

REACHING THE SUMMIT



TOM GUNN
President, University of British Columbia Investment Management Trust.

The road to successful implementation of alternatives.

As many pension funds have learned (to their chagrin), implementing an alternative investment program is not the same as implementing a public securities program. In the past, alternative investing was not done well in Canada and many funds grew to have a love-hate relationship with private equity and real estate. However, some funds, particularly the large ones, have persisted with alternatives, as have leading public sector plans in the U.S. Today, the poor public market outlook has led many to review the successes of these larger funds.

Pension funds now have the advantage of being able to look at experience from around the world and, in particular, case histories from the U.S. Many U.S. institutional investors have realized (probably with the help of good consultants) that the fundamental difference between alternatives and traditional asset classes is that you are not simply buying stocks and bonds—you are buying companies. If you have expertise in corporate management, by all means invest directly. But, if all your training is in buying and analyzing public securities or structuring public market portfolios, don't do it yourself. You are far better off hiring a professional. In the case of alternatives, this means looking at funds, and as a starter, funds of funds.

Many would say that funds of funds are a uniquely bad idea, as you pay fees on fees. However, the reality is that alternative investments are expensive to acquire and manage no matter how you do it. The cost of recruiting and retaining specialized staff is really the benchmark to measure fund of funds fees. You may well find that the extra fees are well below the cost of hiring specialized staff.

The overall implementation strategy issues involves other challenges. These include the long lead-time before positive returns start to show, a lack of liquidity, the mixed quality of information on individual investments, the tasks of determining where to hold your committed cash and finding out how to benchmark performance. Many have tried to enter the field without sorting through these issues. However, the realities have either

frustrated them or caused them to back away altogether.

Dealing with the J-Curve

One of the first things to sort through is how to handle the J-Curve performance pattern. This is generated by the industry practice of charging fees right away on committed capital, while only a small amount of the commitment is actually drawn and invested. This is compounded by the fact that it can take several years to generate really good returns from individual investments, something which applies as much to real estate and infrastructure investments as it does to private equity. To be an active investor in this space, you and your trustees must be prepared to live with returns on potentially great investments that are initially low or, even more likely, negative. In addition, the lack of liquidity in these alternatives means that you will likely be unable to sell your investment early unless you are prepared to take a substantial cut in price.

Current practice is to value alternative investments on a more frequent basis than in the past—anywhere from quarterly to every three years. These valuations are likely to be estimates and, hopefully, conservative ones. Real valuations only take place when there is a new financing or a trigger event like a sale. This, however, may not happen frequently and can lead to lumpy performance.

Then there is benchmarking. A great deal of the benchmarking work on alternatives was based on rosy public market expectations and is now obsolete. When market expectations were in the double digits, an appropriate benchmark for private equity was the S&P 500 plus 500 basis points. But is this still realistic? Another nagging issue is that S&P 500 plus 500 basis points turns out to be first quartile performance for most recent time periods. These questions do have answers, however, and working your way towards them is part of the journey. Perhaps it's best to think of alternative investing not as a quantitative process, but as an art form. Great records have been built not just with investment skill, but with patience and good business judgment as well. Done this way, alternatives are a real winner. ■