Cantab
ASSET MANAGEMENT

Looking at Alternative Asset Classes for Institutions

In recent years, some investment commentators have once again begun to advocate large allocations to alternative assets such as private equity and hedge funds. This article from Cantab Asset Management will seek to compare these asset classes with more traditional sectors.

Hedge Funds

Although a wide range of strategies fall under the 'hedge fund' category, there are some features which are generally present for this structure. Hedge funds are typically marketed as a means of hedging a portfolio against possible market falls. They tend to be benchmarked against a level of absolute return and strive to deliver this return in all market conditions. This can involve the use of a variety of trading methods, including the use of derivatives and the short selling of securities. Theoretically, the use of this asset class is attractive as it can provide downside protection, insulating a portfolio during a market correction or bear market without sacrificing upside returns. Many strategies claim to exhibit low or negative correlation to other asset classes. However, in practice, there are several drawbacks. The most obvious perhaps is the cost; these funds typically adopt a '2 and 20' charging structure (charging 2% of assets plus 20% of gains each year). They are usually opaque, with little transparency around underlying holdings and trading methods, making it hard for investors to truly understand the risks of their investment. They are often illiquid, offering withdrawals only once a quarter or sometimes less frequently. The most significant issue though, we believe, is that these strategies are often a poor hedge. As seen in the Global Financial Crisis, hedge funds do not always provide protection during a general market downturn. For these reasons, Cantab does not normally recommend them to clients.

Private Equity

Private equity partnerships usually invest in private companies, providing funding for management buy-outs and buy-ins. This asset class has the potential to provide strong upside potential to investors as they have access to high growth companies which are unconstrained by the demands associated with public markets. However, we do not generally recommend private equity investments to our clients. Like hedge funds, these investments are typically highly illiquid. Capital is tied up in private businesses which are not easily saleable, particularly in a market downturn. The nature of private equity investments also means that an investor commits a certain amount to the vehicle, with calls for the cash over a period of time. In the intervening period, the committed but uncalled money will likely be invested elsewhere. During a market downturn, private equity investors will suffer because calls can be made when it is difficult for those other investments to be liquidated. Aside from these issues, we have found that the long-term returns of widely available private equity vehicles have lagged those of the strategies investing in listed smaller companies. For clients with the appetite and capacity to bear the volatility and risk of capital loss associated with investing in early stage companies, we are more comfortable investing in listed companies.

Adding Value

Historically, one argument for including these types of investments in a client portfolio would be the difficulty in adding value with active management. However, we believe that in most regions and over most parts of the cycle, it is possible

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to find active managers consistently outperforming their benchmarks. Combining manager selection with a sensible long-term asset allocation has delivered strong alpha for our clients. We do not believe that it is generally necessary to look to these more esoteric asset classes to deliver good results. In particular, we are uncomfortable with illiquid vehicles which lack transparency and charge significant fees. We recognise that our stance may mean missing out on some strategies which deliver good results, but we believe that this is a price worth paying to avoid a 'black box' strategy with the potential to be highly damaging to clients.

If you would like to discuss how Cantab Asset Management can help your institution manage its investments, contact our Team on 020 3651 0570 (London) or 01223 52 2000 (Cambridge), or for more information email advice@cantabam.com.

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