Our Views on Alternative Strategies and Investments

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PART 5

In the fifth and final segment of a multi-part investment education series, Biagio Manieri, Ph.D., CFA, provides an overview of PFM Asset Management's (PFMAM) views on alternative strategies and investments.

An Overview of Alternatives

In previous white papers, we have written about hedge funds and other topics that touched on alternatives investment strategies. In this InvestEd, we will focus on how best to think about and incorporate alternatives into a well-diversified multi-asset class portfolio.

Institutional investor interest in alternatives was initially driven by the performance of certain endowments, such as Yale University. David Swensen, the highly regarded and prior CIO of Yale's endowment, wrote the "how to" book for investing in alternatives: "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment." This approach became known as the "endowment model."

The "endowment model" places alternatives at the core of the portfolio. In 2022, according to the National Association of College and University Business Officers (NACUBO), the dollar-weighted allocations to alternative investments among endowments was 58% and the equal-weighted allocations were 33%. While incorporating alternatives in a well-diversified multi-asset class portfolio can add value for institutional investors, we believe the "endowment model" has weaknesses. These weaknesses and drawbacks can be seen in the fact that portfolios based on the "endowment model" have underperformed a portfolio of index funds over the intermediate and the longer term, as evidenced in data reported by NACUBO.

While some believe this underperformance is likely to change, we remain skeptical. Our investment philosophy takes a different approach to incorporating alternatives in portfolios. As we explained in a previous InvestEd, our investment philosophy emphasizes asset allocation, both strategic and tactical, and low-cost index funds, and use alternatives as a complement to such a portfolio rather than being at the core of the portfolio.[1]

1 For a more detailed discussion about asset allocation, please refer to our earlier InvestEd - An Overview of Our Asset Allocation Process.

Research has shown that asset allocation is the most important driver of investment returns.[2] Therefore, in our opinion, the most important decision with respect to alternatives is which alternatives strategy should be included, given current economic and market conditions. While the “endowment model” puts alternatives at the core of the portfolio and allocates a significant and constant amount to alternatives, our approach is opportunistic and tactical.

While “alternatives” is an ill-defined term, it is a term that is widely used in the investment industry. The low reported correlation and volatility of alternatives give some investors the false sense that these investments are sui generis and distinct from traditional long-only strategies. By “alternatives,” investors usually mean a group of investment strategies that include: hedge funds of various types, private equity, private (unlisted) real estate (as distinguished from real estate investment trusts – REITs which are publicly traded), natural resources and other investment strategies that typically involve illiquidity, shorting, leverage or other characteristics that distinguish these strategies from traditional long-only strategies that invest in publicly traded markets. Most investors draw sharp differences between alternatives strategies and traditional long-only strategies, but in reality, the lines are blurred.

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As an example, private real estate is considered an “alternative investment,” while REITs are considered “traditional long-only” investments. But in both, the underlying asset is real estate property and, therefore, subject to the same economic fundamentals. The same can be said for investing in publicly traded equities of companies that own natural resources such as oil fields, copper mines, etc., versus investing in a private fund that owns natural resource companies. In both cases, the economic fundamentals of the investment are the same.

Therefore, our approach to alternatives is to understand the economic fundamentals of the investment strategies rather than focusing on the legal and compensation structures of the firms managing the strategies. For example, when analyzing private real estate, we do not simply analyze the statistics but understand the underlying assets of these funds, which are the same as REITs. Therefore, we do not have a constant bias in favor of private real estate versus REITs but look at the fundamental conditions to understand whether we prefer one to the other given current valuations and economic and market conditions.

Driven by the demand for alternatives, some asset management firms have responded with investment products that blur the lines. For example, alternative mutual funds or “liquid alt funds.” AQR Capital Management began as a hedge fund but now offers various “liquid alts funds” that are designed to deliver the risk-return profile of hedge fund strategies at a small fraction of the cost. These vehicles are not structured as hedge funds and typically are not considered “alternatives.” Another example would be business development companies (BDCs). BDCs are closed-end funds that publicly trade but pursue strategies similar to private equity funds. In addition, in recent years, we have seen mutual funds invest in private startup companies similar to strategies followed by venture capital (VC) funds.

2 Gary Brinson, “Determinants of Portfolio Performance” Financial Analyst Journal, July/August 1986.

Considerations When Adding Alternatives to Multi-Asset Class Portfolios

Investors' interest in alternatives is typically based on a number of factors, including a low correlation of these investments to other investments in the portfolio. While the reported correlation is low, investors need to keep in mind that this is based on accounting rules. Since private assets do not actively trade, market prices are unavailable and they cannot be marked-to-market, as can publicly traded securities.

The use of appraisal values in alternatives leads to the artificially low volatility of the returns (of alternatives) and depressed correlations with investments that are publicly traded. The result is that the actual diversification from including alternatives is not as great as the statistics suggest. It also means that other statistical measures, such as the Sharpe ratio and others that try to measure risk-adjusted returns, are equally compromised in the case of alternatives.

In a recent Wall Street Journal article, "Getting the Sharp End of the Investing Stick," William Sharpe, the founder of the Sharpe ratio, was asked about the use of the Sharpe ratio by alternative funds. He jokingly replied that it must be the "Sammy Sharpe's Ratio," because it certainly "can't be my ratio." The use of appraised value in the absence of market prices also leads to autocorrelation in the returns reported by alternative funds, which does not exist in the case of publicly traded investments.

Some investors favor alternative strategies because they believe that these strategies deliver an "illiquidity premium." We would make two observations with respect to this point. First, there is little, if any, empirical evidence that an illiquidity premium actually exists. For example, over long periods of time, publicly-traded REITs, which provide ample liquidity, have outperformed comparable private real estate funds, which are far less liquid.[3]

Additionally, and equally important for asset owners that would like to incorporate tactical asset allocation decisions in managing their portfolios, while there is little evidence of an "illiquidity premium," there clearly is an "illiquidity cost." Liquidity has benefits in that it allows for rebalancing in the portfolio, allows investors the ability to make tactical asset allocation decisions and take advantage of investment opportunities, and provides the ability to exit bad investments easily and efficiently. When investing in alternatives, asset owners give up all of these benefits. This is a concern because, in some cases, such as the Financial Crisis and bear markets, asset owners may be forced to sell liquid assets at low prices to meet capital calls from private investments.

Some investors believe that alternatives such as private equity deliver superior returns to publicly traded investments. However, comparing the performance of private equity funds with publicly traded equities is somewhat problematic and not easily accomplished since private equity (PE) funds tend to report the internal rate of return (IRR) and not time-weighted returns. An IRR of 20% is not the same thing as the S&P 500 returning 20%.

Investors need to understand that the IRR as a measure of investment performance has a number of flaws. In fact, the IRR is only a true measure of investment performance when there are no interim cashflows or the cashflows are reinvested at the IRR rate; this is similar to the calculation of yield-to-maturity for fixed income investments. When an interim cash flow occurs earlier in the investment cycle, the IRR is artificially inflated. This effect has led many PE funds to manipulate the IRR by using a credit line to make the fund investment and thereby delaying calling capital from the limited partner (LP); this results in an artificially high IRR.

3 CEM Benchmarking, November 2022 "Asset Allocation And Fund Performance Of Defined Benefit Pension Funds In The United States, 1998-2020".

Investor Howard Marks wrote about the pervasive use of subscription lines of credit in his memo "Lines in the Sand." He points out that these lines of credit are used by PE funds to increase the IRR, although the actual dollar profits are not increased. He further points out that a fund with a higher IRR does not necessarily outperform a fund with a lower IRR and may actually perform worse than a fund that did not use a subscription line of credit.

The issues raised above, particularly the artificially low volatility and correlations reported, mean that we cannot rely on quantitative models such as mean-variance optimizers (MVO) to construct portfolios using alternatives. At PFMAM, we rely on our investment knowledge and experience when incorporating alternatives in clients' portfolios. We consider and analyze the fundamental economic and market conditions to determine which alternatives strategies to include in client portfolios and how much to allocate toward each. For example, if publicly traded equity markets are bifurcated with high variance in the valuation of different securities, adding a long/short equity hedge fund may make sense. The manager will be able to take advantage of the valuation opportunities presented and, at the same time, short the highly valued securities.

Another example is the attractiveness of a strategy that focuses on distressed credit following a long period of rising leverage, loose underwriting standards, a slowing economy and rising interest rates. These conditions will likely lead to higher default rates and stress for financially weak companies, which present opportunities for distressed credit funds.

Appendix: Descriptions of Various Investment Strategies

HEDGE FUNDS

In previous white papers, we have written about the history of hedge funds and discussed various strategies. Hedge funds typically invest in publicly traded markets, although as the hedge fund universe has expanded, making it harder to outperform, hedge funds have migrated into other areas, such as investing in private companies and direct lending. But when investors use the term "hedge fund," it typically refers to strategies that involve shorting, leverage, and/or other tools that are typically not used by traditional long-only investment managers. For example, pair trading or relative value trading, and arbitrage typically involve being long one security while shorting another and may involve leverage to magnify the potential return. A traditional long-only investment manager is typically prohibited from shorting and/or using leverage.

By using "tools" such as shorting and leverage that are not typically available to traditional, long-only investment managers, the hedge fund manager is assumed to deliver a risk-return profile that is different or uncorrelated with publicly traded markets. As such, these strategies are believed to provide diversification to a portfolio made up of traditional strategies that invest in publicly traded markets. Hedge funds strategies can be grouped into a few broad categories: macro, event-driven, relative value, and equity-oriented strategies.

► ***Macro hedge fund strategies*** use "top-down" analysis of economic and market conditions and focus on "the big picture" versus "bottom-up" strategies that focus on individual companies and securities. Macro hedge funds can and do invest across different markets such as equity, currency, and fixed income. Since these strategies invest in asset classes versus individual securities, to be efficient in implementing investment insights, they tend to use derivatives linked to specific markets. The use of derivatives also allows leverage to be efficiently incorporated (derivatives only require an investor to post margin, which is a small percent of the notional value of the derivative).

► ***Event-driven hedge funds*** take positions in securities that are expected to go through some event that could significantly move the price of the security. An example might be a poorly performing company that is expected to restructure and, as a result, become more efficient and profitable. In some cases, the hedge fund may be a passive investor, while in other cases, it may play the role of activist. In cases where it plays the role of activist, the hedge fund will take a position in a security and then engage management to make certain changes. If management is reluctant, the hedge fund may work with other shareholders to nominate directors to the Board and then work to change current management.

► ***Relative value hedge funds*** typically take offsetting positions: long one security and short another where the investment manager believes the relationship between the two securities is temporarily out of synch and expected to converge. For example, if the current yield spread between “on the run” and “off the run” Treasuries is wider than normal, the hedge fund will go long the “off the run” and short the “on the run” Treasury and capture the gain as the spread converges to the historical average. This trade is expected to generate a positive return regardless of what interest rates do.

► ***Equity-oriented hedge funds*** take positions in individual equities. These strategies use bottom-up analysis of individual companies and not the overall equity market. Therefore, they differ from macro hedge funds that take long or short positions in the entire equity market. These funds are also different from the event-driven or relative value funds in that the long and short positions are not necessarily paired or related to each other, nor does the investment manager necessarily believe that some event will occur in the near term that will drive the longs up and the shorts down.

In a typical equity-oriented hedge fund, the investment manager will go long a stock believed to be undervalued and will move up over time and short stocks believed to be overvalued. These funds may differ from each other in the net exposure they have to the equity market. Long-short equity hedge funds will typically be net long the equity market to a varying degree. Some equity-oriented hedge funds focus on shorting stocks believed to be overvalued or where the company’s fundamentals are expected to deteriorate.

While hedge funds may generate returns that do not correlate with the rest of the portfolio, investors considering investing in hedge funds need to understand the liquidity restrictions of these investments. A mutual fund, for example, offers daily pricing and liquidity. However, a hedge fund is (typically) valued monthly and withdrawal requests are (typically) quarterly with advanced notice. If an investor wants to exit a hedge fund, it can take a year or longer to fully redeem the investment. And, under certain circumstances, the hedge fund can erect barriers that will prevent redemptions from the fund. The use of “side pockets” (separate accounts that contain illiquid holdings) by some hedge funds further complicates the redemption process.

PRIVATE EQUITY (PE)

► ***Private equity funds*** invest in and own private, non-publicly traded companies. PE funds differ in the specific strategy they employ. Venture capital funds invest in early-stage, fast-growing companies that are typically unprofitable and may not even generate revenue. The strategy is high-risk, high-reward. Companies such as Facebook and Google were, in their early years, funded by venture capital (VC) funds.

► ***Buyout PE funds*** invest in and take private, more mature companies. These companies are believed to be trading at a discount or somehow mismanaged. Once taken private, the PE fund would replace current management and restructure the company to make it more efficient over a period of a few years.

After the company has been restructured and shows improved profitability, it is either taken public in an initial public offering (IPO) or sold to a strategic buyer. A trend we are observing is that portfolio companies of one PE fund are sold to other PE funds or to the general partner's (GP) next fund.

► ***Growth capital funds*** are another variation of private equity strategies. With these strategies, the fund typically does not take control of the company, but rather provides needed capital for the company to continue to grow. In the category of "private equity," we may also include various strategies that provide debt capital, such as mezzanine lending funds, venture capital debt funds, or other similar strategies that provide debt financing rather than take an equity position in the underlying company.

The illiquidity restrictions of private equity funds are more onerous than for the typical hedge fund. Typically, PE funds have lives of about 10 years, and in some cases, longer. Asset owners considering PE investments need to think about whether they can tolerate this illiquidity. Of course, it is possible to sell one's stake in a PE fund in the secondary market, but the GP usually needs to approve the transaction. Economic and market conditions requiring an asset owner to sell may result in unfavorable pricing.

REAL ASSETS

The term "real assets" is used to distinguish certain investments from others that are considered to be "financial assets." For example, publicly traded equities are considered financial assets, while private real estate (as distinguished from REITs), natural resources, infrastructure, and timber are considered "real assets." Some investors believe that real assets are a good inflation hedge as opposed to financial assets, e.g., publicly traded equities. Investors' interest in real assets is driven by the expectation that these investments are long-lived, deliver fairly predictable cash flow, hedge inflation, and have a low correlation with other segments of the portfolio.

In some cases, these assets are regulated, which provides a certain level of stability. For example, the pricing and profitability of toll roads and utilities are similar assets that are considered essential and exhibit monopolistic properties and are therefore regulated by government agencies and not subject to market forces. In these cases, profitability is more assured in that pricing is set to achieve a certain return on assets or equity.

For additional information, please reach out to your PFMAM representative or email Biagio Manieri at manierib@pfmam.com.

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