



VIEWING ALTERNATIVES THROUGH THE APPROPRIATE LENS

Proper perspective helps investors integrate alternatives into their portfolios.

BY ANDREW SMITH

More often than not, institutional investors tend to view hedge funds as an asset class, instead of a diverse group of strategies. As such, hedge fund strategies are grouped into an “alternative” asset class bucket where risk is defined relative to an absolute return target, while in “traditional” asset classes risk is defined relative to a benchmark index. Few institutional investors recognize the inconsistency of having two definitions of risk within the same portfolio.

The outcome is that institutional investors worry more about negative returns in their alternative strategies than in their traditional strategies — even when alternative strategies outperform with less volatility. In negative markets, some institutions may feel exposed to alternatives, leading to efforts to reduce allocations in favor of traditional assets. This ignores the fact that many alternatives represent underlying equity or fixed-income exposure just like traditional assets (which explains why alternative strategies have not provided the “hedge” against falling markets some hoped for).

However, despite similarities in underlying exposure, the case for alternatives is strong. Hedge funds are dynamic strategies, unfettered by benchmarks, thus more nimble than traditional strategies constrained by investment guidelines to a restricted opportunity set. Integrated within a traditional portfolio the dynamic nature of hedge strategies leads to low correlation and diversification benefits, often complementing traditional strategies.

The Outlook for Alternatives

There is a real opportunity in alternatives. Hedge funds have the ability to capitalize on recent market dislocations in both equity and credit markets. With the disappearance of proprietary trading

desks and a new regulatory regime for the investment banks, hedge funds have the field largely to themselves. Alternatives represent a remarkably diverse group of practitioners and strategies. The strong will survive and flourish.

The Madoff scandal has made investors wary, yet for discerning investors who perform real due diligence, alternatives are a powerful tool. Investment in alternatives requires on-site access to each manager — evaluating not only their investment records but also their portfolios, operations, professional backgrounds and business models. Few institutions have the resources in-house to perform this analysis and invest directly. Reputable funds of funds still make sense for many investors as this structure brings with it manager diversification and professional oversight and management.

It is common to view alternatives as separate from traditional investments. However, even a diversified hedge fund of funds represents balanced exposure to equity and fixed-income strategies. Understanding this diverse range of complementary strategies and managers — and how to integrate them into a traditional portfolio risk model — should be a consideration for any institutional investor, even during these turbulent times. ❖



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