

THE CHANGING ROLE OF. Alternatives

Coverage of the 2008 AIC Conference.

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ALTERNATIVE INVESTMENT CONFERENCE ONLINE

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It was a brutal year for all asset classes, and alternative investments were no exception. This 2008 Alternative Investment Conference came at an important time, following on the heels of dismal market returns in November. The event was held at the Four Seasons Troon North Hotel in Scottsdale, Arizona, where academics and practitioners gathered to share ideas and insights in challenging times. Our theme, The Changing Role of Alternatives, addressed the impact of the current market environment on many of the top strategies, from private equity to hedge funds. Presenters also discussed new and emerging approaches such as synthetic funds and 130/30.

This year, we introduced a new feature to our conference agenda—informal interactive polling, which created a real-time snapshot of our plan sponsor delegates' views on hot topics related to alternative investments. These can be found in the sidebar accompanying our conference coverage, on page 9. Of course, you'll find a summary of the conference proceedings below. But check out our Web site, www.investmentreview.com, for a more in-depth look at each presenter and their topic. We hope you find it all interesting and useful in these challenging times.

The conference kicked off with a discussion of private

equity by Stuart Waugh, managing director, TD Capital Private Equity Investors. In his presentation, he noted that, while there is room for cautious optimism, private equity markets will not be immune to the tremendous volatility in financial markets or the slowing of the general economy. However, according to Waugh, “times of economic upheaval often represent significant buying opportunities in some key segments of the private equity markets. Given its focus on long-term value creation, private equity is well positioned to benefit from times of economic upheaval, as it has in the past, during periods of market turmoil and capital scarcity.” The mid-market in particular is an area for potential growth, as large leveraged buyout deals continue to get squeezed out by a lack of any available credit. Going forward, two types of mid-market buyout fund managers will likely prevail—established managers who have profited through prior market cycles and managers focused on control-oriented distressed opportunities. Waugh did sound a note of caution—“The challenges of investing in this segment are many,” so investors must seek out the best partnership in advisors with long track records and demonstrated success in the mid-market area.

Long-short extension strategies were the next topic on the agenda, with speaker Tony Elavia, managing director and chief executive officer, Madison Square Investors, asking whether or not experts' predictions that 130/30 assets would reach \$1 trillion by 2010 would materialize. Given market conditions and the shifting investment landscape, Elavia examined how investors view these strategies and asked whether or not they are still viable. “The good news is that despite a tough market

environment for 130/30 strategies, a subset of 130/30 managers have delivered alpha,” he said. However, going forward, experienced short selling, infrastructure (prime broker management, operations, legal, compliance, etc.), consistent alpha generation, and risk management will be the keys to attracting institutional assets. Elavia went on to highlight some of the notable differentiators associated with investing in different regions outside of the U.S., as well as some of the advantages and disadvantages. Typically international markets are not as efficient as U.S. markets, making international 130/30 an appealing investment. However, there are certain hurdles to overcome when short-selling outside of the U.S., including legal issues, fewer stocks available to short, and higher borrow costs.

HEDGE FUNDS

Looking specifically at hedge funds, our next speaker, Joseph Morgart, senior vice-president, Alternative Investment Strategies, Pyramis Global Advisors, looked at the institutionalization of this asset class and the growing importance of risk management. “In this unprecedented market context, the hedge fund industry is evolving rapidly,” he said. “It is consolidating and becoming more institutionalized, all under a microscope by investors, regulatory bodies and the media in the midst of an economic crisis.” In particular, the changes facing the industry are positive ones that will result in stronger managers and better operations as well as informed investors. Changes on the horizon include a shakeout on the manager front, with more traditional hedging strategies taking the lead and highly leveraged ones disappearing. The prime broker landscape will also shift from single-focus to a stable of suppliers that compete on price availability and sustainability. In addition, investors will become more demanding and ask tougher questions. Fund of hedge fund managers will be faced with the challenge of a shrinking universe of investments and a new focus on fees. The new environment will serve investors better, but it will be smaller, rich in opportunities and much more transparent.

For institutional investors who still have not invested in hedge funds, headline risk is a major factor in their decision to stay away, according to Tristram Lett, managing director, Integra Capital Management Ltd. Operational risk, in particular, is responsible for 50% of fund failures. One way to avoid headline risk is to invest in managed accounts, which are uniquely able to deal with

the key sources of headline risk. “There are two essential features of a managed account,” said Lett. “First, it must be independent of a manager’s own accounts and second, the account is owned by the sponsoring agency.” Control of the account is transferred from manager to sponsor, with the manager acting as a sub-advisor under rules and conditions of the sponsor. This separation of duties provides investors with protection, but a sophisticated surveillance system and experience on the part of the sponsor are needed to make this work. Appropriate supports to ensure there are no breaches of guidelines must be in place along with a series of transparency checks. “Managed accounts are not the panacea for the major risks associated with hedge funds unless accompanied by the appropriate support mechanisms,” concluded Lett.

Continuing the hedge fund discussion, Laura Lindsey, assistant professor of finance at Arizona State University, talked about an emerging issue for investors—shareholder activism. In particular, recent work on hedge funds that identifies activism by the type of SEC filing, for example, has found that activist hedge fund blocks are associated with higher stock returns and improved firm performance when compared to the performance of blocks owned by passive hedge funds. Lindsey discussed the findings of a new working paper completed with Christopher Clifford in which the two researchers seek to understand factors influencing shareholder monitoring and its effect on firm performance. “We find preliminary evidence that organizational forms, for which typical compensation arrangements include carry or a one-to-one profit arrangement, are much more likely to be active block holders, as identified by their filing choice with the SEC,” explained Lindsey. The pair also finds evidence suggesting activism is an effective strategy for these organizations and that returns do not come at the expense of existing shareholders or corporate performance.

For investors seeking a low-cost alternative to hedge funds, synthetic funds are increasingly available, according to Florent Salmon, vice-president, Alternative Investment Management, Desjardins Global Asset Management. “They are at the frontier between active management and indexing and as such should be offered using a relatively competitive fee structure,” said Salmon. Synthetic funds rely on four pillars—a diversified portfolio of assets, a tradable benchmark, standard but robust portfolio insurance techniques,

and daily rebalancing. Until recently, he explained, brokers were the main providers of insurance against market risk through expensive derivative products. Large institutional investors should now be in a position to internalize standard insurance processes. Synthetic funds are a step toward achieving this goal. As in traditional asset management, synthetic funds need a good selection of assets for their core portfolio. Diversification across a relatively large selection of assets with good risk/return characteristics is required and the challenge associated with asset selection is very much intact. Finally, they are inexpensive, have limited or no counterparty risk and provide investors with full transparency.

NICE WEATHER

At the end of the conference, our last speaker turned to a new frontier in capital markets—weather derivatives. Jason Wei, professor of finance at the Rotman School of Management, University of Toronto, shared his research on this emerging asset class. “Weather affects almost every sector of the economy, ranging from agriculture to entertainment,” he said. “A recent study estimates that 23% of the U.S. GDP is weather-dependent. The corresponding number for Canada is 25%.” So when the weather derivatives market made its debut in 1997, there was great potential for growth. Today, temperature-based contracts account for most of the trading and can be used for hedging, trading or investment purposes. “When viewed as alternative investments, weather derivatives have potential to reduce risk and enhance Sharpe ratio,” said Wei. Notwithstanding the significant impact of weather conditions on the economy, the correlation between stock market indices and local temperature is typically very low, suggesting the diversification benefit of weather derivatives. In a simple illustration with equity, bonds and real estate in the conventional portfolio, adding weather derivatives can increase the Sharpe ratio from 0.52 to 0.78.

As more cities are being listed on the CME for temperature derivatives and as the trading volume increases, investors are becoming more aware of weather derivatives. In the meantime, the increasing concern for global climate will also spur more attention to the weather and its impact on the economy. “We have every reason to believe that the weather derivatives market will enjoy an even broader participation, making weather derivatives a truly alternative class of investment instruments,” he concluded. ■

Alternative Snapshot

Results of AIC interactive poll

The 2008 Alternative Investment Conference got interactive. During the event, we employed interactive, real-time polling software to gauge plan sponsors’ views on key topics in the area, from the impact of the market meltdown to their views on fees in the future. As the following charts show, there are some interesting trends developing in the wake of last year’s brutal market performance. When asked whether the market meltdown has made them rethink their approach to alternative investments, the majority (68%) said yes (Figure 1). We also asked a hindsight question—for 2008, which investment would you rather have been exposed to, fund of funds or MSCI EAFE (Figure 2). The answer—fund of funds by a mile (90%).

Moving to their future plans, there is a trend apparent in the short term, with 23% of respondents planning to boost their allocations to infrastructure (Figure 3). Half of our respondents, however, appear to be planning to up their exposure to a number of alternatives—50%. They also seem to think fees ought to go down soon—83% of them think they’ll drop in the next two to five years (Figure 4). Finally, looking at barriers to moving into alternatives, respondents pointed to lack of capacity (38%), unknown risks (23%), board/trustee education (18%) and cost (18%) as their main impediments (Figure 5).

FIG. 1 - Has the market meltdown made you rethink your approach to alternative investments?

No - 32%

Yes - 68%



FIG. 2 - Hindsight question – for 2008, which investment would you rather have been exposed to?

MSCI EAFE - 10%

Fund of Funds - 90%



FIG. 3 - Which alternatives do you plan to increase allocations to in the next 1-2 years?

Real estate - 8%

Private equity - 4%

Infrastructure - 23%

More than one - 50%

Hedge funds - 8%

None/Not listed - 8%

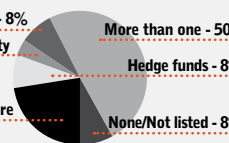


FIG. 4 - Do you think fees for alternative investments will come down in the next two to five years?

No - 17%

Yes - 83%



FIG. 5 - Which of the following are your biggest barriers to alternative investments?

Lack of Capacity - 36%

Investment guidelines - 5%

Cost - 36%

Board/Trustee Education - 18%

Unknown Risk - 23%

