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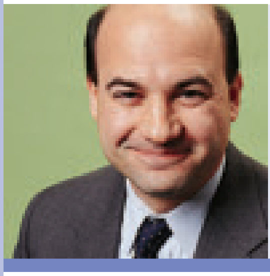

THE ALPHA-ONLY ADVANTAGE

More institutional investors are seeing benefits in scaling back on beta.

What constitutes a "best practice" is changing dramatically for plan sponsors across the Americas. The traditional challenges plan sponsors have faced in past years typically focused on which long-term strategic asset allocation was best for the plan, as well as the long-term tradeoffs between risk (i.e., volatility) and returns on equity (ROE), assets (ROA), and surplus (ROS). Although these questions certainly had their technical and conceptual challenges, they were also conditioned by the expectation that accepting market risks—whether equity beta or fixed income duration—generally proved profitable.

However, half a decade of sideways returns in equity and fixed income markets worldwide have dramatically changed both the investment landscape and the challenges faced by plan sponsors in meeting their specific investment objectives. In particular, the faith that high-performance traditional investment products alone can meet the needs of institutional managers has been shaken. In order to meet the still-considerable investment return hurdles that are faced by institutions, plan sponsors have begun to shift some of their attention and investments to alternative assets. Indeed, this shift has been captured by the title of a recent article in CFA Magazine: "Searching for Alpha…Because You Can Never Go Beta Again."

What has also changed, particularly among plan sponsors in the United States, is that some of the most respected and successful institutional investors include those who regularly invest outside traditional stock and bond mandates. They include managers, such as David Swenson of Yale University, who regularly commit up to 50% of their funds to non-traditional assets or strategies. Still, most institutional managers face significant constraints both in terms of the liability stream they must meet as well as board expectations on what constitutes appropriate investments for the institution.

The shift in the investment landscape has led plan sponsors to address two new critical challenges: how much alpha-only and non-traditional investments should I own, and how can I employ tactical asset allocation strategies for the benefit of my plan? Luckily, addressing these challenges has become more tractable with the emergence of a vibrant industry of alpha-only products and a wider range of non-traditional asset classes including private equity, real estate, and physical commodities, each with its own risk, return and liquidity considerations.

Tactical asset allocation has also emerged as a critical capability for investment managers to help plan sponsors meet their investment hurdles, employing both stand-alone asset allocation products as well as overlay strategies in a quest to enhance overall portfolio returns. Overlay strategies have some particular advantages for institutional investors: they do not disrupt underlying managers or the institution's long-term strategic asset allocation; they are capital efficient and require the institution only to pay for success in generating alpha returns, and; they can often offer a low correlation both to other asset classes and to the strategies of other managers. Also, to the extent that these strategies can capture value opportunities among the major stock, bond and currency markets worldwide by using Canadian capital for the purchase and sale of futures, forwards and swap contracts, overlay strategies may represent a practical means for plans to achieve the value opportunities available in world markets without compromising their domestic investment guidelines.

In short, the challenges posed by less reliable investment markets have increased the demands on plan sponsors. However, plan sponsors today also have a much wider range of alpha-only and non-traditional investment products to help them meet their plan goals. Combined with renewed interest in tactical asset allocation products and overlay strategies, plan sponsors are also availing themselves of a wider and much more effective range of investment solutions to meet their ever-challenging investment objectives. ■