Using Alternative Investments to Increase International Exposure

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Editor’s note: This article provides an overview of using alternative investments as a vehicle for increasing international exposure. It does not offer analytical proof on why consultants should consider alternative investments.

Investment consultants traditionally have viewed international investments as one of those minor asset classes they learned about under modern portfolio theory. Over the past five years or so, however, the impact of globalization and the bull market in commodities have forced us to pay more attention to this important asset class. Other reasons to pay attention also include the following:

- A significant percentage of the world’s largest corporations are headquartered outside of the United States.
- Many of the brand-name products we use, such as Toyota, Nestle, and GlaxoSmithKline, are foreign-owned.
- Major sea changes have taken place on the geopolitical front, including the break-up of the Soviet Union, the fall of Communism, the opening of China, and the emergence of India as an economic power.
- A surge in demand for commodities of all types has been sparked by economic development in China, India, and Central Europe. This surge especially has fueled the economies of resource-rich countries in Latin America, which have commodities beyond oil.
- Financial markets are starting to take shape in the developing world; emerging-market equities have been among the top performers over the past 12 to 36 months.
- The re-emergence of Japan after what seemed to be an eternal recession.
- Although less true now, international equities traditionally have offered a lower correlation to U.S. equities, thus reducing the overall volatility of a portfolio.
- Currency changes offer further diversification to U.S. market investments and can reduce market correlation.

Not surprisingly, current fund-flows analysis shows huge amounts of money flowing into the international arena. AMG Data Services reported record equity fund inflows of $147.5 billion in 2005, with $86.2 billion or 58 percent of that amount going into international equity funds.1 In fact, Dr. Jeremy Siegel recently recommended a 40-percent allocation to international, which is at the high end of the range for traditional advisers.2 (Certainly all Monitor readers know the “Wizard of Wharton” and pay close attention to his thoughts. See the review of Dr. Siegel’s new book, The Future for Investors—Why the Tried and the True Triumph over the Bold and the New, in this issue of the Monitor.)

Despite the reasons for allocating more funds internationally, many investors have remained on the sidelines over the years. They generally believe foreign markets to be more volatile or riskier than U.S. markets, due to currency fluctuations as well as greater political and economic uncertainties. They have regarded emerging markets as even riskier investments because those countries are subject to greater economic, political, social, and regulatory upheavals. Additionally, investors have been uncomfortable with non-U.S. companies because they have less publicly available financial information and different accounting and financial reporting standards.

Determining the right vehicle for increasing international exposure is difficult, and this contributes to the reluctance. As long as the allocation was minor, investment consultants put their clients into international mutual funds. Wealthier clients went to separate account managers. More recently, the explosive growth of exchange traded funds (ETFs) has presented interesting and innovative ways to increase exposure. However, most investment consultants have not embraced alternative investments as a vehicle for increasing international exposure. The purpose of this article is to examine that possibility.

The Historical Background

As figure 1 indicates, investors have benefited by staying domestic in some years, but they truly missed opportunities in other years. Generally, international equities (as measured by the MSCI EAFE Index) outperformed the U.S. large-cap domestic market (as measured by the S&P 500) during much of the 1980s but significantly trailed the domestic market during the 1990s.

More recently, this relationship has begun to turn again in favor of international equities, largely due to...
the impact of globalization and the strength of commodities. Nonetheless, the past volatility may make the argument for “absolute return” funds more compelling.

Events that began to take hold in the early 90s set the stage for a much different international investing landscape. There has been a worldwide expansion of capitalism, with increasing investment capital, rising stock markets, and expanding global liquidity. Moreover, investors are beginning to look at portfolio management beyond the traditional allocations to developed-market stocks and bonds. It is not just another diversification play. Instead, it is being viewed as a place of expanded investment opportunities. Indeed, in Dr. Siegel’s new book, The Future for Investors, he notes that only 52 percent of the world’s market capitalization is in the United States.3 He likens it to investing only in companies that begin with the letters A thru L and arbitrarily ignoring companies that begin with letters M thru Z.4

Figure 2 illustrates this expanded view of asset allocation, where investors are establishing truly global portfolios across all asset classes.

Alternative Strategies to International Investing
During the past five to ten years, we have witnessed a sea change in the
investment business as many investors rolled into the relatively uncharted waters of hedge funds and allocated large amounts to real estate and private equity opportunities. The experience of investing in these alternative asset classes has helped set the stage for a more global expansion today. We now will consider some of the alternative strategies through which investors can gain further international exposure.

**Hedged Equity Portfolios**

The traditional strategy is to buy a basket of diversified international companies and then employ hedging techniques against stock market index futures and/or selected currencies. Another more pointed strategy is to establish country-specific portfolios and hedge market and currency risks where available. An example is to create a portfolio of Japanese stocks and then employ a hedge against the yen and/or the Nikkei average. (See “Long/Short Investing in International Equities: An Interview with Nigel Hart,” in this issue of the Monitor.)

**Hedge Funds**

Hedge funds give the investor one of the best-known vehicles for gaining international exposure. By their nature, hedge funds take both long and short positions, employ leverage, use arbitrage techniques, and trade in options and futures. The industry also tends to categorize hedge funds into distinct groupings such as the following:

- Low- and high-volatility funds
- Market neutral and directional funds
- Relative value, event-driven, equity hedge, and opportunistic

Within these groupings, we then have specific strategies such as convertible arbitrage, managed futures, distressed debt, and global macro. Several of the strategies enable investors to obtain international exposure across a number of asset classes and markets. The following are a few to consider:

- **International Fixed Income Arbitrage**—With this strategy, investors seek to exploit pricing inefficiencies among financial markets around the world, for both securities and derivatives. They will take both long and short positions, sometimes making a directional bet. Returns are therefore derived from dislocations in established relationships or spreads among countries and specific securities, rather than from predicting interest rate changes. Leverage frequently is employed. One would classify this as a relative value strategy.

- **Emerging Markets**—One of the most opportunistic and highly volatile strategies is that of an emerging markets hedge fund. Here, fund managers will invest in both equity and debt securities of emerging economies with the aim of exploiting the inefficiencies inherent in immature but growing economies. They position their portfolios to take advantage of credit spreads as well as governmental fiscal and monetary policy changes. They are limited, however, in their ability to short many of the emerging market currencies and market indexes. There is some discussion that emerging markets are a new asset class, separate and distinct from traditional international exposure.

- **Global Macro**—As the name implies, these managers essentially use the world as their stage. It is undoubtedly what most investors think of in terms of international investing, but it is only one market strategy. First, they seek out opportunities...
The key aspect of private equity investing is gaining “access” to the right opportunities. To that end, many of the largest bank and brokerage firms have brought and continue to bring private equity offerings to the market.

Participating in this strategy enables investors to capture some of the action taking place in such areas as currencies, energy, and worldwide trade imbalances.

Private Equity
Both the greatest opportunity as well the greatest risk lie with private equity investing overseas. Without question, each of the risks involved with domestic private equity investing may be even greater overseas. Despite the apparent risks, private equity investors have been flocking to overseas markets.

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International private equity opportunities have been concentrated in some of these following areas:
- **Europe**—Private equity is becoming more of a mainstream asset class in Europe. In particular, the large end of the buyout market has presented significant opportunities over the past year. Further economic integration coupled with generational changes at many family corporations could further spark this market.
- **Israel**—Israel has provided some venture opportunities for investors with the right risk profile, particularly in technology and pharmaceuticals.
- **Far East**—The most action, of course, has been in Asia. While this area still harbors greater political and economic risk than Europe, conditions are becoming more favorable for private investors. For example, Asian countries now are more open to selling significant stakes in their corporations to Western investors. The push toward urbanization has raised disposable incomes and is creating more of a consumer society. This will create opportunities to build companies that produce basic consumer products. Also, local banks are providing more debt capital to fund buy-outs. Finally, there have been some favorable exits from investments made over the past few years, thus giving investors added confidence they might be able to monetize their holdings.
- **China**—Of course, the big story in private equity is China, where global private equity firms have been establishing offices and raising substantial funds from investors throughout the world. Private equity will continue to play a necessary and critical role in building China’s economy; it fills a void between a developing banking sector and a fledgling stock market. To a great extent, private equity is the only real way to fund new enterprises. Private equity firms tend to develop a particular focus such as venture technology, buy-outs, and restructurings. Needless to say, while opportunities seem to be plenti-
As in politics, all real estate is local. Having the right property manager is as important as having the right portfolio manager.

Structured Notes
Another especially interesting way to gain international diversification is to purchase a structured note. These frequently are called principal protected notes. Essentially this investment works in the following way:

- Structured notes are hybrid securities that have the appearance of fixed income with an equity kicker of some kind.
- They generally are issued by large commercial banks or brokerage firms. As such, these firms are the issuers and represent the credit risk in the transaction.
- The principal protection part is that investors are guaranteed a return of their original investment or some part thereof at maturity.
- The equity part involves an additional return that is tied to an index or basket of indexes or currencies. The investor will get a percentage of the increase in value of the designated index.
- An example would be a note that is tied to the performance of the EAFE index or to a basket of Asian currencies. The investor may be guaranteed a return of principal plus 50 percent of the increase in value of the index.

Structured notes are a risk-controlled way to participate in foreign currency movements of specific countries and regions. You will not capture the full upside move, but you will get some of it without significant risk of capital.

Issues and Challenges
Earlier, we spoke of the risks inherent when investing internationally. In addition to the market risks, however, one faces other challenges when investing internationally with alternatives. In particular, investors will encounter a more elaborate due diligence process and need to be willing to accept higher costs.
Due Diligence

The international space adds another layer of due diligence issues. Here are some of the factors to consider:

- In his latest book, Collapse: How Societies Choose to Fail or Succeed, Dr. Jared Diamond states: “Globalization makes it impossible for modern societies to collapse in isolation.” Even if this is so, we cannot ignore geopolitical risks of individual countries and regions.
- Currency crises in emerging market economies are another due-diligence risk. Here again, hedge funds may be able to react quickly but real estate and private equity investments could face long-term problems depending on how the currency crisis is handled. Specifically, it could impact the repatriation of funds in some cases.
- Private equity investors have to evaluate the exit strategies available today and be able to project progress in the development of public financial markets in the future, as well as changes in capital control regulation. Additionally, one will want to assess the overall growth in private company investments in a country or region, so as to have available strategic buy-out options from private firms.
- Just dealing domestically, one is always challenged to figure out where future tax legislation is headed. This is multiplied when investing in a range of foreign jurisdictions. Because private equity and real estate are long-term investments, one needs to carefully evaluate a country’s budgetary and longer-term fiscal policies.
- When selecting private equity and real estate funds, investors should assess the firms’ capacity to put resources on the ground. The initial due diligence is not enough because these investments require continuous monitoring. To accomplish that, the firms need to have some scale to expend the capital.

Costs

A few words about costs when investing internationally:

- When investing in traditional international equity and bond portfolios, one may expect to incur an additional 35 to 75 basis points to cover custody and the increased resources for research.
- With hedge funds, it is not easy to generalize because there may not be a measurable price differential for the international component.
- With private equity and real estate, investors likely will incur a measurable increase in costs to compensate for the additional expenses of running these funds. The actual amount will vary depending on fund size, geography, and the resources required to operate the fund. The increase in costs could come from any or all sources of compensation including the management fee, profit, or placement fee.

Conclusion

Properly implemented, alternative investment vehicles are just as useful for international investing as for domestic investing. It just is harder for the investor and the investors’ advisers. The investor needs to process another dimension of risk. The investment adviser needs to expand due-diligence capacity and be able to source specific opportunities. The tax adviser needs to deal with foreign taxes, slower K-1s, and varying domiciles.

Realistically, no investment consultant can adequately research or conduct due diligence on the numerous hedge fund managers in the international arena. While nobody likes to pay an additional layer of fees, it probably is more justified to take a “fund-of-funds” approach in international than domestic alternative investments.

The important concept, however, is that adequate exposure to international investing is necessary under both modern portfolio theory and post-MPT. The question is, how much and how shall it be provided. As in domestic investing, international alternative investing—if successfully implemented—can improve returns and reduce the volatility of an investor’s international asset allocation.

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Endnotes

3. Ibid.: 232.
4. Ibid.: 225.