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

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Institutional investors have seen what their portfolios have delivered over the past decade and have 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 that they have in the public equity markets.

In this article, 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 developing 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—an evolutionary process. We discuss the future of traditional active investment management and how it is likely to look a lot like today’s alternative investing.

THE CASE FOR ALTERNATIVE INVESTMENTS

It may be time for a different name for “alternative” investments. Exhibit 1 indicates the explosive growth in alternative assets since 1990 for real estate and hedge funds, and since 2000 for hedge funds (the longest periods for which data were available). The private equity industry, representing a $3.2 trillion global asset class as of 2012, 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. Hedge funds weigh in at over $2 trillion, having moved beyond an investment only for wealthy individuals and university endowments into a standard asset category for pensions and other institutional investors. Estimates of global investable private real estate run as high as nearly $27 trillion, considerably larger than the capitalization of the U.S. stock market. Alternatives have become mainstream.

By many estimates, 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 that many public funds are actuarially expected to earn on their total funds. The higher-risk/higher-expected-return and opportunistic segments of real estate offer similar rewards for the most successful investors.

Hedge funds, for their part, typically do not offer returns in aggregate that compete...
with equity investments, owing to their general lack of persistent market exposures and lower volatility. They inhabit a space between stocks and bonds, however, 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 are 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, such as restrictions on short sales and monitoring for portfolio adherence to the style of a specific benchmark; and certain alternative investments may cross lines between asset classes, or not be limited by 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?

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. The most recent five-year results are shown in Exhibit 2. As in past studies, the average active manager underperformed a style-specific benchmark in most investment categories. (Fixed income was the value-added outlier.) Traditional active managers in aggregate have consistently failed to add value.

Research continues on the historical average performance of the private equity asset class relative to the

<table>
<thead>
<tr>
<th>EXHIBIT 1</th>
<th>Growth in Alternative Assets, 1990–2012 ($ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>Hedge Funds</td>
</tr>
<tr>
<td>1990</td>
<td>39</td>
</tr>
<tr>
<td>1991</td>
<td>58</td>
</tr>
<tr>
<td>1992</td>
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<td>2002</td>
<td>626</td>
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<tr>
<td>2003</td>
<td>820</td>
</tr>
<tr>
<td>2004</td>
<td>973</td>
</tr>
<tr>
<td>2005</td>
<td>1,105</td>
</tr>
<tr>
<td>2006</td>
<td>1,465</td>
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<td>2007</td>
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<td>2008</td>
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<td>1,600</td>
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<tr>
<td>2010</td>
<td>1,917</td>
</tr>
<tr>
<td>2011</td>
<td>2,008</td>
</tr>
<tr>
<td>2012</td>
<td>2,252</td>
</tr>
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</table>

E X H I B I T  2  
Traditional Active Management Value Added (Ending December 2012)

<table>
<thead>
<tr>
<th>Traditional Fund Category</th>
<th>Five-Year Value Added</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Large Cap Equity</td>
<td>-0.80%</td>
</tr>
<tr>
<td>U.S. Mid Cap Equity</td>
<td>-2.79</td>
</tr>
<tr>
<td>U.S. Small Cap Equity</td>
<td>-2.17</td>
</tr>
<tr>
<td>U.S. All Cap Equity</td>
<td>-1.22</td>
</tr>
<tr>
<td>Non-U.S. Equity</td>
<td>-0.84</td>
</tr>
<tr>
<td>Emerging Markets Equity</td>
<td>-1.90</td>
</tr>
<tr>
<td>Global Equity</td>
<td>-0.24</td>
</tr>
<tr>
<td>Investment Grade Intermediate Fixed Income</td>
<td>+1.56</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s S&P Indices versus Active Funds (SPIVA) Scorecard, Year-End 2012.
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% a year on average, with mixed average performance over time from venture capital. Another study found that the average tailored public market equivalent (PME)—the ratio of distributions to calls, discounted by the return of the NASDAQ index (for venture funds) and a stock index customized by firm size (for buyout funds)—for a large, broad sample of private equity funds over the 1984–2010 period was 108% for venture funds and 109% for buyout funds, respectively, indicating outperformance of the public stock market after adjusting for risk. In the area of hedge funds, an analysis of performance of 8,421 funds from the TASS database over the January 1995–December 2009 period, after adjusting for survivorship, back-fill, and stale pricing, finds a statistically significant alpha of 3.01% a year relative to large-capitalization U.S. stocks, intermediate U.S. government bonds, and cash.

Performance Persistence

Performance persistence refers to the extent to which past outperforming funds continue to do so in the future. Although 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 good-performing funds continuing to do so in the long-term future. An excellent 2003 summary by Allen et al. (2003) of performance persistence research using data collectively spanning the period from 1945 to 1994 reported that 8 of 27 studies found unqualified evidence of persistence, 9 failed to find such evidence, and 10 reported mixed results (such as varying degrees of persistence effect over time or persistence only in the short term). More recently, Busse et al. (2010) examined a sample of 4,617 active domestic equity institutional products over the 1991–2008 period and found minimal evidence of performance persistence after correcting for momentum (as well as no evidence of aggregate or average alpha). What evidence there is of persistence often arises from consistent poor performers, who languish at the bottom of peer groups as a result of high fees or insufficient skill at identifying superior investments to overcome trading costs. Huij and Landsdorp (2012), for example, found evidence in a sample of 252 U.S. dollar–denominated mutual funds from 1990 to 2010 that recent “loser” funds (lowest quintile of performance) persistently underperform; recent winner funds show better future performance but not significantly above that of the benchmark. Pointing to a possible missing piece of the puzzle of active management success, however, the Huij and Landsdorp study examined performance across markets and found a relationship between breadth—as measured by cross-sectional dispersion of fund returns, average fund tracking error, and the “diversification effect” of adding a new fund to a portfolio—and performance persistence. That is, the broader the opportunity set, and the more active the managers, the more strongly skill may be rewarded. That suggests that more fertile ground for performance persistence may be found among more flexible, less benchmark-bound strategy types.

Within alternatives investments, indeed, the persistence story may be different. Anecdotal evidence observed by private equity investors and advisors suggests that superior private equity managers continue to be superior in the future. As an example of empirical evidence, Kaplan and Schoar (2005), in an analysis of Venture Economics data from 1980 to 2001, found strong persistence of performance across private equity funds consecutively raised by the same firm. In the case of hedge funds, Jagannathan et al. (2010) found significant performance persistence over three-year periods among superior funds (and little among inferior funds) after adjusting for exposure to market factors, in a study of 1,755 funds from the HFR database from May 1996 to April 2005. And a broad study of returns from the Prequin database on 896 private real estate funds raised in the 1980–2009 period found positive and highly significant correlations between IRRs of current funds and those of predecessor funds, as with the private equity research.
The Impact of Management Fees

In traditional asset classes, it is well understood that fees have a negative impact on net performance earned by the investor. Index fund management giant Vanguard found a negative relationship between fees and net-of-fee returns in each of nine subclasses of U.S. equity mutual funds and five subclasses of fixed income mutual funds, over a 10-year period ending December 31, 2010. 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” (index fund-like results with active management costs) tend to charge higher fees, but also generate higher net-of-fee performance.

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

Recent research indicates that private equity managers earn at least their management fees back in returns. 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 et al. [2009], in a study of the CISDM, HFR, MSCI, and TASS hedge fund databases from January 1994 to December 2002, found that funds with greater managerial incentives—measured by sensitivity of compensation to performance as defined by the investment management fee schedule, greater managerial ownership (and thus, participation of portfolio managers in the fund’s financial results), and the presence of high-water mark fee provisions, which restrict performance fees unless past losses are recouped—have superior future performance.

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 et al. [2009] also found that management discretion (longer lockup, notice, and redemption periods) is related to superior hedge fund performance in the same aggregation of hedge fund databases mentioned earlier. Specifically, one standard deviation (about five months) increase in a lockup period is associated with a 90 bp, or about 7%, increase in average returns.

Alternative strategies are far less benchmark-bound than traditional investments. This is illustrated in dispersion among traditional and alternative active manager returns. Exhibit 3 shows the long-term spread between top- and bottom-quartile managers in traditional and alternative asset classes: U.S. all-cap public equity, non-U.S. diversified all-cap equity, core and core-plus (mostly investment-grade, intermediate-duration) fixed income, value-added real estate (investments involving some development/redevelopment and moderate leverage), opportunistic real estate (non-stabilized investments and higher leverage), venture capital (funding of newer business ventures), and buyouts (acquisitions of businesses or products involving significant debt financing.) Values are re-centered around zero to focus on dispersion rather than average returns.

Although 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 primarily through actively managed vehicles. Active risk is nearly inseparable from the asset class. Conversely, active management in traditional investments, 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. Relatively costly, potentially underperforming active management can inhibit that growth. Likewise, for many investors, the role of fixed income is to reduce volatility and/or downside risk. Active management that strays far from the benchmark may introduce unnecessary risks for an investor who allocates assets by their role in the program, as many users of “core-plus” fixed-income products with significant out-of-benchmark allocations to high-yield, emerging market debt, and other return-seeking bond categories discovered in the turmoil of 2008. (Where might alternatives fit in a functional framework? Such flexible, value-added strategies might be part of a separate “active” or “skill” allocation.)

**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 investors would like to reduce their total fund’s risk concentration in equity. Recent research makes the case that risk concentration is acceptable in the long run when it is sufficiently compensated. But reduction in concentration is desirable if it can be done without reduction in expected return. Some alternative investments, such as private equity, value-added and opportunistic real estate, and those hedge fund investments that are designed to deliver equity-like returns through a combination of skill (alpha) and market exposures, fit the bill—but only in sufficient amounts.

Exhibit 4 shows contribution to risk (total fund volatility) using a publicly available set of 10-year capital market expectations, for an investor with a 70% allo-
categorization to return-seeking assets, at increasing levels of alternatives allocations from 0% to 50% of the total fund. Return-seeking assets consist of global public equity, diversifying assets (20% high-yield bonds and bank loans, 20% emerging market debt, 20% commodities, and 40% core real estate), and alternative investments (private equity, hedge funds, and non-core real estate). Contribution to total fund volatility is calculated by partitioning the weighted variance-covariance matrix at the total fund level into its components (simply summing up the relevant row for each asset class). 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.

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 5. 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 ends 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

![Exhibit 4](image-url)
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 investors who wish to pursue an Opportunity-type portfolio consider allocations of 40% of return-seeking assets (dollar allocation) 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. 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.

An Opportunity portfolio structure would be a very significant change for many institutional investors. Rather than hold back any improvement in efficiency to be gained from a greater allocation of risk to alternatives, incremental steps in this direction, as the investor gains comfort, are a superior choice to inaction. We call for an evolution in risk taking, not necessarily a revolution.

**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. Although 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. 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

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**Exhibit 5**
**Investor Characteristics and Portfolio Choice**

<table>
<thead>
<tr>
<th>Investor Characteristics</th>
<th>Considerations for Alternative Investment Allocations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>• Investors with greater oversight resources and governance structures that allow them to act quickly on opportunities may be suited for larger alternatives allocations</td>
</tr>
<tr>
<td></td>
<td>• Investors with longer effective time horizons may be suited for larger alternatives allocations, especially less liquid asset classes such as private equity and non-core real estate</td>
</tr>
<tr>
<td>Time Horizon</td>
<td>• Larger investors may be suited for larger alternatives allocations</td>
</tr>
<tr>
<td>Portfolio Size</td>
<td>• Ability to diversify</td>
</tr>
<tr>
<td></td>
<td>• Market impact</td>
</tr>
<tr>
<td></td>
<td>• Potential for closet indexing</td>
</tr>
</tbody>
</table>

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*Exhibit 5 continues on the next page.*
visible way. Given the inherent risks of many of these investments, short-term volatility may have a particular-ly notable effect on peer rankings. (And high disper-sion among manager results means that investors who are unsuccessful in identifying skill risk underperformance over the long term as well.)

The costs of alternative investing are a multiple of those experienced in traditional investments. Last, alternatives are, as a rule, less liquid than traditional investments, and investors may be along for the ride for 10 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, 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. Muhtaseb [2012] discussed several ways in which this is already happening, as mutual fund and exchange-traded fund (ETF) managers increasingly use leverage, short sales, relative value strategies, and other hedge fund techniques to capture opportunities and meet retail investor demand for alternative strategies.

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.

CONCLUSION

Institutional investors are surveying the landscape of current traditional investment opportunities and finding that they need more return and less risk. In this article, we lay out the case for alternative investments—defined here as private equity, real estate, and hedge funds—relative to traditional actively managed stocks and bonds. These alternative categories have produced better results in terms of average performance and performance persistence than has traditional active management, driven, we argue, by their greater breadth and flexibility in terms of investment approach and management discretion and an incentive compensation structure that encourages superior performance. Investors who are willing and able to withstand greater complexity, cost, and illiquidity can maximize their opportunity with active management, and diversification of risk, by taking a substantial portion of their risk with alternative investments.

ENDNOTES

1Many investors consider commodities to be a fourth alternative asset category. Although commodities may play a useful role in many institutional portfolios as a diversifier, inflation hedge, and source of value added from skilled active managers, we do not classify them here as one of the primary alternative classes. Commodities’ liquidity (when accessed through futures) and availability as a passive investment mean that they have as many characteristics of a traditional diversifying asset (along the lines of high-yield bonds and emerging market debt) as a typically skill-dependent and less liquid alternative investment.

2Source of private equity market size data: Prequin (Prequin Fund Manager Profiles and Prequin Performance Analyst). 2012 market size data as of June 2012. All market size data combines “dry powder” and unrealized value. Private equity market share data from Jensen [2007], citing Morgan Stanley.


4Source of real estate market size data: Economist Intelligence Unit. International Monetary Fund, Prudential Real Estate Investors (PREI) research. See also Pramerica [2012].

5Survivorship bias is introduced when databases include only the returns of investment products that are still in existence. Because poor-performing funds are more likely to be closed down or merged into other funds, including only “sur-vivors” tends to bias average performance upward in typical databases. The SPIVA data correct for survivorship bias by including the returns of closed and merged funds.

6See Harris et al. [2012].

7See Robinson and Sensoy [2011].

8See Ibbotson et al. [2011].

9See Tomperi [2010].

10See Vanguard Research [2011].

11See Cremers et al. [2011].

12See Deuskar et al. [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.

13See Robinson and Sensoy [2013].

14See Agarwal et al. [2009].
An early discussion of a version of the functional approach can be found in Greer [1997].

See Sebastian [2012].

For the purposes of this analysis, the alternative asset class is diversified within its subcomponents (hedge funds, private equity, and non-core—value-added and opportunistic—real estate).

Core real estate may be considered a diversifying asset rather than an alternative investment in the vein of private equity and hedge funds.

See Lerner et al. [2007].

REFERENCES


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