

Dinesh: You make a very elegant point but my question would be how can you get through to the trustees or the investors with this level of understanding. It isn't easy as you don't necessarily have access to the investors directly and we have consultants to through which makes it difficult?

Giovanni: The investment process and the risk tolerance definition should be drawdown-based. Drawdown is a very simple, linear measure closely related to our linear perception of risk, whereas volatility is just a quadratic term that is not so intuitive.

If the board could define a multi-period risk tolerance in terms of drawdown potential, a range of say minus 10-15%, the portfolio construction process should then coherently use a drawdown-based methodology, so that each asset is evaluated through its stand-alone potential drawdown and its contribution to the whole portfolio.

In that way, all the pieces are coherent with each other: the portfolio's drawdown-risk level is coherent with the board's overall risk tolerance; the risk management process is coherent with the portfolio construction approach, which is coherent with the due diligence performed on managers also in relation to their potential max drawdown.

Maire: In your experience, how do you ensure the investment committee have the relevant experience to oversee how the assets are managed?

Dinesh: We need to consider that there are 3 groups: the trustees themselves who may or may not have the right skill set which is supplemented with the in-house teams who often have good expertise and finally the investment consultants.

The combination of these three groups of people would ensure that you are hopefully making good decisions on behalf of the pension schemes.

Clearly the skill level varies depending on the size of the scheme. Some of the bigger schemes can afford to have a number of trustees on board who have the right skill set along with a good in house team. The medium to small size schemes are reliant on having good investment consultants and more recently questions have been raised as to whether interests are aligned there or not.

To this effect, the pension regulator issued some investment guidance on Defined Benefit ("DB") plan investments which is helpful.

At the moment trustee boards are having difficulty with having the right skill set because of the complexities of the products that are coming onto the market.

Overall, they have reasonably good expertise on the trustee boards because then for the traditional products it is fine but once you get into the more complicated ones like alternative investments there isn't a right mechanism for trustees to feel comfortable that they are making the right decisions.

I have seen particularly in the U.K a lot of asset managers who are now talking directly with pension schemes which is tremendous and very welcome because now you are getting the story right from the people who are going to manage your money which is fantastic.

Jack: Describing the 3 different decision making bodies is correct and you certainly hope that investment consultants as professionals in this have the right experience and if you are large enough to have an in-house team that they have got the experience there as well.

It is certainly something that we at AIMA have been focusing on quite extensively on over the past couple of years on the need to provide further education to trustees around alternatives in a way that wasn't available to them in a form that was easily digestible to them previously.

It has gotten more complex over the years so the need for educational tools for the boards of trustees has never been greater.

We are on our fourth publication of papers which are purely directed

> "With investment products and solutions getting more complex it is becoming quite a challenge for trustee boards to get the right level of expertise on board"

What worries investors is that you can never have enough skill on the trustee board as by definition the trustee board is limited and you can't have an infinite number of trustee board members coming in. There is no mechanism to bring in trustees for short term periods at the moment.

With investment products and solutions getting more complex it is becoming quite a challenge for trustee boards to get the right level of expertise on board unless there is some mechanism to bring in experts outside the consultant world who have the right level of accountability as the trustees have which would be quite helpful in terms of making that change.

at boards of trustees.

I am not trying to suggest that the degree of financial literacy on boards of trustees is low or limited and indeed most of the boards I have come across there is certainly a high degree of financial literacy but that continues to need to be updated and education needs to be provided.

You can see occasionally, particularly on public boards, where you get lay trustees who may be a union leader from the particular industry that the pension plan is established for where there is very limited amount of education and to have a full functioning board you want the highest level of education possible and not just for one or two experts but across the entire board of trustees.

This allows for well balanced, informed and democratic decisions to be made because there is potentially a risk of decisions being made by boards of trustees which might not always be in the best interest of the retirees that the pension fund represents however good the intentions

We have seen a lot of negative press at times on hedge funds and other alternatives and if you have boards of trustees who are being influenced by some of these comments then decisions that may be coming out of those boards of trustees may not be the right ones although they may be made with the best of intentions.

The way to solve this is to provide education and the relevant tools and information in order for them to be able to make the most informed decisions that they can and this is something that we are trying to help with at the moment.

Dinesh: Coming from the asset management world, these tools and education would be fantastic.

Maire: And moving on; alternative assets are still perceived by many as being expensive and intransparent; how is this view changing in your opinion?

Jack: In the past year or so we have seen an increased focus on the cost of investing in alternatives particularly from the headline fees which are quite often referred to as 2/20 in the hedge fund world but also in the private equity world as well.

This perception still exists out there but the reality is that behind those headlines, the average fees that are being charged are now considerably lower than that.

Investors themselves have more purchasing power than they did 10 years ago so there is a lot of discussion going on between investor and manager about the cost of services particularly in fees as well as the other terms and conditions that are negotiated including lock ups, discounts for size etc.

What is changing is that fees are coming down but this is not about a race towards zero or a race to a level of fees that will become comparable to ETFs for the simple reason that they are very different products.

A passive ETF fund is a very different fund from an actively managed alternative fund and investors understand this. What they want to achieve is an equilibrium where the management fee does pay for the costs of running the firm and fund but is not so excessive that it produces a huge surplus that can be paid straight down towards a bonus lin.

Investors are willing to pay for true performance and alpha. What is being discussed is performance above a hurdle or benchmark and most recently we have seen a proposal being put forward by one of the consultants for a 1 or 30 fee structure, 1% management fee or a 30% performance fee above an alpha hurdle and this is getting quite a bit of traction.

Some of the investors I have spoken with have said that this is going towards a level and a split of performance between management and investor that they see as appropriate.

There is a lot of change going on and we haven't finished with this change yet but clearly this description of hedge funds being expensive has had a reaction to it and fees are now coming down.

Dinesh: Competition has increased in this space which has had a positive impact on the cost structure as well as on the transparency issue.

I feel that the investment management industry has been clever and has listened to the investors who have said that the cost is high so they have come out with a hybrid solution where they mix traditional assets with alternative strategies in there so they are a little lower in cost which has been helpful in terms of getting the best of both worlds.

People are now open to risk sharing the costs based on risk share and it is now becoming quite acceptable to say that if you are going to take risk you might as well do it jointly.

There is a lot of positive development on this front which is reassuring both the trustees and the investors.

Giovanni: I agree that fees are clearly a pressure point for the industry but I don't agree with the negative headlines emanating from the media outlets on that subject. The perception of the 2/20 model as the industry standard is outdated and grossly oversimplified.

Instead, I see a positive trend in the industry towards a better alignment of interests between managers and investors and in general towards more flexible fee structures tied to performance through the disentanglement and the customisation of the portfolio of terms. Consultants have been a positive driving force on this front.

As Jack was saying, the fee sensitivity of investors shouldn't force that process too much because if the economics for the managers become too volatile and too close to the break-even point, a layer of business risk is potentially introduced. Here there is a risk of cognitive dissonance by allocators about expense ratios: they want lower fees, but at the same time, they want a well-run, due diligence-proof institutional infrastructure together with a stable team of talents and all that is quite costly.

Maire: Thank you all for sharing your thoughts on this topic.

SECTION 2

CHALLENGING THE APPROACH TO ALTERNATIVES

2.1 WHITEPAPER

Alternative risk premia: investment panacea or illusionary hype?

2.2 INTERVIEW

With investors concerned with the impact of rising rates, is the argument swinging back in favour of hedge funds?

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2.1 WHITEPAPER

Alternative risk premia: investment panacea or illusionary hype?

Pascal Spielmann,
Portfolio Manager, LGT Investment Partners

"In theory, theory and practice are the same. In practice, they are not."

Albert Einstein, 1879 – 1955

In light of compressed asset yields, the concept of alternative risk premia investing has received a lot of attention among the institutional investor community over the recent years. They are typically defined as the spread between the return on one set of securities versus another and extracted based on some clearly defined quantitative investment rules. Some popular alternative risk premia include the spread between

- *the return of small vs. large stocks ("size"),*
- *cheap vs. expensive securities ("value"),*
- *recent winners vs. losers ("momentum"),*
- *higher vs. lower yielding securities ("carry") and;*
- *low vs. high risk companies ("low volatility").*

Many of these well-known, empirically-tested sources of returns have been extensively documented and explained by academia for decades. What is new, however, is that institutional investors are more and more keen in taking on pure alternative risk premia exposure. This has evoked a myriad of new offerings, in particular from broker/dealer banks which provide convenient access to bespoke risk factor indices in the quest of increasing commission income by trading the underlying baskets of securities. So what is driving the sudden popularity of this investment concept? Is it just an illusionary hype or can it be an adequate answer to today's investment challenges?

Alternative risk premia – what fuels the hype?

Not so long ago, institutional investors discarded alternative risk premia for three main reasons: first and foremost, with reasonably high yields on traditional assets, investors had no need to break out into rather complex quantitative investment strategies. Second, investors disliked the fact that alternative risk premia investing resembles hedge fund investing as it involves some degree of leverage and shorting, be it in the form of dynamic long/short strategies or cross-sectional spread positions. Last but not least, low or negative correlation between equities and bonds, the bedrock of modern portfolio construction, worked remarkably well over the entire career memory of most of today's asset allocators.

However, depressed real interest rates and currently high valuations in equities and credit have led yield-hungry investors to search for new sources of return not found in long-only investments. Moreover, investors have started to realise that the world's major reserve currency central banks might be close to running out of power to stimulate the economy as their ability to reverse a future downturn through interest rate cuts or more quantitative easing (QE) is limited. Hence, investors also seek to reduce their dependence on the traditional diversification approach of holding equities and bonds. The hope is to reduce the downside of a balanced portfolio without curtailing its upside.

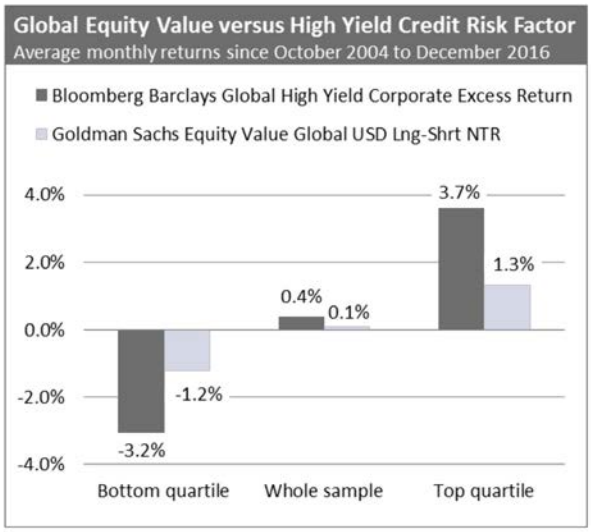
In theory, alternative risk premia strategies are ideally suited to meet both requirements: new sources of returns and better diversification. However, in practice, we are afraid that many attempts to enhance

portfolio stability with alternative risk premia may fail because of imprudent risk premium selection, overly rigid execution and the breakdown of imponderable correlation structures in phases of elevated market stress. In our mind, investors are well-advised to avoid these pitfalls by following three simple but effective portfolio construction principles.

#1 – Beware, all that glitters is not gold

Long-term positive returns and effective diversification requires a thoughtful investment process. At the onset is a conscious choice of what kind of risks to include in the portfolio. It is important to be selective as not all alternative risk premium strategies are equally valuable in spite of their academic grounding and popularity in the marketplace.

For example, equity value factor investing is akin to taking on high yield credit risk in disguise. As you can see from the chart below, the classic value factor performs particularly well or poorly in line with the best and worst quartiles for high yield credit markets, i.e. when spreads are rapidly tightening or widening. This makes intuitive sense because many of these stocks, for example energy and mining companies, become cheap or richly priced for a reason. Yet, on average, the long-run compensation from the equity value factor has been almost nil. In other words, equity value factor investors are mostly compensated for taking on exposure to distressed credit risk, where selection skills are key for investment success while a purely quantitative investment approach may disappoint.



Source: Bloomberg, Goldman Sachs, Barclays Capital. Goldman Sachs Equity Value Global USD Long-Short Net Total Return (Ticker: GSRPEVWF) mirrors the return of the classic Fama & French high minus low (HML) book-to-market value factor. The portfolio is constructed by sorting a liquid global equity universe (top 85% of stocks by market cap from each developed market) by respective book to price metric and then going long the top quintile and short the bottom quintile. Bloomberg Barclays Global Corporate High Yield Excess Return (Ticker: LG5OER) is the weighted average excess return for each bond in the index over a duration-matched U.S. treasury bond. Monthly returns of GSRPEVWF have been sorted by bottom and top quartile months of LG5OER.

#2 – Err on the side of agility, not rigidity

Many proponents of alternative risk premia investing are arguing that it is not possible to "time" factors, which would be tempting but very difficult to do well, as with trying to time the stock market. Therefore, the argument goes, investors should simply focus on assembling a diversified set of factors they believe in over the very long-haul based on both empirical evidence and economic theory. As investment practitioners, we have a lot of sympathy for that view albeit cannot fully subscribe to it.

On the one hand, we are fully cognisant of how difficult it is to time markets. We do not claim to have any particular insight or better foresight which would allow us to predict factor returns. On the other hand, as principal investors and fiduciaries we aim to do the best job in the absence of a crystal ball. To us, this means that while we cannot predict returns, we still can adapt to changing conditions knowing that there are scenarios when "cash is king" and risk-taking is not rewarded in markets.

Hence, we prefer to err on the side of agility, not rigidity, by building conditional exit rules – so-called "safety valves" – into some risk premia strategies and would advise investors to do the same.

Note that the principle of erring on the side of agility not only applies to single risk premia strategies but should also be embedded as a risk control principle at the overall portfolio level. For instance, a drawdown control rule which systematically reduces risk-taking proportionally across all active risk premia strategies whenever a pre-defined trailing loss trigger level is achieved, further helps to mitigate the consequences of being wrong. It is this focus on agility using highly liquid financial futures that will enable protection of capital in a severe market crash rather than being rigidly stuck in a continuing losing situation, which as the saying goes... can last a lot longer than you can remain solvent.

#3 – Focus on the payoff, not just on payout

Last but not least, we would caution investors against thinking of alternative risk premia as alternative betas. Beta is a term originating from the capital asset pricing model. Mathematically, beta measures the steepness of the ordinary least squares regression line between two return series. It is computed as the correlation of the two return series multiplied by the ratio of the respective volatilities. Importantly, beta assumes a linear relationship between an explanatory variable (e.g. the broad equity market) and a dependent variable (e.g. specific asset returns). It's a measure for an asset's sensitivity to non-diversifiable risk, also known as systematic risk or market risk.

However, when it comes to alternative risk premia investing, the term "beta" is a misnomer. The point is, alternative risk premia have a distinctly non-linear payoff profile: by harvesting the spread between the return on one set of securities to another, the upside is always

capped at the spread locked-in at inception while the downside is asymmetrically higher. Hence, investors are exposed to considerable "left tail risk" which is compounded by the fact that in phases of elevated market stress, spreads tend to widen and correlations can break down. This may happen even across presumably uncorrelated risk premia such as value and momentum as experienced during the "quant quake" in August 2007 when some of the then leading hedge funds posted high double-digit losses within a matter of a few days. Ominously, the current proliferation of quantitative factor investing strategies resembles in many ways to the crowding of the quants of that time with the exception that investor herding today is not confined to cross-sectional long/short factor strategies only but now also encompasses the long-only "smart beta" world. Put differently, the quant meltdown in 2007 was localised in the so-called equity market neutral and statistical arbitrage space, which is how risk premia and factor investing was boxed at that time. Now, it is a system-wide risk across the investment world as it has become mainstream.

Given this, investors are well-advised to look beyond simple correlation statistics and put more emphasis on the co-movement of alternative risk premia in the tails of return distributions, i.e. the best and the worst of times for global markets, for instance, mirrored by the returns of a conventional 60/40 equity-bond reference portfolio. Moreover, we would advise investors to look beyond the simple payout structure of alternative risk premia and focus more on the return-to-risk payoff profile they seek to achieve under constantly changing conditions, which are typically fluctuating between improving and deteriorating macroeconomic fundamentals on the one hand as well as perceived price stability and high volatility on the other hand.

In fact, one of the big advantages of disciplined rule-based investing is that the resulting payoff profiles can be engineered with much more precision than expected returns, which will always remain uncertain. The same analytical rigour and systematic approach used to accrue alternative risk premia in calm markets can be employed to target cost-efficient tail risk protection. For instance, by systematically sizing up exposure to safe-haven assets and short-biased strategies during phases of elevated market stress, investors are very likely to make positive returns in an equity sell-off. Of course, such strategy does not extract risk premia. Quite to the contrary, it is designed to deliver generic "crisis alpha" by making money when risk-taking is generally not rewarded in markets while preserving capital and avoiding the high insurance costs of put options during normal market conditions. Hence, despite not being a pure alternative risk premia, such a "Long Volatility" style can still fulfil an important role in a portfolio context.

Conclusion

Alternative risk premia are neither an illusion nor a panacea for today's investment challenges. Investors should rather look at them as active ingredients for developing practical portfolio solutions. In addition, investors are well-advised to define the space more holistically to include well-diversifying investment styles such as "Long Volatility" which go beyond pure alternative risk premia accrual. Well-implemented, economic rule-based strategies can enhance returns, reduce costs and improve diversification to equities and bonds over a full market cycle, thereby further strengthening a balanced portfolio's resilience to potential shocks that may come along.

However, first and foremost, investors must be clear about their objectives, look through the dust and not be lured away by the always compelling performance backtests of "alternative beta" strategies. In our view, the portfolio construction principles we have outlined can help investors to avoid falling into the most common pitfalls but they are not a standalone recipe for long-term success either.

Once implemented, alternative risk premia strategies must be carefully monitored, continuously researched and enhanced. Here, strong alignment is paramount since there is no combination of risk premia strategies that would once and forever maximise the likelihood of investment success under any given scenario, no matter how cleverly the underlying trading algorithms have been designed. In that regard, alternative risk premia investing is not very different from academic research, running a company or any other forward-looking and value-adding activity: only continuous learning and refinement can ensure long-term success.

2.2 INTERVIEW

With investors concerned with the impact of rising rates, is the argument swinging back in favour of hedge funds?

Interviewer

Máire McGuire,
Publisher,
Clear Path Analysis

Interviewee

Alan Pickering,
Chairman, Bestrustees

SUMMARY

- *Impact of rising rates*
- *Hedging and rising rates*
- *Assessing the portfolio*
- *Investment in the coming years*

Máire McGuire: Let me begin with the title question, with investors concerned with the impact of rising rates, is the argument swinging back in favour of hedge funds?

Alan Pickering: I think that 'lower for longer' is encouraging trustees to revisit their attitude to all asset classes. Our experience with certain asset classes in the past may have left a nasty taste in the mouth - this smacks of prejudice rather than the intellectual analysis. Whatever might have been our experience with hedge funds in the past, we should revisit the asset class with an open mind. However, like many alternative asset classes, we need to look below the strapline to see what might actually be involved with those particular hedge funds that have been drawn to our attention.

Máire: With talk about ETFs recently, what are the best ways to hedge against rising rates?

Alan: Most well advised defined benefit schemes are on a journey plan to a destination agreed between trustees and sponsors. While the destination might be agreed, the estimated time of arrival may still be the subject of regular review. What to hedge and how to effect that hedge should be debated on a scheme specific basis. Most of us are identifying a hierarchy of risk and deploying our risk budget accordingly.

Máire: How do you assess how much a rise in rates affects your portfolio? How do you view it as a trustee? What has had the most impact in the last 12 months?

Alan: Again, speaking as a trustee of a number of schemes, I have to take a different attitude according to particular scheme circumstances and the preferences of the employer. Employers with overseas parents often bring a difference perspective given their attitude to pension risk and the perception of that risk prevalent among the analysts' community who might be presenting a picture of corporate health – or ill-health – to market participants whose views might affect the share price or rating of the sponsor.

Máire: How do you see investment in alternative products growing in the next five years? Is there a best investment?

Alan: Even the word 'alternative' is worthy of definitional debate. Some mainstream asset classes were once described as alternative. I think that the trustee community should ask their advisers to challenge them with new ideas reflecting the world as it will be in future rather than continually looking through the rear-view mirror. Other things being equal, I do have a preference for simplicity and would always insist that dividing our portfolios in to ever smaller segments must always be subjected to the 'so what?' test. Doubling not very much will always end up with not very much as result and one must ensure that the cost of an investment does not dwarf the return from that investment.

Maire: Thank you for sharing your thoughts on this topic.

2.3 INTERVIEW

Factor Investing and uncommon alternative investment approaches

Interviewer

Máire McGuire,
Publisher,
Clear Path Analysis

Interviewee

Max Townshend,
Investment Manager,
Local Pensions
Partnership

SUMMARY

- *Factor investing and uncommon alternative investing*
- *Opportunities in alternatives*
- *Skillsets of an alternative investment manager*
- *Asset classes of the future*

Maire McGuire: With investors concerned with the impact of rising rates and inflation, where do you see the opportunities in alternative investment approaches?

Max Townshend: The collapse in real interest rates has made the job of long term investors, particularly those with inflation linked liabilities like pensions schemes, much harder. The UK is an extreme case where risk free term deposits now guarantee the erosion of purchasing power. If real interest rates do recover, investors may expect a pickup in risk premia. And if rates rise on the back of continued growth, this transition will not be painful for equity markets. But any hiccups to real growth should this transition occur could materially damage the investment objective of many of these savers. Given this uncertainty, it may never have been more important to hold a diverse portfolio of investments whose return drivers are spread across a range of possible macro environments.

Alternative risk premia should play a role in investors' allocations, as a framework for asset allocation as much as anything else. The idea of assessing what common risk factors your existing investments expose you to, and looking to build out and manage the size of these risk exposures through a rational process, is a new idea for many asset owners including LPP and our clients. It is a rewarding process that should be expected to pay for long horizon investors.

Maire: Are there any asset classes that you prefer at present? What about infrastructure, PE and real estate?

Max: For LPP and our clients, these private assets are no longer alternatives – we, like our peers, have long established teams dedicated to deploying capital in these markets; our clients have allocations to infrastructure, to private equity and to real estate in their policy (benchmark) portfolios. Through the GLIL partnership, we have made a long-term commitment to direct UK infrastructure alongside other LGPS funds.

But we are increasingly scrutinising these illiquid allocations against public market equivalents; while property and infrastructure bring attractive characteristics like inflation linkage and stable cashflows, private equity proposals must be expected to generate a clear premium over listed market equivalents to justify a relatively higher cost of equity and illiquidity. All of these – formerly "alternative" – assets are heavily exposed to similar growth, inflation and real interest rate risks as those found in a traditional 60/40 equity bond allocation. This is where less mainstream alternatives play an important role in balancing risk; insurance linked markets and cross asset risk premia approaches like trend following, carry and value are among the allocations we made last year.

With all-time lows in pricing, it might not be seen as a good time to allocate to property insurance risk premia; similarly, liquid alternative risk premia have recently seen a large increase in capital deployment, the effect of which on future returns is unknowable in advance. But equities, infrastructure and real estate are all trading at historically high valuations, and ex ante fixed income term premia are by

many measures at close to zero. This makes these relatively newer "alternatives" important cogs in any asset allocation, despite the uncertainty.

Máire: Tell us more about factor investing and uncommon alternative investment approaches.

Max: I'm not aware of many new long term opportunities that are being harvested with any scale. Terminology and product wrappers, however, have evolved significantly in recent years. Alternative risk premia, smart beta and factor investing are great examples. Hedge funds have picked up trends and carry across asset classes for decades. Tremendous public attention has been placed on these market effects, and products exploiting these return drivers at low cost have recently proliferated.

This has been a wonderful development for the science of investing, and while for some asset managers these low cost products may hurt revenues, for the best hedge funds it should prove to be an enormous boon. Previously, average investment funds were able to leverage well known, easily exploitable return effects to earn high management and performance fees. Managers generating "true alpha" had a tough time demonstrating their value and superiority as a result.

Now alternative betas provide a great benchmark for many types of investments. If managers can demonstrate an ability to generate a truly independent source of return, "alpha", then the value of this in diversifying traditional and alternative beta risks is tremendous. Today, robust alpha appears cheap at a 2&20 fee rate in a way simply wasn't possible to appreciate with the lenses of yesterday; the difference is that these types of alpha are now as hard as ever to find.

Máire: How do you see investment in alternative products growing in the next five years? Is there a best investment?

Max: What is "best" depends entirely on investor risks and needs. With alternative risk premia as an example, relatively small schemes can now access a diverse portfolio of non-traditional return drivers in a single off-the-shelf product at low cost. This is a fantastic development. Larger investors may be better off accessing these premia individually, and either through internal or external management build a portfolio of exposures best suited to their needs. The best investments are those that compliment a given investor's asset, liability and agency considerations. We are less constructive on assets geared to sovereign duration; with term premia so low, it's hard to see interest rates delivering positive crisis beta like in past cycles, let alone over a full market cycle.

In the coming years, I expect to see benchmarking in alternatives improve significantly. In private markets, public market equivalent hurdles should have more prominence, and practises like the use of bridge financing to game the IRRs that determine carry should be curtailed. On the liquid side there remain some obstacles to defining what a benchmark position in, for example trend following, carry or value, should be. Any benchmarks should absolutely consider asset class restrictions and the horizon of the effect being exploited, but this level of detail is little different to equities where longstanding benchmarks exist considering geography, industry and market capitalisation.

Excuses as to why managers' performance should not be measured relative to an appropriate benchmark (if one exists) must be worn away, and it is the duty of asset owners to ensure this is effected sensibly.

Máire: What are the skillsets for an alternative investment manager?

Max: Managers all like to stress the strength of their operational platform from back office through front; they also all claim to have a most robust investment proposition. What is growing in importance is the ability and willingness to work with their clients – pensions, endowments, family offices – to help us understand return drivers and portfolio fit, and if appropriate provide customisations to mandates to maximise their utility relative to investors' assets and liabilities. This emerging trend is less scalable, and managers are understandably cautious in how they approach this.

For beta products, the winners will be smaller managers with a hunger to establish new business, and in the long run larger managers that have invested in their platform to facilitate custom implementations and accordingly have a lower cost of scale.

What I expect from all managers is consideration of investor need; a product might not be right for us, but we hope it is right for someone. Whether alpha or beta, whether through investment outlook or quality of execution, whether at "2&20" or "10 bps flat", all managers should be looking to provide value and deliver useful solutions for investors. Investors should want managers' skills as much as managers want investors' assets, these should be fruitful relationships and it is disappointing to meet the managers with seemingly myopic product offerings. Thankfully it feels like this is improving each year, which bodes well for the building multi-year partnerships between the owners and managers of institutional assets.

Maire: Thank you for sharing your thoughts on this topic.

2.4 INTERVIEW

Increasing the diversification of managers and the best ways to do so: an examination of fund of funds, partnership structures, advisory approach or via multi- alternative funds

Interviewer

Máire McGuire,
Publisher,
Clear Path Analysis

Interviewee

Thomas Weber,
Managing Partner,
LGT Capital Partners

LGT Capital Partners is an award-winning alternative investment specialist firm with a successful track record since 1997 in providing innovative solutions for investors. The firm manages over USD 55bn in assets and has over 450 institutional investors including pension funds, insurance companies, sovereign wealth funds, banks, asset managers, endowments and foundations. With over 370 employees in 10 offices worldwide, the firm offers a global access point to alternative investments including private markets, liquid alternatives and multi-asset class solutions.

Maire McGuire: How do you currently diversify managers ensuring the best, in a purely alternative investment strategy and how does it compare with other asset strategies?

Thomas Weber: Being a longstanding investor in alternatives since the mid-1990s, we are constantly on the lookout for best-in-class managers that can be part of robust alternative portfolios. In order to diversify managers, we look at diversification by investment strategies/style and in terms of exposures as well as risk factors. When constructing a new portfolio, we start with a forward-looking scenario-based optimisation process, modelling the expected returns of the underlying alternative strategies (private equity, hedge funds, insurance-linked securities, real estate, commodities etc.) in the different scenarios. In addition, we look at the underlying exposures and complementary risk factor exposures as we have full position transparency with our managers. The results are (multi) alternative portfolios that can serve different purposes: diversifying traditional portfolios with high equity or bond risk or more absolute return-focused ones.

Diversification in traditional asset classes requires fewer managers in general as there are limited degrees of freedom and fewer alpha opportunities.

Máire: Alternative funds used to offer little transparency and fewer options, how has that changed in the last 2 years? What is driving interest?

Thomas: We have recently seen a significant increase in regulation that leads to more disclosure and transparency on alternative funds. However, we believe increased regulation only partially addresses the issue. There is no substitute for full position level transparency and operational control in these strategies through managed accounts which is a concept we have implemented and embraced since the year 2000. Many institutional investors are interested in this as it prevents surprises on position-taking and allows for timely risk management action, in particular, during crises. Additionally, some investor groups require transparency for regulatory reporting purposes (e.g. Solvency II).

Máire: What are the main benefits to partnership; looking at selection of the right external partner, ensuring the manager maintains a differentiated strategy and stays relevant?

Thomas: In selecting the right external alternatives partner, it is crucial to find an experienced manager that has a long history of

investing across different asset classes over a number of market cycles. A close partnership with the client starts with developing an optimal solution from an investment management as well as a structuring point. Additional elements include setting the appropriate investment objectives, selecting the appropriate vehicle and asset allocation as well as determining reporting, distribution and communication/knowledge sharing.

Maire: What kinds of expertise should investors be looking for in a manager in terms of asset allocation, manager research, portfolio implementation and are there specific kinds of managers for specific kinds of investors?

Thomas: There are many different types of managers in this world and for an overall solution, investors require expertise in all the aforementioned areas. My advice would be to look for real-life experience and strong alignment of interest. Expertise in asset allocation, manager selection and portfolio/risk management need to be proven over different market cycles and with a successful performance track record. Understanding the motivation and incentives of the manager should be key for the client. Some clients might prefer large brand names with a stronger asset growth focus, others prefer firms with a principal investor's perspective focusing on investing and increasing investor's capital alongside their own and benefiting from performance fees rather than from asset growth.

Máire: What do you think is the next evolution in alternatives investment?

Thomas: On the investment side, I see significant advances in combining traditional and alternatives portfolios. Moving away from asset class buckets (e.g. private equity, hedge funds, insurance-linked securities) to having state of the art portfolio structures and managing investments in an integrated fashion, i.e. on the equity side, determine how much risk is allocated through private equity, hedge funds, active long-only and passive strategies. In addition to traditional market risks this approach also takes into account alternative risks, i.e. illiquidity, catastrophe, alternative beta as well as skill risk. Again, with full transparency one can measure and observe those.

On the liquid alternatives side, I see the integration of alternative risk premia and manager selection alpha as an important development. I'm sceptical about the quality of the ever-growing alternative risk premia market but believe an investment-driven and transparent approach in this area combined with manager skill can deliver significant benefits. One is an understanding of what portion of a traditional manager's return could be systematically replicated; Another is functioning as a benchmark to determine the true alpha of managers as well as for performance fee calculations. The integration of manager and alternative risk premia requires an integrated risk view and full transparency. I am convinced that this makes liquid alternatives portfolios more efficient and better positioned for the future.

EXPERTISE IN ASSET ALLOCATION, MANAGER SELECTION AND PORTFOLIO/ RISK MANAGEMENT NEED TO BE PROVEN OVER DIFFERENT MARKET CYCLES AND WITH A SUCCESSFUL PERFORMANCE TRACK RECORD

On the business side, the inclusion of liquid alternatives into Defined Contribution (DC) pension schemes will be an important evolution. Innovative approaches in that area will tailor to an increasing investor demand to diversify out of equity and fixed income markets.

Maire: Thank you for sharing your thoughts on this topic.

SECTION 3

LIQUID ALTERNATIVES

3.1 INTERVIEW

Has the rising popularity of liquid investments overlooked the restrictions fund managers will face in asset and investment selection?

3.1 INTERVIEW

Has the rising popularity of liquid investments over-looked the restrictions fund managers will face in asset and investment selection?

Interviewer

Máire McGuire,
Publisher,
Clear Path Analysis

Interviewee

Richard Clarke-Jervoise,
Head of Private Capital Investment, Stonehage Fleming

SUMMARY

- *The rising popularity of illiquid assets*
- *Impact of restrictions*
- *Asset and investment selection*
- *Illiquid asset: and enabler or a disruptor*

Máire McGuire: Let me begin with the title question, has the rising popularity of illiquid investments over-looked the restrictions fund managers will face in asset and investment selection?

Richard Clarke-Jervoise: The principal constraints for wealth managers looking to invest in private capital are regulatory. Given that most private capital funds are unregulated, there are significant barriers to offering these to non-professional investors. In order to address this, wealth managers need to develop strong tools and systems for addressing both suitability and regulatory eligibility before offering private capital investments to clients. Once this is done, they frequently require different regulatory approvals which can be particularly challenging when it involves cross-border marketing.

In addition to the regulatory constraints, there are a number of specific constraints linked to the asset class itself. Unlike listed markets, there are no passive funds available in private capital meaning that wealth managers need to invest considerable resources in order to access and select the best managers for their clients. These types of funds typically also have much higher minimum investment requirements than listed funds. This may be a deterrent for smaller wealth managers. Other considerations are the need for specific reporting, accounting and administration platforms.

Máire: How will the restrictions impact asset and investment selection?

Richard: All of these constraints require significant investment in both cost and time before wealth managers can realistically offer illiquid investments to their clients.

Many families we meet have significant appetite for private capital, particularly for direct investments and direct investments in funds. Research shows that the average family office commitment to private equity is approximately 20% of total assets. However, given the higher costs and the high minimum investment amounts, we typically tell clients that the minimum amount they require before investing in direct private equity or directly in funds is $50-100m. For smaller families therefore, it can be challenge to access the asset class.

Where investing directly in companies is not a viable option, a possible route is to invest via private capital funds. Similarly to investing directly in companies, the choice is likely to be driven principally by the extent of time investors want to spend researching investments and the amount of capital they have to deploy.

There are also other options, including bank feeder funds, for those interested in private capital investment. However, these have a whole range of drawbacks principally relating to high levels of additional cost as well as the length of time it takes to deploy capital and the resultant significant cash-drag in the early stages of building a portfolio.

Máire: Why, as some say, will the emergence of illiquid alternatives be an enabler for some institutions and a disruptor for others? How do you view it?

Richard: With the backdrop of continuing low interest rates, periodic bouts of extreme market volatility and a fall in return expectations for most asset classes, the ability to access higher returning investments, such as private capital, is increasingly important for many investors. Being able to access this type of is therefore of strategic importance to many wealth managers. For our own clients, an attraction of private capital investment has been the ability to invest in high quality private companies, because such investments can have a particular resonance for entrepreneurs and families whose own wealth may have originated in a successful private business.

However, investors must remember just how illiquid some alternative investments really are: the life of an average private equity fund is ten years and may in some cases be longer. For many investors, this kind of time horizon does not pose any problems. However, it should be pointed out that an October 2015 study conducted by the BVCA highlighted that a mismatch of liquidity horizons as being the single largest risk in private capital funds. Therefore, those interested should make absolutely sure that they will not need to access the money they are committing before the end of the fund-life.

Máire: How do you see investment in illiquid alternative products growing in the next five years?

Richard: We have seen demand grow substantially in the past five years and I expect this to continue to grow in the future. At the same time, the market is also evolving rapidly with many alternatives emerging to the standard 10-year limited partnership. These involve co-investments, separate accounts as well as semi-liquid products. I believe that these types of products will continue to grow in the future and will be particularly appealing to many wealth managers and their clients.

Maire: Thank you for sharing your thoughts on this topic.

RESEARCH SHOWS THAT THE AVERAGE FAMILY OFFICE COMMITMENT TO PRIVATE EQUITY IS APPROXIMATELY 20% OF TOTAL ASSETS

SECTION 4

ALTERNATIVES:
A focus on asset classes

4.1 INTERVIEW

Rethinking the Role of Alternatives

4.2 INTERVIEW

With increased globalization are there assets that are truly uncorrelated?

4.1 INTERVIEW

Rethinking the Role of Alternatives

Interviewer

Máire McGuire,
Publisher,
Clear Path Analysis

Interviewee

Bev Durston,
Managing Director,
Edgehaven

SUMMARY

- *Role of alternatives in portfolio*
- *Changing role of alternatives*
- *Allocation strategies*
- *Choosing your managers*

Máire McGuire: What role do alternatives play in your investment portfolio? What types of alternatives do you allocate to and why?

Bev Durston: Alternative assets comprise a diverse range of investments beyond listed bonds and equities that can be used to improve diversification, enhance returns and reduce risk within a portfolio. From direct lending to macro and from reinsurance to infrastructure, alternatives provide a very broad opportunity set which require deep experience and expert navigation. Using this definition private equity is not considered an Alternative asset by Edgehaven. Instead private equity is a form of equity which should be measured against a listed public equity benchmark.

Maire: Do you think the role of alternatives is changing?

Bev: No I don't think that the role of Alternatives is changing as the three benefits identified above (diversification, return enhancement and risk reduction) are very broad themes. However I do consider that investors choose to stress different attributes according to their overall portfolio needs and requirements. So one investor might focus on the diversification element that they bring whilst another might be seeking enhanced returns from, say, a low yielding listed fixed income portfolio. As Alternatives have become more mainstream – for example Alternatives are becoming increasingly popular in the Defined Contribution market – then the demand for these assets has increased substantially.

Máire: Looking at the entire portfolio how do you decide your allocation strategy?

Bev: There are no fixed asset allocation constraints to Alternatives in the work that we do. Rather than simply filling "fixed bucket" allocations Edgehaven builds bespoke portfolios for clients with hand-picked alternative fund selections. These seek to meet client objectives in investing in Alternatives and also complement the existing portfolio. Fund selections are made with the most attractive ideas at the time and where fund terms are reasonable. Many of the funds are only investing for a short period of time (say 3 – 5 years) and then harvest the gains and return the monies back to investors. This keeps the portfolio fresh and mean it does not become hostage to stale ideas or to out of favour sub-categories.

Máire: How do you see investment in alternative products growing in the next five years?

Bev: Edgehaven believes that the growth will remain significant in the next five years for two main reasons. Firstly the demographic ageing of pension funds over time mean that as more and more of the beneficiaries retire their appetite for growth asset betas which have higher volatility diminishes. In contrast alternative programs can be built with capital preservation as a main focus and this is also true of many hedge fund (or cash-plus) strategies. Secondly the retail market has a growing appetite for interesting investments and alpha sources which are not as volatile as equities and yet which provide outcomes

that currently only institutions can access. The provision of Alternative assets to the retail space will be another large driver of increased demand in this space.

Máire: Where are the opportunities in alternatives at present, what asset classes are you looking at?

Bev: There are a range of interesting ideas that Edgehaven is working on right now for client portfolios. Smaller sized and / or emerging hedge fund managers are our preferred method of allocating to absolute return strategies as these are more nimble and hungrier for success plus also offer investors better terms. In Asia we have recently invested in a number of opportunistic property managers across the region. And in Europe we favour direct lending to smaller companies at a mainly senior, secured level. Europe is also home to banks which still transact regular capital relief transactions to raise capital. This is a strategy which maintain its complexity premium to other fixed income strategies over time.

Máire: Is any part of your portfolio managed passively? And how do you differentiate between managers? How do you make the choice of which manager to use?

Bev: In Alternatives there are no parts of the portfolio that is currently passively managed. However quant strategies are replacing some of the low hanging fruit in hedge fund strategies and so-called "Alternative beta" funds have been gathering significant assets in this arena. Edgehaven prefers specialist managers who have significant capital invested in their own product. We prefer performance based fees with a reasonable hurdle before the manager can extract performance fees. Often there may be several managers who are capable of being selected in a particular strategy. In this instance the differentiator is how investor friendly the terms of the fund are together with the overall governance standards of the manager.

Maire: Thank you for sharing your thoughts on this topic.

"QUANT STRATEGIES ARE REPLACING SOME OF THE LOW HANGING FRUIT IN HEDGE FUND STRATEGIES AND SO-CALLED "ALTERNATIVE BETA" FUNDS HAVE BEEN GATHERING SIGNIFICANT ASSETS IN THIS ARENA"

4.2 INTERVIEW

With increased globalization are there assets that are truly uncorrelated?

Interviewer

Máire McGuire,
Publisher,
Clear Path Analysis

Interviewee

Dragomir Veilkov,
Chief Investment
Officer, Compass Invest

SUMMARY

- *Uncorrelated assets and downside protection*
- *Investing in private or direct alternatives*
- *Alpha strategies*
- *Hedge fund opportunities*

Maire McGuire: Do strategies really exist that are uncorrelated, can provide downside protection and generate real returns?

Dragomir Veilkov: In the globalized world, the traditional asset classes have a tendency to move in the same direction. Therefore, in a search of portfolio optimization a few alternatives are becoming mainstream - infrastructure, real estate and private equity. I would add to these also commodities which traditionally protect the investments as they tend to outperform in an unexpected and high inflation environment. To the alternatives suitable for the portfolio diversification I would add Insurance-linked securities (ILS) as they show low correlation to traditional asset classes.

Máire: Is the hedge fund party over? If not, where, in your opinion, are the opportunities?

Dragomir: The hedge fund industry experienced several years of outflows mainly because of the poor returns vs-a-vis slowly adjusting fee levels. The macro environment did not help for their performance either dominated by low volatility and low to negative interest rates, emerging markets economies and commodities being under pressure. Nevertheless, the demand for the alpha is still here and hedge funds will manage to capture substantial part of this demand. A few opportunities I observe are related to entering new niches not common for them until now, i.e. market –making activities, lending, asset servicing or shifting towards more private and illiquid investments (mainly occupied by Private Equity firms so far). The same tendency would be valid for Private equity firms as they would re-focus partially to some of the hedge funds' traditional activities.

Last but not least hedge fund have to adapt and to adjust their fee structure model.

Máire: What about Renewable energy? Precious metals? Infrastructure? Real estate? Real assets? Life settlements? Venture?

Dragomir: With the shift of the macro paradigm from low interest rate/low growth/low inflation to more growth positive and inflation accelerating stage of the economy the portion of the investment in Real Assets becomes more appealing. The best inflation protection should come from assets such as Commodities, Real Estate, Infrastructure, Natural resource Equities including Renewable energy combined with TIPS and precious metals. The right mix of them would be able to provide solid insurance mechanism in a higher inflation environment.

The case for infrastructure is even stronger as this asset class should benefit from a massive investment public/private program for upgrades and major improvements of the existing facilities.

ILS (life settlements) is logical to continue to attract institutional investors as it is anticipated to remain appealing and a valuable diversifying source of uncorrelated returns.

Máire: Can a niche within the same industry perform very differently?

Dragomir: Certainly if you analyse for example the commodities industry; you may identify different performance patterns within the sub-classes – energy, metals, agro commodities etc.

Máire: When you consider alpha, does investing in private or direct alternatives offer a premium significant enough to warrant the perceived or real risks associated with these investments?

Dragomir: There is research which demonstrate that the investments in private equity or venture capital are overestimating the real benefits of such investments in the portfolio context due to the lack of transparency and selection data bias.

In my view, we should look at the issue for the suitability of the investment in alternatives and particularly to what extent such investments fit investors' profile , risk tolerance and time horizon. If the investor has a short-term investment horizon he would plan and evaluate its strategy for the next 1-2 years. The revenue drivers of this strategy would be more driven by the price and market fluctuation.

On the other hand, the long-term investor would usually plan for the next 5, 10 even 20 years. Having such a long term horizon the investors are focused on their overall performance in the long run. The revenue drivers for long term investors are different since they would rather focus on fundamentals of the underlying companies and the assets which will generate growth overtime.

Therefore, I believe that investments in alternatives and particularly in private equity justify portfolio's "alpha" generation and substantiates the premium embedded in the pricing structure.

Similar less liquid investments that are suitable for long term investors might bring::

- *Enhanced returns from long-term real estate or infrastructure investment (for 5-10 years or even 20 years) based on historical data confirming that the returns for longer periods exceed those of the public markets consistently*
- *Viable Hedging possibility against the performance of the stock market and the forces of the economic cycle. Private equity is a suitable alternative as it generally shows Negative correlation with both of them (the secondary market and economic cycle)*
- *Improved market timing as Long term investments tenor usually exceed the market cycle and therefore long term investors can make investment decision based on fundamental value which gives more flexibility*
- *Lower transaction cost as the turnover is normally much smaller and operations take place less frequently.*

Maire: Thank you for sharing your thoughts on this topic.

I BELIEVE THAT INVESTMENTS IN ALTERNATIVES AND PARTICULARLY IN PRIVATE EQUITY JUSTIFY PORTFOLIO'S "ALPHA" GENERATION AND SUBSTANTIATES THE PREMIUM EMBEDDED IN THE PRICING STRUCTURE

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