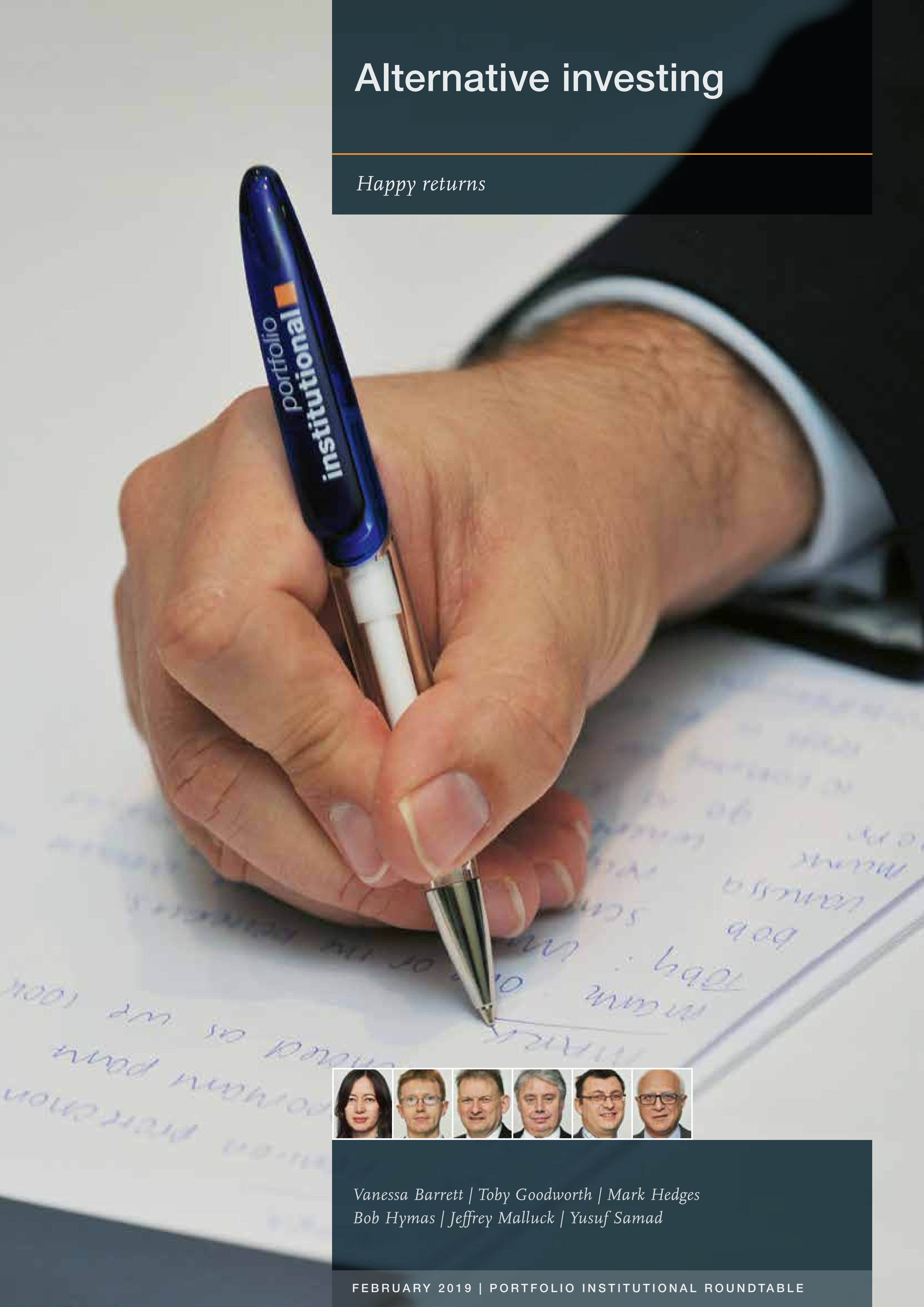
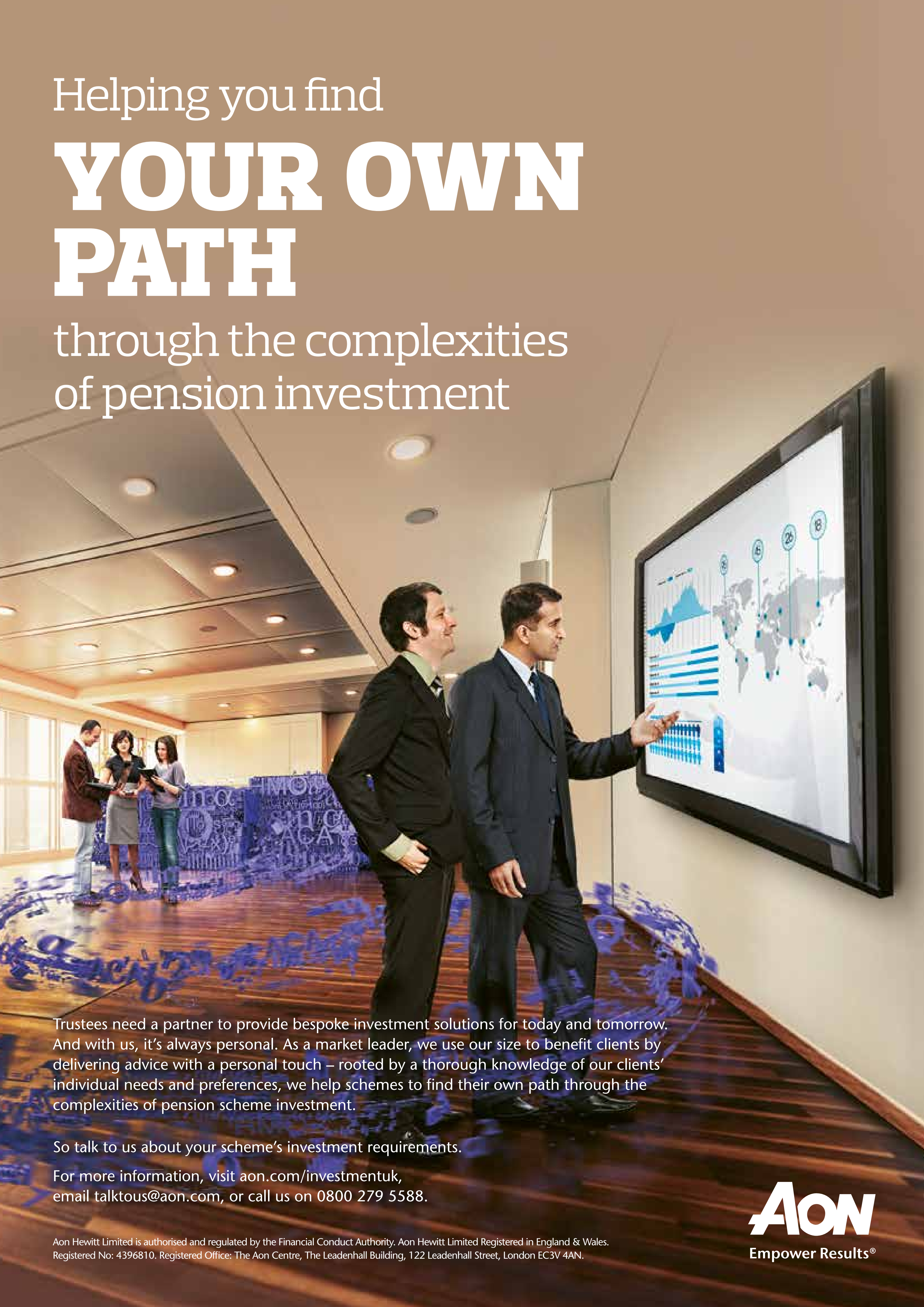


Alternative investing

Happy returns

*Vanessa Barrett | Toby Goodworth | Mark Hedges
Bob Hymas | Jeffrey Malluck | Yusuf Samad*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Alternative investing: Happy returns

Alternative investing is becoming a mainstream strategy. Once considered niche, there are few institutional investors today, if any, who have only bonds and publically-listed equities sitting in their portfolio.

They are likely to hold a range of other assets in their product mix, which could include property, infrastructure, private debt, commodities, hedge funds or private equity.

The influence of these alternative assets on defined benefit (DB) pension schemes' ability to pay member benefits is expected to remain strong. Indeed, a global survey by asset manager BlackRock found that 47% of trustees intend to invest in real assets during 2019.

Then there is a forecast by PwC that institutional portfolios around the world will hold $18trn worth of alternative assets by 2020. If the accountancy giant is proved to be accurate here, then the value of the market would have almost doubled in five years.

This rising popularity was sparked by the financial crisis, especially among smaller schemes. Such assets appealed to investors needing stable, regular and long-term income streams but were faced with disappointing gilt yields.

The risk-return profile of alternative strategies and the long-term investment horizon of pension schemes proved strong enough to ease concerns over the illiquidity of many of these assets. Then there is diversification. The idea that building a portfolio of real assets could provide a return from various sources ticks another box on cautious trustees' wish-lists.

A low correlation to publically-listed bonds and equities means that such strategies could provide a desired return in the face of volatility hitting mainstream investment markets.

This claim could be put to the test this year. Fears of a slowdown coming in some areas of the world, continuing uncertainty over how the UK will leave the European Union, the ongoing face-off between the US and China and investors continuing to lock-in their gains from a prolonged equity bull-run could challenge the perception that these assets are worth holding despite their illiquidity.

This is, therefore, a timely topic for discussion and our debate with asset owners and their advisers on the issues shaping alternative investing can be read on the following pages.

Mark Dunne

Editor, *portfolio institutional*

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Head of risk and diversifying strategies
bfinance

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Trustee executive
BESTrustees

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Nationwide Pension Fund

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Editor
portfolio institutional

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Investment director
Wellington Alternative Investments

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Professional trustee

Jeffrey Malluck
Senior investment consultant
Aon

Vanessa Barrett

“It isn’t easy to find credit managers that have restructuring or recovery expertise.”

Vanessa Barrett, Wellington Alternative Investments

Portfolio Institutional: PwC predicts that institutional portfolios could hold $18.1trn of alternative investments by 2020, up from $10trn in 2015. Why are such assets so popular?

Yusuf Samad: It is an extension of the purpose of long-term investors, particularly pension funds, to invest in the economy and make a return from different sources.

There is a huge beast sitting outside of the public equity and fixed income markets. You could invest in that at different stages of the lifecycle to diversify your sources of return in, for example, private equity or, at the other end of the lifecycle, leveraged buy-outs.

The changes in accounting standards and mark-to-market are also driving interest in alternatives.

Bob Hymas: It’s an area that the larger schemes have been invested in for some time. What has happened in recent years is the investment universe that smaller schemes can access has become greater and they are starting to recognise the value of diversification and moving away from public equities. So it is a case of access as much as anything else for smaller schemes.

Vanessa Barrett: In terms of accessibility, particularly in private credit, a number of things have happened. There has been the search for yield and a disintermediation of the banks, creating the ability for broader investors to tap into an asset class that has historically been limited to bank balance sheets.

What we have witnessed is an explosion in private credit, which we get asked about quite a lot. Private credit, certainly in our conversations with clients, is always top of mind in terms of where flows have been going, and the expectation is that it will continue to go that way.

Toby Goodworth: It is important to understand what we mean by alternatives. There is a natural tendency to jump to private markets, but you can still use traditional markets in a non-traditional way. I focus on liquid diversifying strategies, which cover all things hedge funds, absolute return multi-asset and alternative risk premia. They are as equally important to a portfolio to provide diversification as illiquids. It is spreading the message that alternatives don't necessarily only mean private markets.

Samad: That is just a way of investing rather than an asset class by itself; it's more a strategy. In private markets you are getting a source of return from underlying economic activity.

Goodworth: I look at diversification not by asset class but by different return streams. You can get a return stream that is diversifying from a different asset class, yet you can also get a different type of return stream using the same asset class in a different way. So you could have different dimensions to diversification. It is important not to forget that.

Jeffrey Malluck: The key thing with diversification and income, especially with this big influx into private credit, is that the opportunity only presented itself to the wider range of pension funds in the 10 years since the financial crisis.

Trustees and consultants have evolved, recognised the opportunity and made allocations to alternative strategies. From a risk/return perspective, this diversification has been beneficial.

PI: How is the Nationwide Pension Fund using alternatives?

Mark Hedges: Diversification is the key driver for moving into what we call 'private markets' rather than 'alternatives' because there are potentially liquid alternatives.

Our approach has been to get value from diversification, from illiquidity, into something with more complexity. That has been a long-term plan. The trustees started this in 2006 with real estate and infrastructure and it's moved beyond that into a variety of private equity strategies, private credit and real estate debt.

We have two allocations to private market assets. 20% is return-seeking, so it's a fundamental driver, whether it's income from private credit or capital growth from private equities.

Then we have an almost 10% allocation to alternative matching assets. They are illiquid. It is long-lease property and commercial ground rents. It is strategies that are focused on driving out the long-term income from illiquidity.

It takes time to build these things up, so it has been a journey. We have broadly reached our target allocations and our expectation is that over time, as we de-risk the fund, more funding moves into liquid gilts. That means the residual piece can remain in that illiquid market.

If you are in our long-term low dependency target portfolio, that 10% to 15% return doesn't have to be in liquid assets. It can be in illiquid ones to get that premium because you have 85% of the fund in liquid assets, which are there to match liabilities. We call it 'alternatives' but it's pretty much mainstream for most people these days.

Malluck: When you are de-risking you don't need to think: "I need to go into liquids." You can look at long-lease property or ground rents, which have quite attractive income streams and inflation protection.

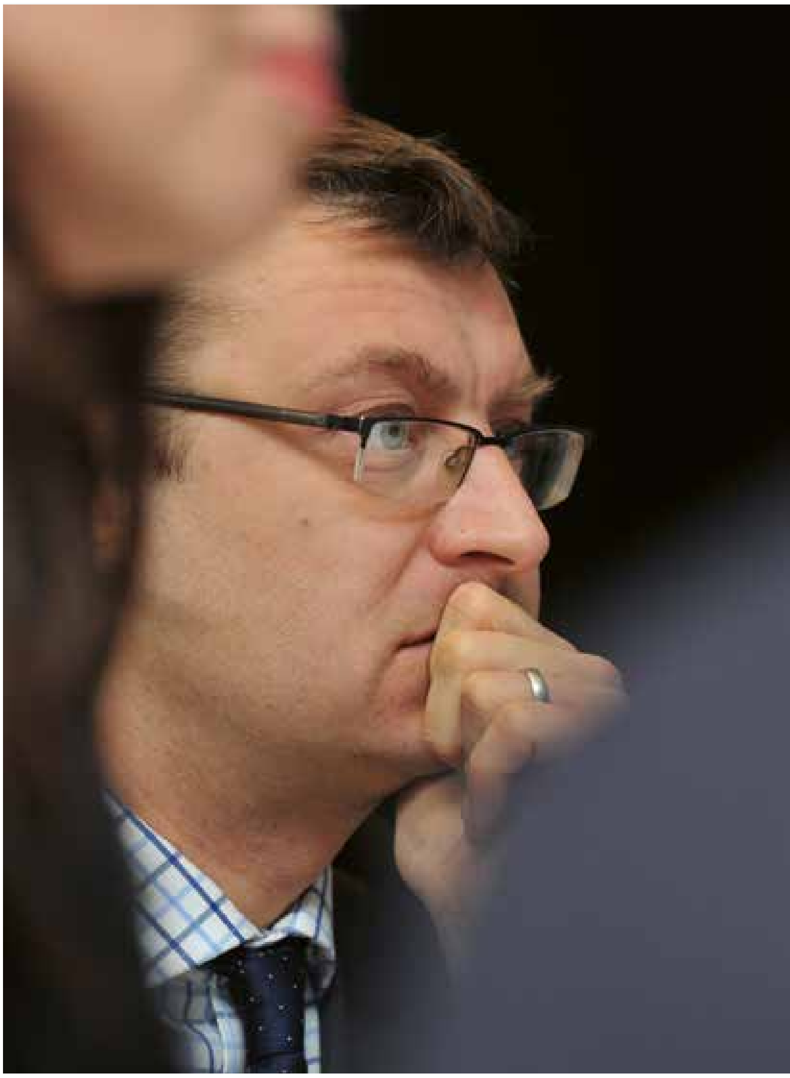
Samad: We call this 'alternatives' and the other assets 'traditional', but 200 years ago what would you have invested in? Property. So which one is the alternative?

Hymas: That's a valid point because when you are sitting with a group of lay trustees and you say 'alternatives' and 'private markets' they pull away from that. Whereas if you talk to them about 'de-risking' and 'diversification' they get it, they understand it.

You can scare people off by using the wrong terminology. That is why you start to see investment in alternative assets increase at the smaller end of the market. There is access but there is also an understanding so trustees can see how it fits into a strategy. That is quite a fundamental change over the past 10 years.

Samad: The buzzword word we have not mentioned is 'inefficiency'. The dispersion of returns between some managers is huge. If you look at venture capital in the first or third quarter the difference is something like 40%. If you look at the same for public equities it's 2.5%. If you look at bonds it's 1%. That tells you the degree of inefficiency that exists and if you can select the right managers you can get higher returns.

So there is a return element to this and there is also an element of getting away from the herd. So you seek inefficiency.



PI: What alternative assets are in your portfolios, Yusuf?

Samad: In the Pension Protection Fund's portfolio we had private equity and global real estate. We had alternative credit, and it wasn't just private direct lending, it ranged from loans to mezzanine lending to opportunistic credit and distressed.

So there is a huge spectrum out there which people should talk about but they miss out on perhaps because direct lending seems to be all the rage.

Then there is infrastructure, farmland and timberland. We did have a hedge fund strategy and the global macro systematic stuff, but in my experience you make a return one day and lose it all the next. It's a zero sum game.

Goodworth: Mark, you mentioned a move to complexity. Those investments are more complex than some other elements within the alternatives category. Do you find that it is a challenge to get more complex things across the line, either a conceptual understanding or just the mechanics of how the strategy works?

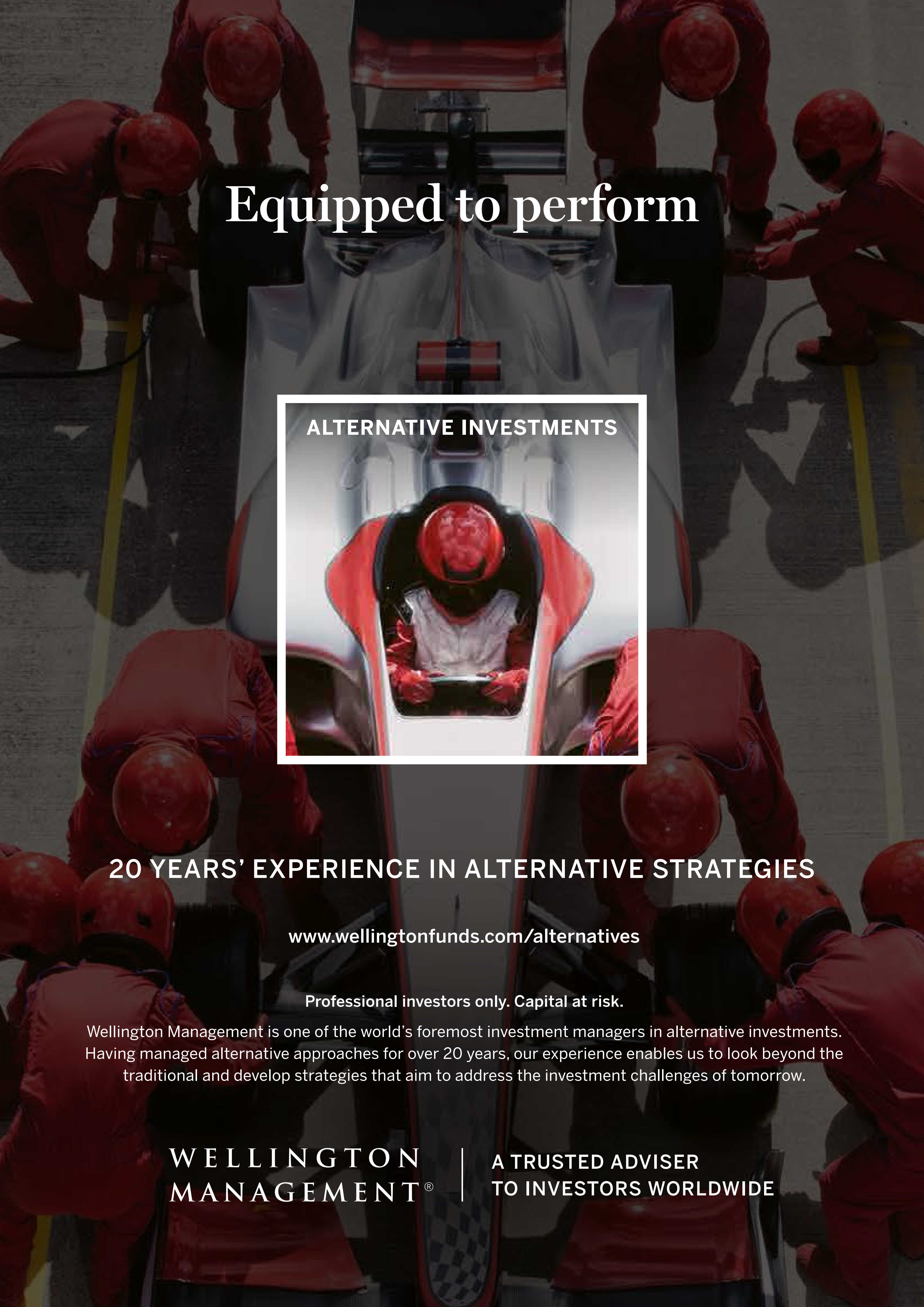
Hedges: In all spaces markets look overpriced, so it's trying to find managers who can differentiate. Often in this market that leads you into somewhat more niche strategies where they are specialist and probably, therefore, have barriers to entry to their particular field. That means you have to understand what they are doing.

A prime example of this is a bank capital relief strategy, which if you have a securitisation background is fairly straightforward but when you mention 'securitisation' to trustees they think it was the cause of the crisis, whereas, frankly, it was liquidity.

It becomes more of a challenge because you need to understand what the manager is doing and how they are going to add value and make money. Then you have to understand that in a way that you can convince your trustees.

So it is more challenging, but in the current environment it's where the opportunity is because more mainstream alternatives, such as a typical US mid-cap buy-out, are likely to be bought at the top of the cycle, so the opportunity to add value over the next five to 10 years would be lower than someone who invested in 2012 and has reaped the rewards of a rising market.

So as you plan ahead you have to keep recycling this pool, it is not about growing it any bigger but where do you recycle it. Obviously, you will stay with managers who have been successful, but going forward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it will not be the benign environment we have had for the past 10 years that has enabled a lot of these alternative providers to do well. It is going to be more challenging.

So it is trying to find people we feel have something that will enable them to have a more defensive position. It's particularly the case when we look at private credit managers. We want to find people who can differentiate themselves because there are so many out there and they are all offering a vanilla product and you worry that if there's a downturn are they going to be able to manage it.

Private credit doesn't have any upside. It's debt for a reason, so you have to worry about their skill-set because not that many of them have managed through a downturn and seen what losses do. That is my worry with private credit so we have been quite selective. We avoid mainstream bank syndicated loans because the likelihood is that you are not going to be able to control those deals when they start to go wrong because you could be sat there with seven or eight other lenders.

So we focus on people who are doing things differently and attract a segment of the market where they have a specialism or can operate in a slightly different way, so they have a unique selling point.

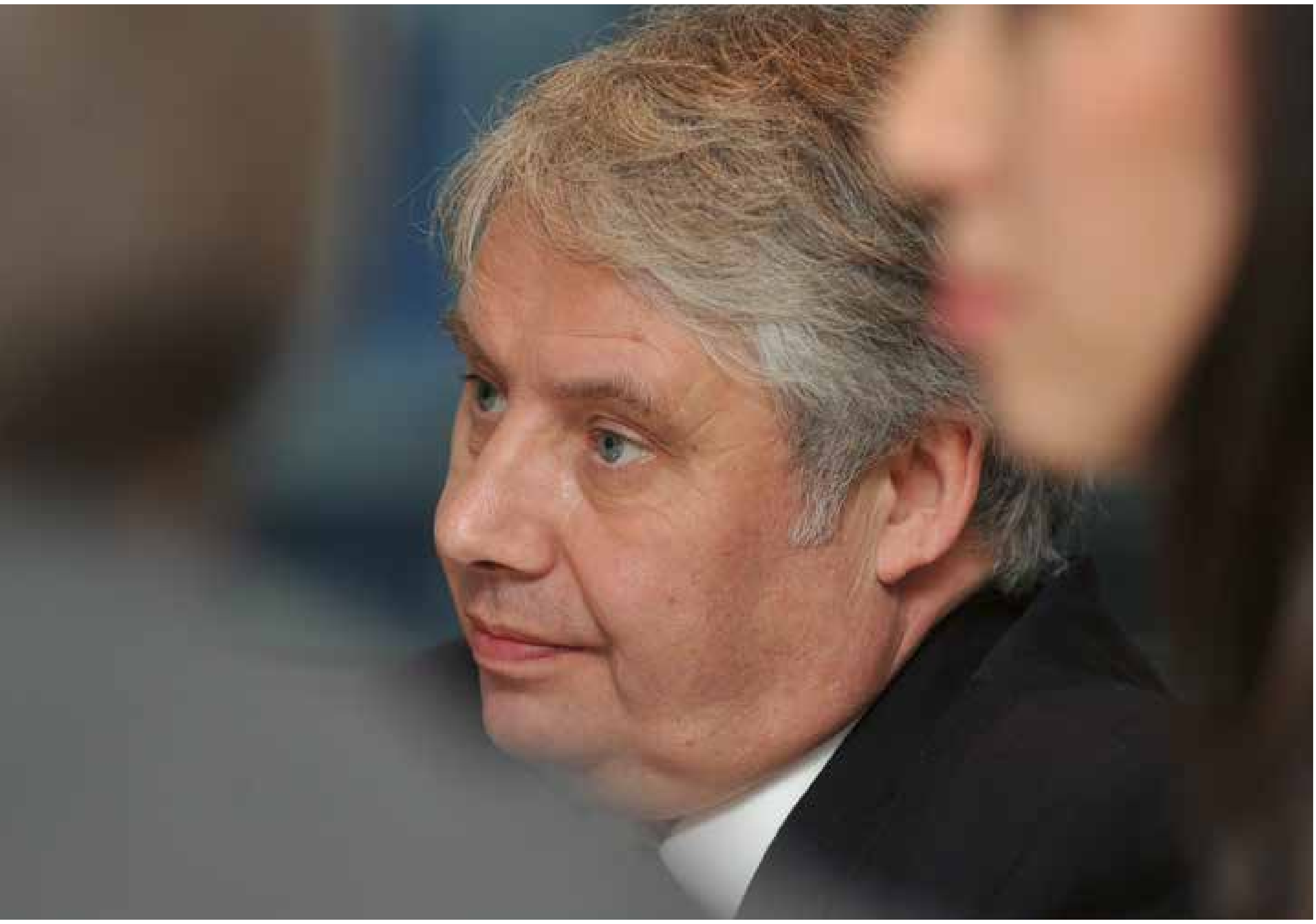
PI: So where do you find these people?

Hedges: We are a small team but Scott Freeman, who heads up my private markets team, and I have been in the private equity market since 2002. So we have an extensive network of placement agents,

"There is a huge beast sitting outside of the public equity and fixed income markets."

Yusuf Samad, Professional trustee

Yusuf Samad



banks and fund managers. Frankly, by the time I get back to the office I'll probably have two more deals in my inbox to look at because as soon as people know you are in the market you get inundated.
The problem is not so much seeing the opportunities, it's trying to sift through them.
When sifting through them the first thing we ask is, what's different? What is it that this fund has that puts it in a unique place where they could add value, particularly in this environment?

Goodworth: The aim of alternatives is to diversify, but diversification is a personal property. What diversifies my portfolio doesn't diversify your portfolio. There are common themes, but diversification is personal, so making it niche doesn't mean everyone automatically herds to the same thing.
Are you seeing competition for your diversifying assets or do you find that what you want is not what everyone else wants?

Hymas: Generally, in the schemes I represent, it is through pooled vehicles so it's a slightly different scenario to looking at individual managers.
Going back to some of the comments made before, what we tend to see is alternative credit and real estate playing a big part. When you start to go beyond that the word 'private' tends to be a bit of a challenge, it concerns a lot of lay trustees, but also a big consideration is liquidity.
It's one of the issues that comes up in infrastructure because most schemes are starting to look at a time horizon which they might think does not actually fit with an infrastructure investment. There are interesting challenges, but on a pooled basis you aren't getting into this level of granularity around the individual deals.

Barrett: Mark, to your point about these private deals maturing and the need to recycle your investment, are you looking to move up and be more liquid or are you thinking about more niche products?
Also, how do you find capacity in these niche products? It is an interesting point because there is always going to be a demand for niche products, but capacity is always a constraint for pension funds.

Hedges: We have two portfolios. The 10% in alternatives would stay, but the 20% return portfolio will be reduced to about 7.5% over time. What would happen as we de-risk is we won't recycle all of that cash. We will do smaller allocations, so instead of doing £50m with a fund manager we will do £35m, so we maintain a broad diversity of funds within the portfolio.

There will be private equity and infrastructure, but we don't have buckets for each of those, it's opportunistic in terms of the allocation over that 20%. It is wrong to be forced to put 5% in private equity if it's not a good time to be investing in private equity. If it's a better time to invest in private credit then we invest your money into private credit.

We are of a size where we are nimble enough to do that. If you are a big pension fund you can't manage it like that because you are managing bigger numbers. That gives us an opportunity because a lot of the nicher activity is not going to get on a big fund's radar because they want to place £100m to £200m. A £300m fund is not interested.

A classic fund for us that we got into is a specialist credit fund that raised £300m. It doesn't need consultants to sell it; it's done so well and has been doing it for 20 years. We were fortunate because we have a wide network where someone introduced us to it, but often it becomes difficult for people to get into. If you are a large fund some of these niche strategies just don't work for you because you can't deploy enough money into them.

Malluck: That is a key point with pension schemes. It is not so much that we have 15% in alternatives and we are de-risking and therefore we go to 10%, it's what that allocation consists of. Then from that you can say: "We might have X in whole loans or mezzanine, but when we get those redemptions back let's shift that into senior secured strategies, long-lease property or ground rent, something that is more stable, secured and still pays that income stream that will continue to help you on that de-risking journey."

Hymas: You are both touching on that key point as to how pension scheme investment is starting to evolve and look more at the cash requirements going into the future. Buy and hold strategies are being presented far more to the boards that I sit on, and they are focusing on what the cash requirement is and how you match it. So there is a changing focus and emphasis now, which is quite interesting as to how that can develop into the portfolio.

Samad: The capacity point is interesting. Today the competition is the very large sovereign wealth funds. They are taking up the capacity of good managers. So the big challenge, especially if you are a larger investor, is to get your money in there against these guys and also not to spoil the returns by causing a deviation in strategy. It has become a challenging aspect of the private markets because finding good things is rare. The trouble is everybody sees that.

For smaller schemes the issue is that if it is a smaller fund they are more reliant on consultants. Consultants don't want to do research on smaller funds, on one entity. The consultant model is one report sold to 10 people.

Goodworth: I have a slightly different view because we have a firm policy of no buy-lists. That does obviously gravitate towards nichier managers.

Malluck: One of the things you need to look at is if the money the manager is looking to raise fits the strategy. For direct lending we think larger managers have an advantage as they can compete with banks. For more niche strategies we prefer managers to constrain capacity.

PI: Are investors following a multi strategy or market neutral approach?

Barrett: Probably both. What investors are looking for at this point in the cycle – whether from the private or the traditional liquid side – are uncorrelated returns. So it is a question of finding strategies that are diversifying, have strong downside protection and are uncorrelated.

The discussions we have been having are on those two strategies. Market neutral tends to be quant-driven. The multi strategy side tends to be for big strategic clients that need to look across our platform, for which we build something customised, or in the liquid alternative space where a lot of smaller and mid-size investors are struggling with their overall hedge fund allocation, paying a lot of fees at different levels and are looking to consolidate the fees. They come to places like Wellington to look across our platform and have a diverse range of strategies without the double fee at different layers.

Jeffrey Malluck

"Trustees and consultants have evolved, recognised the opportunity and made allocations to alternative strategies."

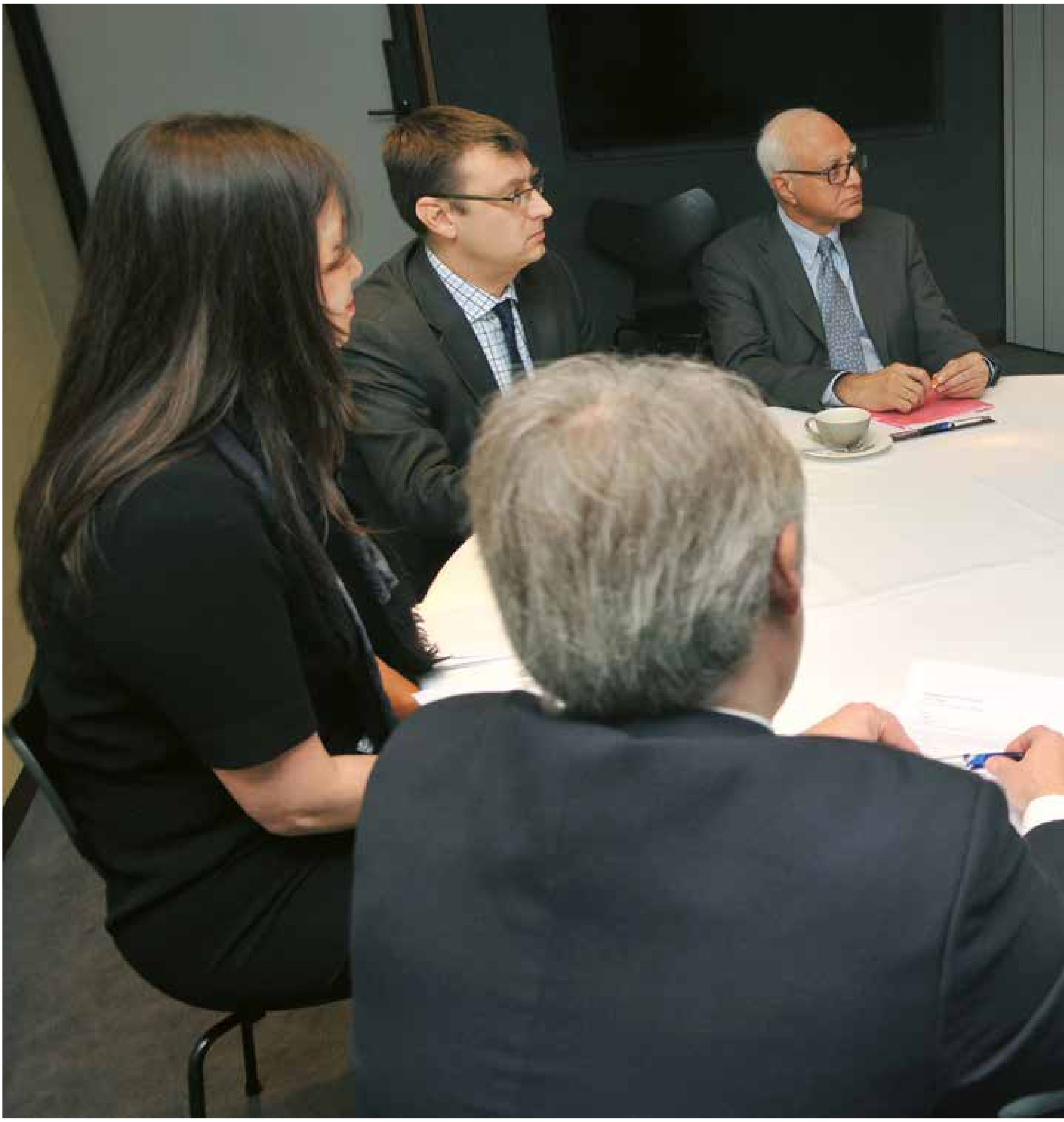
Jeffrey Malluck, Aon

Goodworth: I would agree with that. All of the projects we are doing globally have a number of themes. The first is diversification and diversification of equity risk in a low-cost liquid manner.

So we have a strong focus on multi asset simply because no one is quite sure what is going to provide diversification or generate return. So having exposure to a range of asset classes and investment styles is seen as robust upfront diversification rather than trying to optimise for a potential scenario that seems to be changing day by day.

We are seeing a lot of interesting quant strategies. Quant investing seems to go through a love/hate meta-cycle, but we are in a period of appreciation of quant at the moment. You can take that to the nth degree with machine learning and big data. We don't find too much appetite for that but an acceptance of quant is on the cards at the moment.

You need an element of quantitative portfolio construction to keep market neutrality, because that's changing all the time, but acceptance of quant multi asset, liquid, low cost, diversification in whatever form. That can be hedge funds, alternative risk premia or absolute return multi asset. We have done projects across the spectrum but they are the main underlying characteristics.



PI: Are you using quants in your fund, Mark?

Hedges: No. We abandoned our quant exposure many years ago because, frankly, they couldn't explain how they were making money.

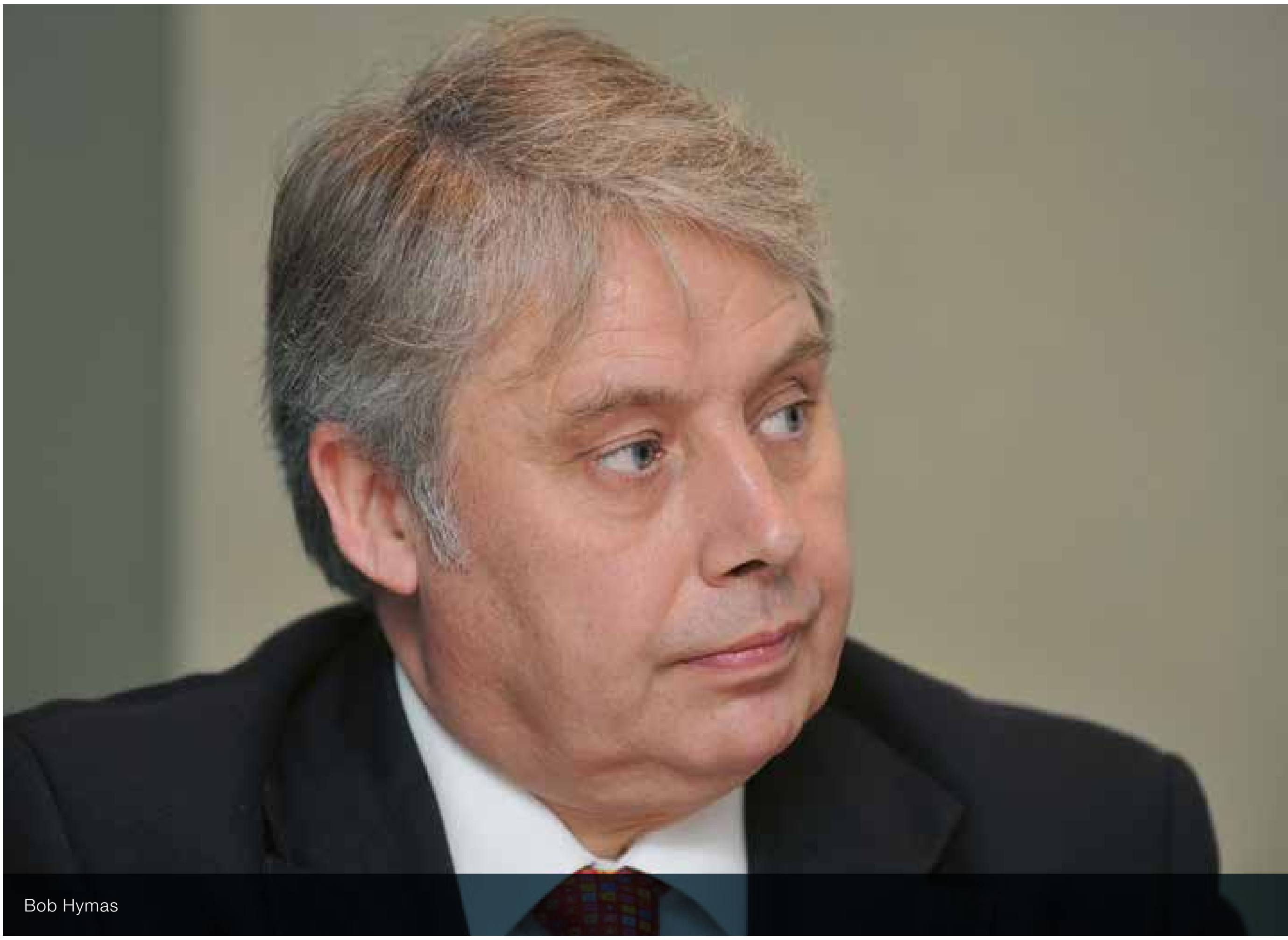
What clearly happened with this model is they refined it year-on-year and they had these different signals and they could allocate to this and to that, but it became quite clear as you went through it that there was a residual bit. When it made money, it was in a residual that they couldn't explain. If they lost money, it was in a residual that they couldn't explain.

Goodworth: When did you get out? Things have changed significantly. Back then I would agree it was more black boxy and was a bit: "Why did you make or lose money?" The answer always came back: "Who knows?"

'Interpretability' is the key word now and if you look at alternative risk premia strategies you would probably find those more transparent than some discretionary investing strategies.

Hedges: We have looked at alternative risk factors, had a view and then outlined to the trustees a strategy that said: "Actually, in terms of looking at the shape of our public equity portfolio, let's do a third passive market cap; a third synthetic, so that we take the risk but the cash is there to buy more matching assets; and a third in alternative risk factors." So it is not all market cap because, fundamentally, I'm uncomfortable with that.

With the portfolio steadily declining, the trustees asked why go to the expense and effort because that's where we are going to be reducing risk anyway. That is why we haven't gone for the alternative factors in equities.



Bob Hymas

"Buy and hold strategies are being presented far more to the boards that I sit on, and they are focusing on what the cash requirement is and how you match it."
Bob Hymas, BESTrustees

Hymas: Downside protection is a big part of conversations now. That is without getting too far under the bonnet as to what the mechanics and the details are, but diversification and cash-flow are the conversations that are taking place round the trustee table at the moment.

We are expecting challenges, and maybe we are seeing them already, but certainly the expectation is that there is more to come.

Goodworth: In terms of diversifying return streams you can almost split it into two camps. You have the diversifying return steam that carries on doing the same thing independent of market conditions.

Then you have what I like to call the 'heroic diversifiers', those things that look like they are not doing much eight times out of 10, but deliver diversifying returns in significant quantity during particularly troubled markets. For example, it is fair to say that managed futures have struggled over the past few years, but in 2008 they were quite beneficial and diversifying. So they can be challenging to hold because their aim is to deliver in turbulent markets and by their definition we don't see them too regularly.

Samad: We have had some experience of 'heroic diversifiers'. Unfortunately, to the point you just raised, 80% of the time when the markets are going up they are just a cost drag. The absolute return funds have done nothing, although some of them promised that they would deliver in good and bad times. It worked in the past, but has stopped working for some reason.

So it becomes a question of whether you should diversify into those streams that are not correlated or those that you can't measure, like the private markets, rather than expense that cost.

So you go back to some of the models and endowments that took 60% equities and 40% bonds. They said that the 40% would deliver the returns they needed so you should hold them. It is a big cost to hold these things for stability purposes.

At the end of the day, long-term you have got to go for your returns, so you need equity-like instruments that are well diversified.

PI: With reports claiming that the conditions attached to loans in the private credit market are far from demanding, how are lenders reducing the greater risks they are taking?

Samad: I was 25 years in banking as a credit officer and when one thing goes bad the whole institution just freezes. Banks have huge armies of people to deal with remedial management, legals and recovery. Those guys are kept busy during recessions, they run the roost.

Which of those non-bank guys have that? They don't have enough resources and when this happens they are not going to be originating. That would be the time to originate those assets because there will be cheaper stuff or better margins out there.

Barrett: That is a good point. It isn't easy to find credit managers that have restructuring or recovery expertise.

Samad: What is different since the crisis is the huge growth in private equity ownership. Larger private equity funds are telling companies that they don't need to go public because they can stay private, and alongside that is private debt. The two are working together and just spiralling up.

When interest rates rise and things start to fall, where will the problem come from? It will come from the debt side.

Hymas: It's a valid point. What we are concerned about as trustees is that we have invested in different products than we did 10 years ago. We have all the back testing and the models which show they responded as they were expected to respond when things go wrong, but, of course, back testing will always prove that because they are designed to deal with those particular circumstances.

We do not know the future circumstances, so there is always that doubt in one's mind if they will perform in the way that they are intended to perform.

You don't get the great returns during periods of growth because they are designed to protect against the downside. There is always a question of will they actually protect against the downside. We do not know. You can only rely upon what you are being told and the modelling that has taken place and the circumstances will most likely be different to what has been modelled, which is inevitable.

So there is a concern, which is why a lot of trustees say: "Let's just stay where we are in traditional."

Hedges: That is why we steer clear from the vast majority of private debt firms. I only want to invest in someone who has structured the covenants around making sure that a deal is right and is protected by various cash-track mechanisms and coverage ratios so that the equity player cannot get the cash out if the business plan is not being met. It is being trapped for the benefit of the debt-holders. If those things aren't there because people are giving away covenants to make deals work then I'm not interested.

When I look at private equity, I want a fund that is actually deleveraging its businesses, so that it's increasing my equity value. I have never been a fan of private equity leverage. It is about investing in real economic growth. You are investing in a plan that they are going to grow this business, grow its revenues. It's not about financial engineering. We have a deliberate bias in what we look for in managers and what they are doing in these spaces. Hopefully, it protects them to some extent in a downturn.

Barrett: What about drawdown structures in credit? Is that something that you have seen or are speaking to managers about, given where we are at this point in the credit cycle?

Samad: Credit is typically different to private equity funds in that they tend to be drawdown structures. This is good because you don't pay commitment fees. You only pay when you drawdown.

Barrett: So you are looking for credit funds that you aren't invested in and you are looking to invest in them at the bottom of this turnover cycle. That is different to investing in direct lending at this point in the cycle.

Hedges: If you are investing in new direct lending funds at the moment you need to be careful. You have to find someone who's in an area where they have little competition. They are originating and structuring all of their deals, not just taking a syndicated loan, and have a unique selling point that protects them. And, crucially, analysing what their skill-set is for managing in distressed situations.

There's a lot more effort in trying to sort out a problem than originating a loan. These funds are often relatively small teams, so you need to be assured that they know how to manage problem deals.

Samad: The easiest thing is to get the money out of the door; the hardest is to get it back.

Hedges: Yes, so what are your controls for getting the money back? Get me an upfront fee and start amortising on day one. We are 12 months in on a three-year loan and I have de-risked by a third. That's not a bad structure to have, but doing a 10-year bullet repayment structure with no covenants, I'm not interested.

Samad: When I started in banking in the 1970s, you always had to have amortisation. Today non-banks are popular with the private equity sponsors because they give them bullet repayments.

The other point is that whenever you did a loan, the first question a credit officer would ask was: "What are the ways out?" You need two ways out. One is somebody else lending to that entity, but the world has changed. I remember when there wasn't that somebody around.

Hedges: That's the environment we may find ourselves in again.

Goodworth: But that comes back to a liquidity issue.

Samad: Or the greater fool theory.

Hedges: That's an interesting point. With private equity things can stay private because you have funds that are getting bigger and their exit strategy is: "Well, we'll find another financial buyer."

I want to be at the bottom of this chain. I want to be the fund that is the first institutional money into that business, is growing it. It has an exit strategy that's not about selling to another financial buyer; it's more about positioning the business so that a strategic player wants to buy it.

It worries me that we are getting these bigger funds and companies stay private. It will get to a point where someone's not going to want to buy it – what happens then? The mega funds are a concern.

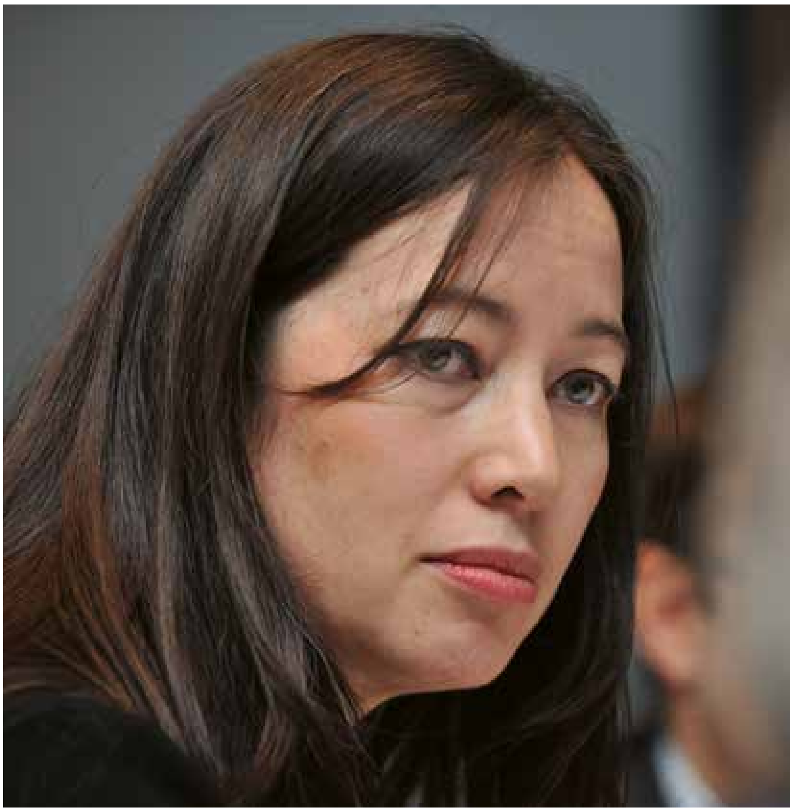
PI: So how do you pick you investments here?

Hedges: We have a deliberate tilt. We don't invest in people who are assets under management hungry. A classic investment would be a boutique provider who has a £300m to £500m fund and its next fund is £300m to £500m in the same space doing exactly the same thing in that he's trying to grow businesses.

His money comes from his carry, he's not making money off the fees and the reality is he's trying to find people that will buy those businesses. So they will try to create something that a strategic buyer wants to buy, so his exit route's not necessarily looking to another private equity firm.

Samad: I don't want to get too down on private equity, but that is the key risk. There are some behaviours being exhibited that are somewhat unique at this point in the cycle. For those who can wait and keep their powder dry, there will be great opportunities. There will be funds sold at discounts, the secondary fund of funds will be interesting and there will be some people having to offload their private debt cheaply.

So waiting and being patient is the mindset that




Toby Goodworth

"I look at diversification not by asset class but by different return streams."

Toby Goodworth, bfinance

investors need. Large institutions, where there will be a huge cash-flow need, and trustee bodies that insist on asset allocation targets being met are being driven by irrational motives.

PI: We are talking about long-term investments, so how are they benchmarked?

Goodworth: Portfolio improvements and portfolio efficiency. If you are introducing something that is truly diversifying it should improve your rate of return and hopefully reduce your portfolio risk as well.

Alternative assets should look to improve the risk profile more than the return profile. Traditional assets do the heavy lifting, so they can't necessarily improve the risk profile but they can improve the return profile. So you look to the alternatives to improve the risk profile.

Incremental improvement to a portfolio's sharpe ratio and some kind of downside measure is how you benchmark a diversifying asset because diversification is part of a portfolio; it's not an absolute concept. You can't put it up against a benchmark and measure diversification that way. You have got to look at it in situ.

Hymas: As we move to cash-flow driven investment, it's about are you receiving the cash that you expect to receive at the right time. It is as simple as that. There are the other elements that need to be considered, but ultimately if you are looking at a cash-flow process you want to make sure you are receiving the cash you expect.

Malluck: It is similar to a private credit fund. If the manager says they are going to deliver 7% you want to make sure that manager delivers 7%. That's what you signed up for and is what you should benchmark them against as opposed to gilts or corporate bonds. You are paying them to deliver.

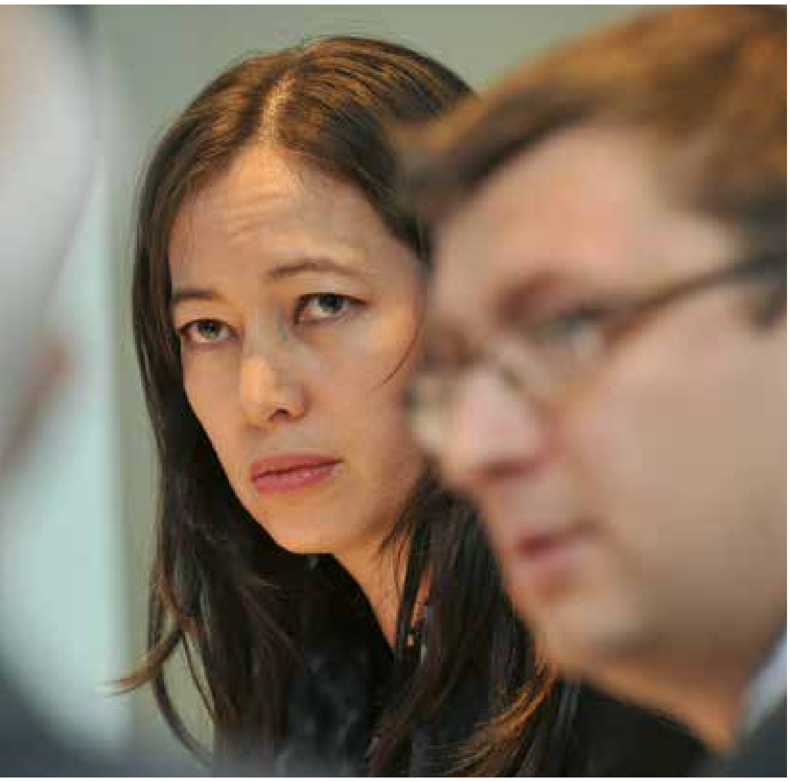
Samad: The issue of benchmarks for private assets is tricky. There needs to be enlightened governance in there. You need to have expectations of a long-time horizon and maybe cash-flow return targets, but that's not what happens. What I have observed is people trying to put benchmarks that measure the compensation paid to their managers. That distorts the picture. What happens is that instead of adopting an absolute-return benchmark, people put together public market proxies.

So if you are doing debt you might stick it to the Credit Suisse Leveraged Loan Index. These universes of peer group benchmarks are mark-to-market on a daily basis, so instead of investing for a 30-year hold

"We call it 'alternatives' but it's pretty much mainstream for most people these days."

Mark Hedges, Nationwide Pension Fund

Mark Hedges



horizon with five to 10 years in an individual asset class, your team is behaving on a daily or monthly basis, definitely not annually, because bonuses are tied to them.

So the whole governance system needs to be enlightened so it is understood that returns in the short term is not the objective, but diversification and lower risk is. Unfortunately, bonus compensation gets in the way, and that is where there's a huge distortion.

Goodworth: It's recognising the difference between precision and accuracy.

Samad: If you are a consultant and put together these peer group benchmarks, the question is: "Have you selected the right managers?"

It is a false game. For private equity the benchmark is useless because 90% of the people in the benchmark would not be raising money at the time that you are investing.

I have been through this painful discussion many times to keep the time horizon in perspective because these are not short-term risks.

Hedges: I agree. We don't benchmark performance. Ultimately, we look at each manager. We have had managers whose first two deals have tanked, it's looking horrible and yet they have delivered the 20% net internal rate of return target and it was a 2007 vintage fund. So you have to believe in the thesis at the outset because that's what you have bought into.

You can try and sell them in the secondary market but, frankly, you have bought these deals and you are stuck with them, so you have got to believe in them at the outset. You have to do the work upfront to get you to a point where you think this worth investing in because I'm going to be sat here for the next 10 years to see it through. You have to live within that.

You are going to get it wrong sometimes but as a portfolio, is it delivering your target return as you build it up. It takes time. It has taken us 10 years to build our portfolio. You don't get there in these markets overnight because it takes time to deploy it.

Funds have a five-year investment horizon and then five or seven years of managing the assets, so you cannot monitor them on a short-term basis. You have to look at it in the long term.

Hymas: I absolutely agree. One of my frustrations is a diversified growth fund (DGF) that has never got anywhere close to its benchmark; it's always underperformed against it. It raises questions, but the answer is: "It's the wrong benchmark." Yet when you look at the fund in the DGF universe it's one of the better performing funds. So the information coming through isn't doing the manager any favours.

Why they use it, I don't know, but when you look at how the fund is performing, it's performing as we want it to. So you have got to take that step back and not get too drawn into what the benchmark is trying to tell us.

You have got to have an explanation that makes sense to your lay trustees and you can't get into this detailed analysis because it just confuses.

Malluck: Investment horizon needing to be taken into perspective is key. Infrastructure managers in crisis time might have 15 investments and there are going to be one or two of them that don't meet their target. There will be those awkward conversations, but when they ride it out and get to the end they usually do work it out if they have an experienced team. So it's not quarter by quarter: "Oh, it's done this, and it's done that." It's having a time horizon perspective, allowing the manager to work out the business if there are hiccups, but they are not going to get every single investment correct.

Diversify now? Making the case for alternative assets

Aon's Jeffrey Malluck, senior investment consultant, explores how investors can diversify their portfolio through investment in alternative assets

What is driving interest in alternative assets among institutions?
Equity and credit markets have performed well over the past 10 years. However, the current macro-political environment poses a number of risks to investors. The expectation is that equity and credit markets are likely to experience increased volatility with the potential for further short-lived sell-offs before a larger downturn. Diversification can lower portfolio volatility and enhance return. Allocating to alternative assets, which are typically less correlated to traditional markets, can help achieve this.

A key problem is that with high equity valuations, particularly in the US market, it does not take much to disappoint expectations. This was apparent in Q4 2018 as global equity markets fell significantly on the back of US/China trade concerns, higher interest rate expectations, slower global economic momentum and global political uncertainty. Global equity markets, as measured by the MSCI World Index, had their first negative calendar year performance since 2011.

Now in 2019, continued market sensitivity to news-flow and data releases suggests that further surges in market volatility would not be surprising. In recent years, equities have been well-supported as a result of low bond yields, so market sensitivity to an upward break in bond yields remains a risk.
Credit spreads (the higher yield from corporate bonds over government bonds) have also fallen to tight levels as a result of the favourable corporate and economic backdrop, quantitative easing and a move to ultra-low policy interest rates. Investors can diversify and help lower the risk of adverse market conditions to their portfolio through investing in assets or strategies with returns which are uncorrelated with traditional assets.

Which assets are proving popular?
Institutional investors are increasingly showing appetite to commit to less liquid alternatives. Illiquid assets can provide an attractive level of return which is driven primarily from income. These strategies can be used as part of a de-risking journey or as a source of generating additional return. Examples include:

Global property
An allocation to global real estate enhances the stability of income in a real estate portfolio and can provide a cushion against country-specific risks. This risk is aptly illustrated by the lower return expectations of UK real estate during Brexit uncertainty. Lower risk strategies focussed on the core/core-plus end of the market could be expected to deliver returns of 6% to 8% p.a. Higher risk value add strategies would typically target returns in the mid to low teens.

UK pension schemes have diversified their equity and fixed income allocations globally but have tended to retain a home bias when it comes to their property allocation. We view favourably allocations to global real estate.

Bank capital relief
Enables a bank to use capital markets to lay off some of its risk by buying credit protection on a portfolio of loans. This helps banks to achieve their regulatory capital requirements by essentially 'insuring' a portion of the risk associated with that portfolio, thereby reducing the amount of regulatory capital they are required to hold on their balance sheet. This type of transaction allows the bank to reduce its credit risk without having to sell assets or reduce its lending activity. A bank is therefore often willing to pay a significant premium since the impact on its return on equity can be substantial. Target returns for these strategies are typically 8% to 11%.

Direct lending

A form of corporate lending typically made to small and medium-sized enterprises (SMEs). Loans are typically secured on company assets and investor returns primarily comprise a margin above cash and arrangement fees. Target returns for these strategies are typically 6% to 10%.

Property debt

A loan secured against a property and its underlying income stream. The interest on the loan is paid out of the rent from tenants. If the property company cannot pay the interest on the loan, the underlying properties may be sold to repay the loan. The loans often attract arrangement fees. Some are structured so that the lender benefits if the underlying properties rise in value, which is particularly attractive when there is the potential for redevelopments/refurbishments. Returns can range from mid-low single digits to low-double digits, depending on the security.

Global infrastructure

The fundamental systems and assets needed for the operation of an economy. The capital provided for these projects was historically publicly funded but since the 2008 financial crisis, government debt has ballooned to levels where there is insufficient public funding for all infrastructure projects. Private investors can access a large opportunity set within the infrastructure universe that includes a wide range of assets and strategies. For institutional investors, infrastructure has a number of desirable characteristics including cash-flow generation (some of which can have inflation linkage), low correlation to traditional asset classes and attractive risk-return characteristics. Returns are typically 10% to 15%.

What should investors look for when selecting an alternatives investment manager?

Due to the specialisation of these alternative strategies, manager selection is critical when making an allocation. We have a preference for managers that have raised previous funds as it allows investors to analyse historical performance. In addition, we prefer managers with an experienced and well-resourced team, strong sourcing and workout capabilities and where managers are aligned with investors.
Investors have a range of ways to implement these strategies. From multi-manager approaches, which could be a fund of funds, or by developing their own portfolio; to multi-asset single funds or a single-idea approach.

With much uncertainty heading into 2019, the year ahead could be quite a bumpy ride for investors. To mitigate and manage this risk we would encourage investors to continue to diversify and look further afield than the traditional asset classes.

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The case for uncorrelated returns

Vanessa Barrett, Investment Director, Wellington Alternative Investments

Over the past 10 years, extreme monetary policy has distorted capital markets. Asset prices are defying investment fundamentals: equity markets are no longer driven by growth and profitability, while bond yields are abnormally low or even negative. Meanwhile, political risk has grown, and populism has raised concerns that protectionism may reverse three decades of globalisation, leading to subdued capital market returns and further volatility. Investors are therefore seeking returns that have little or no correlation with traditional markets. Here, we look at some potential absolute return solutions.

Solution 1: Absolute return fixed income

With fixed income making up a large part of many portfolios, investors are naturally keen to guard against duration and credit risk. That is particularly true now, as current reflationary trends exert upward pressure on interest rates and as the credit cycle matures. Absolute return fixed income strategies can aim to mitigate such risks in portfolios by shorting fixed income assets via liquid derivative instruments (for example, government bond futures).

Proper due diligence is essential to ensure that a strategy exhibits low correlations to various market betas while incorporating prudent downside controls. This is particularly important given the proliferation of absolute return and other unconstrained fixed income strategies. Evidence of high correlations to credit or other fixed income markets may indicate that a given strategy really depends on market beta.

True absolute return fixed income strategies are structured not only to preserve capital in periods of market stress but also to take advantage of the mispricing that typically occurs at such times. We believe they are a potential solution for investors seeking both return and diversification.

Solution 2: Multi strategy

Multi-strategy approaches seek to capitalise on the ability of various active alternative strategies to capture dislocations created by market gyrations. Their success rests on three central pillars:

- Strong risk-adjusted returns generated through the active management of the underlying strategies
- Low correlations between each strategy
- No reliance on structural beta at the strategy level

Typically, they will combine eight to 12 strategies to provide investors with meaningful yet steady performance, while limiting drawdowns and, crucially, correlation to equities and rates markets.

They offer two advantages over a portfolio of alternative strategies. First, the timing decision for each strategy is determined by a team that is close to the markets. Second, netting the performance fee across strategies can lead to significant cost benefits – if the approach's performance is below a specified level, no performance fees are due, even on underlying strategies that have done well.

We believe it is important to look for a multi-strategy manager that has a wide range of differentiated, highly specialised strategies with significant track records, as well as risk management that can monitor for any unintended position, sector or factor concentration at the portfolio level.

Solution 3: Multi-asset alternative risk premia

Given the challenging investment outlook, many investors have turned to alternatives, such as hedge funds and private equity – only to be disappointed by often lacklustre returns, illiquidity and high fees. For them, alternative risk premia strategies may be an attractive option. Investors may use these lower-cost, liquid strategies as a core alternative holding, freeing up the fee budget for allocations to truly differentiated, high-quality hedge funds.

Four strategies, which account for the bulk of hedge fund returns, provide the key building blocks for alternative risk premia:

- Momentum – identifying trends that are likely to persist
- Relative value – buying one asset (or interest rate, time frame, etc.) you like while selling another you don't like
- Carry – capturing the difference in yield between two assets
- Equity styles – exploiting one or more of the characteristics that drive share prices

Alternative risk premia strategies generally take long and short positions. So whether markets rise or fall should be irrelevant; what matters is whether the assets you buy perform better than the assets you sell short. Investing in these non-directional strategies can help to reduce overall portfolio volatility and smooth returns. And, because the dynamics behind alternative risk premia are unrelated and have different drivers, they can offer powerful diversification benefits.

Until recently, access to alternative risk premia was limited, but systemised investing has made such strategies widely available. Their rules-based systemised processes analyse vast volumes of market data and make objective, emotion-free investment decisions, which can lead to more consistent results – particularly at times of severe market stress.

Conclusions

As concerns grow about stretched asset valuations and rising volatility, many investors are looking for uncorrelated sources of return to help them achieve their long-term objectives. Absolute return strategies are a potential solution and can also be accessible, liquid and cost-efficient. The precise choice will depend on your existing investments, risk tolerance and any investment constraints, but may include fixed income, multi-strategy or multi-asset alternative risk premia strategies.

Learn more: **www.wellingtonfunds.com/alternatives**

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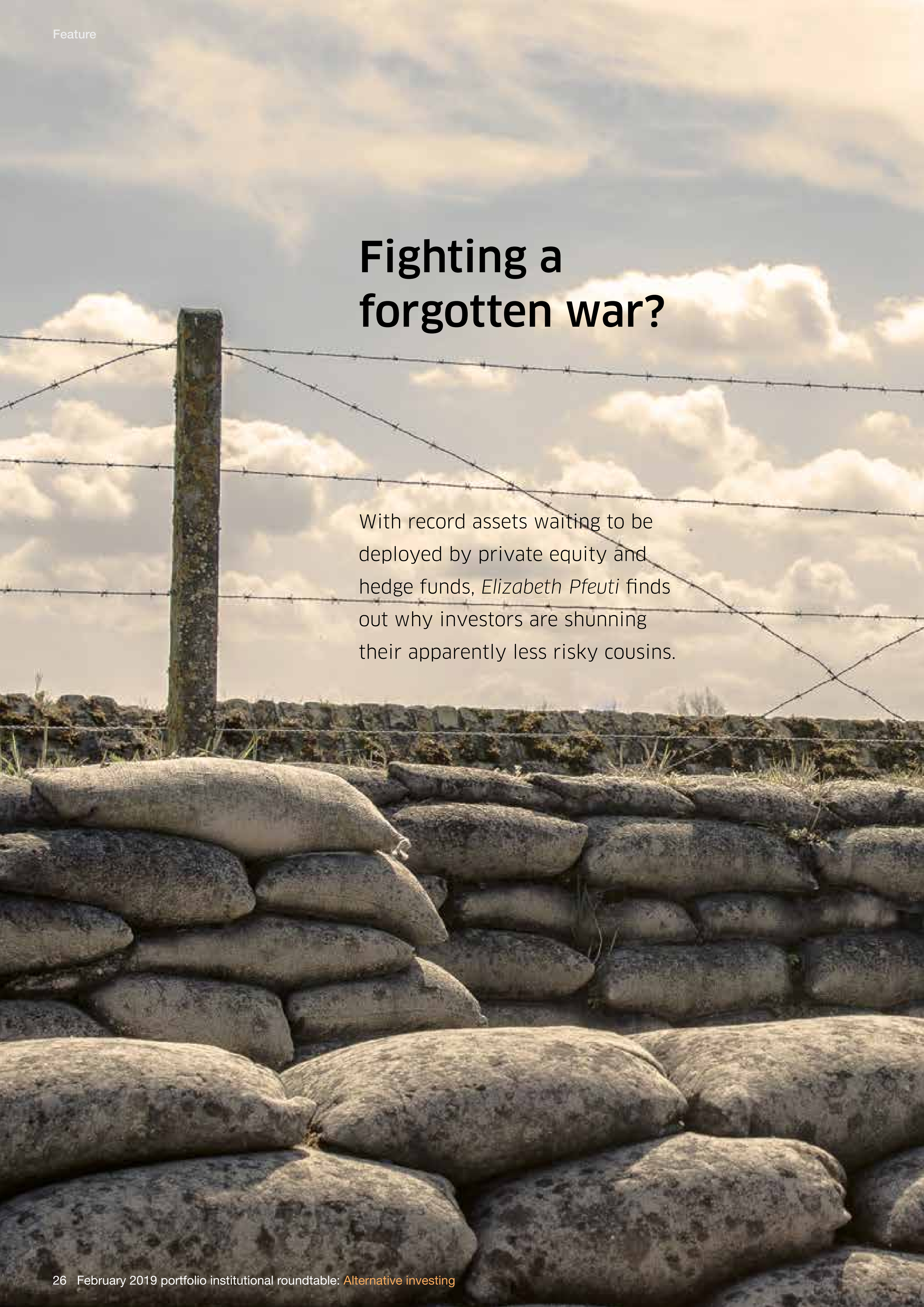
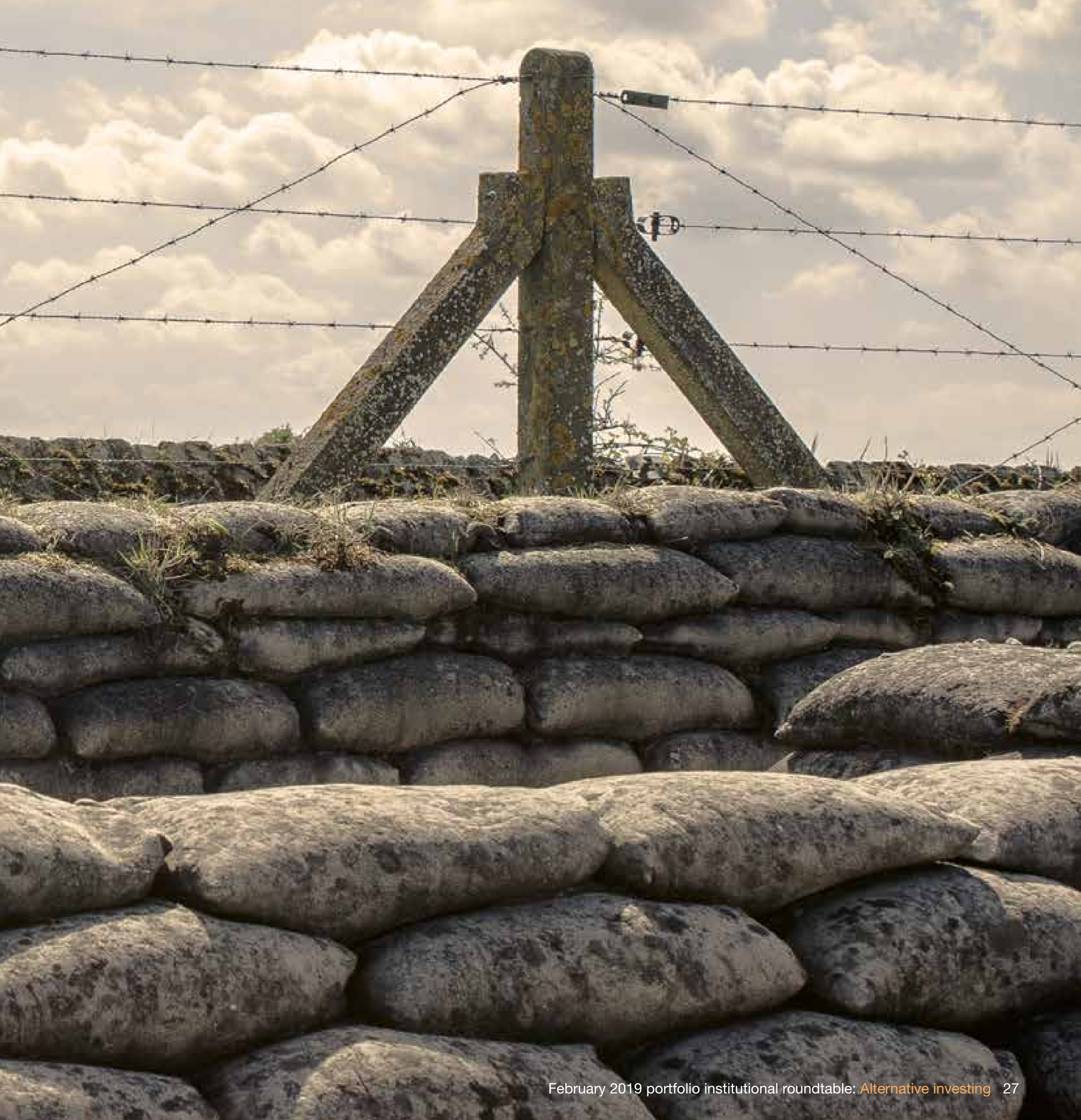


Fighting a forgotten war?

With record assets waiting to be deployed by private equity and hedge funds, *Elizabeth Pfeuti* finds out why investors are shunning their apparently less risky cousins.

At the end of the last decade, several factors converged on the hedge fund sector that threatened to spoil the high-octane party of the previous 10 years. Despite some stellar returns, investors were finding the fees increasingly expensive, while others took issue with the opacity around strategies and holdings. Some worried that these funds might not be very liquid in high-stress scenarios and wondered how they would react in a crisis. Just before the decade ended, many of



these fears proved to be right. As the financial crisis developed and markets began to crash, plenty of hedge funds were undone.

Gates were erected to stop investors pulling money out of funds that were unable to liquidate securities at short notice, while others were shown to be entirely correlated with equity markets. All the while, many investors found themselves paying exorbitant fees for losing just a few basis points less than their traditional mutual fund managers – or losing their assets completely.

Into the breach of this catastrophic display stepped liquid alternative funds, which banks and asset managers had been cooking up behind the scenes for a couple of years while watching an increasingly uncomfortable investor base. Wall Street's finest, including JP Morgan, Merrill Lynch, Goldman Sachs and Credit Suisse, created vehicles that had all the perceived upsides of the hedge fund universe, but none of the pesky illiquidity, opacity and high fees.

By using a wide range of derivatives, these funds were able to replicate the average performance of many of these hedge fund sectors, without getting caught in the same bind as the originals.

> **"If a hedge fund is earning you double-digit returns, to a certain extent, you care less about the cost."**
>
> Mark Walker, Coal Pension Trustees

It seemed like a great idea, especially with equity markets showing no sign of recovery. A flurry of investor assets, once free from their hedge fund gates, flew into these funds in the UK and US, along with some on mainland Europe, according to Morningstar.

And that should have been the start of the success story – but it wasn't. By 2015, the show was on its way out of town.

Mark Walker, Coal Pension Trustees' chief investment officer, says that he remembers these funds being marketed while running Unilever's pension schemes, where managers claimed they could generate hedge fund-like returns for drastically reduced fees.

Walker says he did not take up the investments as there were two points that turned him off. "Firstly, I recollect they tracked a peer group average, when we were aiming for a significant margin over this measure," he adds.

"At Unilever, we had a specific long-term return target over cash and a shorter-term peer group success measure. If we could not beat that, what was the point? It is the same with these funds. Why only aim to be average?"

Walker adds that there were also issues with the data being used to construct the indices used by the funds, including a survivorship bias that skewed the numbers. "Yes, they were being offered at a lower cost, but the returns were lower than we expected," he says.

And if the projected and expected returns were not enough to turn an investor's head to begin with, their recent performance has not done enough to keep them interested either.

CENTRAL PROBLEMS

Brian Kilpatrick, a former head of the Marks & Spencer Pension Scheme and now a director at Law Debenture, says that the experience of these so-called hedge fund clones had been a function of how quantitative easing (QE) had impacted markets.

"They seek to exploit a range of 'alternative' persistent betas which arguably may have historically been regarded as alpha," he adds. "Through QE and the lower asset return premia and volatility there has not been the usual opportunity set this type of strategy seeks to exploit."

What none of the banks and fund managers could have predicted in the throes of the financial crisis was the reaction of central banks, which has been a major stumbling block to the success of liquid alternatives.

Kilpatrick says that the returns on equities since the crisis have been high. "People have been frustrated with the returns they have been getting from many absolute return funds, hedge fund replicators and relative-value diversified growth funds, which target equity-like returns, but at a lower risk," he adds.

Another pension fund investor says that these funds were still being marketed, "but given how well equity markets have done in the recent past, and how poorly a lot of these strategies have performed, they are difficult to justify".

In October, Wilshire, a consultancy, said the sector's performance was down 2.77% that month, adding to a forgettable year.

DECLINE OF THE CLONES

The real kicker for these funds is that while they have been forlornly seeking assets, those they were meant to replace have been firing up again. In 2016, hedge funds recorded their first year without a monthly loss since 2003, according to data monitor Hedge Fund Research – and the assets soon followed.

Depending on whose data you choose, assets in "mainstream" hedge funds surpassed a record $3.4trn in 2018, despite investors fleeing those focused on emerging markets.

Their cloned cousins have continued to fade, however. Data from Morningstar shows that from an organic growth rate of more than 37% in 2015, it had sunk to 14% by the end of 2017 and shrank over the course of 2018, too.

"These funds have been like fire insurance when the fire never happens," says Jason Kephart, senior analyst at Morningstar. "Also, people have grown impatient. These funds are producing low returns in a bull market, where it is costing people money to own them."

Walker at Coal Pension Trustees says that even if the issues with the benchmarks and their constituent parts had been resolved, there remained an issue about the performance of many hedge funds since the financial crisis, too. Despite some standout performances, there was an oversupply of mediocre funds that were not helping the sector's overall image. With an equity bull market strengthening since 2012, many investors have been happy to stay with more mainstream assets.

"If a hedge fund is earning you double-digit returns, to a certain extent, you care less about the cost," Walker says. "While fees are coming down in some areas of the hedge fund market, so have the returns – and that also feeds into the peer benchmark being used by the alternative funds."

Another issue for large institutional investors has been the paucity of funds available. While there are plenty of hedge fund managers and other types of investors, the liquid alternatives market functions on a "winner takes all" basis, according to Kephart, "where five funds took all the assets and a further 50 got next to nothing".

This is a significant point for large investors, who seek to invest a relatively large ticket size because of the due diligence involved. Kephart says these investors are not keen to be a major shareholder in small funds – often their investment terms and conditions do not allow them to be – which leaves only the largest funds to choose from.

This problem has been compounded by the lack of staying power displayed by the funds. Morningstar research in May 2018 found the four categories with the highest rate of fund "deaths" over the past five years fell under the liquid alternatives umbrella.

Around a third of funds do not make their fifth birthday, according to Kephart, with almost as many never actually gaining a three-year track record.

TRIED BUT UNTESTED

An additional concern for investors, who are keenly eyeing a record bull market and a flexing yield curve, is that these liquid alternatives have not been tested in a downturn.

"There is still a nervousness amongst our decision makers about leverage and the use of derivatives and what would happen in times of stress," says Chetan Ghosh, chief investment officer of the €8.5bn Centrica pension schemes.

"While some of these fund strategies have intellectual merit, many investors want to see how they react in a full market cycle. Whether they would pass a live test."

He adds that there was also some evidence that in a mild sell off, algorithmic strategies actually add to its ferocity. "That is disconcerting," Ghosh adds. "We have a watching brief on it."

> **While some of these fund strategies have intellectual merit, many investors want to see how they react in a full market cycle.**
>
> Chetan Ghosh, Centrica pension schemes

However, there could be a glimmer of hope for these alternative funds – should they pass the live test of a market correction.

One pension fund investor said the enhanced liquidity meant they could get some traction with defined contribution (DC) investors, but this would have to be tested in a downturn situation before any platform or master trust would accept them as an option for members.

For Kilpatrick, if volatility returns to the market there could be opportunities for the vehicle, but it still has a lot to prove.

He also thinks investors have become more comfortable with illiquidity, which is now being exploited in credit and other debt funds – vehicles that were also created in reaction to the financial crisis but have had more success.

"As bank regulations have reduced the amount of corporate and real estate lending their available capital can support, the asset management industry has developed a number of investment strategies to deploy capital into these areas creating new opportunities for investors," he says.

Kilpatrick adds that there was "a material amount of money" that has gone into these funds, which typically have a degree of illiquidity with a tie up of five years but with "relatively attractive expected returns", which is what has failed liquid alternatives.

If more investors become worried about equities falling, liquid alternatives might get some attention, according to Walker at Coal Pension Trustees, but he warns that fund managers should be getting back to basics and "asset classes with strong fundamentals" rather than create a discounted copy of something that is already out.

"There is no problem with managers trying to deliver diversified returns at a reasonably low cost, but you may be better off finding a manager that is likely to outperform, if you can," Walker says. "Many managers are middle-of-the-road; you are better off not bothering with them."

However, if some do pick the right strategy to weather the next crisis – and no one will know what it is until it hits – it could save the sector, says Kephart at Morningstar.

"Success breads envy," he adds. "If they get the performance, the assets will follow. If they don't, they won't.

"They are new compared to many other asset classes and have to go through a period of trial and error."

If central banks had acted differently and the illiquidity crisis had stayed in town for longer, it might have been a different story.

"They seemed like a good idea at the time and diversification does make sense," Kephart says. "But can these funds deliver or have they just missed the boat?"

For all their good intentions, liquid alternatives might still be fighting the last war, when investors need to prepare for the next one.

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