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How do Alternative Investments Fit?

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Hedge funds have been marketed, to a great extent, on the basis of historical performance and volatility. But everyone knows that past performance is no guarantee of future returns. Observers of Canadian capital markets will know that the last 15 years have been more kind to bond holders than stock investors. Over this period Canadian fixed income produced a higher return than Canadian equities with much lower risk. This performance was the result of bond yields declining from the 1986 level of around 10 per cent to about 5 per cent currently. Without this last bit of information, someone looking at this period might reasonably conclude that investors should prefer Canadian bonds to Canadian equities.

Recently, in *Benefits Canada*, my colleague Marcel Larochelle and I put forward six important questions to consider when investing in any asset class or strategy: (1) What were the sources of past returns? (2) Can past returns be attributed to skill? (3) Has anything changed? (4) How much can be lost? (5) How can losses be managed? and (6) What are reasonable future return expectations?

Points 1 and 3 are key. For both buyers and sellers, the challenge with alternative investments is to obtain answers to basic questions about sources of past returns and future return expectations. Even some of the historical performance data for hedge funds is suspect because it is determined by looking at manager universes and these suffer from survivor bias.

We conducted a fairly naïve experiment on survivor bias. We started with a group of 200 hypothetical zero alpha managers, each with the same characteristics, as follows:

COMPONENT OF RETURN

	Cash	Market	Alpha	Total
Expected Return =	4%	2%	0%	6%
Expected Risk =	0%	9%	12%	15%

We then simulated 10 years of quarterly returns for each manager and assumed a 30 per cent survivor bias over the period and constructed an index with the remaining managers.

Starting with a group of managers who had bond-type returns and equity-like volatility, we ended up with a universe that had a ten-year average return of nine per cent, with an annualized standard deviation of eight per cent: equity-like returns with bond volatility! This experiment illustrates how insidious survivor bias can be. Additional challenges for these universes come when both well- and poor-performing managers do not disclose their returns.

All this being said, can we get useful information concerning past performance and future expectations? We think so, but it will require more work on the part of hedge fund providers, consultants and the investors who buy these products. This involves three factors: the use of historical data to understand sources of return; the development of forward-looking projections (deterministic or stochastic) of the various return components; and the study of the relative contribution to the total expected return and volatility for each source of return.

We have used the above approach to examine various hedge fund strategies. The model we built for bond arbitrage relied on monthly spreads and returns. We were able to identify the leverage required to generate various levels of returns, the volatility involved with the strategy, and the maximum loss for any given approach. Extending this, we would be able to build a realistic assumption for future returns for bond arbitrage strategy.

More work remains to be done and it is hoped that more analysis is coming, since any strategy or asset class that can help investors manage risk or enhance return deserves serious consideration. Answers to these questions will give investors the insight and understanding needed to invest in these strategies – at the very least it will enable them to make the informed decisions that are incumbent upon fiduciaries. ■

