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Alts Are the Antidote to Active Management's Hard Times

Amid the collapse of alpha generation, institutional investors can adapt in the current environment

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A number of forces converged in the first half of 2016 to produce widespread underperformance among many highly respected active asset managers. While active management has been challenged since the financial crisis, recent losses appear to be a distinctly new phenomenon, by virtue of their sheer scale and concentration with managers that had defied gravity with superior performance over the past few years. For many institutional investors, including elite foundations and endowments that are now reporting their fiscal years ending June 30, 2016, such severe underperformance has many questioning whether they should abandon active management entirely for passive strategies.

The urge to flee active management in the face of such poor results is logical, and may even benefit investors with less competition for the limited supply of truly outstanding managers and the alpha they generate. However, this is not the time for investors to abandon active management. Instead, investors should embrace a broader suite of approaches and tools to complement deeper relationships with the very top active managers, including making larger allocations to private markets, new categories of alternative investments and 'smart beta' (or 'cheap alpha').

The equity hedge fund sector has been in gradual decline for the last 20 years and collectively stopped producing positive alpha at some point in 2011 (see chart below).

Note:

1. Alpha calculated as return of HFRI Equity Hedge (TR) Index TR USD Hedged vs. a 50/50 MSCI World/LIBOR GBP 3 month index

2. The regressed beta of HFRI Equity Edge (TR) Index TR USD Hedged vs. MSCI World LC is 0.52 over the analyzed time period.

And negative alpha generation has been pronounced among many sought-after hedge fund managers, many of which reported some of their highest levels of underperformance in over a decade in the year ending in August 2016. Collectively, these elite managers produced negative annualized alpha of 7 percentage points over the period.

Three primary drivers — market, macro and fee model factors have contributed to the recent setback in net manager alpha production. Most of these factors have been present for a number of years, but they have together strengthened and converged since July 2015 to create headwinds of seemingly hurricane strength.

The first is increased market competition and technical factors, such as the growth of hedge fund industry assets, creating increased competition for excess returns, especially in more efficient asset classes such as equities. This has gradually shrunk the investable universe for funds and led to ‘crowding’, notably in mega- and large-cap momentum stocks. Greater information flow and transparency has also compounded the challenge, with many investors piling into the holdings of the most highly respected funds.

Additionally, quantitative and other algorithmic-based strategies have scooped up a significant portion of available alpha since the global financial crisis. Growth in quantitative, passive investing and ‘smart beta’ strategies has likely distorted the market by driving prices away from fundamental value.

Macro forces have also become much more influential on overall investment performance. Fed Dashboard estimates that in the U.S., Federal Reserve policies alone have accounted for up to 90% of the S&P 500’s collective returns since the financial crisis. More generally, central bank-induced quantitative-easing policies and low, zero and negative interest rates have distorted market pricing and asset allocation.

Perhaps the factor weighing most heavily on the net performance of active managers has been their fee structure**,** especially in the case of hedge funds. High fees were often overlooked in past high-return environments, but with today’s lower returns generally and lower alpha specifically, the misalignment between fees and returns needs to be fixed.

Given the numerous challenges that have prevented managers from delivering persistent alpha, all investors should be reassessing their allocation to active managers, which typically represent 50% to 70% of a sophisticated endowment portfolio. Yet investors should not simply transition entirely to passive investing.

Rather, a successful investment program should have five key elements in order to deliver net excess returns across the full market cycle:

(1) **Use ’smart beta’ and ’cheap alpha’ strategies:** Eliminate active managers who charge high fees for returns in excess of their market (beta) indices where such “excess returns” can be cheaply replicated through low cost funds or exchange-traded funds that deliver skews toward quality, value, momentum and other factors. In other cases, active managers have offered a strategy with more reasonable fee structures, replicating expensive hedge fund strategies at a fraction of the typical fees, such as low cost merger arbitrage.

(2) **<u>Accept only managers whose fees are proportional to alpha</u>:** Seek managers whose management fees generally decline as client assets grow and performance fees are triggered by exceeding a hurdle or benchmark. Performance fees should be applied as closely as possible to the alpha derived from truly differentiated manager skill.

(3) **<u>Higher allocations to private market investments</u>: Allocate more to** private equity, private debt, and private real estate, less exposed to many of the pitfalls of public markets, especially the tendency towards mass irrational investor behavior. They benefit from illiquidity premiums, manager operating skill, and the presence of profitable sub-strategies, such as private equity "tuck-in" investments executed at relatively low multiples. However, the fees must bear a proportional relationship to expected alpha.

(4) **<u>More "alternative alternatives"</u>: Invest in** smaller asset classes – often too small to draw large institutional players – that are less likely to be over-capitalized and can offer healthy returns with little or no correlation to conventional market betas. Examples include energy and weather-related trading strategies, retrocessional catastrophe insurance, litigation finance and appraisal rights.

(5) **<u>Fewer and deeper active manager relationships</u>: Stay committed to** the few enduringly great managers generally are appropriately sized to their opportunity set, pursue well-articulated processes for identifying and evaluating opportunities, and have a firm belief in doing things "the right way" (e.g., a strong trading controls and compliance environment). Identifying these extraordinary stewards of capital requires a hefty investment in research and extensive due diligence. Even then, investors must recognize that the most talented managers make winning investments only about two-thirds of the time.

This is not a time to sit under a false shelter waiting for sunnier days. This is an environment where institutions should be re-architecting investment programs to create lower-cost, more resilient all-weather portfolios.