Off the beaten path

Investors are seeking above-market returns as the investment environment remains volatile. Our panellists give their take on alternative assets as the means to achieve this

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THANKS to global uncertainty and elevated volatility, plus the continuing low-rate backdrop, more investors are exploring alternative investments as a means to eke out returns above the market. We ask a panel of experts for their views.

Genevieve Cua: What do you see as the biggest misconceptions about alternative investments such as hedge funds and private equity among private clients? What value might they add to portfolios?

Yves Guntern: Perhaps the biggest misconception among private clients is that these asset classes are often seen as being more risky than traditional asset classes. In the current environment, with higher volatility in equity markets coupled with many investors chasing higher yields by piling into high yield credit assets, alternative investments can actually reduce the overall risk of the portfolio as these assets can increase diversification and reduce volatility within a portfolio. In fact, it is interesting to note that hedge funds actively manage their own exposure to risk.

Given the current market conditions, there is a growing trend to allocate to alternative investments, as there has been a deterioration of the risk return ratio in traditional portfolios and investors are looking for solutions for a diversified source of alpha while reducing overall volatility. This is why alternatives can be a very good answer to issues that investors are currently facing, and we are seeing clients increasingly allocate to these alternative assets.

Hartmut Issel: One common misperception arguably emanates from the relative lack of transparency pertaining to hedge funds, as a result of which they are often deemed risky. However, it turns out that as an asset class, hedge funds' volatility is generally in between bonds and equities. In addition, because of this high volatility perception, some investors expect higher returns compared to what the broader asset category typically delivers.

In some cases, there is a view that hedge funds use extensive hedging, whereas in general this is not a key hallmark. Rather, some main traits of hedge funds are that they can use multiple degrees of freedom to express their view. Some of them employ shorting techniques or other constructs to benefit from falling prices, something that traditional long-only funds cannot do.

Lastly, investors point out that both hedge funds and private equity funds are less liquid compared to other investments, which is a disadvantage. It should be borne in mind though, that this disadvantage comes with a reward in the form of higher expected returns, the so-called illiquidity premium. True enough, investors generally need to be prepared to apply longer time horizons to such investments. Especially in the current low rate environment, any extra potential return should be particularly welcome. In addition, the lower liquidity can also help prevent behavioural biases, such as extensive trading or attempts to time the market, which often turn out to be ill-timed in the end.

Didier Duret: The biggest ambiguity is to expect alternative investments to be the snake oil curing all investment problems, providing absolute return with limited risk. The expected returns from hedge funds have been affected by the central banks' hyper-accommodative monetary policy. The successive global risk aversion waves and reactive monetary policies have not created an environment where hedge funds can differentiate and create beta-neutral rewarding strategies.

Private equity remains an alternative investment of choice for qualified investors as they are plugged to direct investments into companies. The difference comes with private equity's capacity to influence future cash flows.

THE BUSINESS TIMES' WEALTH ROUNDTABLE

Genevieve Cua, BT Wealth Editor poses questions to wealth experts for their views on alternative investments.

Yves Guntern is *Union Bancaire Privée (UBP) Head of Alternative Investments.* He is responsible for partnerships with single hedge fund managers and business development. Yves is an avid skier as well as a passionate sailor who has participated in several regattas in Europe.

Hartmut Issel is *UBS Wealth Management Executive Director and Head of Equity & Credit APAC.* He started his career at UBS as buy side analyst, eventually going to New York to lead the North American research unit. He joined Singapore as Wealth Management Research head in 2009. He enjoys cycling and is interested in Indian and Asian history.

Didier Duret is *ABN AMRO Private Banking Chief Investment Officer.* As chairman of the Private Banking Global Investment Committee, he provides ABN AMRO investment advisers, private bankers and clients with comprehensive advice and financial market strategy covering 40 markets. He constantly finds links between his personal passion for classical music and his professional passion in the way he directs his team.

Pierre DeGagné is *DBS Private Bank Head of Funds Selection.* He is responsible for the selection of high conviction funds in the traditional and alternative space. With an emphasis on deep dive research, his team works to identify funds that can outperform on a forward looking basis. He is an avid runner and clocks around 50 km a week. He also enjoys spending time with his four-year-old daughter.

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Pierre DeGagné: There are some misconceptions around absolute return funds. There is a perception that being absolute return focused means that the product is only supposed to provide a positive return absolutely. The reality is that their target is to produce annual positive returns, but there might be times when returns are negative.

Returns must be understood in the broader sense of the overall positioning and market impact. Low correlation may not mean zero correlation. Building a diversified portfolio including uncorrelated assets can help to cushion shocks. A proper alignment of an investor's time horizon to the type of alternative is also an important consideration.

With hedge funds, too often investors seek funds that have done well historically, without asking the question: Why should this fund continue to do well?

Genevieve: In your view, what alternative investments and strategies are best suited as all-weather investments and volatility dampeners (in the context of the current environment), and why? What size of allocation would you recommend?

Yves: In order to reduce volatility, investors should focus on strategies with low correlation to equity markets. Historically, trading strategies such as macro and CTA (commodity trading advisers) have demonstrated very low correlation to bonds and equities. Attention should also be paid to relative value strategies that tend to focus on pure alpha generation rather than follow market trends. On the equity long-short side, there is a strong case for managers that run their strategies with moderate net exposure to markets.

The size of allocation ultimately depends on the risk appetite of the investor, but it should be of a size where hedge funds will have a significant impact on the portfolio. This would mean anything north of a 15 per cent allocation. Investors need to ensure that they structure their portfolios with sufficient allocation in order to get the real benefits of hedge funds.

Hartmut: The use of hedge funds as a diversifier and, in times of ultra-low interest rates, also as a return enhancer in our portfolios has become fairly standard. As an example, in a mainstream balanced portfolio, we recommend a 20 per cent allocation to hedge funds. Only three years ago this proportion was lower. That we have raised it twice is due to the increasingly meagre return expectations for bonds, and here high-grade government bonds in particular – it is mainly their share in the portfolios that was reduced.

Regarding sub-strategies, we maintain the view that a hedge fund portfolio should be broadly diversified across styles and thus offer different performance drivers. We note that relative value strategies are usually the least dependent on market direction.

Regarding private equity, longer-term return expectations should be above listed stocks, but so is volatility. Therefore, we tend to add them more on specific requests. Meanwhile, fetching an additional illiquidity premium in a low-rate environment is worth consideration.

Didier: The problem that clients want to solve with alternatives is to insert assets in their portfolios that can cushion sharp market drawdowns. It can be achieved with a CTA that has the opportunity to operate swiftly with financial futures. Also, long-short strategies with a net short exposure are relevant today to provide some form of insurance against equity losses. What clients don't want is hidden beta exposure to the market that will increase their own exposure.

Pierre: In general, private equity is likely to outperform many hedge funds. Where many hedge funds are struggling to continuously provide daily liquidity, clients who are more comfortable with private equity have the potential to benefit from the illiquidity premium.

Among hedge funds we prefer those which are fundamentally uncorrelated to markets, such as systematic CTAs and market neutral long-short strategies. It is harder to bury leveraged beta in these products, and if you choose carefully you can find managers that fundamentally provide alpha and positive diversification effects.

Genevieve: There is ongoing concern about hedge fund fees and performance, both in the context of single manager funds and funds of hedge funds. As advisers and wealth managers, please share some thoughts on this.

Yves: The pressure on fees is a reality and is felt every day. The pressure is increasing largely because over the past months and even years, hedge funds have underperformed in relative terms against traditional asset classes. In an environment where equities have been supported by monetary policies in the US and Europe, thus having very positive performance, and where fixed income has also done very well, it is normal that hedge funds (which are much more focused on risk management) would underperform.

However, in environments where volatility and risks overall – whether financial, economic or geopolitical – have increased, hedge funds should outperform relative to traditional asset classes. Although it is certainly fair to have pressure on fees to ensure accountability, it is important to remember that running an actively traded strategy requires much more resources, time and energy versus a passive investment.

Investors also need to be aware that certain strategies, in order to be efficient or successful, can only be managed with a limited amount of capital. This means higher costs and thus, higher fees can be justified. This may not be true for all hedge fund strategies and definitely not for all managers, so it is important to look carefully at these elements when selecting managers.

For fund of hedge funds (FoHF), the hedge funds universe comprises approximately 10,000 funds with many new entrants every year and would require an experienced and qualified professional to select the few best managers from such a large universe. This is why allocating to FoHFs would ensure that all the managers have gone through a full due diligence process, both from investment and non-investment perspectives and that those managers are monitored by professionals on a daily basis. From a portfolio construction approach, it allows the investor to have a proper process which takes into account correlation, concentrations and risk management.

Hartmut: It is true that fees are often raised as a question by our investors. As the leading wealth manager with high volumes invested in the industry, we seek to negotiate attractive terms for our clients. More generally speaking though, we again highlight that hedge funds are almost the only asset class where we did not take our return expectations lower over the last 12 months. We continue to look for a steady mid-single digit, low volatility return compounded over five years. This would be after fees.

Didier: With low fixed income yields and rather deceptive hedge fund average performance in the last two years, the 2 per cent management fee and 20 per cent performance fee model is absurd. Hedge funds have entered a reality check. The long-only funds and hedge funds are judged with the same metric: achieving positive real returns net of fees.

Pierre: In private equity, fee structures seem unlikely to change. Some highly skilled hedge fund managers may even migrate to these structures or move to more imaginative operating structures.

In hedge funds we expect fees to potentially trend downwards (especially for liquid alternatives) and for the market to consolidate around larger fund management companies, with lines between traditional and alternative investments becoming even more blurred. W