

Making a Meaningful Allocation to Alternatives

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It now seems to be generally accepted that there is a place in most well constructed portfolios for some exposure to alternative assets, which can, through diversification and non-correlation, enhance the risk/return profile of a portfolio.

However, there is more to taking the decision to invest in alternatives than just saying yes or no. While the potential benefits of alternative investments may be obvious, there are many different issues for pension schemes and their trustees to consider. Not least, what is an alternative? In which types of alternatives should one invest? What is the optimal mix? How can it best be implemented? What returns can investors expect? What other implications should one now consider?

The first issue to consider is how to define alternatives. We believe that there are two obvious answers to this question, neither of which is wholly satisfactory. The first is the market shorthand, which says that alternatives are hedge funds, private equity, infrastructure and other strategies where returns are driven by alpha. The second is the semantic answer, that an alternative investment is something different from the existing investments in a portfolio and so is defined in contrast to each client's portfolio. By this definition, an alternative could be a different beta source just as much as an alpha source.

From this, we can see that there is no static definition of alternatives. While typically hedge funds, infrastructure and commodities are considered alternatives, this is more due to their absence from a standard client portfolio, rather than to a set of characteristics that they share.

We think that the best way to view the issue is to look for two elements in an 'alternative' investment which together provide a working definition. First, there should be a high total expected return. Second, there should be low correlation

with existing investments. This opens the door to considering lowly correlated sources of beta as well as alpha. Commodities, property or senior loans might fit this category.

Investors also need to consider how best to construct models for alpha. In order to construct a strategic benchmark for alternatives, investors need to have a working model of the return and risk characteristics of the constituent investments. When those investments have reliable fundamental economic links, this can be done in a straightforward, quantitative manner. But what about alpha-dominated investments? Here, much depends on manager skill and this, by definition, cannot be easily modelled. Investors must therefore rely more on qualitative assumptions and the presence of these assumptions needs to be borne in mind when the results of the model are considered. Our view is that investors should be modest and cautious in their assumptions and avoid falling into the trap of gaining a false level of comfort by modelling extraneous 'noise'.

The next issue is to decide which alternatives should be included in a portfolio. It follows from the definition of alternatives given earlier that these investments will tend to have a low correlation with conventional assets. But what benefits can an investor reasonably expect in choosing alternatives and what alternatives should be used? Making a number of reasonable assumptions about investment objectives, extensive modelling based on typical investment portfolios and using a very wide range of possible alternative investments would suggest that marked improvements in expected portfolio characteristics can be achieved through investing part of the portfolio in a well-diversified mix of alternatives.

Embracing the notion that a well diversified mix of alternatives is the

optimal solution brings its own challenges. Different alternative investments bring with them different implementation issues. While some alternatives are available through relatively standard investment vehicles, many rely on the use of specialised derivative instruments and leverage. Others may have very limited liquidity. Investing in a range of alternatives will inevitably entail facing a range of these problems – problems which can make the process costly and time consuming, if not actually impossible for all but the very largest schemes.

That said, we do believe that these obstacles are not insurmountable. One solution is to effectively outsource this process to asset managers with the necessary range of skills to create investment structures which deliver a single point of investment to schemes, such that the burden of risk management and governance falls to the asset manager.

So what should schemes be looking for from asset managers? Firstly, the manager needs to have the ability to identify the set of alternatives with the right characteristics for the scheme's portfolio. We have a working definition of alternatives – investments that have a high total expected return and a low correlation with conventional asset classes. Different investments will contain these two features to different degrees. Low correlation with the existing portfolio does not have to come only from alpha-dominated strategies. The desired diversification can come from assets which provide exposure to unconventional markets, a good example of this being commodities. We see the value of including such assets (sometimes referred to as 'exotic beta') to an investment set. We believe that the following asset categories should be included in any list of alternatives: Commodities (Metals, Agriculturals, Energy); Hedge Funds; Private Equity (Large-cap, Small-cap, Distressed, Real

Estate, Infrastructure); Senior Loans; High Yield Bonds; Currency; Property Securities; Emerging Markets Debt; Global Macro; Volatility; Emissions; and Freight.

This list is not exhaustive and more asset classes could well be incorporated over time. One obvious takeaway from this list is that the alternative asset class cannot be divided perfectly from the rest of the investment universe. It is really part of a continuum which moves from conventional, beta-dominated to alpha dominated assets.

The next step is to come up with a way of modelling the behaviour of these asset categories. It is important to examine their correlations, volatility and expected returns, as well as the shape of the return distributions and to account for liquidity.

For certain assets, historical volatilities and correlations can be readily determined, but alpha-driven assets aren't so easy to handle. For some, it is possible to combine available historical returns with an estimate of a sustainable Information Ratio. Other assets, like many hedge funds, simply cannot be addressed through conventional asset data and so qualitative assessments have to be made instead. The complexity of the modelling process increases greatly as asset classes such as private equity are added.

After estimating returns and volatilities, the next step is to consider correlation. It is key to analyse the relationships of all the alternative assets and also the relationship of these assets with the conventional assets in the scheme's existing portfolio. Analysis which measures the correlation of alternatives with UK equities and UK bonds indicates that not only do the alternative asset classes demonstrate a low correlation with UK equities and bonds, but they also show a low correlation with each other, suggesting that by diversifying across a range of alternatives, the volatility of a portfolio may be lowered further.

All this would indicate that there is a strong case for investing in a diversified mix of alternative assets. However, this conclusion is only useful if the decision can be implemented properly, which also presents several key challenges. The first is to access the right investments. However good the modelling may be, it is based on asset classes (or proxies for asset classes), not on actual products in which we can invest. Moving from the model to a portfolio of real assets is a particular challenge for high alpha strategies like hedge funds and private equity. It is clearly critical for schemes which are considering this to therefore look for managers with the knowledge and experience in the relevant asset classes, not least because the cost implications for a manager who cannot manage all the asset classes are likely to make such a portfolio impractical.

With so many disparate parts, different kinds of investment vehicles, and divergent liquidity patterns, the implementation of the alternatives portfolio and its integration with the client's existing portfolio is a real obstacle. The logistics of investing and monitoring investments, and the governance burden of unconventional assets could make diversification into alternatives impractical for many organisations. A single manager is able to take responsibility for all of these functions.

Summary

In summary, we believe that all schemes could benefit from the diversification and risk/return characteristics which a diversified portfolio of alternatives could bring. However, smaller pension fund schemes have been prevented from making these investments by the major administrative, governance and risk management burdens that making these investments one by one would bring. Asset manager-led solutions which combine the necessary asset allocation and modelling skills, together with a broad range of underlying alternatives strategies that is available in a pooled fund format as well as on a separate account basis, would seem to be the answer.

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