

Go Big or Go Home: The Case for an Evolution in Risk Taking

June 2012

Hewitt EnnisKnupp, An Aon Company
© 2012 – Aon Corporation

The Case for an Evolution in Risk Taking

Key Points

- Alternative investments—private equity, real estate and hedge funds—have natural advantages in risk and return over traditional stock and bond investments
- A large allocation to alternatives relative to current institutional practice is needed for a material contribution an institutional investor's bottom line
- Clients should consider whether moving toward an Efficiency portfolio with an emphasis on low-cost passive management, or an Opportunity portfolio with heavy reliance on value added through active management—especially alternative investments—is most appropriate for them
- **Clients who can tolerate the cost, complexity and illiquidity should consider Opportunity-type allocations of 40% of their return-seeking assets to private equity, non-core real estate, and hedge funds**
- Success with traditional active investments is best found through conviction—rejection of “closet indexing” in its various forms

Introduction

Institutional investors have seen what their portfolios have delivered over the past decade and been left wanting more. Global equity markets have produced disappointing returns with wild swings of volatility. Active management has had a mixed record. Looking forward, capital market expectations warn of a challenging environment for meeting portfolio objectives, while expectations of risk and uncertainty remain high. Many investors express concern with the concentration of portfolio risk they have in the public equity markets.

In this paper, we make the case for a shift in risk-taking from traditional assets to “alternative” investments—private equity, real estate, hedge funds, and strategies that blur the line between the three principal categories. We discuss a framework for considering total fund investment policy that ranges from cost-effective simplicity to active opportunity-seeking, and argue that investors should begin to move toward one model or another. We discuss the future of traditional active investment management, and provide some thoughts on how best to succeed in the traditional world we currently inhabit.

The Case for Alternative Investments

It may be time for a different name for “alternative” investments. The private equity industry, representing a \$1.4 trillion global asset class, accounted at its peak for a quarter of global mergers and acquisitions activity, half of leveraged loan volume, a third of the high yield bond market, and a third of the initial public offering (IPO) market.¹ Hedge funds weigh in at \$2 trillion, having moved beyond an investment for wealthy individuals and university endowments only into a mainstream asset category for pensions and other institutional investors. Estimates of global investable private real estate run as high as \$26 trillion, considerably larger than the capitalization of the U.S. stock market.² Alternatives have become mainstream.

By most estimates, including ours, private equity investments offer the highest expected returns of any broad asset class. Investors who need growth in their portfolios have the potential to achieve it here. Private equity is the one broad asset class that offers a return above the 8% rate of return many public funds are actuarially projected to earn on their total funds. The higher-risk, higher expected return value added and opportunistic segments of real estate offer similar rewards for the most successful investors.

Hedge funds, on the other hand, typically do not offer returns in aggregate that compete with equity investments, owing to their general lack of persistent market exposures and lower volatility. However, they inhabit a space between stocks and bonds, with hedge fund managers who can generate consistent alpha offering high *risk-adjusted* returns relative to market alternatives.

Alternatives are characterized by underlying drivers of performance that, in some cases, offer diversification benefits without the corresponding reduction in long-term expected returns of fixed income. Alternatives are risky, or return-driven, assets, but allocations to them can reduce risk. They are driven by different factors than stocks and bonds.

Alternatives are part of a complete set of diversified market exposures. Public equity offers growth through participation in the public ownership of established companies, but private equity diversifies across the spectrum of ownership and maturity of businesses. Real estate returns are driven by supply and demand in the real estate market, not solely by economic growth and interest rate factors that drive stocks and bonds. Hedge funds offer access to “exotic beta” market factors like the value premium, currency, and volatility that are not readily available (or not conveniently packaged) in traditional markets.

The Case for Alternatives as *Superior* Investments

Investors have increasingly embraced the concept of *breadth* in investment strategies over the past decade. Alternative investments can offer the ultimate in breadth in the sense that hedge fund strategies are free of many traditional constraints; and certain alternative investments may cross lines between asset classes, or not adhere to them at all. In addition, some alternative investment areas may be characterized by greater market inefficiency than public markets, potentially giving a tailwind to active management. How has traditional active management stacked up to alternatives?

¹ Market share data from Jensen [2007], citing Morgan Stanley.

² See Pramerica [2012]

Average Performance

For a decade, Standard and Poor's has maintained the S&P Indices Versus Active Funds (SPIVA) Scorecard, which provides an analysis of traditional active manager performance after adjusting for common database issues, including the survivorship bias that typically inflates returns.³ The most recent five-year results are shown in Exhibit 1. As in past studies, the average active manager underperformed a style-specific benchmark in most investment categories. (Global equity, which benefits from maximum breadth of active equity strategies, is the value-added outlier.) Traditional active managers in aggregate have consistently failed to add value.

Exhibit 1

Traditional Fund Category	5-Year Value Added As of December 2011
U.S. Large Cap Equity	-0.10%
U.S. Mid Cap Equity	-1.79
U.S. Small Cap Equity	-1.30
U.S. All Cap Equity	-0.62
Non-U.S. Equity	-1.23
Global Equity	+0.30
Investment Grade Intermediate Fixed Income	-0.61

Source: Standard & Poor's S&P Indices Versus Active Funds (SPIVA) Scorecard Year-End 2011

Research continues on the historical *average* performance of the private equity asset class relative to the public market alternative. Conventional wisdom is that the median private equity manager produces a return similar to or below that of the market, after fees, while successful and unsuccessful managers' returns are dispersed widely around the midpoint.

More recent evidence from the business schools of Virginia, Oxford and Chicago—conventional wisdom notwithstanding—suggests that buyout managers have outperformed over the long term by 3% per year *on average*, with mixed average performance over time from venture capital.⁴ Another study found outperformance of the public equity markets for a large, broad sample of private equity funds over the period 1984-2010.⁵ In the area of hedge funds, an analysis of performance from a major database, after adjusting for survivorship, back-fill and other biases, finds a statistically significant positive alpha.⁶

³ Survivorship bias is introduced when databases include only the returns of investment product that are still in existence. Because poor-performing funds are more likely to be closed down or merged into other funds, including only "survivors" tends to bias average performance upward in typical databases. The SPIVA data corrects for survivorship bias by including the returns of closed and merged funds.

⁴ See Harris, Jenkinson and Kaplan [2012].

⁵ See Robinson and Sensoy [2011]

⁶ See Ibbotson, Chen and Zhu [2011]

Performance Persistence

Performance persistence refers to the extent to which past outperforming funds continue to do so in the future. While it is well understood that past performance is an imperfect guide to the future, and manager selection decisions should be made based on a variety of factors, evidence of persistence in performance suggests continuing rewards to skill.

There is a rich collection of literature on performance persistence in the mutual fund industry, with mixed results but little strong evidence of strong-performing funds continuing to do so in the future.⁷ A recent study finds little to no evidence of performance persistence in active domestic equity funds (as well as no evidence of aggregate or average alpha).⁸ What evidence there is of persistence often arises from consistent *poor* performers, who languish in the bottom of peer groups as a result of high fees or insufficient skill at identifying superior investments to overcome trading costs.

Within alternatives, the story may be different. Anecdotal evidence suggests that superior private equity managers continue to be superior in the future. An analysis of a robust set of Venture Economics data finds strong persistence of performance across private equity funds consecutively raised by the same firm.⁹

Among hedge funds, Jagannathan [2010] finds significant performance persistence among superior funds.¹⁰ And a broad study of private real estate performance finds strong evidence of a relation between fund performance and that of the manager's previous funds, as with private equity.¹¹

The Impact of Management Fees

In traditional asset classes, it's well understood that fees have a negative impact on net performance earned by the investor. Index fund management giant Vanguard finds a negative relationship between fees and net-of-fee returns in each of nine sub-classes of U.S. equity mutual funds, and five sub-classes of fixed income mutual funds, over a ten year period ending December 31, 2010.¹²

The relationship between fees and performance may not, however, be a completely straightforward one. Recent research suggests that the most active traditional managers—that is, those who take the largest active positions relative to the benchmark and avoid “closet indexing”—tend to charge higher fees, but also generate higher net-of-fee performance.^{13,14}

In alternatives, there is evidence that the relationship is not so clear. Highly successful individuals in alternative investment management can earn very large compensation packages; this compensation tends to attract gifted and skilled people who would otherwise likely pursue other high-status professions, including traditional money management. A study of mutual fund and hedge fund employment and

⁷ See Allen, Brailsford, Bird and Faff [2003] for a good summary of the performance persistence literature.

⁸ See Busse, Goyal and Wahal [2010]

⁹ See Kaplan and Schoar [2005]

¹⁰ See Jagannathan, Malakhov and Novikov [2010]

¹¹ See Tomperi [2010]

¹² See Vanguard [2011]

¹³ “Closet indexing” refers to paying active management fees for index fund-like (before-fee) performance.

¹⁴ See Cremers, Ferreira, Matos and Starks [2011]

compensation practices finds evidence of highly successful mutual fund managers being offered side-by-side hedge fund management arrangements by their employers as a retention strategy.¹⁵

Recent research indicates that private equity managers earn at least their management fees back in returns.¹⁶ High alternatives compensation is driven by high fees, in particular a combination of a base fee and an incentive fee that can be very large when performance goals are met. Empirical evidence suggests that there is no, or even a positive, relationship between fees paid to private equity and hedge fund managers, and net of fee performance. The incentive compensation element of alternatives fee schedules appears to have a positive effect on performance, more so than actual fee levels. Agarwal [2009] finds that funds with greater managerial incentives have superior future performance.¹⁷

This is not to say that high fees do not detract from returns—a dollar of fees paid is a dollar out of the investor’s pocket. But in an area of the market in which high active fees are the price of admission, evidence suggests that the fees are at least earned.

Management Discretion and Flexibility

Likewise, management discretion plays a role in superior performance. Lockups of capital allow managers to pursue longer-term investment strategies without disruptive withdrawals. Agarwal [2009] also finds that management discretion (longer lockup, notice and redemption periods) is related to superior hedge fund performance.¹⁸

Alternative strategies are far less benchmark-bound than traditional investments. This is illustrated in dispersion among traditional and alternative active manager returns. Exhibit 2 shows the long-term spread between top- and bottom-quartile managers in traditional and alternative asset classes, re-centered around zero to focus on dispersion rather than average returns.

¹⁵ See Deuskar, Pollet, Wang and Zheng [2011]. The authors do not find evidence of the mutual fund industry losing their best performers to hedge funds. However, the strongest talent may join the hedge fund industry directly.

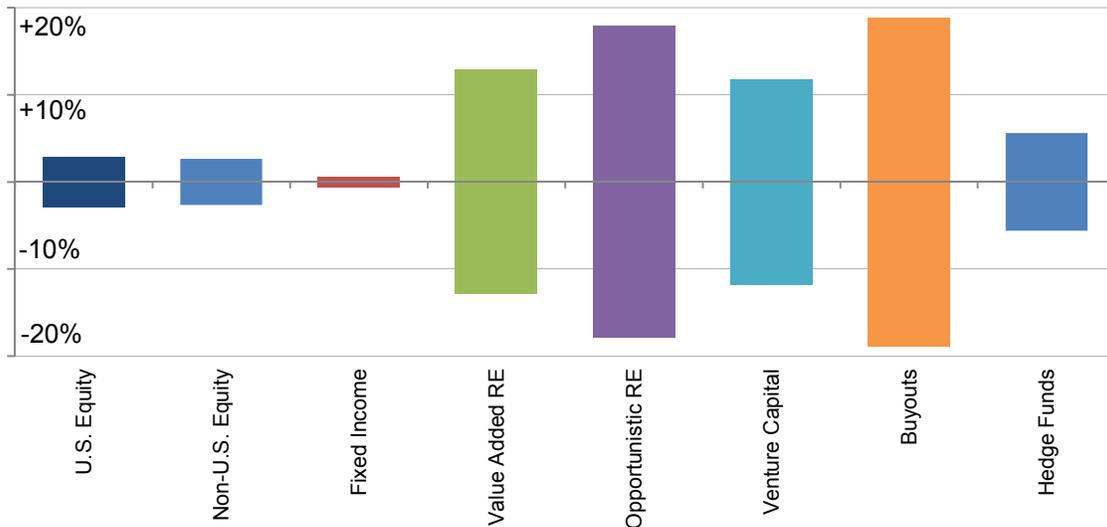
¹⁶ See Robinson and Sensoy [2012]

¹⁷ See Agarwal, Daniel and Naik [2009]

¹⁸ See Agarwal, Daniel and Naik [2009]

Exhibit 2

10-Year Manager Performance Dispersion



Source: eVestment Alliance, Thomson Reuters, NCREIF, The Townsend Group, Hedge Fund Research, Inc. Data as of September 30, 2011, except hedge fund data which is through March 31, 2012

While adept manager selection is critically important in traditional investments as well, typically the rewards of success and costs of failure are small relative to those experienced in alternatives. When finite resources (staff, Investment Committee and Board time) must be applied to overseeing investments—and manager selection and oversight is only one of many competing priorities—there is a clear advantage to focusing those resources on an area where the impact is greater. When seeking success beyond the average, shouldn't you look the hardest where your efforts make the most difference?

Asset Class Roles

Lastly, the market exposures of alternative investments are available only through actively managed vehicles. Active risk is inseparable from the asset class. Conversely, active management in traditional asset classes, especially low-risk fixed income, can muddy the role of the asset class, such as “growth” or “safety”. When examining asset allocation through a functional lens, the role of equity assets in the portfolio is to generate growth over time to achieve objectives and reduce costs; the role of fixed income is to reduce volatility and/or downside risk. (And flexible, value-added strategies might be part of a separate “active” or “skill” allocation’.) Particularly in fixed income, active management that strays far from the benchmark may introduce unnecessary risks for an investor who allocates assets by their role in the program.

The Case for High Conviction

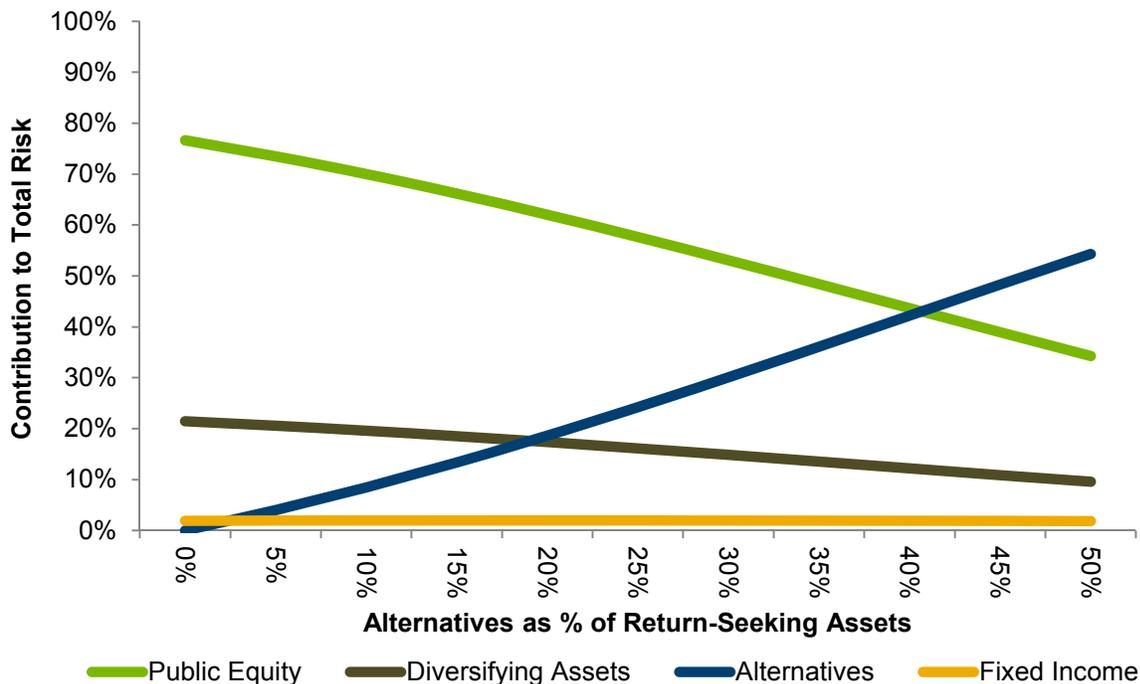
Alternative investments contribute meaningfully to the fund’s bottom line (risk and return) only when they are a significant portion of the fund—demonstrating the investor’s high *conviction* in them and their role in the total portfolio.

Many would like to reduce their total fund’s risk concentration in equity. Our recent research makes the case that risk concentration is acceptable in the long run when it is sufficiently compensated.¹⁹ But reduction in concentration is desirable if it can be done without reduction in expected return. Some alternative investments fit the bill, but only in sufficient amounts.

Exhibit 3 shows contribution to risk (total fund volatility) using our ten-year capital market expectations, for an investor with a 70% allocation to return-seeking assets. Return-seeking assets consist of global public equity, diversifying assets (high yield bonds, bank loans, emerging market debt, commodities and core real estate), and alternative investments (private equity, hedge funds, and non-core real estate).²⁰

Equity risk dominates fixed income in all cases; only when alternatives are about 40% of return-seeking assets do they equal the contribution to results of public equity.

Exhibit 3



¹⁹ See Sebastian [2012]

²⁰ The diversifying and alternative asset classes are diversified within their subcomponents based on our view of efficient portfolio construction.

The costs of alternative investing, on the other hand, have fixed elements that cause small allocations to be nearly as consuming of resources as large ones. Most importantly, we refer to the time that Boards and staff spend overseeing alternative programs, but some hard dollar costs such as consulting and legal fees are relatively insensitive to allocation size as well. Investors with alternatives allocations that crowd out consideration of other investment policy and management initiatives while not contributing much to the bottom line should consider increasing them to a meaningful level, or eliminating them.

In the course of investment policy setting, investors should consider the characteristics that drive portfolio choice. These are described in Exhibit 4.

Exhibit 4

Governance	<ul style="list-style-type: none">▪ Oversight resources▪ Speed of action▪ (Freedom from) scrutiny
Time Horizon	<ul style="list-style-type: none">▪ Life span▪ Net cash flow position▪ Ability to access less liquid opportunities▪ Ability to capture liquidity premium
Portfolio Size	<ul style="list-style-type: none">▪ Ability to diversify▪ Market impact▪ Potential for closet indexing

These characteristics, and the investor's preferences, help determine where a fund might lie on a spectrum of investment complexity. Funds with more robust and nimble governance, longer time horizons and greater portfolio size have greater room for more complex, opportunistic portfolios. We describe the low and high end of complexity as follows:

- An *Efficiency* portfolio is characterized by simplicity, with a focus on achieving market returns at minimum cost. These portfolios will have little or no allocation to alternatives and heavy use of indexing in traditional asset classes.
- An *Opportunity* portfolio is characterized by a heavy reliance on skill over market returns, with increased cost and complexity an accepted part of seeking above-market returns. These portfolios will have large allocations to alternatives, and may or may not choose to take substantial additional active risk in traditional areas.

We suggest that investors take stock of their circumstances to see whether Efficiency or Opportunity better represents a desirable direction for their fund. Those choosing Opportunity might consider ramping up alternatives allocations. Those choosing Efficiency might retain or move toward investment structures with reduced cost.

How much is the right allocation to alternatives for those who are willing to tolerate risk and complexity? We suggest that clients who wish to pursue an Opportunity-type portfolio consider allocations of *40% of return-seeking assets to alternative investments including private equity, hedge funds and non-core real estate*—or approximately 30% of total assets at a 75% return-seeking asset allocation.²¹ These investors must be willing to accept significantly higher fees and costs, need for oversight resources, program complexity, illiquidity and other issues, in return for the opportunity to seek the most value added and highest long-term returns through perhaps the most efficient way of allocating risk.

Risks

Let us briefly review risks in alternative investments. Investors must have “skill at finding skill” among managers, or access to it through their advisors, to succeed with alternatives. While some evidence indicates that alternatives managers add value on average, as shown earlier, wide dispersion in results means that *manager selection* is of critical importance. Results differ not only among investments but among investors; research has shown significant dispersion among institutional investor types in terms of their performance in the private equity asset class; endowments have realized substantially higher returns than public and corporate pension funds in private equity, pointing to a need for industry improvement in manager selection procedures among pensions.²² Average or median results in alternatives will likely produce disappointment at best.

Outside of the endowment community, modest allocations to alternatives are still the norm. Corporate and public plan sponsors who “go big” in these asset classes must be prepared to *differ from peer practices* in a visible way. Given the inherent risks of many of these investments, short-term volatility may have a particularly notable effect on peer rankings.

The *costs* of alternative investing are a multiple of those experienced in traditional investments. Lastly, alternatives are as a rule *less liquid* than traditional investments and investors may be along for the ride for ten years or more.

The Future of Traditional Active Investing

Over time, we believe that institutional investors will allocate an increasingly large portion of their overall risk budgets to alternative asset classes, at the expense of public equity and fixed income, and especially traditional active management. More traditional mandates will be filled with passively managed alternatives, and publicly traded active management mandates will decline as managers shift, where their skill set allows, to less constrained and less traditional investments—what are called “alternatives” now. Traditional active investment will not disappear soon, but we believe that *passive* and *alternative* asset management will take its place as the most popular methods of implementing an investment policy.

²¹ We view core real estate as a diversifying asset rather than an alternative investment in the vein of private equity and hedge funds.

²² See Lerner, Schoar and Wongsunwai [2007]

Succeeding With the Traditional

How can investors maximize their probability of success with the *traditional* investments that most likely currently make up the majority of their portfolios? We believe that the same conviction that drives substantially increased commitment to alternatives—and that drives results within the best of the alternative investments themselves—can increase success with the traditional.

The structural enemy of active management success is closet indexing. The remedy is to act with conviction in active investments. Resist “enhanced indexing” mandates and the dilution of active bets across too many overlapping active portfolios. Seek out concentrated portfolios of managers’ best ideas, combined with indexing as needed for active risk control and liquidity. Holdings in which active managers indicate the most conviction (their “best ideas”) have been shown to produce greater performance—but many managers hold deadweight positions just to minimize risk relative to the benchmark.²³

Use performance-based fees when the terms are attractive, to promote an alignment of interests with the manager. Seek out investments where the manager invests alongside you. Evidence suggests that funds in which managers invest their personal wealth have superior risk-adjusted performance.²⁴

Lastly, consider going big, or going home, with traditional active management. Reflect on your answer to the question: Why do you use traditional active management at all if you don’t believe in it enough to use it for all of your stock and bond assets?

²³ See Cohen, Polk and Silli [2010]

²⁴ See Khorana, Servaes and Wedge [2007]

References

Agarwal, V., Daniel, N. D. and Naik, N. Y. (2009), Role of Managerial Incentives and Discretion in Hedge Fund Performance. *The Journal of Finance*, 64: 2221–2256. doi: 10.1111/j.1540-6261.2009.01499.x

Allen, D., T. Brailsford, R. Bird, and R. Faff. 2003. A Review of the Research on the Past Performance of Managed Funds. ASIC REP 22, Australian Securities and Investment Commission.

Busse, Jeffrey A., Goyal, Amit and Wahal, Sunil, Performance Persistence in Institutional Investment Management (July 2006). EFA 2006 Zurich Meetings Paper. Available at SSRN: <http://ssrn.com/abstract=890319> or <http://dx.doi.org/10.2139/ssrn.890319>

Cohen, Randolph B., Polk, Christopher K. and Silli, Bernhard, Best Ideas (March 15, 2010). Available at SSRN: <http://ssrn.com/abstract=1364827> or <http://dx.doi.org/10.2139/ssrn.1364827>

Cremers, Martijn, Ferreira, Miguel A., Matos, Pedro P. and Starks, Laura T., The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance (December 15, 2011). Available at SSRN: <http://ssrn.com/abstract=1830207> or <http://dx.doi.org/10.2139/ssrn.1830207>

Harris, Robert S., Jenkinson, Tim and Kaplan, Steven N., Private Equity Performance: What Do We Know? (February 10, 2012). Fama-Miller Working Paper; Chicago Booth Research Paper No. 11-44; Darden Business School Working Paper No. 1932316. Available at SSRN: <http://ssrn.com/abstract=1932316> or <http://dx.doi.org/10.2139/ssrn.1932316>

Ibbotson, Roger G., Peng Chen, and Kevin X. Zhu. "The ABCs of Hedge Funds: Alphas, Betas, and Costs." *Financial Analysts Journal*. 67.1 (2011): 15-25.

Jagannathan, R., Malakhov, A. and Novikov, D. (2010), Do Hot Hands Exist among Hedge Fund Managers? An Empirical Evaluation. *The Journal of Finance*, 65: 217–255. doi: 10.1111/j.1540-6261.2009.01528.x

Jensen, Michael C., The Economic Case for Private Equity (and Some Concerns) (November 27, 2007). Harvard NOM Working Paper No. 07-02; Swedish Institute for Financial Research Conference on The Economics of the Private Equity Market. Available at SSRN: <http://ssrn.com/abstract=963530> or <http://dx.doi.org/10.2139/ssrn.963530>

Kaplan, Steven N., and Antoinette Schoar. "Private Equity Performance: Returns, Persistence and Capital Flows." *Journal of Finance*. 60.4 (2005): 1791-1823. Print. <http://www.mit.edu/~aschoar/KaplanSchoar2005.pdf>

Ajay Khorana, Henri Servaes, Lei Wedge, Portfolio manager ownership and fund performance, Journal of Financial Economics, Volume 85, Issue 1, July 2007, Pages 179-204, ISSN 0304-405X, 10.1016/j.jfineco.2006.08.001.

(<http://www.sciencedirect.com/science/article/pii/S0304405X07000530>)

Phalippou, Ludovic, A Comment on Recent Evidence on Private Equity Performance (March 1, 2012).

Available at SSRN: <http://ssrn.com/abstract=1969101> or <http://dx.doi.org/10.2139/ssrn.1969101>

Pramerica Real Estate Investors, A Bird's Eye View of Global Real Estate Markets: 2012 Update, February 2012

Robinson, David T. and Sensoy, Berk A., Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance (March 14, 2012). AFA 2012 Chicago Meetings Paper; Charles A. Dice Center Working Paper No. 2011-14; Fisher College of Business Working Paper No. 2011-03-014. Available at SSRN: <http://ssrn.com/abstract=1890777> or <http://dx.doi.org/10.2139/ssrn.1890777>

Lerner, J., Schoar, A. and Wongsunwai, W. (2007), Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle. The Journal of Finance, 62: 731–764. doi: 10.1111/j.1540-6261.2007.01222.x

Sebastian, Mike, Risk Parity and the Limits of Leverage, Hewitt EnnisKnupp, 2012

Tomperi, Ilkka, (2010), "Performance of private equity real estate funds", Journal of European Real Estate Research, Vol. 3 Iss: 2 pp. 96 - 116

Vanguard Research, The Case for Indexing, February 2011

Contact Information:

Mike Sebastian

Partner

Investment Solutions

+1.312.715.3352

mike.sebastian@aonhewitt.com



An Aon Company

About Hewitt EnnisKnupp

Hewitt EnnisKnupp, Inc., an Aon company, provides investment consulting services to over 500 clients in the U.S. and abroad with total client assets of over \$2 trillion. Our more than 200 investment consulting professionals – a result of the merger of Hewitt Investment Group, Ennis, Knupp & Associates, and Aon Investment Consulting – advise endowment, foundation, not-for-profit, corporate and public pension plan clients ranging in size from \$3 million to over \$740 billion. For more information, please visit www.aonhewitt.com