Rethinking the Institutional Approach

Alternative Assets & Strategic Allocation

John B. Abbink

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For Carol

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I have never been as punctilious a scholar as I should be, and in any case most of what I think I know about finance has been acquired through osmosis rather than formal study. I cannot believe that all of the observations I make in this volume, but for which I lack a reference, are original to me, and I am fairly certain that much that I have gained through experience or conversation has occurred to and been published by others. While I attempt to reference them where I can, I apologize to those who deserve a citation but have not received one. If my readers are kind or indignant enough to help me with references and my effort is fortunate enough to achieve a second edition, I will attempt to give credit where it is due to those whom I have unintentionally slighted.

Although I accept full responsibility for the errors and omissions I have doubtless made, I have benefited from conversations with numerous friends and colleagues as well as comments on drafts of my text from many others. I am indebted to Wally Anders, Jeffrey Boardman, William Hayes, Stephen Hoedt, Richard Katz, Michael Mainelli, Steven Resnick, Ferenc Sanderson, Andre Sharon, Timothy Swanson, and Gary Zdolshek as well as my editors at Bloomberg Press for their criticisms and suggestions. I would also like to thank my wife for her patience with a project that consumed many evenings and weekends.

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Exchange Information Services, Barclays Capital, the Chicago Board Options Exchange, Dow Jones & Co., FactSet Mergerstat, Hedge Fund Research, IntercontinentalExchange, NASDAQ OMX Group, the National Council of Real Estate Investment Fiduciaries, the Russell Investment Group, and Standard & Poor's Financial Services for permission to use their data. Bloomberg Finance L.P. has provided me with currency, spot commodity, and equity price data, as well as permitting me to use its Bloomberg Professional® service to obtain convenient access to the data of several of the other providers already mentioned, for which I am also grateful.

Introduction

There is a wealth of literature on alternative investments, ranging from collections of admiring interviews with the various wizards and rocket scientists whom the media seem to think populate the industry, to detailed strategy-by-strategy guidebooks and an ever-mounting corpus of densely argued academic discussion. Although there is considerable chaff among the wheat in all this mass of material, alternative investments are certainly not in want of attention, and by now many of the requirements of serious investors who are new to the topic, let alone those of sensation-seekers, have been quite fully addressed. There is little need for yet another introduction to alternative investments or yet another encyclopedic handbook to guide newcomers through the luxuriant profusion of different alternative investment techniques.

The literature on what to do with alternative investments—how they fit into portfolios and their role in an investment allocation that includes traditional investments as well—is much thinner on the ground. This is not to say that no useful work has been done in this area, and this volume relies on a number of authors who have made important contributions to the study of the portfolio function of alternative investments, as witnessed by my references to them. However, it remains somewhat puzzling that there are not more studies of this kind—after all, institutional interest in the area has been extremely lively for several years. On reflection, it seems that there are three influences that discourage significant progress on this front. One is an intense focus on the role of talent in investment management, to the exclusion of virtually all other possible influences on the ability of alternative investment managers to generate returns. The second is the fairly widespread view—almost but not quite the consensus—that alternative investments are something radically different from conventional investments, so conceptually distinct that they cannot usefully be discussed in the same context, using similar terms and comparable analytic techniques. Finally, there is an intractable problem deriving from the woefully inexact terminology of alternative investments, which constantly forces commentators into problems of definition, resulting in yet more encyclopedic surveys of the territory simply to achieve some clarity about what exactly it is that is being discussed.

Talent is a great discussion stopper: once it is accepted as essentially the only explanation for investment performance, then there is not a great deal more that can usefully be said. It is God-given and inherently mysterious. While talented investors clearly share with each other certain characteristics, such as insightfulness and decisiveness, talent of any kind is fundamentally opaque to further analysis. There are no handy touchstones or interview techniques that can assure us that we are in its presence. It is only somewhat helpful that, unlike God's grace (at least according to St. Paul), we can recognize talent by its works, but even then it is usually very difficult to distinguish the products of skill from those of luck and hard work. The fact that the managers of alternative investments have an interest in maintaining the mystique of talent does not help matters.

The contribution of talent to good investment performance is undeniable. Where numerous highly trained and diligent professionals have access to much the same information required to support their decision-making, luck and relentless dedication alone cannot account for the investment successes of the few compared to the mediocre performance of the many. However, there is a tendency in far too much of the literature on alternative investments to identify talent with α (excess risk-adjusted return). In fact, α is often treated explicitly as though it were somehow a quantitative measure of skill. This neglects Edison's analysis of the relative contributions of inspiration and perspiration to genius, but it also discourages analysis of the risk-taking that is the ultimate source of all returns. We can give talent its due—and no one should dream of denying its importance in investment or in other walks of life—while still finding useful things to say about how talent, hard work, and luck conspire to generate investment returns in an environment of uncertainty.

This focus on talent is most pronounced in the hedge fund arena. It is possible to read entire volumes on private equity or real estate investment without encountering much, if any, name-dropping, but this is not the case with any but the driest and most scholarly writing on hedge funds. An important contributor to this cult of personality is almost certainly hedge funds' near-universal lack of transparency. Although the enhanced performance that derives from active management of private equity or real estate investments may not receive much press attention, the primary investment activities—the purchases and disposals—that are executed by managers of these types of assets are carried out very much in the open. The lack of similar transparency for hedge funds seems to have driven their chroniclers to concentrate on the managers themselves, rather than their activities and the decision-drivers that motivate them.

The second unfortunate influence on the literature of alternative investments is the very widespread tendency to treat them as though they belong to a separate asset class, something completely different from conventional investment vehicles. This is another discussion stopper: to insist on radical difference is to insist on entirely different terms of reference. It is an impediment to comparative analysis, and, if taken to an extreme, it implies that it is not possible to adopt a rational approach to allocation between conventional and alternative investment categories or even within the alternative category. In fact, most alternative investments employ the same assets as conventional investment vehicles, and few of their trading practices are completely unique to alternative investments alone. The fairly rare exceptions are far outnumbered by alternative investment vehicles that use publicly traded equity and fixed income or something very similar to them as the fundamental sources of their returns. It would seem unlikely on the face of it that alternative investments' differences from conventional ones place them in a category entirely apart from them.

The content of the term "alternative investment" has been lost if it does not make sense to ask the question, "Alternative to what?" If the question is still meaningful, then we are forced to conclude that alternative investments must be analyzed as part of a continuum of investment opportunities stretching from savings accounts through the wilder regions of venture capital, commodity speculation, statistical arbitrage, and so on. Unless we regard alternative investments as completely exogenous return generators, analogous to "investing" in lottery tickets, then we must be able to analyze them with the same sorts of tools that are used in thinking about conventional investments—perhaps not identically the same tools, but at least very similar ones. If alternative investments were truly members of one or more distinct asset classes, quite separate from conventional investments, then it is not clear that they would be amenable to comparative analysis at all. In that case an investigation of the grounds for making allocations to them, such as is attempted in this volume, would be largely beside the point.

Apart from tone and an artificial segregation of alternative investments from investments generally, the third aspect of the way that alternative investments are discussed that has interfered with institutionally oriented examination of them is rampant terminological inexactitude. There are many occasions when knowledgeable professionals have to nail down the definition of commonly used terms simply to hold a meaningful conversation about alternatives with each other. The confusion fostered by loose terminology may enhance the crepuscular allure of alternative investments and may in some cases be helpful to funds’ marketing efforts, but it unquestionably interferes with any attempt to understand them. When every term needs to be defined, it is difficult to get past the starting gate of discussion, and I believe that this accounts for most of the difficulty that the literature faces in attempting to progress much beyond general introductions to the topic.

However, the battle to achieve precise nomenclature has long been lost, so there is little point in attempting to offer a new taxonomy of alternative investments, because it would only add to the muddle. And perhaps a certain amount of imprecision is appropriate to the discussion of alternative investments. In a field where creativity is so rife and nuance so important to differentiating among the various approaches to investment, a rigid system of terminology might well constitute a greater barrier to understanding than allowing for a certain amount of interpretive ambiguity in the terms of reference. Constant retracing of steps to concrete examples and clarifying definitions may be a tiresome impediment to progress, but perhaps that is the price required to make any progress at all. While I discuss the classification of investments in Part IV, the intention there is to offer an aid to thinking about allocation, rather than a fixed and exhaustive scheme of categories, and what I offer is intended to be quite flexible.

Throughout this book, my intention is to examine alternative investments as investments. Their strategies are explored in the context of strategies that are applied to conventional investments, and their risks are examined from the standpoint of where any investment's risks come from. What results turns out to be a comparatively colorless treatment of the topic, lacking in "war stories," gossip, and hyperbole, but I do not believe that an attempt to understand alternative investors' remarkable creativity detracts from or trivializes their undeniable accomplishments. While I hope that my remarks can be of some value to any investor who has acquired an interest in these vehicles, they are directed primarily at plan sponsors, trustees, managers of funds of funds, and others with the responsibility for forming investment policies that employ these vehicles. The ranks of institutional investors who are confronted by allocation decisions involving alternative investments have swelled rapidly over the last decade or so, and may continue to do so despite recent disappointments. In my view, their needs for a functional understanding of these investment vehicles have only occasionally been well served by what has been written about them. This volume will by no means succeed in filling that gap, but in conjunction with the contributions of others, it endeavors to push that project forward.

What Is Alternative about Alternative Investments?

It is not unreasonable to expect that something that is generally identified as "alternative" should in some sense be different, and many alternative investments truly are. By this, presumably everyone who uses the term means that they are different from conventional investments in cash, stocks, and bonds. However, much to the bewilderment of the uninitiated, their difference is not usually to be found in their choice of investment instruments—some truly strange alternative specimens nevertheless restrict their attentions to familiar assets. In this respect, at the very least, alternative investments as a group certainly do not inhabit a separate asset class.

The majority of hedge funds trade exclusively in stocks and bonds, perhaps with some options and futures thrown in for variety's sake. Private equity is first and foremost equity, whereas real estate assets are, at bottom, either equity or debt. Direct financing strategies differ fundamentally from purchasing certificates of deposit only insofar as they may include an equity "kicker" apart from their basic structure as loans. Commodities, foreign currencies, art, and collectibles are noticeably different from the assets held by conventional investment vehicles, and there are a handful of true exotica of the alternative investment world that are completely unfamiliar to conventional investment practice. By and large, however, it is impossible to conclude that the assets employed in alternative investment products are what make them "alternative."

Alternative investments may be leveraged or activist, they may be hedged, operate over unusual time horizons, or be parts of an arbitrage strategy. *Any of these may also be true of conventional investments*:

- The Investment Company Act of 1940 permits mutual funds to leverage themselves up to 50 percent of the value of their assets, and increasing numbers of funds make at least partial use of this permission. Although use of leverage in other regulated investment contexts such as ERISA pensions or IRAs is more restricted, it is not impossible to find ways to introduce leverage into them, too.

- Activism, such as initiating proxy contests and similar initiatives to encourage managements to pursue a desired course of action, has become a common technique among many conventional investors, including mutual funds and, in a very high profile way, certain states' retirement plans. Arguably, it was conventional investors who introduced alternative managers to the idea of such activism.
- Hedging is by no means absent from conventional investing—notably currency hedging in cross-border products, but also position and transaction hedging activities that make use of futures or options in fixed-income mutual funds and domestic equity vehicles.
- Time horizons can also be quite varied in conventional investment vehicles—although very short-term trading strategies may not be so common, they are not unknown. There are equity managers with annual turnover well in excess of 200 percent and a large number of bond funds with twice and even three times that level. These amounts of trading turnover may not rival some of the most active Commodity Trading Advisors (CTAs) or high-frequency hedge funds, but they are certainly enough to keep their trading desks very busy. At the other extreme, there are numerous conventional managers that hold equity positions for five years or more, approaching the average holding periods of private equity vehicles.
- Participation in arbitrage is fairly unique to alternative investors, but there are arbitrage-like aspects to many conventional investment techniques—particularly those encountered in bond markets—and by no means all alternative strategies engage in arbitrage or anything that resembles it.

In each of these respects, the difference between alternative investment vehicles and conventional ones seems to be a matter of degree rather than a difference in kind. No radical change is encountered in moving from the sphere of one to that of the other. We could be tempted to conclude that alternative investments are in fact just like conventional investments—only more so. Reaching a similar destination by a quite different route, Bookstaber (2007) writes,

> The hedge funds/alternative investments moniker is a description of what an investment fund is not, rather than what it is. The universe of alternative investments is just that: the universe. It encompasses all possible investment vehicles and all possible investment strategies minus the traditional investment funds and vehicles. (244)

Cynics might argue that what truly makes alternative investment vehicles different is their fee structure, and like all competent cynics, they have a point. It has been suggested, I think by Warren Buffett, that hedge funds in particular are less an investment category than a compensation scheme. Although performance-related fee structures are permitted to conventional investment managers, few in fact adopt them. And the often breathtaking generosity of the fees charged even for very simple investment vehicles that are hardly even "alternative" (2 percent management fee and a 20 percent incentive fee for an index buy/ write option strategy!) are unknown among conventional investment managers, whose charges generally bear at least a vague relationship to the cost of offering their services. However, their fee structures can hardly be regarded as a fundamental, distinguishing characteristic of alternative investments. These structures are external to the investment program, and although they have proven highly resistant to change, it is not inconceivable that an alternative investment vehicle could charge economically justifiable fees and still be regarded as "alternative." Various products of this kind have in fact found their way into the marketplace: no one regards them as conventional simply because they are comparatively affordable.

Most alternative investment vehicles also share various features of legal structure and regulatory oversight that differentiate them from typical conventional investment instruments. But again, these are external differences rather than characteristics inherent to these products, and in many cases there are conventional vehicles that have chosen to adopt the same or similar structures. Most alternative investments are structured as Limited Partnerships, and most of them impose some form of lockup on their investors' commitments. Most of them are lightly regulated if at all, and if they are subject to U.S. regulation, it may be through the Commodity Futures Trading Commission or even the Small Business Administration (in the case of some mezzanine funds) rather than the Securities and Exchange Commission (SEC), which oversees most U.S. conventional managers. These characteristics may not be distinguishing features of alternatives in the sense that we are looking for, but they do account for a number of important differences between alternative and conventional investment products, including minimum net wealth requirements, maximum numbers of investors, restrictions on solicitation, the blithe vagueness of offering memoranda, and so on. However, alternativeness seems to have created a conventionality of its own. For certain forms of investment, these inconvenient structures are unnecessary—vehicles making these sorts of investments could be structured in a way that was much less of an imposition on their investors. When their managers are asked why they have chosen the less convenient structure, they invariably reply that it is what customers for that type of investment expect. Having steeled themselves to the nuisance of this or that structure, the customers would presumably be disappointed not to have the opportunity to demonstrate the sophistication implied by their tolerance for its inconvenience.

In alternative investments' heroic period, during the late 1980s and early 1990s, they were notable for their sheer, swashbuckling aggressiveness. When "macro" hedge fund managers were Kings of the Street and buyout firms were Barbarians, it was common practice to characterize investment strategies as "alternative" simply on the basis of their voracious risk appetites. Yet even in that fabled Golden Age, this characterization failed to encompass the entire alternative investment universe—some investors were concerned with market neutrality, the pursuit of "absolute return," and similarly less-than-gun-slinging risk profiles even then—but it was a widespread view amply reflected in the media. The environment has changed considerably since then, both because the returns to swashbuckling are no longer as great as they once were, and because the entry of institutional investors into the alternative investment arena has encouraged a different attitude toward risk. Since the 1990s, this sort of aggressiveness has become much less characteristic of alternative investment managers, although it persists in isolated spots and experiences the occasional revival. The media have yet to notice, and continue to regard all alternative investors as inveterate risk-takers, when they are not otherwise engaged in fawning on or vilifying them.

A feature of many alternative investment vehicles that is related both to their colorful pasts and to their legal and regulatory status is their lack of a specified investment discipline. General Partners frequently grant themselves extremely wide latitude in the sorts of assets they may hold and the techniques that they may employ to select and exploit them. It is not uncommon, for example, for a hedge fund's or commodity pool's private placement memorandum to neglect to mention even in the most general terms which types of instruments it will employ, what trading signals will motivate its activities or the time horizon(s) over which it will trade. Alternatively, the permissions a General Partner grants itself may be specified at excruciatingly pedantic length, but so encyclopedically as to impose no effective restraint on its activities whatsoever. For example, one such document I encountered recently lists, in exhaustive detail, thirty classes of instruments that the fund might choose to employ ("…collars, floors, warrants, swaps, swaptions…") and, on the off chance that any possible investment vehicle was overlooked, concludes with "…and any other interest or instruments on a cleared and non-cleared basis as determined by the Portfolio Manager in its sole discretion." However, the growing presence and influence of institutional investors in the alternative investment arena, with their desire to allocate among identifiably different investment vehicles, has tended to encourage greater style purity among alternative investment managers. In this respect, alternative investments are arguably becoming *less* "alternative," and in certain respects they increasingly resemble conventional, institutionally oriented investment products in their concern with consistency and predictability.[1] And in any case, indiscipline has never been unique to alternative investments: even in these Style Box-obsessed times, there are still plenty of mavericks among conventional equity and fixed-income managers who invest more or less as the spirit moves them and in the assets that attract their momentary fancy.

There is also what might be regarded as a counter-trend underway, toward the creation of explicitly multi-strategy vehicles. This does not actually represent a "renaissance of indiscipline," as multi-strategy managers clearly require at