

Growing Acceptance of Alternatives

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Perceptions often drive individuals towards a particular course of action, a decision or action not necessarily in their best interests. If greater information is made available to them or existing information is presented in another way their decision or action may be completely different. Perceptions of private and institutional investors influence their investment decisions. For institutions servicing the high net worth market it is the job of private client investment advisors or private bankers to ensure that those decisions have been reached from a well-informed perspective.

Research conducted by management consultants Maslinski Lawrence found that when private clients were asked if they would be interested in investing in an asset class which has historically offered consistent capital appreciation while offering capital preservation characteristics to provide a degree of protection against market downturns, the majority of clients were interested and wanted to hear more. These characteristics apply to many individual hedge funds and of course well diversified hedge funds of funds. When the same clients were asked if they would invest in hedge funds many of the same clients said no, clearly illustrating negative perceptions towards hedge funds.

The perception that prevents many investors allocating capital to hedge funds is the belief that all hedge funds are highly leveraged speculative investment vehicles and such investments obviously do not satisfy the wealth preservation and wealth creation attributes the

average private investor is looking for.

It is obvious from this research that hedge funds are often misunderstood. It is true that some hedge funds can be very risky, however with those particular types of funds the higher risk offers the potential for high returns. Soros Fund Management's Quantum and Quota funds are reported to have suffered significant losses recently due to the selloff in technology stocks and exposure to Euro weakness, however long term investors have certainly been rewarded for higher risk with average annual returns for the Quantum fund between 1989 and 1999 of around 30 percent.

The macro or global asset allocator category of hedge fund is an example of just one hedge fund sector. There is a range of sectors including relative value, event driven and equity hedge which can all be further subdivided into strategies based on the trading or investment methodology utilised within those sectors, the degree of market sector or geographic specialisation, the leverage employed and the underlying instruments used to pursue the funds' investment aims.

Unlike traditional investment funds, hedge funds have the flexibility to invest in a wide range of investment instruments, may take long, short or market neutral positions and may employ leverage. This flexibility enables hedge funds either individually or when combined in funds of funds to have low correlation with more traditional asset classes.

Modern portfolio theory espouses the virtues of diversification through including non or lowly correlated assets in portfolios to lower portfolio risk for a given expected return. Fund managers have applied this technique for years in managing equity and bond portfolios. Today many traditionally conservative investors such as pension funds are adding hedge funds and other alternative investments to traditional portfolios for the same reasons.

Many private banks are recognising that they can provide private clients with a valuable service with regards to hedge funds and can get well paid for it. Hedge funds generally have high initial investment requirements which make it difficult for individual investors to achieve adequate portfolio diversification and will preclude many individuals from getting access to top performing funds.

Just as rigorous stock selection is advocated for traditional investors, rigorous due diligence is required in selecting hedge funds. Recent scandals such as the Manhattan fund where alleged fraud has resulted in investors losing millions highlight the importance of knowing the managers and monitoring them on an ongoing basis to ensure the criteria used in initially selecting them hold true.

Through creating their own funds or utilising external hedge fund of funds private banks are able to offer private clients

♦ diversified exposure to the sector

<ul style="list-style-type: none"> ◆ access to top performing funds clients may not otherwise be able to get ◆ initial due diligence and ongoing monitoring of the constituent funds and ◆ smaller minimum investment requirements. <p>With typical annual management fees around 1% and the possibility of additional revenues through performance fees such products represent an attractive addition to a private bank's product offering and can help offset margin erosion being experienced with more traditional products.</p> <p>Liquidity and transparency have rarely been strong selling points for hedge funds historically. Times are changing however as institutional investors are increasingly attracted to and are being courted by the hedge fund sector. Any improvements made for the benefit of institutional clients can only help the private client sector.</p> <p>The internet is having a dramatic impact as evidenced by online trading on the Bermuda Stock Exchange through the likes of altvest, hedgeworld and plusfunds as well as the provision of sector news, fund details and historical data by these and other web sites. Continuing developments will ensure that over time the sector will be considered more mainstream and will become accessible to the affluent and retail ends of the market as well as the existing high net worth and institutional clientbase.</p> <p>As with hedge funds, private equity and venture capital offer a vast array of potential investments along with similar barriers such as minimum investment criteria, limited access to top managers and lack of liquidity. The right investment depends amongst other things on</p> <ul style="list-style-type: none"> ◆ investors' risk tolerance, ◆ their sectoral or geographical preferences, 	<ul style="list-style-type: none"> ◆ their future liquidity requirements and of course ◆ the private equity manager's track record and proven expertise in the selected field. <p>Here too private banks are able to offer a valuable service to clients in providing education about and efficient access to this market. At several private banks, clients are already offered opportunities to coinvest alongside private equity fund managers, to invest in specific funds or invest in funds of funds.</p> <p>In Europe, interest has historically concentrated on the private equity leveraged buyout market rather than venture capital. The technology boom however has resulted in venture capital firms raising money, investing it and realising investments over a shorter time scale than was previously the norm. With high internal rates of return being produced by technology focused venture capital firms in the US, European institutional and private investors have been allocating higher percentages of their alternative investment portfolios to the venture capital sector.</p> <p>The boom in telecom, media and technology sectors has resulted in many old economy stocks being overlooked, resulting in fundamentally attractive equity valuations that are bound to be on the radar screens of many leveraged buyout firms. The potential for transacting private equity business in Europe has clearly been recognised as evidenced by the growing number of venture capital and leveraged buyout specialists setting up shop across Europe. With average allocations to private equity/venture capital by institutional investors in Europe running at less than 3% versus close to 8% in the US and over 6% in Australia, Europe obviously has a certain amount of catching up to do. Demand for alternative investments is almost certain to rise quite steeply in both</p>	<p>the institutional and private client markets.</p> <p>Client research for Maslinski Lawrence suggests that most private clients are receptive to alternative investments provided their attributes are properly explained. A competent and trusted advisor can overcome the inevitable prejudices stemming from any adverse publicity or negative perceptions due to lack of knowledge.</p> <p>Contrary to the long held views of many private client advisers this research demonstrates that "conservative" private clients will entertain new ideas. Conservatism in investment typically relates to a desire to have a low risk portfolio. A typical private client's primary goal is wealth preservation followed by the secondary goal of utilising that existing wealth to create greater wealth. If those two goals can be achieved through a more innovative approach to wealth management combining conventional and alternative asset classes the net result is a happy conservative client.</p> <p>The problem for many asset managers is that, while they recognize the increasing role of alternative investments, they are institutionally wedded to the traditional portfolio product and introducing new concepts into this very traditional culture is no simple task.</p> <p>The problem for most established institutions is that successfully adding alternative investments to a conventional product range requires considerable management commitment to achieving a quite fundamental cultural change. The role of alternative investments in the client management strategy must be clearly defined and supported at all levels. There must be recognition that investment will be required to put in place the necessary product, infrastructure and client communications while the scale of initial demand from</p>
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existing clients may be difficult to predict.

- ◆ A product development strategy must be agreed, setting out a basis of priority
- ◆ Specialist expertise will be required for ongoing development of new products.
- ◆ Decisions must be made as to whether expertise should be internal or outsourced.
- ◆ Policy regarding private labelling externally sourced products versus marketing third party names will need to be set.
- ◆ A concentrated programme of client communications and relationship manager training will be essential for successful and appropriate marketing.
- ◆ Internal support processes will have to be defined and put in place specifying the respective roles of product specialists and relationship managers.

Those who are familiar with traditional private client institutions will understand the internal barriers that need to be broken down in this process. Front line client managers, quite reasonably, tend to be possessive about client relationships built up over many years. They will often be suspicious of newly recruited specialists trying to sell innovative products. They don't want their clients sold products that may undermine the trust they have fostered and will take some persuading to cooperate

The internal management task poses a considerable challenge to most private client institutions.

But while they are coming to terms with this challenge, their clients and contacts become increasingly vulnerable to more innovative and fleet-footed competitors. It would be quite wrong to suggest that established private investors are all about to change the habits of a lifetime, yet

the trend towards alternative investments is clearly established. Institutions that fail to respond will, to say the least, find it increasingly hard to compete for new clients in the future.