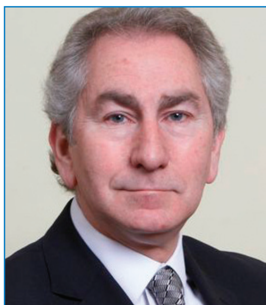
Can we find and keep alpha in alternatives?

"WE OFTEN DESTROY THE OBJECT WE MOST DESIRE." IAN MORLEY OF ALLENBRIDGEEPIC EXAMINES THE POSSIBILITY THAT THIS IS PRECISELY WHAT INSTITUTIONS WILL DO WITH THEIR GROWING INTEREST IN ALTERNATIVES IN GENERAL, AND HEDGE FUNDS IN PARTICULAR



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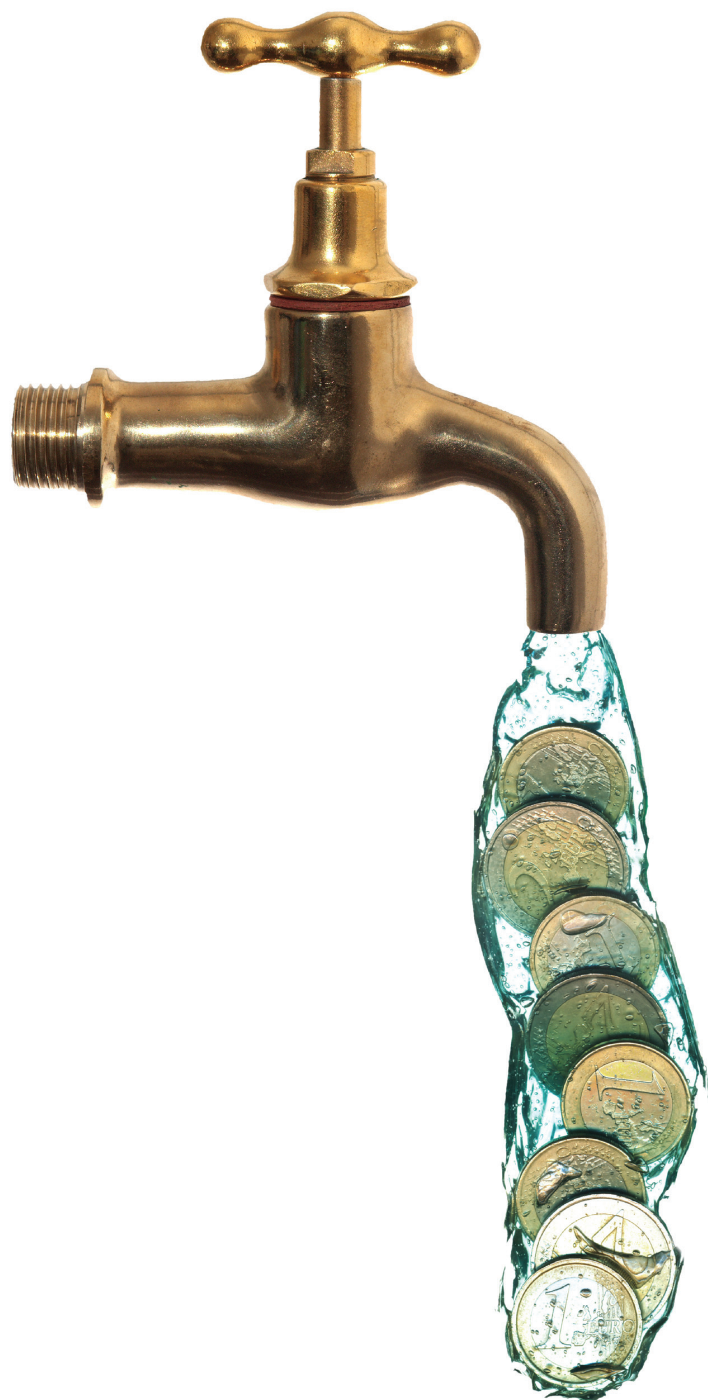
In the traditional world of fund management, the term beta normally relates to the general return of the market and alpha something above that return. You do not have to be Wittgenstein to work out that the superior cannot become the general. Therefore, alpha cannot become beta. Institutional interest in hedge funds often seeks alpha in beta terms. The creation of hedge fund indices makes this illusion seem possible.

The traditional management industry has not gone into decline because the managers are less skilful than alternative managers, but simply because a combination of circumstances has overwhelmed any possibility they had of beating indices in the first place. Among the obstacles is the fact that they underestimate the "attritional" effects of brokerage costs on returns, and then find themselves constrained by a series of prescriptive and proscriptive rules drawn up by regulators and consultants. All with the best intentions which ultimately end up preventing that which they seek: alpha. It is not by chance that the road to hell is paved with good intentions! Regulation, with its general fear of concentration and restrictive trust documents, often results in LGPS funds being forced to do many things that they otherwise might not choose to. The tyranny of the benchmark then asserts itself in its insidious forms, with traditional managers cowed by pusillanimous consensus of deviating away from the peer group. In this environment, there is little scope for beta products with alpha fees to survive for long. Particularly where beta returns can be bought at a low cost through index-funds or ETFs, the outcome for traditional fund management is a "no brainer". Into this established world of benchmarks and consultants, steps the brave new world of the hedge fund industry, armed with their Adam Smith approach to free markets, unencumbered by benchmarks and the hobgoblin small-mindedness of indexation. Carrying their beacon of absolute returns, they boldly face the traditional institutions with a mercurial combination of confidence and naivety.

With the mantra of absolute returns, hedge funds sit uncomfortably in the traditional world of defined terms and contributions. Hedge funds are, as yet, uncluttered by the concept of relative performance (a euphemism for poor performance, still to rear its ugly head within the hedge fund world). Ironically, this is one of the reasons that it is so hard for the institutions to come to terms with hedge funds. They do not easily sit within the normal asset allocation process, nor can they easily be placed within the box marked "equities" or "fixed income". For some, hedge funds are an asset class in their own right. Others ridicule this concept, because hedge funds are primarily made up of traditional assets of stocks, bonds, currencies and commodities. They see them as a style class rather than a true asset class. Either way, they have displayed positive growth in the last few years compared to the dramatic destruction of wealth in traditional equity-linked pension investment, even accounting for the 2008 debacle. Yes, hedge funds lost less than equities. The non- and negative correlation of hedge funds is now being taken seriously by institutions. Add to this the catalyst of fiduciary and legal responsibility on the part of trustees not to ignore investments that add value, and a form of moral dimension is added to what might otherwise just have been a financial empirical imperative to take hedge funds seriously.



If the consultants can't measure it, they can't understand it. If the consultants can't understand it, then they won't let LGPS funds buy it. This Freudian attention to measurement might seem more appropriate to the boudoir than financial services, but it is not about to change. By measuring it, you can compare it, by comparing it you can put it with others, by putting it with others you can create a benchmark, by creating a benchmark you can turn it into a commodity, by turning it into a commodity you can buy it cheaply and that is how the traditional asset management business was basically destroyed.

You cannot buy alpha (the financial word for talent) at a discount. If alpha truly exists, it is a rare commodity and you will have to pay the going rate, and that is at a premium to the commodity rate. It is only worth paying this premium if the alpha is sustained over a reasonable time horizon. This is probably the real challenge for the mediocre. It is worth observing that it makes sense to pay top football managers and orchestra conductors, racing car drivers and senior executives (well, some senior executives) more money because they deliver alpha in their various fields. The cost of these payments is relatively small when measured against the added value of the return, or at least should be. Institutions often raise the question of liquidity. In its natural sense, liquidity is water running out of a tap, until there is a drought and then it ceases to run. The daily onshore liquidity of regulated funds is, in essence, a myth. You can get in and out every day, until you can't. That means that when there has been a major problem or a large redemption only then do you read the small print. You then discover the manager can suspend dealings or widen the spread or use other mechanisms to defend the regulatory illusion of daily liquidity. The market reality of transparency is that it is nonsense: available when you don't need it and unavailable when you do! You cannot create liquidity by regulatory fiat. Liquidity is a reflection of the market, not something apart from the market. Hedge fund liquidity is more in line with reality. Liquidity is mostly monthly and, in cases where longer periods are involved, some funds only trade liquid instruments; others may provide their own limited liquidity, which overcomes some of the less liquid underlying funds. Just don't rely on it during a crisis. Pension plans have accepted this limited liquidity with private equity and closed-ended funds and therefore perhaps this is less of an overall problem than it first appears. Perhaps the most misunderstood area is that of risk. The concept of risk has moved from being a series of quantitative and qualitative assessment to a form of modern theology. A collective of hedge funds are empirically, in my view, less risky than equity markets.

This is contra-intuitive but actually true. Institutions and their consultants do get somewhat besotted with measuring the apparent risks of hedge funds. Perhaps, at the outset, a basic tenet of the philosophy of investment needs to be stated. Without risk, there

is no return. Too much risk control, too much diversification, too much concern for liquidity, too much instantaneous measurement of co-variance will ultimately result in a profit-neutral position that may only produce a cash return. If that is the case, it is probably not worth bothering with in the first place.

The object of the exercise is to combine the art with the science and reduce the risk while maintaining a level of return historically around that of equities, but with demonstratively lower risk. The plethora of the quantitative analyst's language lexicon has its role. Deviations, standard deviations, semi deviations, Sharpe ratios, Omega ratios etc, are meant to enlighten the investor, but are often used for sophistry and obfuscation. The institutional demand for transparency – something they don't get in most of their other alternative investments – is often requested without it being understood why they actually need it or perhaps, more importantly, what they will do with the information when they receive it. Seeing all the trees is not necessarily helpful when trying to look objectively at the wood. This is one of the main reasons many LGPS funds choose to exclude hedge funds from their strategic asset allocation. An over-sophisticated presentation of an already-complex strategy makes it nearly impossible for the lay Pensions Committee member to make an informed decision about whether or not to invest. Yet LGPS funds should be actively seeking less-correlated alternatives to quoted equities, and ones which, with care, can be used to reduce risk and volatility. The onus is on the sellers to use plain English explanations when presenting to Pension Committees.

One of the core problems is that the very well-established hedge funds and funds of hedge-funds, while intellectually and, perhaps, egotistically attracted to the idea of having large institutional investors, do not need their money at any price. Those who do need the money may well compromise their ability to produce alpha by accepting terms that are themselves not fully thought through or even understood as to why they are being requested or met. Mutual disappointment in a few years time is all too palpable; in essence a result of mis-buying and mis-selling.

There are solutions, but it requires a considerable effort on both sides. The hedge fund industry, through its trade association AIMA, needs to enter into a serious dialogue with major pension plans. Persuading consultants to use standard AIMA documentation will be a good starting point. The desire of the consultants to create their own RFPs to show that they have added value merely adds paper, not value. LGPS funds need to come to terms with the fact that good hedge funds will not be bought on the cheap, nor should they be forced into some kind of artificial benchmarks. They also need to recognise the importance of paying for good quality investment and operational due diligence, ahead of any funding.

Hedge funds, in turn, need to recognise that institutional investors with long-term concerns for their pension holders need to have some form of asset liability match where the hedge fund sits realistically within the asset liability model. If the hedge fund industry can prevent itself becoming too intoxicated with the sheer monetary size of the pension plans, and if the pension plans can recognise that true alpha is a value-added rather than a short-term replacement for their poor equity holdings, then these mutually consenting adults can enter into a long-term relationship and will not feel that they have been taken advantage of by each other.

My first law of pension plan states that when talking to pension plans, God gave you two ears and one mouth. Use them in those proportions. Notwithstanding the fact that I am sometimes unjustifiably inclined to break my own laws, I would suggest that it is good advice and better still, sound common sense to follow this particular dictum.

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