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Investors amend their allocation processes

By Elise Coroneos

Markets by their nature possess an element of uncertainty. Down the decades, investors have turned to sundry strategies, including hedge funds, to deal with this uncertainty and give them that performance edge.

At MAR's recent Ninth International Conference on Hedge Fund Investments, investors told how current market uncertainty has led them to question old truths about how they allocate and make way for new approaches.

One such investor is Albert Hsu, the US investment officer for Atlantic Philanthropies, a $4 billion foundation with about 25% of its assets in hedge funds. Hsu estimated that he spends 80% of his time working on the foundation's hedge fund portfolio.

Set up in Bermuda about 20 years ago, Atlantic Philanthropies is the largest foundation with an announced spend-down goal, meaning it will make grants of between $200 million and $400 million a year until the fund is spent in 15 years' time.

Hsu said that the key to ensuring that the foundation can reach its 15-year goal comes down to a reduction in volatility. "We are looking for skill, we are looking for alpha; it is not about beta. So what we are doing expressly is attempting to maintain our nimbleness."

Volatility in volume

While it is no secret that current market conditions are highly volatile, Hsu was curious to find out just how volatile were the markets he was combating. He went back 20 years to look at daily movements in the S&P 500.

What he discovered was that 5.4% of the overall daily moves of the index over the last 20 years reached volatility levels above 2%. However, when only the period from 1997 to October 10, 2002, was considered, this percentage of daily moves above 2% jumped to 11%.

"You have to go back to the 1973–74 period to get close to this type of data and prior to that the 1930s," said Hsu. "Not even in 1929, which is more equivalent to what happened in 1987. It is really that period after 1929 in the early 1930s where most of the wealth was lost, and I would say we are in a similar period right now. I think the 19▶

HEDGE UPDATE

New AmEx fund leaps to $125m

American Express Alternative Investment launched the **Boston Equity Fund** on September 1 with $25 million in seed capital, which has since then grown to $125 million. The long/short strategy takes an opportunistic approach to US equities. Portfolio managers are **Nick Thakore**, **Bob Ewing** and **Doug Chase**, all three 2▶

Speakers at MAR's recent hedge fund conference in Bermuda discussed their strategems for finding performance edge.
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Interesting times beget an interesting strategy.
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◀1 probability of a deflationary recession has increased."

Having established the severity of the volatility affecting markets, Hsu took steps to reduce its hazardous effect on the foundation's portfolio. This meant spreading its risk across more managers and redefining its classification of hedge funds. The foundation's typical investment to hedge fund managers had been 50 basis points, or roughly $20 million; this has now been reduced to allocations of 25 basis points, or $10 million.

"This shift in size has been accompanied by a shift toward long/short directional equity," says Hsu. "And we have been shifting outside the US, particularly focusing in Asia and Japan."

Muirfield Capital Management, which invests in about 30 hedge funds using 15 strategies, has also made changes in its portfolio. "We have a big bias against large funds, we think that size is a big negative to returns," said Geoffrey Stern, the chief investment officer of Muirfield, also speaking at the MAR conference.

"We are trying to seek equity-like returns with half the volatility of the equity market, and we think we can do that."

In addition to making smaller allocations across more managers, Hsu believes that correctly classifying hedge funds within the foundation's portfolio will also aid in reducing its overall volatility.

A case in point is the foundation's investment in an onshore hedge fund-type structure that is essentially 80% net long and 20% short relative to the S&P 500, with an incentive fee also based on performance relative to the S&P 500. In most portfolios, such an investment may make up a piece of the pie allotted to hedge funds; at Atlantic Philanthropies, however, it is classified as traditional.

"Just because it has a hedge fund structure does not mean that it should be classified or defined with that allocation," said Hsu, who noted that he often allocates long/short market neutral equity within the traditional slice.

"It is very important because the typical definition of hedge funds is a legal definition, a partnership," he said. "It does not take into account the myriad risks that are involved in investing with different hedge fund strategies."

> "You need to do this top-down thinking because styles do matter"

Stern of Muirfield also expressed a desire to understand the risk inherent in each fund and to diversify accordingly. "We are trying to take many different risks and spread our portfolio across all the different risks," he said.

Stern believes there will be significant alpha in the distressed, mortgage-backed and long/short strategies in the next few months.

Changing old habits

Another verity that came into question at the conference was a hedge fund's use of the bottom-up allocation process, and whether it is appropriate for the current environment.

Madhav Misra, chief investment officer of fund of funds at Allianz Hedge Fund Partners, said that while single managers can produce absolute returns irrespective of market conditions, the minute a fund of funds diversifies its allocation, it takes a market view.

"Once you combine managers into portfolios albeit in your own account or through a fund of funds, you are then suddenly stuck with factor bets and an implicit market bet, whether you like it or not," he said.

Misra's view is influenced by his research showing correlations between strategies, style-based returns and the market conditions. "Basically what we've come to is a realization that return expectations for different hedge fund styles are quite dependent on market conditions," he said.

Allianz, having accepted that a portfolio of hedge fund investments constructed from the bottom up has an implied market view, has decided to engage a proactive, explicit market view more in line with a top-down approach.

"Bottom up still matters, it is critical, it is probably 70% of our value added of every fund of funds, but you need to do this top-down thinking because styles do matter," said Misra.

Its new focus on market factors has led Allianz to develop a market view for the next three months, which includes stocks and interest rates going lower, slightly less volatility and a narrowing of credit and quality spreads.

"We then basically take a series of factor betas we've drafted and our market view to come up with an expected return that is not based on any historical returns," he said.

Given this baseline view of market factors, Misra believes funds of funds can expect annualized returns of between 3% and 7% over this period, or 1% to 4% if a double dip scenario takes place.

"This expected return then goes into the risk budgeting algorithm that comes out with an implied return by manager," he said. "And when we get new money in, we try to move closer to that optimal scenario."

As a result of its top-down approach, Allianz is currently overweight in fixed income arbitrage, global macro and distressed debt. It is underweight directional equity and the Jones model; and neutral on statistical arbitrage and equity market neutral.

Despite all the attention on how and where investors decide to invest their hedge fund allocations for maximum advantage, it is important that they be aware that this will ultimately prove futile if they do not give a significant enough weighting to the asset class, says Hsu of Atlantic Philanthropies.

"Having a 1% to 5% allocation in hedge funds will not make a significant impact on their overall portfolio," said Hsu, who firmly believes investors should be able to make money or at least preserve capital in this market. "And given that some of these organizations are faced with increasing issues of the underfunded status of their pension funds, it really poses a quandary to them.

"So unless they increase that percentage to between 10% and 20%, which is a huge allocation dollarwise, they are in serious trouble, particularly in the third year of down returns." ■