Australian Alternative Asset Allocation

By Scott A. J. MacDonald

Editor’s note: Though this article focuses on Australia, diversification is a global issue.

With the continuing volatility in all equity markets and other traditional assets, the move into alternative investments should be an easy decision. But why is the obvious just not that simple? After all, most investment professionals today understand what luminaries in asset allocation and portfolio management such as Yale’s legendary chief investment officer David Swensen have been saying and doing for some 30-plus years: “[A]bsolute return, real estate, and private equity—contribute to the portfolio construction process … allowing the creation of portfolios with higher returns for a given level of risk or lower risk for a given level of returns. Investors treating alternative assets as legitimate tools in the portfolio allocation process reduce dependence on traditional marketable securities, facilitating the structuring of truly diversified portfolios.” (Swensen 2000, 204)

With this in mind, why is the allocation to alternatives among Australian superannuation funds estimated to stand at only 6–8 percent (with much of that in infrastructure and private capital) of the total estimated pool of A$1.3 trillion? This should be a concern to those of us exposed to high levels of domestic equities with little or no such portfolio diversification. We have observed over many years that many of the top-performing portfolios, such as Harvard, Princeton, Yale, and many other endowment funds, are allocating 18–20 percent of their total portfolios to absolute return funds or hedge funds (see figure 1).

However, this is viable only for those investors with the knowledge and research ability to seek out and access managers of superior skill. The alternatives arena typically is global in scale and therefore market-beating strategies are achieved only by the best of the best. Arguably, even these managers have limitations when it comes to consistently beating markets and justifying the high fees that typically go along with this type of investing. It also may befuddle us to realize that although we have yet to meet a self-confessing poorly performing manager, they do exist.

Having said this, it is worth noting that the growth of the hedge fund sector remains strong as investors seek alternative strategies to bolster performance, dampen risk, and continue to diversify exponentially growing portfolios. The 2008 Hedge Fund Asset Flows & Trends Report 4Q supplement reported, ”Hedge funds added another 3.98% in assets in the fourth quarter 2007, increasing its total to USD$2.78 trillion” (A$3.02 trillion). The industry grew by 16.95 percent in 2007, compared with 26.81 percent in 2006, excluding performance gains, according to the report, published by HedgeFund.net and Institutional Investor News (see figure 2).

By any study of the data and any understanding of the nature of expanding global capital markets, it is true that investment opportunities abound. These same opportunities are at the mercy of bright hedge fund managers who are not constrained by traditional thinking or portfolio rules that restrict investment style or technique development, because hedge fund managers are able to engage the multitude of derivative and financial instruments at their disposal to enhance portfolio returns. Many of these astute operators find excess
returns (alpha) in these inefficient and highly dynamic markets. Excess returns are produced by these hedge fund managers and, as Swensen (2000, 246) puts it, are “strategies that exploit mispricings in marketable securities. By offsetting market exposure with hedges, investors reduce systematic risk and cause results to depend on manager skill.”

The Greenwich Alternative Investments 2007 report (www.greenwichai.com) shows the comparative benefits of hedge funds to major benchmarks and the relative standard deviation (one measure of risk) of such exposures1 (see Table 1).

Investors employ these managers to pursue and engage the markets aggressively and intelligently, and it is with this in mind that we mere mortals need assistance in identifying such high-quality investment professionals. The trick is in the selection process, due diligence effort, and understanding this complex investment sector. This is time-consuming and expensive, and for Australian investors the tyranny of time zone and distance only adds to these burdens. However, by developing a platform approach to structure such investments, the associated research processes can be achieved with appropriate consultation to experienced independent hedge fund procurement practitioners.

To develop the empirical knowledge, to meet and develop trust with such an extraordinary group of managers, and to even begin to assess their skills requires a major commitment and represents the most important aspect of investing in alternative investments.

So the question is this: After all this effort and expense, has it been worth it? Swensen (2000, 246) seems to think so.

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1. CAR=Cumulative Average Return, STD=Standard Deviation

Source: www.greenwichai.com
“By selecting high-quality partnerships pursuing value-adding strategies, Yale University achieved a nearly 30-percent per annum rate of return on private investments over the quarter-century from 1973–1998,” he writes. As for hedge funds, Swensen continues, “Because absolute return strategies generate equity-like returns largely independent of market movements, the asset class contributes extremely attractive return and diversification characteristics to portfolios.”

With this in mind we need to ask Australian superannuation managers to review their asset allocations. As we estimate the unallocated hedge fund component, assuming an allocation rate of 10–15 percent to hedge funds (and not the 18–20 percent that U.S. endowments have allocated) will require an increased allocation to the hedge fund sector over the next three years of potentially A$125 billion to A$150 billion (see figure 3).

It is without doubt the right time now for all involved in the Australian superannuation industry to take a good look over the next 12 months at asset allocation models and reweight them with alternative investments for prudent diversification and better investment management outcomes.

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Endnotes

1 Superannuation is an Australian pension that requires employers to pay a proportion of an employee’s salaries and wages (currently 9 percent) into a superannuation fund, which the employee can access upon retirement.

2 For more information and to order a copy of the “2008 Hedge Fund Asset Flows & Trends Report,” please visit: http://www.iialternatives.com/ain/fundflows08.