

Asset Allocation or Alpha?

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Portfolio structuring is up for grabs, according to speakers at NACUBO's Endowment Management Forum.

By Mimi Lord

In an investment environment where many top strategists are expecting paltry returns from conventional asset classes, discussions increasingly are centered on finding alpha. That's the magical concept of extra returns (beyond their asset-class benchmarks) garnered by skillful managers. NACUBO's late-January Endowment Management Forum in New York City provided fertile ground for money managers and campus endowment officers to share views on opportunities and pitfalls in the quest for alpha.

Whereas previous forums offered plentiful discourse on alternative asset classes, the recent gathering—with its theme of global investing—advanced the concept of “alternative” to an entirely different level. Perhaps the most revolutionary strategy presented was that of turning the prevailing approach to portfolio structuring upside down. As described by William Spitz, vice chancellor for investments and treasurer of Vanderbilt University, the top-down “portfolio policy” approach—which specifies broad asset classes and numerous sub-classes and styles with designated allocations—creates scores of pigeon holes that have to be filled, regardless of their opportunity to provide alpha. Far more promising, he said, is a bottom-up strategy that focuses on finding alpha in essentially any type of investment and then building the rest of the portfolio around it.

Spitz said that the current approach of specifying asset classes and sub-classes first and then finding managers to fill them is ridden with problems. Here are several:

- Many skilled managers moved to the hedge fund world in search of flexibility and high fees, leaving lesser talent to manage traditional strategies.
- Current optimization models provide precise (but possibly inappropriate) asset allocations based on inherently imprecise forecasts of capital market returns.
- Many investment strategies are converging so that it's difficult to assign them to traditional asset classes when developing overall allocations. Not only are alternative asset classes converging, but there's blurriness even within conventional asset classes such as domestic and international equities. For example, Spitz asked the audience to think about whether Coke, with operations all over the world, is a U.S. stock or an international stock.
- Some managers may not fit the specified buckets in the stated policy portfolio. Why be forced to hire mediocre managers in the stated strategies simply because the investment policy is too rigid to permit stronger managers?

Of course, a hodgepodge of alternative or even conventional investment strategies can't be thrown together without regard to the resulting risk profile, warned Spitz. After the alpha-potential managers have been identified, it's time to run the analytics to determine the resulting betas and risks. Other asset classes and derivatives are then added to the portfolio to obtain the desired exposures and risk parameters. This approach, he said, requires portfolio analytical tools, transparency of positions, and frequent updates.

Reving Up the Engine

Spitz's presentation dovetailed with the preconference workshop on portable alpha by Morgan Stanley Investment Management. Speakers Jack Coates and Charles Stucke explained a strategy in which a fund of hedge funds provides alpha, referred to as the “alpha engine,” and then derivatives such as

futures, options, or swaps are used to gain the desired market or “beta” exposures. The alpha is considered portable because it can be used with any type of beta exposure. For example, perhaps the alpha engine consists of a variety of absolute-return strategies that have an overall beta close to zero. That simplifies the process of adding beta exposure—through futures on the S&P 500, for example—to achieve the desired overall portfolio betas. More likely, the alpha engine contains some embedded beta that needs to be taken into consideration before obtaining more of the same beta exposure.

The goal of this portable alpha strategy is to provide more reliable means of increasing expected returns or decreasing risk with a diversified fund of hedge funds as the alpha engine. To be worthwhile, the returns of the alpha engine need to be sufficient not only to cover the costs of the beta exposure but also to exceed any alpha that likely would have been earned by traditional managers.

Panelists at the portable alpha session emphasized the complexities involved with the strategy and the initial resistance of most investment committees. Dale Marie Hunt, of West Virginia University Foundation, said that she and her staff wrote a white paper on portable alpha and discussed the concept at four quarterly committee meetings before moving forward. Albert Hsu, of Anchor Point Capital, noted that although multiple hedging strategies may be involved, a portion of the portfolio should be directional to have upside potential. Despite what he referred to as “the war for alpha,” he remains optimistic about prospects.

Unintended exposures sometimes occur when one manager is in charge of the alpha engine and another is in charge of the beta portion, said Alan Lenahan, of Fund Evaluation Group. To avoid that outcome, he recommended a turnkey approach in which one firm manages the overall strategy.

Pacific Investment Management Company’s Stephen Beaumont discussed several portable alpha strategies using fixed income vehicles as either the alpha engine or the beta exposure. In the former, an actively managed, fixed-income portfolio (with varying degrees of alpha and tracking error targets) serves as a consistent source of portable alpha over which derivatives are used to obtain desired beta exposures to equities, commodities, or real estate. In the latter, absolute-return strategies are overlaid with fixed-income beta exposures, such as inflation-protected securities or the Lehman Aggregate Index, which are replicated in the derivatives or forward markets. The objective with this strategy is to synthetically create the fixed income overlay and thus preserve cash for investing in alternatives.

Which Type of Investor Are You?

Regardless of whether equities, fixed-income, or absolute-return strategies are used as the alpha engine, the challenge remains of finding alpha in the first place. David Swensen, chief investment officer of Yale University, said there are essentially two types of investors: those who have the capacity to follow a high-quality active management program and those who don’t. In other words, there are those who can obtain alpha and those who can’t. In his recent book, *Unconventional Success: A Fundamental Approach to Personal Investment*, Swensen focused on the latter and essentially recommended that those investors follow low-cost, passive strategies for the bulk of their portfolios.

Most individual and small institutional portfolios can’t compete effectively in active markets due to lack of scale, staffing, and expertise. They should steer clear of certain types of alternative investments (e.g., absolute return, leveraged buyouts, venture capital, oil and gas partnerships, and timber) that have huge disparities between top-quartile and bottom-quartile performance, he advised. Swensen said that in particularly tough areas such as leveraged buyouts and venture capital, the median returns look a lot like those of the S&P 500 or the Wilshire 5000. “Why take the huge extra risk to get these kinds of returns?” he asked. Active management returns are diminished by high fees, excessive asset gathering, and soft dollars, which he referred to as a legalized form of kickbacks.

An analysis of the 2005 NACUBO Endowment Study, presented by TIAA-CREF’s Jeff Margolis, supported Swensen’s comments about enormous performance disparities in certain private markets. In venture capital, for example, large endowments of more than \$1 billion earned more than double the returns of \$50-\$100 million endowments, 20.3 percent compared to 9.2 percent.

For investors unable to compete effectively in active management, Swensen recommended a generally passive approach of indexed funds with the following allocations:

- 30 percent domestic equities
- 15 percent foreign equities
- 5 percent emerging markets
- 20 percent real estate
- 15 percent traditional bonds
- 15 percent Treasury Inflation-Protected Securities (TIPS)

For those investors, investing should be boring—like watching grass growing. If they try to engage in active management on a casual basis, “they are bound to fail,” he said. Swensen’s pioneering approach to alternative investing has contributed handsomely to Yale’s 20 years of 16 percent annualized returns. With total endowment assets of more than \$15 billion, Yale’s endowment contributed approximately \$610 million to the university’s 2005 budget, roughly one-third of the total. Yale’s current asset allocation is

- 14 percent domestic equities
- 14 percent international equities
- 5 percent fixed income
- 25 percent absolute return
- 25 percent real estate
- 17 percent private equity

Proceed With Caution

Rob Arnott, of Research Affiliates, LLC, cautioned endowment managers about spending policies that cannot be sustained in a low-return environment and strongly encouraged the use of capital campaigns to augment portfolio values. His analysis indicates that over the next five years, domestic stocks—which he believes are currently overvalued—will provide 0 percent real returns; conventional bonds, 2 percent; TIPS, 3 percent; and real estate, 2.5 percent. Arnott advised attendees to consider greater diversification; to seek alpha both conservatively by avoiding negative alpha and aggressively by taking advantage of opportunities; and to actively manage the asset mix by adding out-of-favor investments and shedding overvalued holdings. He cautioned endowment fiduciaries that taking more risk doesn’t guarantee additional return. “Risk assures you of large returns—but it may have the wrong sign attached to it.” If governing boards take on more risk than they can tolerate, they may not have staying power and may bail out at depressed prices.

Arnott also encouraged investors to be wary of sizable commitments to capitalization-weighted equity index funds. Popular stock index funds such as those mimicking the S&P 500 increase the likelihood of holding overvalued securities since some of the largest capitalization stocks reached their valuations through the pricing errors of overzealous investors, he said. The largest capitalization stocks have underperformed the average stock in subsequent periods of 1, 3, 5, and 10 years. In his view, a more sensible approach to indexing consists of weighting the index components by fundamental measures such as sales, cash flows, book value, dividends, or some composite of fundamentals. Arnott’s research indicates that fundamentally based indices have outperformed cap-weighted indices consistently and over varying types of market behavior.

TIAA-CREF’s Susan Ulick spoke of the growing trend for money managers to structure their research efforts so that analysts follow industries from a global rather than a local perspective. Companies have diversified their operations and their customers around the globe, and investors increasingly are selecting companies based on their ability to compete globally. Industries requiring a global research approach include energy, autos, commodities, capital-market banks, household products, and large pharmaceuticals, said Ulick. Industries still typically followed on a regional basis are Real Estate Investment Trusts (REITs), utilities, regional banks, and health care services such as HMOs and hospitals. Industries currently in transition from regional to global are IT services and

telecommunications. Despite the growth of global research, Ulick said the markets in rapidly growing countries such as India and China are still relatively inefficient, providing opportunities for alpha.

Commercial real estate investing has transitioned over the past couple of decades from a private market with a close-knit circle of investors and no benchmarks to today's large and public market for REITs that offer transparency and constant valuations, noted Sam Zell, of Equity Group Investments, LLC. In recent years, REIT offerings from around the world have expanded to about 30 countries. Given social factors that are resulting in delayed marriages and growing numbers of retirees who like the income component of real estate, Zell believes that the outlook for real estate remains positive for the next decade.

Byron Wien, of Pequot Capital, expressed his concern that the United States may be losing its leadership position in many aspects of the global economy. The country continues to be the leader in only five industries: computer software, computer hardware, biotechnology, aerospace, and entertainment. He also highlighted the relative decline in the percentage of U.S. graduates in science and engineering fields, as well as the danger of the country's spiraling debt. "We're living too high" in America, said Wien. "Our standard of living is being financed by the kindness of others [foreigners] and it can't go on forever."

Words From the Wise

Forum speakers also shared these valuable comments.

- Since smaller endowments generally do not have the resources to find above-average managers, employ the services of a consultant whose knowledge of managers likely will result in higher returns that more than pay the consultant's fees. (Carol Coleman, Arizona Western College)
- When introducing the topic of a new asset class to consider, educate the committee and give members time to learn and become comfortable. (Coleman, Swensen, Arnott, and Hunt)
- By not considering broader diversification and alternative investments, investment committees and staff are not fulfilling their fiduciary responsibilities. (Michael Sullivan, University of St. Thomas)
- Many endowments could reap benefits through greater diversification in public markets such as international equities, REITs, and commodities, even if they don't have the resources to delve into private markets. (Margolis)
- Endowment fiduciaries are accustomed to adopting investment policy statements, but they also need to adopt operating policies that cover such things as the role of staff, committee, and board; committee size and member tenure; the manager search process; committee meeting agenda; committee minutes; voting process; and so forth. (Lou Morrell, Wake Forest University, and Craig Aase, Macalester College)
- Have investment expertise on the investment committee and limit membership to five or six, if possible. (Morrell)
- Perform rebalancing on a regular basis—monthly or at least quarterly. (Swensen)

Generally speakers agreed that despite globalization and greater information flows, alpha still exists. Alpha may, however, present itself in unfamiliar territories and strategies.

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