Alternative Investments: Past, Present, and Future

By Verne Sedlacek

Alternatives have become traditional. They were truly alternative in decades past but have now entered the mainstream. The latest NACUBO-Commonfund Study of Endowments (NCSE) reports that more than half of all assets held by university endowments are in the broad array of strategies that we refer to as alternatives. And although the magnitude of allocations to alternatives among endowments and foundations remains skewed to the largest pools, institutions of all sizes have increased allocations, and in the past decade allocations have risen dramatically among other institutional pools, most notably pension funds.

What has propelled this growth in alternatives? Alternative investment strategies are included in a portfolio to enhance returns, reduce risk, or both. They are fundamental to the structure of the so-called endowment model of investing, which concludes that long-term asset pools (whether endowments, foundations, long-term reserves, or pension funds) can outperform investors with shorter-term time horizons by providing capital to less efficient, more complicated, and illiquid sectors of the capital markets. Today, institutions that have established portfolios of alternative strategies are critically assessing whether alternatives still make sense. Two questions are most commonly asked. The first is: Do alternatives provide better risk-adjusted performance than traditional long-only equities and bonds? The second question is: Are alternatives effective portfolio diversifiers? A related question is whether the high fees typically associated with alternatives are justified.

We believe that alternatives have, in general, contributed significantly to portfolio performance over the past 20 years—either by providing better returns or reducing volatility. More important, we conclude that thoughtfully constructed portfolios that include allocations to alternative investment strategies are well-positioned to continue to outperform the traditional 60/40 benchmark. But, simply allocating 20, 30, 40 percent, or more to alternatives does not ensure success. Talent is key and for investors unable to gain access to top-tier investment managers, we have just two words of advice: Caveat emptor.

For the purposes of this discussion we focus on three specific types of investments that make up a majority of the alternative allocations for most institutional investors: private equity, venture capital, and hedge funds. Because their investment structures are similar, we use the term “private capital” to include both private equity and venture capital.

Defining Alternatives

We tend to lump a broad range of alternatives into a bucket alongside the equities and fixed-income buckets, but alternatives are not an asset class. They are an amalgamation of investment strategies included in portfolios for specific purposes. These are (1) growth, (2) deflation hedge, (3) inflation hedge, and (4) diversification/uncorrelated alpha (see figure 1). Some alternatives are truly risk assets that are in portfolios to generate growth via underlying equity exposure, such as venture capital, private equity, distressed debt, and long/short equity hedge funds. Other alternatives may have higher correlations to fixed income and thus can be more deflationary hedges. Still other alternatives, such as commodities, real estate, and natural resources, are largely uncorrelated over market cycles with equities and fixed income and serve the portfolio as inflation hedges. Left over among alternative strategies are certain hedge fund strategies that have no market exposure and exist solely as portfolio diversifiers and sources of uncorrelated sources of alpha. These include global macro strategies and market-neutral hedge strategies.

With the exception of commodities (which can be indexed), all of these strategies are highly dependent on manager skill and are less liquid than most publicly traded equities and fixed-income markets. Hedge funds will have lock-up provisions that in general range from three months to 1–2 years, and private equity and venture capital programs are usually 10–12 years or longer. A simple way to look at these groups is as follows:

Private equity and venture capital: Designed to provide enhanced returns relative to public equity markets at the cost of liquidity

Hedge funds: Designed to dampen portfolio volatility, protect against market declines, and provide uncorrelated return streams over market cycles

We examine each of these strategies below, with a focus on how they can impact portfolios now and in the future.

Private Equity

As the private equity industry evolved, long-term investors cited a number of rea-
sons buttressing the rationale for investing in these strategies:

- Greater alignment of interests between investors and the users of capital
- Capital scarcity
- Market inefficiencies
- The use of leverage to boost returns
- Diversification benefits
- The illiquidity premium

Has private equity lived up to expectations? Returns to private equity have remained above those of public markets, as we will describe below. In terms of alignment of interests, private equity investors still sit on boards and tightly oversee portfolio company management teams that normally have significant equity holdings. The private equity firm’s general partners still closely monitor the company, change management when needed, and provide guidance and assistance to management. This model has and should continue to be part of the value proposition for this investment strategy.

What about capital scarcity? A significant amount of private equity has been raised over the past decade. In the very early days, the investor base was limited to a narrow range of high-net-worth investors and a few endowments; the investor base today has expanded substantially, with almost every type of long-term investor dipping toes or more into private equity waters. The question is: Has this destroyed the dearth of capital argument? The answer is yes and no. We have moved from very small numbers in the early 1980s to annual capital raises of more than $100 billion today. However, when this market size is viewed as a percentage of the market capitalization of the public equity markets, the relative size of private equity remains small and not much different than in the mid-80s. So, although the space has significantly more money, it is still relatively small—less than 0.4 percent of public stock market capitalization even after a huge uptick in fundraising at the end of the boom in 2007 (figure 2).

In the early days of private equity investing, leverage was a critical part of the calculation. Today, leverage has become less important, and instead, the two main drivers of returns have become multiple expansion and earnings growth (figure 3). In the 1980s, more than half of the change in values was the result of the use of leverage. In the 1990s, the greatest contributor to returns came from multiple expansion. The decade of 2000–2009 was more evenly balanced between multiple expansion and the growth of earnings. As we go deeper into the 2010s, we believe that the lion’s share of returns will come from operational improvements driving growth in earnings. This changes the way we think about investments. In the 1980s managers who added value focused more on financial engineering; today, it is about finding managers who can improve operations and raise earnings at the company level. This ability to change the course for a portfolio company is, in our view, the biggest determinant of what separates top managers from median managers.

The promise of diversification benefits from private equity investing, which propelled some of its growth in decades past, has changed over time. Historically, at least some of the apparent lack of correlation of returns came from the way general partners marked their positions to market. Generally, losing positions were written down when the market or operating results were poor and winners were not marked up until there was an event like a new round of financing or a sale of the company. This has changed over the years. New accounting pronouncements (ASC 820 and AU-2009-2012) and pressure from institutional limited partners have forced private equity funds to value based on a number of factors. As a result, the volatility of private equity as well as the correlation to public equity has increased.

---

Figure 1: Asset Types and Purpose in the Portfolio—Hypothetical Example
Much has been much written about the illiquidity premium (also called time frame arbitrage) over the past several years, but with no real consensus. We believe that the net of fees illiquidity premium has existed at about 3 percent annually and will continue to provide returns in excess of the public market even for average managers. Getting close to first-quartile returns, however, will continue to add significant value above the average manager (and conversely, bottom-quartile firms may struggle to consistently outperform public markets).

In sum, then, private equity today is a global investment business. Substantial assets have been raised to invest in Europe and more recently in the emerging markets. The techniques of U.S. private equity have been transported outside the United States and that has allowed many of the same attributes to prevail in Europe (and other developed countries) and the emerging markets. Private equity remains a compelling and viable method of gaining exposure to future economic growth in the vast sphere of private companies (generally more than 95 percent of all companies in a developed economy are private).

**Venture Capital**

Venture capital investing generally has been viewed as distinct from private equity even though the strategies share a number of common attributes. Most notably, the differences that distinguish venture capital and private equity are the sources of return and payout patterns. Like private equity, in the nascent days of venture investing long-term institutional investors allocated capital to these strategies over traditional public market equities for the following reasons:

- Greater alignment of interests between investors and the users of capital
- The ability to generate “innovation alpha” by investing in disruptive technologies not available in public markets
- Payoff structure of home runs over strikeouts
- Diversification benefits
- The illiquidity premium

Has venture capital lived up to its promises? The conclusion for venture capital is more nuanced than for private equity, driven in part from the historic high level of venture fund-raising in the late 1990s and the resultant dot-com crash in 2000 (figure 4). Where do we go from here? Venture capital principles remain unchanged, but we believe fundamentally that one cannot scale innovation beyond its natural limits and, as such, providing more capital lowers returns. Today, a relatively small number of venture capital managers capture the lion’s share of the gains. Hence, strong performance is possible as index returns suffer.

We believe alignment of interests is still intact. Reality has set in, however, and the importance of operating results and profitability has returned to venture managers, as has the relevance of fund sizes to invest-
ment performance. Bigger is not better in venture capital. As a result of the large amount of money raised, with a portion raised by marginal firms, there was a significant capital overhang in the 2000s. This certainly contributed to poor returns during the past decade; moreover, the dollars going into venture have decreased as the performance of this investment class has lagged.

A key question is whether the “home run/strike-out” payoff patterns have changed and, if so, will they become more favorable for investors. In the halcyon days of investing in venture, typified by vintage years 1994 and 1995, the number of investments among top-tier managers that were home runs (defined as multiples of invested capital, e.g., 3x to 10x and 10x or better) were at least 30 percent during those two vintage years, and the invested dollars with a loss were in the 40-percent range. It appears that the industry may be evolving from a home run/strike-out approach to one with more singles and doubles and fewer strike-outs and home runs. This payoff structure is closer to what we have seen in the private equity business, although the promise of the home run is still what drives many venture capitalists and those institutional investors that continue to commit to this strategy.

The diversification benefits of venture investing, particularly in periods of capital market stress, no longer exist. So, although innovation occurs across all market cycles and is not correlated to equity markets, exit strategies (e.g., initial public offerings) exhibit high correlations to public equity markets.

Where does all of this leave us as it relates to venture investment? We do not believe that we will see another bubble like the one that we experienced in the late nineties in our lifetimes. So we should expect returns that are comparable to what we will see in private equity.

One word of caution: The difference between the return of the top-quartile managers and the average manager is larger in venture than in any other asset grouping. Table 1 shows this wide gap between first-quartile managers and the other three quartiles, using public-market equivalent (PME) benchmarks as the measure. So, allocating capital to the best managers is a necessary pre-condition for success.

Finally, in assessing where venture goes from here, as with private equity, we should not forget the changes in emerging markets. In China and India we have found terrific opportunities that have in many cases resulted in excellent returns. Innovation and disruptive technology are not the sole purview of Silicon Valley: Today, immigrants make up 40 percent of STEM (science, technology, engineering, and math) students in masters and PhD programs. This number ballooned to 205,600 students as of 2011, according to Immigration and Customs Enforcement records, and many of these non-U.S. students are returning to their home countries to be the entrepreneurs of the 21st century.

Hedge Funds
These are among the most enigmatic of all the strategies in the alternative bucket. For most institutional investors, hedge funds came to the fore in the early 2000s when the Internet bubble burst. In that period hedge funds were flat to up a little when the equity markets were down 20-plus percent. That’s when hedge fund asset growth really took off.

Table 1: Persistence in Performance

<table>
<thead>
<tr>
<th>Previous Fund Quartile PME</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>Total</th>
<th>PME</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>49.4%</td>
<td>20.5%</td>
<td>16.9%</td>
<td>13.3%</td>
<td>100%</td>
<td>2.85</td>
</tr>
<tr>
<td>2</td>
<td>28.0%</td>
<td>32.0%</td>
<td>26.7%</td>
<td>13.3%</td>
<td>100%</td>
<td>1.38</td>
</tr>
<tr>
<td>3</td>
<td>27.0%</td>
<td>30.2%</td>
<td>22.2%</td>
<td>20.6%</td>
<td>100%</td>
<td>1.34</td>
</tr>
<tr>
<td>4</td>
<td>3.9%</td>
<td>23.5%</td>
<td>27.5%</td>
<td>45.1%</td>
<td>100%</td>
<td>0.69</td>
</tr>
</tbody>
</table>

Today, hedge fund assets under management are at an all-time high, yet net inflows have fallen to 2–3 percent annually from 11 percent pre-2008. Fewer funds are being launched and two-thirds of the industry is now concentrated with managers with more than $5 billion in assets under management. Hedge funds are a maturing industry, but that does not mean they are no longer a good investment.

The following factors helped propel growth in hedge fund strategies among institutional investors:

- Diversification benefits
- Capital scarcity and unconstrained mandates
- Manager skill and alpha
- The use of leverage to boost returns

Not surprisingly for anything experiencing tremendous growth, hedge fund investing has undergone enormous change over the past 20 years. The fundamental rationale for hedge fund investing remains intact; one of the most significant changes is in implementation. Over the past half decade, this change has come in the shift from investing via hedge funds of funds to direct investment with hedge fund managers. Figure 5 shows this separation: Both approaches grew rapidly in the 10 years from 1997 to 2007, just as both pulled back during the 2007–2008 financial crisis. Post-crisis, growth resumed for direct investment but remained flat to modestly lower for the funds of funds alternative. What happened?

Twenty years ago, hedge fund investing was not new—but it was new to most investors. At first, they treated hedge funds as almost a standalone allocation, segregated from mainstream equities and fixed income as well as more familiar alternatives such as real estate, hard assets, and the previously discussed private equity and venture capital. Investors believed this would allow them to better manage hedge funds’ risk/return profile and accommodate liquidity needs. In this environment, a commingled product, like a fund of funds, provided immediate diversification as well as the assurance of knowing the provider had vetted the managers and would deliver all the associated portfolio management services (which, in the case of hedge funds, can be quite complex and time consuming).

Over time—as investors gained experience managing their hedge fund allocations—thinking began to change. Investors no longer looked at hedge funds as a separate asset class (indeed, they never were a separate asset class, but rather a range of discrete investment strategies). The discussion shifted to the role of hedge funds in the asset allocation policy: What’s their place in our equity or fixed-income allocation? Should we carve out a role in our thematic bucket or inflation bucket?

In this context, direct investing is a reasonable choice because it responds to the desire—and ability—to use hedge funds in a very precise and targeted manner. For example, an institution seeking to enhance the risk/return profile of its equity allocation may want to introduce a hedged equity strategy—perhaps a commodity trading advisor (CTA) or global macro manager and that level of precision may be achieved most effectively by going direct. In another instance, after a long decline in interest rates to record low levels, investors, as well as their consultants and intermediaries, are closely monitoring their fixed-income allocations. Rates appear to have only one way to go; the question is when. In this environment, a long/short credit fund or a multi-strategy credit fund offers the potential to hedge the rate risk.

Direct investment is also a way to implement a thematic strategy. The case can be made, for example, for targeting Asia based on favorable demographics, including a burgeoning middle class, stronger domestic markets, and less dependence on exports. An institution can build an allocation with a long-only approach. Instead, however, it may decide that it can address the opportunity while managing tail risk by investing with regional hedge fund managers implementing a long/short or market-neutral strategy.

Other factors are driving the shift to direct investment. Flexibility goes hand-in-hand with precise targeting, because going direct gives investors the ability to determine the size of their commitment and shape the profiles of the allocations. Another factor is transparency. Reports coming directly from individual hedge fund managers are perceived to provide better insight than a fund-of-funds report that rolls up the results of multiple managers. Finally, there is the desire to keep fees to a minimum, and going direct circumvents funds of funds-level fees.
That said, due diligence, manager monitoring, and reporting—along with other services provided by funds-of-funds managers—are never free and must be absorbed by the client.

For that reason, direct investment is an opportunity for the consultant community to provide hands-on service and support, and some consultant firms have broadened their in-house hedge fund services to include single-manager offerings. Still, many consultants are challenged by the increased complexity and cost of offering direct hedge fund options to clients. In response, some consultants are forming advisory partnerships with asset management firms to bridge the resource gap. These partnerships can take several forms, including the “extension of staff” concept in which the consultant has access to manager sourcing, evaluation, diligence, analytics, and reporting.

Investors and their consultants should keep in mind two considerations when making direct hedge fund commitments—due diligence and operational complexity. These factors may stretch resource-constrained investors, but consultants generally are well-positioned to lighten the burden. That leaves three issues for investors to consider as they reflect on direct hedge fund investing:

Access. The objective of sourcing unique talent among a vast and diverse universe of hedge fund managers raises the central question of access: Is the investor able to invest with top-tier hedge fund managers—many of whom may be inaccessible to all but the largest institutional investors—or merely settle for those that are available?

Liquidity. Investors should understand how liquid or illiquid a particular strategy is. Less liquid strategies, like credit and distressed debt, are more likely to put up gates in a period of financial turmoil (such as 2008) but long/short or macro strategies generally are more liquid.

Risk management. Investors must synthesize all these factors and develop a risk-management discipline that allows them to comfortably make investments in selected hedge funds. Once again, consultants can help investors think about risk factors, but the investor must make the ultimate call, consistent with the investment policy.

The trend toward direct investing does not make the fund-of-funds alternative obsolete. Funds of funds may be appropriate for investors large and small. Investing in a hedge fund of funds is a step closer to a total portfolio-management solution. The fund-of-funds manager has vetted the hedge fund managers, constructed the portfolio, and monitors it through time.

Depending on the nature of the fund of funds, it also can deliver the all-important benefit of diversification; most funds of funds are constructed around 20–30 funds, though some larger funds of funds may hold 50 or 60 names. Most funds of funds take a multi-strategy approach with a varying degree of market exposure. It is common to see these funds of funds diversified by strategy, style, and region. Strategy-, region-, and sector-focused funds of funds also exist. An example is a multi-strategy fund focused on Asia or, somewhat less prevalent, a technology-focused fund of funds.

Investors may want to remember that the decision is not binary. They have the option to include both direct investments and funds of funds in the same portfolio. An investor may employ a hedge fund of funds as its core allocation and complement it with a satellite strategy focused on a particular strategy or region.

Summary
Historically, alternative investment strategies have delivered on their promise. Private equity and venture capital have provided returns well above public market equities. Hedge funds have provided alpha across market cycles and have protected in down markets. Furthermore, this performance has held true on a net-of-fees basis.

But these statements are not without qualifiers. Most important, investment talent is key, because median performance is less likely to provide consistent outperformance relative to traditional long-only strategies. So, deploying capital with top-tier investment managers in private equity and venture capital and across hedge fund strategies is necessary in order to achieve attractive risk-adjusted returns.

So what does the future hold for alternatives? We believe that the fundamental principles and drivers of investment performance that have propelled returns for alternatives over the past two decades are largely unchanged. More managers are applying more capital in these strategies, but allocations to these strategies as a percentage of global equity market capitalization remain relatively small. Still, one truism of the past is even more pronounced today: An index-like approach to alternative investment strategies certainly will disappoint.

In general, perpetual and other long-term asset pools such as endowments, foundations, and pension funds have not been able to maintain purchasing power over the past generation by simply allocating to a basic mix of passively managed equities and bonds. Active management of long-only strategies will only bridge part of the gap. As such, we believe that significant allocations to alternative strategies—thoughtfully constructed, with top-tier managers—are necessary to preserve intergenerational equity and thus fulfill the long-term missions and obligations of institutional investors.

Verne Sedlacek is president and chief executive officer of Commonfund. He earned an AB in economics from Princeton University. Contact him at vsedlacek@cfund.org.

Endnotes
1. The National Association of College and University Business Officers (NACUBO)-Commonfund Study of Endowments, known as the NCSE, is an annual nationwide survey of the endowment management and governance practices of more than 800 U.S. colleges and universities.
2. Readers who wish to learn more may access “Alternatives Reality: What to Expect from Future Allocations,” which is available on Commonfund’s website, www.commonfund.org.