

Alternative Investments

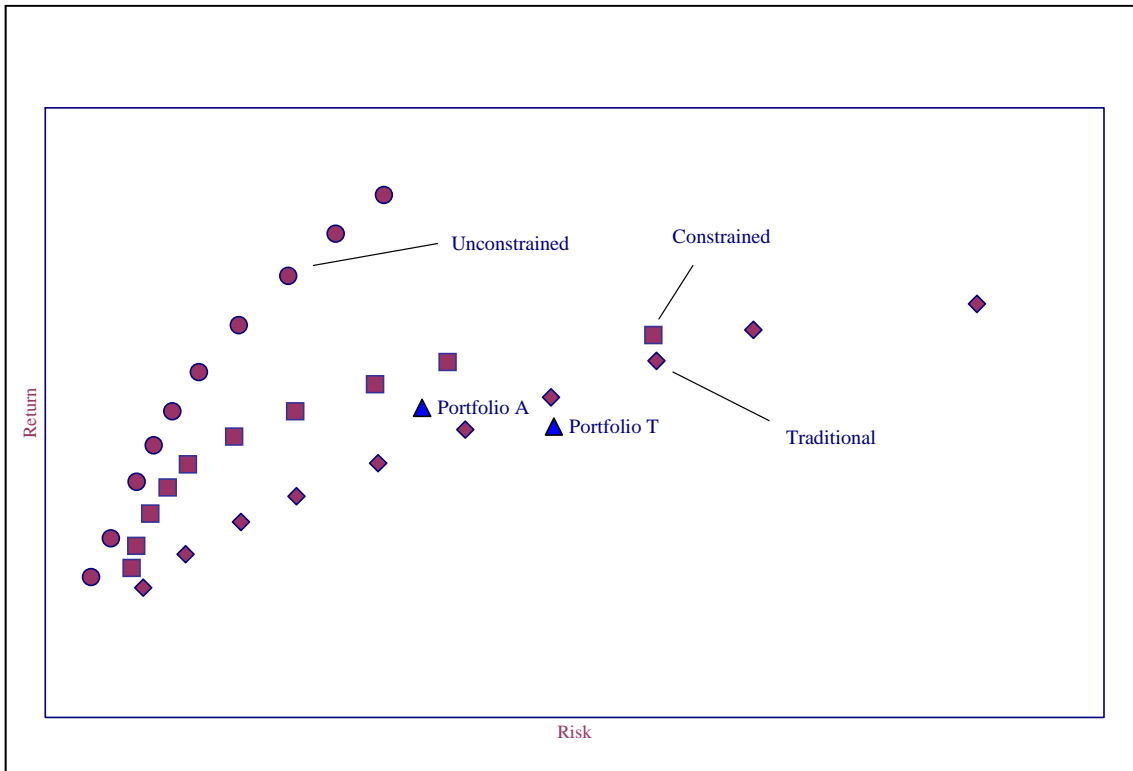
“Alternative Investments” has been one of the most widely discussed topics among our clients in recent years. Let’s start with some basic definitions. Broadly speaking, “alternatives” refer to different courses of action, means, or methods by which objectives may be attained - or more simply stated, other ways of dealing with a situation or problem. It’s not clear when the term “alternatives” entered the investment world lexicon, but it is understood today to mean asset classes and investment strategies outside traditional stocks and bonds. DeMarche uses the term alternatives to include real estate, hedge funds, various stages of private capital investing, distressed debt, and commodities. The “problem” we think clients are addressing is the challenge of meeting long-term return objectives. Many market analysts expect this to be a challenge if using only traditional equity and fixed income portfolios, with their relatively modest return expectation consistent with today’s relatively low bond rates and stock dividend yields.

One response to this problem is to increase “expected” returns by adding non-traditional asset classes. Alternatives are positioned to produce higher absolute returns over time without a corresponding increase in total portfolio risk/volatility. This is due to their relatively low historical return correlations to the traditional assets. In this paper, we use the DeMarche efficient frontier optimization model to briefly examine how adding alternatives impacts the optimal asset allocation vs. a more traditional portfolio. While there are many other factors to consider before investing in Alternatives, using an asset mix optimizer can be a useful step to start the analysis. Results produced by the DeMarche optimization model are based on our secular long-term inputs for each asset class, which include expected returns, volatility, and correlations over multiple investment cycles. Using these results as a basic framework can help investment committees examine the tradeoffs of including or excluding different asset classes from a purely historical and quantitative perspective.

To illustrate this tradeoff we have selected a subset of the 24 asset classes in our optimization model, which includes both traditional and alternative strategies. Figure 1 shows the different efficient frontiers, the portfolios with the highest expected return for each unit of volatility or risk, derived from the mixes of assets used. The efficient frontier labeled Traditional shows the most efficient portfolios composed only of traditional asset classes. The frontier labeled Unconstrained includes a full array of both traditional and alternative strategies, with the allocation to any one asset class allowed to range from 0% to 100% of the portfolio. Finally, a third frontier, labeled Constrained, includes the full array of assets, but is constrained so that there is reasonable diversification in the optimal portfolios.

When alternatives are added to a traditional portfolio some asset classes have to be reduced or eliminated to make room for these new assets. We find that when moving from the Traditional to the Constrained efficient frontier the optimal portfolios quickly fill up to the maximum permitted allocation of commodities, distressed debt, and real estate, i.e. even the lower volatility portfolios hold near maximum allowed allocations to these assets. This is followed by hedge funds and finally private equity in the higher return/volatility portfolios. On the other hand, the optimized Constrained portfolios hold minimal allocations in large cap domestic and international stocks and domestic intermediate bonds.

Figure 1 – DeMarche Efficient Frontier



We have also highlighted Portfolio “T” and Portfolio “A” for illustration. Portfolio “T” holds only traditional assets, representing a classic 70/30 blend of equity and fixed income. Portfolio “A” includes alternatives and is similar to the asset allocation of larger endowments and foundations, as reported in recent surveys. “A” allocates 39% to Alternatives, including 22% to hedge funds, 8% to private equity, and the remainder split between real estate, commodities, and distressed debt. Only 45% of this portfolio is in traditional equities, while 16% is in fixed income. We see that Portfolio “A” appears to have both lower volatility and a higher return than Portfolio “T”.

While the above framework provides a method of examining some of the tradeoffs between alternative and traditional assets, there are a number of caveats to consider:

- Portfolio optimization techniques are limited by assumptions that past performance is predictive of the future and that return distributions are normal and stationary.
- Portfolio optimization is very sensitive to the required inputs, so results can vary significantly with only minor changes in assumptions.

- Efficient frontier analysis does not account for the illiquidity risk of private equity and real estate, which is often 7-10 years. The extended and uncertain timing of capital calls and distributions makes it impossible to achieve precise asset allocation targets.
- Reported real estate and private equity returns are impacted by their specific appraisal and valuation methodologies. Prices cannot be measured continuously because they are not actively traded. This makes them difficult to compare to publicly traded securities.
- Reported hedge fund and private equity returns have a positive selection or survivor bias in that firms that go out of business no longer report returns.
- Correlations are measured by comparing returns across asset classes, but some of these assets and strategies have limited histories. In times of stress, correlations tend to converge, reducing the expected diversification impact.
- Alternative asset returns are highly dependent on the success of active management. The dispersion among manager returns is very high.
- Investing in alternatives requires more time and special expertise in manager selection and monitoring.
- Management fees are a multiple of the more traditional assets.

In the final analysis, these issues present barriers to entry for many funds. If some of the alternative assets are understood and judged to be suitable for use, the specific facts and circumstances of the organization and the risk tolerance of the governing body must guide their allocation in the portfolio. Because portfolio optimizers tend to understate risk and overstate the diversification benefits of alternatives, their use in asset allocation studies should be mixed with a healthy dose of common sense and skepticism. These pragmatic judgments are typically quantified in the optimizer in the form of asset constraints. As such, they determine the “optimal” allocation to alternatives more so than any other model input.

What percentage allocation to alternatives does DeMarche recommend? We often get this question, but giving a definitive response would be like picking shoes for someone else. We may like a style and can guess the size, but will they be comfortable and functional? In summary, your asset allocation, with or without alternatives, has to “fit” your institution.

We invite you to learn more about alternative investments by contacting DeMarche Associates at 913-384-4994.

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