SELECT ASSET MANAGEMENT

## Presentation to PortfolioConstruction Conference 2008

# Blending Alternative Investments in a Complex Environment

**August 2008**

Alternative thinking.

# Presentation Overview

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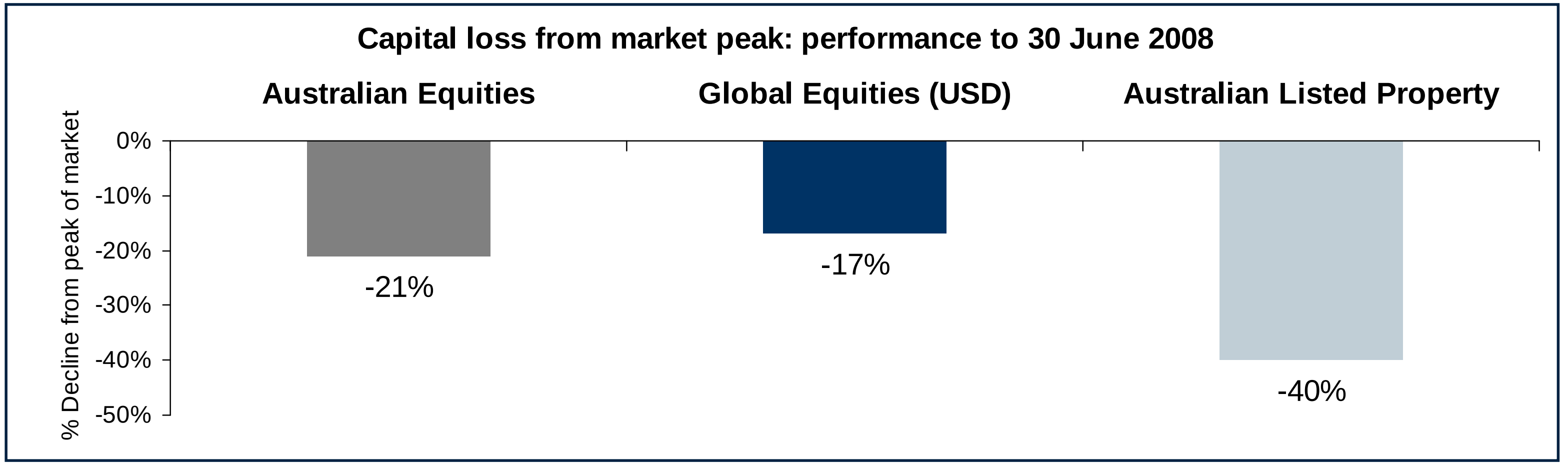
- Introduction
- Alternative investments and their performance in market crises
- Where alternative investments fit in a portfolio
- Portfolio construction and analysis of investment drivers
- Performance measurement and risk management
- The sizing of alternative investment allocations
- Summary and conclusion

# The current investment landscape

- 2007/08 has obviously presented a tremendously challenging investment environment
- Investors that have been hurt the most in 2007/2008 are those that have relied on the past performance of equity markets, easy credit conditions and excessive leverage
- Recovering from bear markets is difficult if investors experience the full downside:




| % required to get back to break-even: | 27.2% | 20.0% | 67.8% |
|---|---|---|---|

Australian Equities - S&P/ASX200 Accumulation Index (peak was 1 Nov 2007), Global Equities (USD) - MSCI World Index (peak was 31 Oct 2007), Australian Listed Property - S&P/ASX Listed Property Trust Accumulation Index (peak was 22 Feb 2007). Source: SSGA, Bloomberg.

# Re-assessment of risk and diversification

- Recent conditions have lead to an overdue re-assessment of risk and portfolio diversification

# Forward thinking investors

- **Some investors have refrained from chasing performance and have allocated significant portions of their portfolios to alternative investments**

- **Example allocations to alternative investments[1]:**
  - US Endowment funds 32%
  - US family offices 45%
  - Global high net worth investors 11%

- **Australian advisors and money managers that have not allocated to alternatives or have only made a small allocation to date:**
  - Are the most vulnerable in the current environment with narrow diversification across traditional asset classes
  - Are increasingly being requested to do so with clients seeking diversification and better returns[2]

[1]Sources: US Endowments - 2007 National Association of College and University Business Officers (NACUBO) Endownment Study, US Family Offices - Institute for Private Investors' Family Performance Tracking® 2007 Survey, High Net Worth - CapGemini/Merrill Lynch 2008 World Wealth Report.
[2]Sources: Johnston, M. and Uddin, B.,2007, "Macquarie/Investment Trends Alternative Investments: Investor Report". Collins, M.,18 May 2007, "Alternatives Go Into Overdrive", InvestorDaily.com.au.

# US Endowment Funds

- 2007 survey by National Association of College and University Business Officers of 785 endowment funds
- Dollar-weighted average alternative asset class allocation: 32%
- Increases in allocation to private equity, natural resources and hedge funds over preceding 10 years 475%, 700% & 279% respectively

**US endowment fund performance summary (annualised), years ending 30 June 2007**

| Time period | 1 year | 3 years | 5 years | 10 years |
|---|---|---|---|---|
| Number of survey participants | 726 | 683 | 636 | 499 |
| **Dollar weighted average endowment performance** | **21.5%** | **16.8%** | **14.4%** | **11.7%** |
| S&P 500 | 20.6% | 11.7% | 10.7% | 7.1% |
| Lehman Bond Aggregate | 6.1% | 4.0% | 4.5% | 6.0% |
| Inflation (CPI) - seasonally adjusted | 2.7% | 3.2% | 3.0% | 2.8% |

Source: 2007 NACUBO Endowment Study. Comparative index returns assume a year-end date of June 30. Rates of return are reported net of management fees and expenses.

# Australian retail investor adoption

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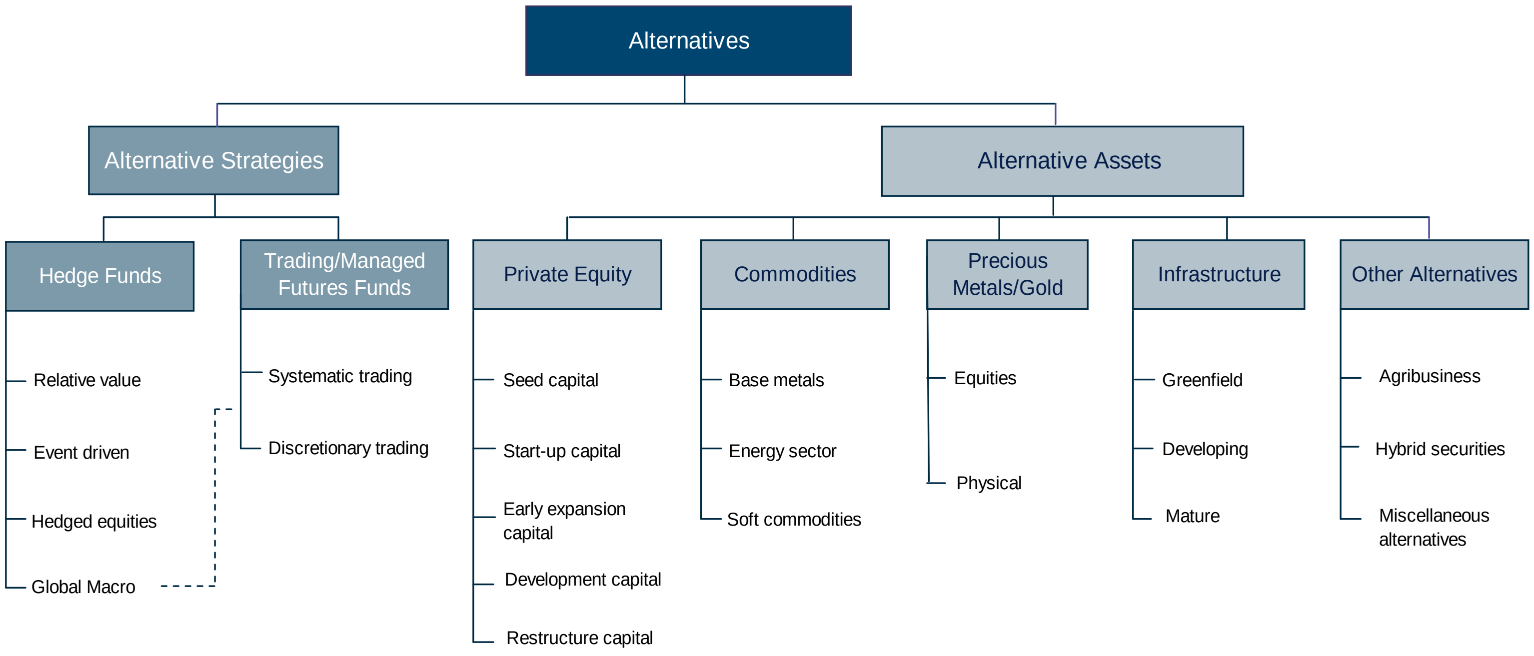
- **Barriers:**
  - Lack of familiarity with investments outside traditional equity, fixed income & property markets
  - Liquidity
  - Less equipped to research and access a broad range of opportunities

- **Can be mitigated by:**
  - Focus on outcomes and potential preservation of capital
  - Listed alternatives - a partial solution to liquidity problem
  - Diversification - potential access via fund of fund structures

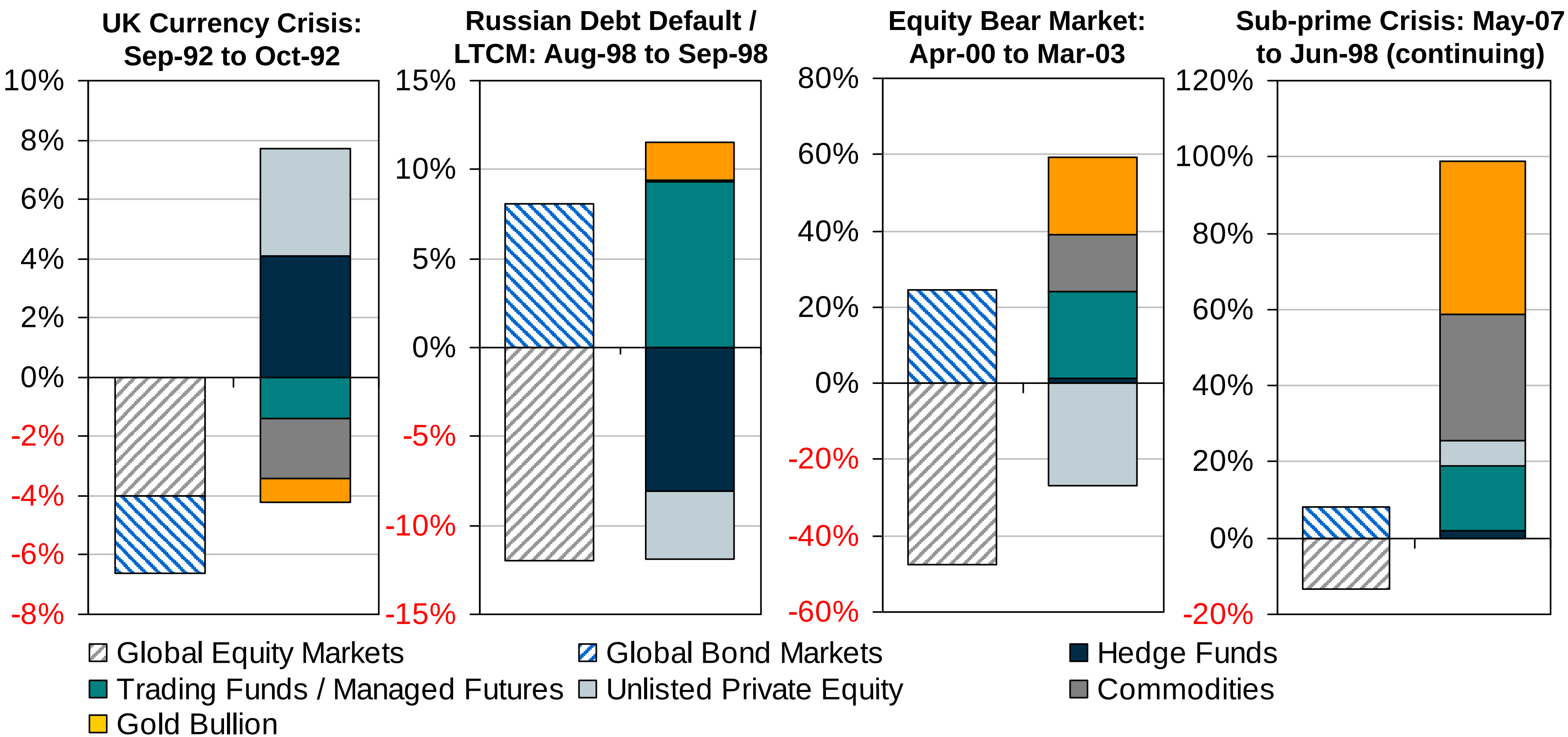
# The alternative investment universe

- It is possible to gain diversification amongst sub-categories of alternative strategies and alternative assets
- Outside these areas there are also a number of emerging alternatives




Source: Select Asset Management

# Performance of alternative investments in periods of market crisis (note: change of axis scale)




Source: Bloomberg, January 1990 to June 2008, unless otherwise noted. Data is as follows - Global Equity Markets: MSCI World Index (USD), Global Bond Markets: JP Morgan Global Bond Index (USD), Hedge Funds: HFRI Fund Weighted Composite Index (USD), Trading Funds/Managed Futures: Barclay CTA Index (USD), Unlisted Infrastructure: Cambridge Private Equity Index (USD), Commodities: Dow Jones AIG Commodity Index (USD), Gold Bullion (USD). Note that Cambridge Private Equity Index performance is published quarterly - for this analysis quarterly returns have been spread evenly over the relevant months within each quarter.

# Performance of alternative investments in periods of market crisis

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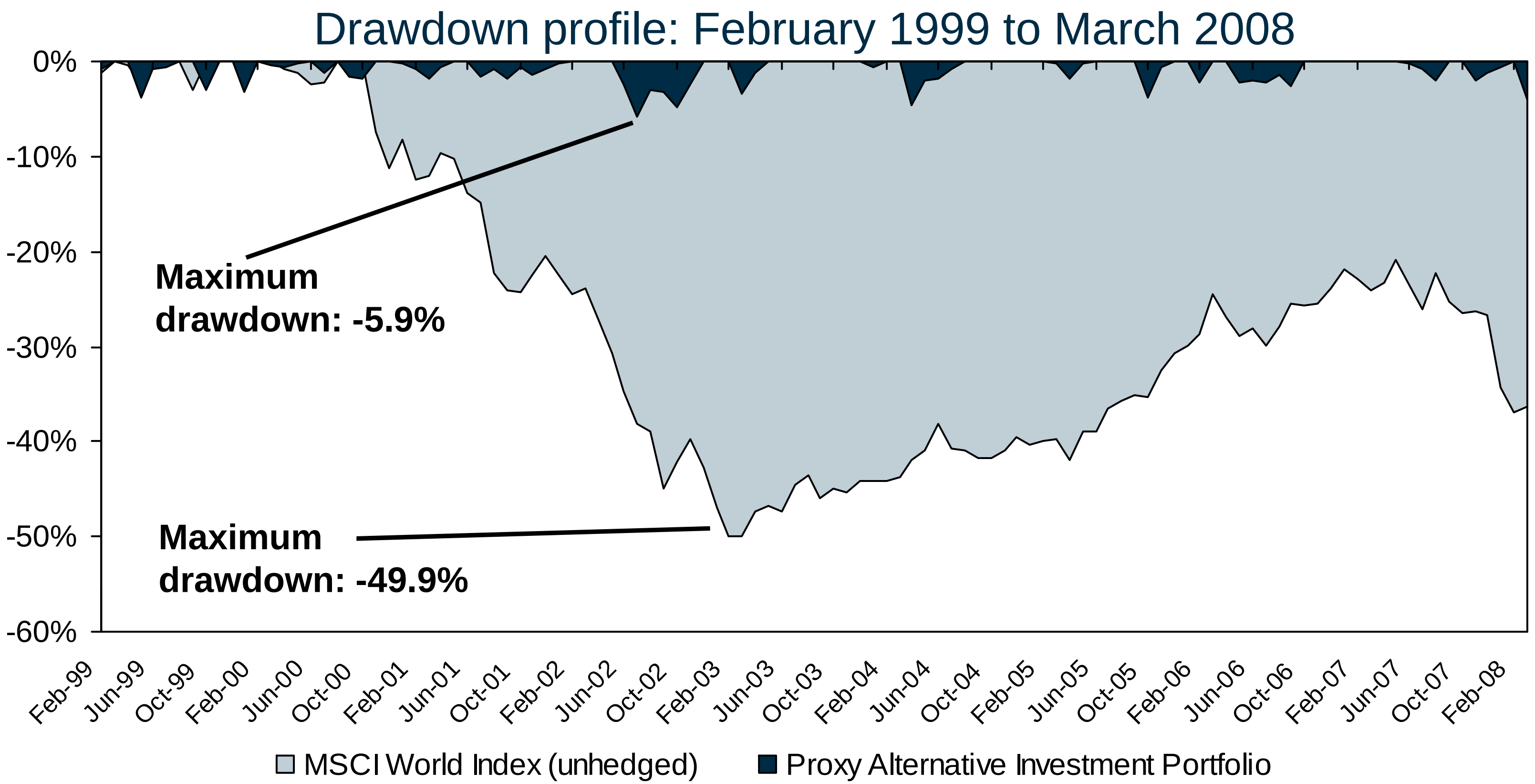
- Whilst protecting capital in many instances, alternative investments have performed differently in various crises, and in some cases have performed poorly:
  - Hedge funds during Russian debt default/LTCM crisis
  - Unlisted private equity during 2002/2003 global equity bear market
- Dispersion of performance amongst alternative investments has been wide – breadth of diversification across a range of alternatives is useful (don't rely too much on one particular alternative strategy or asset class)
- Over-reliance on historical data can be inherently dangerous (discussed later)

# Capital drawdown – proxy diversified alternatives portfolio versus global equities




Note: The maximum drawdown is a measure of risk that refers to the peak to trough decline during a specific period of an investment or fund. Source: Select Asset Management Limited, Bloomberg, February 1999 to March 2008. Global Equities (A$ unhedged) is measured by the MSCI World Index. The Portfolio of Alternatives Investments consists of equal weightings of the HFR Fund Weighted Composite Index 100% hedged to A$, Barclays CTA Index 100% hedged to A$, 50/50 blend of Cambridge and Listed Private Equity Index (both 100% hedged to A$), Dow Jones AIG Commodities Index (100% hedged to A$), 50/50 blend of FTSE Gold Mines Index and Gold Bullion (both 100% hedged to A$), and the UBS Australian Listed Infrastructure Index.

# Are alternative investments suitable for all?

- **Depends on individual circumstances [obviously] but answer is potentially and increasingly yes for all but:**
  - The most aggressive investors who can take a very long-term view and handle market volatility associated with a very traditional asset allocation
  - The most conservative investors seeking 'cash-like' performance over the long term

- **2007/2008 market environment and associated declines in investment returns are the starting points of reasons, but others include:**
  - Inflation mitigation
  - Capital preservation
  - Potential reduction in overall portfolio volatility

# Portfolio construction: three hard questions



- How do I go about constructing a portfolio incorporating alternatives?
- What are some of the risks involved?
- How much should I allocate to alternative investments?

## Traditional vs active vs alternative investments

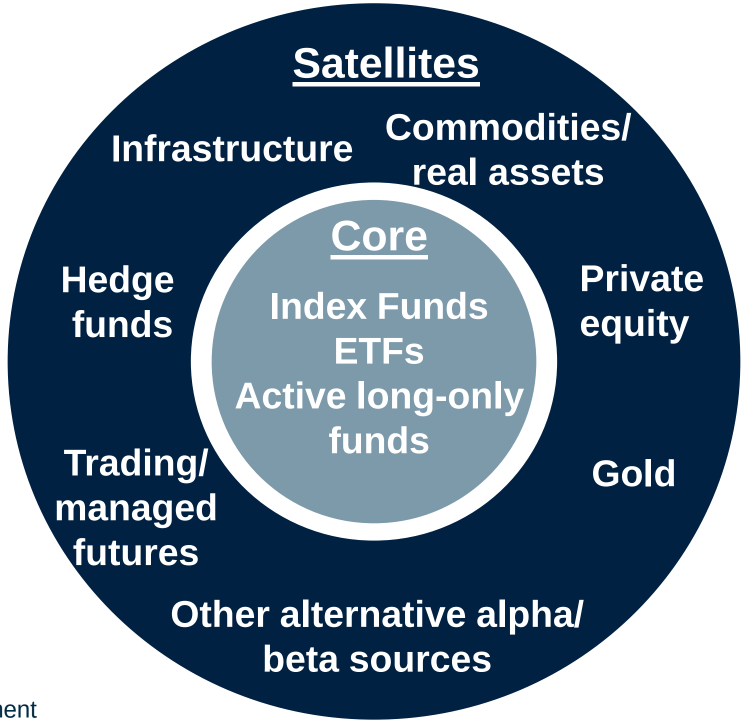
Lower — **Cost & potential for alpha generation** — Higher

| Core/traditional investments | Traditional but active (long only) | Alternatives |
|---|---|---|
| Index funds<br>Some ETF's | Long extension<br>Emerging markets<br>Micro cap<br>Style specific<br>Leveraged portfolios<br>Concentrated portfolios | Private markets<br>Real assets<br>Directional alternatives (alternative beta)<br>Non-directional alternatives (alpha producing e.g. market neutral)<br>Mix of directional / non-directional (e.g. long-biased long/short equity) |

Source: Adapted from Scott Welsh / Jean Brunel. Welsh S., "Incorporating Alternative Investments into High-Net-Worth Portfolios", IMCA Journal, March/April 2008, p26.

# Portfolio construction: core/satellite approach

- Essentially a core portfolio of traditional investments (typically managed funds and/or listed investments - 'long' and therefore demonstrate significant market correlation and beta), supplemented by:
  - A variety of non-traditional 'satellite' investments




Source: Select Asset Management

# Portfolio construction: goals-based or behavioural asset allocation approach

- May not fit well with investment theory purists but has some practical application
- Basic approach:
  - Overall portfolio is broken into sub-portfolios
  - Construction of each sub-portfolio based on specific client goals or time horizons
  - Each sub-portfolio uses a different mix of investments or different asset classes to reach specific goals
- However still need to think about idiosyncratic / single manager risk, liquidity & taxation

| Traditional asset classes | Potential alternative supplements |
|---|---|
| Cash | |
| Fixed Interest | Market neutral fund of hedge funds, multi-strategy fixed income funds |
| Equities | Long/short equity, private equity, sector specific exposure |
| Property | Infrastructure, agriculture (timber, land-based) |

Further suggested reading: Brunel J.L.P., 2005-2006, "A Behavioural Finance Approach to Strategic Asset Allocation: A Case Study", Journal of Investment Consulting, vol, no. 3 (Winter). Brunel J.L.P., 2006, "How sub-Optimal – If At All – Is Goal-Based Asset Allocation", Journal of Wealth Management, vol. 9, no. 2 (Fall). Chhabra, A.B., 2005, "Beyond Markowitz: A Comprehensive Wealth Allocation Framework for Individual Investors", Journal of Wealth Management, vol. 7, no. 4 (Spring).

# Portfolio construction: growth vs defensive alternative investments



- **Not a good idea to generalise and classify all ‘alternatives’ as either growth or defensive**

- **Different alternative strategies and asset classes contain:**
  - Differing underlying exposures
  - Differing performance objectives
  - Differing use of leverage

- **For example:**
  - Market neutral hedge funds versus macro / directional hedge funds
  - Mature, regulated infrastructure versus greenfield infrastructure
  - Structuring and illiquidity (mark to model) can make some strategies look less risky than they really are

- **However a diversified portfolio of alternative assets and strategies can exhibit defensive characteristics if there is low correlation of underlying investments to each other and to traditional asset classes**

# Portfolio construction: ‘optimal’ portfolios and some history

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- **In many cases, determination of an ‘optimal’ portfolio has relied on historic data and traditional portfolio optimisation techniques**

- **This is a fundamentally flawed approach (particularly for alternative investments) because:**
  - Varying correlation of assets/strategies to each other over time
  - Many alternative investments have non-normal distributions (fat tails, skewed distributions etc): issues with mean variance optimisation techniques
  - Illiquidity of some alternative investments makes optimisation more complicated
  - Discounts/premiums on some vehicles (e.g. listed investment companies) complicates the inputs

- **When determining allocations (whether to traditional or alternative investments), appropriate to use:**
  - Long-term expected return and risk characteristics
  - Inputs should not be conditional on near-term business and market cycles – rather those relevant over a long time horizon



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# Portfolio construction: practical considerations

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- **Danger from using historical inputs:**
  - Potential for disproportionate allocations -particularly where liquidity & infrequent pricing has a smoothing effect on volatility (i.e. perceived risk)
  - In turn can lead to artificial constraints on maximum allocations (i.e. pre-determining the allocations themselves) – flawed approach
- **Some forward-looking optimisation techniques have been suggested, using:**
  - Estimates of true risk exposures
  - Factor approach to capture systemic risk characteristics
  - Examination of forward looking risk and liquidity premiums
  - Multi-period simulation approach incorporating the cost of illiquidity (allowing re-balancing only to the extent possible) and the benefits of illiquidity (liquidity premium)
- **Forward looking construction is intuitively a more appropriate process (but it isn't easy!) - hence the temptation to use historical data and constrained optimisation**

Sources: [1]Terhaar, K., Staub, R. and Singer, B., 2003, "Appropriate Policy Allocation for Alternative Investments – A factor approach and simulation techniques", The Journal of Portfolio Management, 2003 (Spring), p101-110. [2]Swenson D.F., 2000, "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment", New York Free Press.

# Portfolio construction: performance and risk management issues

- **Risks obviously differ across the range of investment options available, and it is difficult to generalise these without specific examples**
- **Some factors to consider:**
  - Over-reliance on the Sharpe ratio
  - Asymmetric returns with positively and negatively skewed outcomes: associated issues with mean variance optimisation
  - Illiquidity: difficulties in measuring a required return premium and potential for artificially stable (potentially misleading) returns
  - Ability of some investments returns to trend
- **Some suggested alternative risk-adjusted return metrics:**
  - Conditional Value at Risk (CVaR): focus on far 'left hand' tails of distributions and expected losses
  - Modified VAR – incorporating adjustments for skewed distributions

Source: Till, H., 2006, "Risk Measurement of Investments in the Satellite Ring of a Core-Satellite Portfolio: Traditional versus Alternative Approaches", Edhec Risk and Asset Management Research Centre.

# Portfolio construction and risk management: summary



- Overall, there are different views and a wide spread of manager risks and returns in alternative investment arena – there is no 'perfect' alternatives mix
- For investors without insight into risk management and portfolio construction it is a difficult proposition and it may be more appropriate for them to use a multi-manager solution

# Size of allocations – issues to consider

- Research into the optimal size of allocations does vary, and will invariably differ for any investor based on a number of factors, including:
  - **Illiquidity** – a significant benefit that endowment and superannuation funds have is access to 'patient' capital and ability to invest in less liquid investments
  - **Single manager/asset diversification** – size of minimum allocations and limited access may make it difficult for some investors to gain diversification - where diversification is a very desired outcome
  - **Taxation** – although not always the case, some alternative investments may not be as tax-effective as some traditional investments. Net performance may be adequate compensation, but tax may also play a role in determining allocations and their size

# Listed alternatives: a partial solution to the liquidity conundrum?



- **Benefits:**
  - Provide liquidity for illiquid assets
  - Efficient structure for managers, and some high quality managers are available
  - Opportunity to buy at discount and benefit from discount narrowing in some cases
  - Some have tax benefits e.g. Pooled Development Funds (PDFs)

- **Some complications**
  - Vehicles can trade at discount / premium to net asset backing
  - Some inherent market beta and susceptibility to market sentiment

# Summary and conclusions – final thoughts on diversification

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- Make the size of the overall allocation large enough to make a difference: 5% won't help you and a 10% to 30% allocation is a reasonable starting point

- Invest across a range of alternative strategies and alternative assets
  - Aim for low correlation to mainstream markets and to each other
  - Diversify across theme, strategies and sources of both risk and return (obviously not linked to traditional markets where possible)
  - Balancing appropriate liquidity can be difficult, but is not impossible

- Differences between structure and style of alternative investments
  - Listed alternatives available in many cases trading at attractive entry prices: hedge funds, infrastructure and private equity
  - Offshore versus onshore domicile - tax and structuring implications, as well as currency hedging choices
  - Structured / closed-end products versus open-ended

- It may seem an obvious concept, but it is important to remember that two or more highly volatile investments may actually be complementary and provide strong risk-adjusted returns when combined in a portfolio

# Summary and conclusions – final thoughts on diversification



- **Differentiate between:**
  - Skill based investments; and
  - Those relying on risk premiums which may not exist tomorrow (e.g. Yen carry trade, credit spread narrowing)

- **Accessing some of the best ideas can entail:**
  - Significant work to find managers / opportunities
  - A lot of lateral thinking and extensive due diligence
  - Challenges with structure, domicile, tax etc.

- **'Blow up' risk**
  - Not just hedge funds that 'blow up', many listed companies (and brokers) seem to as well
  - However, underlying manager diversification does provide comfort - make sure that one 'blow up' does not cause critical portfolio damage

- **Major challenge for many individuals to diversify across a broad spectrum of alternative investments themselves**
  - Requires appropriate operational scale and breadth of research
  - Multi-manager solution may be appropriate

# Any questions?

- Q&A

# Select Alternatives Portfolio: diversified access to a range of alternative investments

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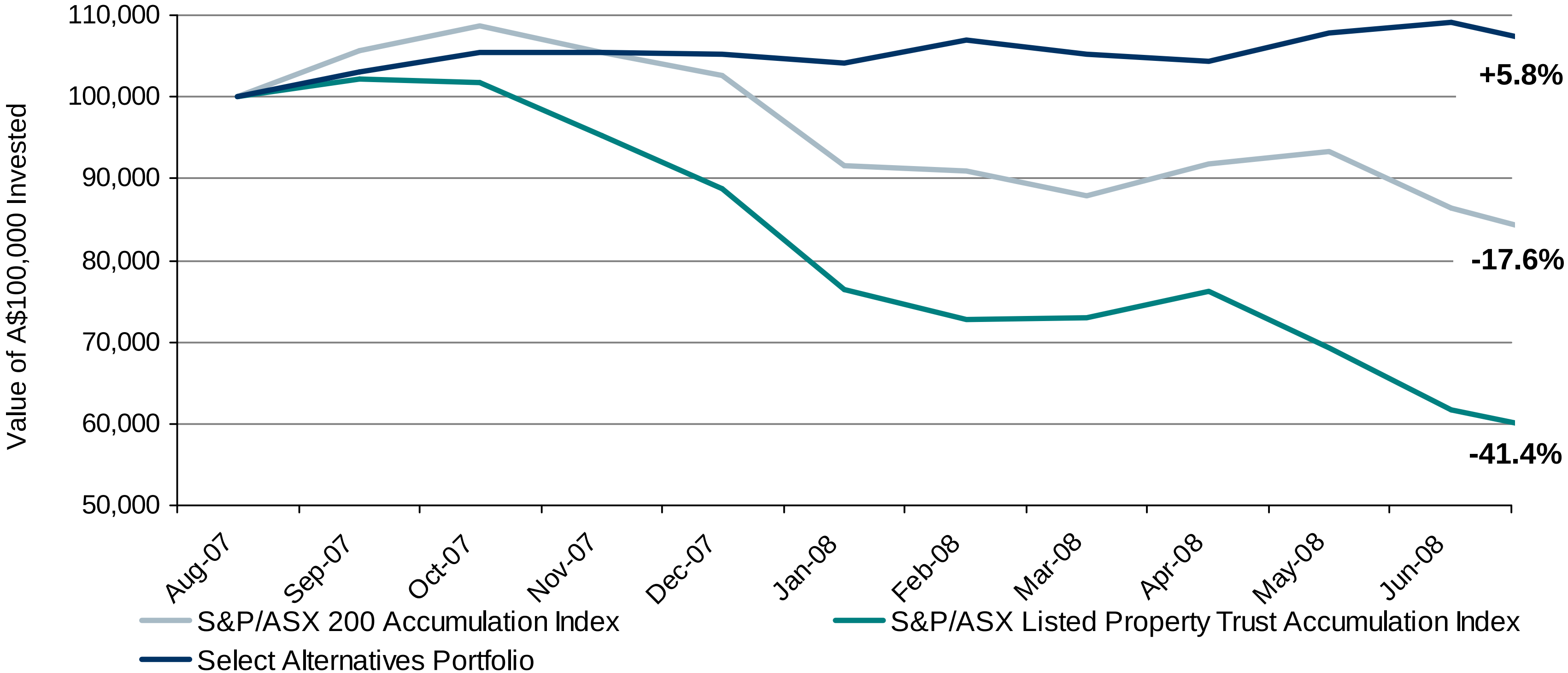
| Investment Area | Ranges % | Current Mix %* |
|---|---|---|
| **Alternative Strategies** | **35 – 75** | **59** |
| Hedge Funds | 25 – 45 | **41** |
| Trading Funds/Managed Futures | 10 – 30 | **18** |
| **Alternative Assets** | **25 – 65** | **33** |
| Private Equity | 0 – 20 | **6** |
| Commodities | 0 – 20 | **8** |
| Precious Metals/Gold | 0 – 20 | **8** |
| Infrastructure | 0 – 20 | **9** |
| Other Alternatives | 0 – 15 | **2** |
| **Cash** | **0 – 10** | **7** |
| **Other^** | | **-3** |

*As at 30 Jun 2008. The total exposure may not sum to 100% due to any direct derivative investments (such as options and futures).

^ Other includes direct derivative investments (such as options and futures).

# Select Alternatives Portfolio: potential for capital preservation and negative correlation

## Select Alternatives Portfolio net performance versus Australian equity and property markets: 1 September 2007 to 31 July 2008




Source: Select Asset Management, Standard and Poors', Bloomberg.

# Select Alternatives Portfolio: strong track record of performance

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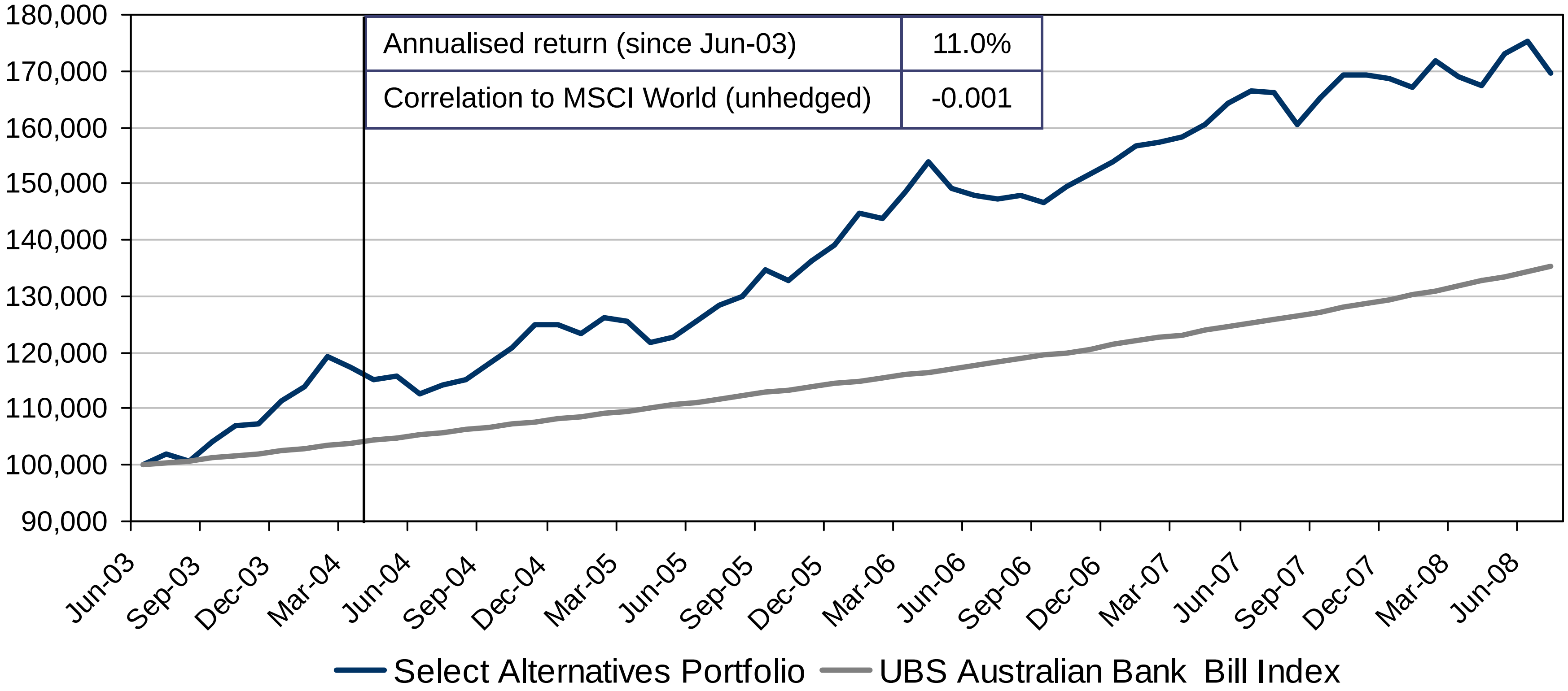
## Jun 03 – Jul 08

### Performance Net of all Fees*




| | |
|---|---|
| Annualised return (since Jun-03) | 11.0% |
| Correlation to MSCI World (unhedged) | -0.001 |

* Prior to 1 April 2004 the name of the Select Alternatives Portfolio was the Select Aspect Multi-Strategy Fund (launched 25 June 2003) and the mandate was different. Past performance is no guarantee of future returns. Figures shown as at 31 July 2008. Source: Select Asset Management, Bloomberg.



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Let’s start thinking about…

## This session was:

1. awful
2. mediocre
3. good
4. excellent

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