Benefiting from alternatives

How and why to get the most from the exposure

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Aberdeen

Today, alternatives are an essential component of most high quality investment portfolios. They offer investors a better chance to meet their goals – be it by diversifying the drivers of growth, providing access to higher potential returns or by reducing portfolio volatility and protecting against tail risks. The range of funds, and the ways in which investors are using them to meet their own specific needs, is on the increase. While this greater opportunity set – and some of the complexities of alternative investments themselves – can present challenges, these are problems that are surmountable with the right support. Some investors have resources in-house, but with advisory, partnership and outsourced solutions available, every investor should be able to benefit from the advantages that alternatives can bring.

Why alternatives?

Alternative investments have become increasingly accessible to all types of investors. Established managers have institutionalised, new managers have sought to steal market share with innovative product design (including regulatory friendly structures); fees, in general, have come down. While these changes haven't eliminated all the complexity associated with allocating to alternatives, they have enabled investors to find an array of strategies that can meet their needs and they have allowed alternatives to become core allocations within investment portfolios.

Investors have been keen to make use of alternatives because of the value they can bring to an investment portfolio. Primarily this relates to the introduction of **alternative drivers of growth** – reducing reliance on the stock market and thereby giving investors more chance and greater confidence in generating the long-term growth that they need – be it to pay their pensioners, support their charity or save for their retirement. Some alternative investments - such as real assets – have return drivers that are more explicitly linked to inflation than the equity market is, helping portfolios to continue to generate real returns through periods of unexpectedly high inflation.

The nature of having different return drivers – or, in some cases by packaging them differently – can also enable some alternative investments to deliver **greater returns** (for example private equity). It can also enable alternative investments to **reduce the volatility** of a broader growth portfolio via a low correlation of returns with other asset classes.

Finally, a small subset of the alternatives universe explicitly aims to provide strong returns through periods of market turmoil. These strategies, including long volatility strategies and tail risk hedge funds, can be used as a potential "**tail risk hedge**" during extreme equity market draw downs and market crashes.

This range of benefits from alternatives underlines their appeal - it also highlights the range of ways that they can be used within an asset allocation to help focus in on an investor's specific risk and return objectives.

Different return drivers

Greater confidence in the long term growth potential

Potential for enhanced returns

Exploit higher returning opportunities

Reduce short-term noise

Lower volatility due to different pattern of returns

Protect against tail events

Live to fight another day

Types of alternative

What actually constitutes an alternative investment will vary from investor to investor. Increasingly the distinction between alternative and traditional asset classes is blurring as investors become more comfortable with, and use more, particular strategies. The classifications between alternatives are also changing, with investors increasingly focused on the risk factors underpinning an investment, rather than more generic asset class definitions. The table below provides a matrix of some commonly accepted alternatives, classified both by asset class and core risk-factor.

Figure 1 – Matrix of common alternatives

Factor Asset class	Credit/insurance	Corporate earnings	Illiquid opportunities/ value add	Real assets	Alpha Opportunities	Tail risk hedges
Exotic beta	EMD and High yield Trade Finance Catastrophe Risk			Commodities	Alternative risk premia Merger Arbitrage	Volatility
Hedge funds	Long-short credit Event driven credit	Long/short equity Event driven equity	Distressed debt	RMBS funds	Relative Value Global Macro Equity Market Neutral	Tail risk hedge funds
Private equity	Private debt Impact bonds	Listed private equity	Buy-out Growth Venture Capital	Farmland Timberland Mitigation banking		
Property	Real estate debt		Value-add property	Core property Real Estate Investment Trusts		
Infrastructure	Infrastructure debt			Core Infrastructure MLPs		

In essence, all the alternative strategies offer exposure to a different set of return drivers to those found in a traditional equity and bond portfolio. Even where strategies are based around corporate earnings, high quality managers can add value to a portfolio through providing enhanced returns and/or additional alpha.

Whether an asset class or risk factor framework works best for an investor will depend on their beliefs and investment arrangements; both can work effectively in providing diversification to an equity:bond portfolio. Increasingly, however, we expect to see institutional investors adopting more of a risk factor based approach. We believe that this could help them better capture unique opportunities, as well deploy their risk budgets within their portfolio more effectively. This approach will, however, also increase the need for bespoke portfolio design, rather than investors simply selecting off-the-shelf products.

Maximising your chance of success

The broad range of alternative investments – and the ways in which an investor can use them - has a number of implications for portfolio management. Importantly, the breadth of the opportunity set can help investors better meet their long-term objectives. This can simply be by fine tuning a risk and return objective, but more nuanced goals can also be captured. Some key considerations for investors looking to develop an alternatives allocation are set out below.

- **Potential returns** (how could the alternatives contribute to portfolio returns?)
- **Time horizon** (how long do you have to generate growth?)
- **Short-term diversification** (correlation and volatility) versus **long-term diversification** (delivering growth even if equity markets are weak)
- **Scenario analysis** (how might the allocation perform in specific scenarios?)
- **Expected tail event performance** (does it need to protect the portfolio in tail events?)
- **Responsible investing**, ethical investing (how well do the investments match an investors beliefs?)
- **Global, regional or local** (what is the desired emphasis of the allocation?)
- **Inflation sensitivity** (how important is this relative to the liabilities?)
- **Ability to liquidate** (can the portfolio earn returns from illiquidity?)
- **Acceptable levels of management fee** (are there any regulatory or other restrictions?)
- **Regulatory constraints** (for example, does the plan need to use any specific types of investment vehicle?)

So how do investors best approach an alternatives mandate? We believe that there are three key principles that should be adopted to get the most from these investments:

1) **Be multi-alternative – capture the breadth of opportunities**. A key rationale for allocating to alternatives is to diversify the sources of growth in an investment portfolio. To do this most effectively, investors need to access a range of return drivers from across the alternatives universe. By accessing a broad range of alternatives, investors can also create allocations that are more specifically focused on their objectives; they can be best positioned to capture changes to the opportunity set; and they can reduce investment and operational risks through manager and strategy diversification.

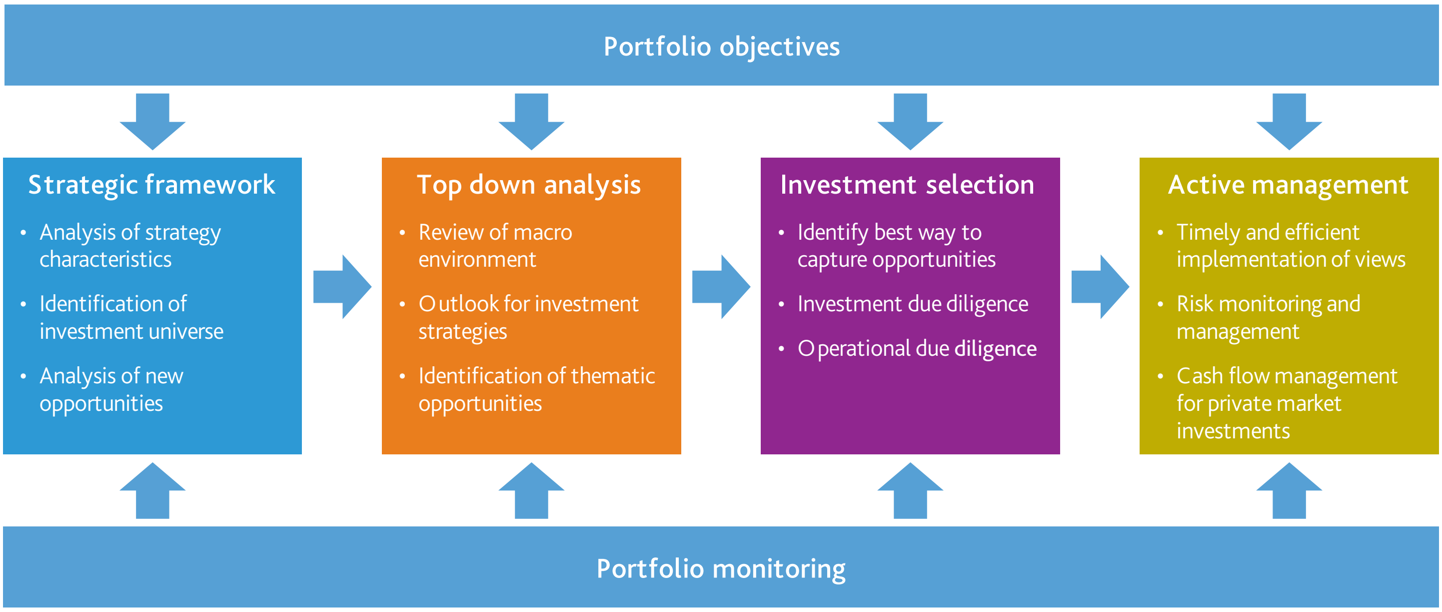
2) **Select the best managers – high quality investments, aligned with your objectives**. We believe that the best way to capture the returns available within alternatives is through the use of specialist and dedicated managers focused on specific opportunities. This can be through a focus on a particular style of investment (e.g. greenfield infrastructure or active currency), or investment region (e.g. frontier debt or emerging market macro). By picking a concentrated portfolio of specialist managers, we believe that it is possible to get the strongest returns from these opportunities. We also believe that manager skill is rare and it can be fleeting, but it can be vital to ensure that you capture the returns that you are targeting. Operational due diligence also needs to be an integral part of any manager selection decision.

3) **Focus on sustainable long-term returns – harvest risk premia through an uncertain future**. The returns in any asset class or strategy are cyclical and hard to time, but risk premia should be rewarding over the long-term. As such, while it is possible to add value both through dynamic risk management and also by exploiting market opportunities when they arise, we believe that the core benefits from alternatives come from long-term investing rather than short-term trading; this should therefore be the basis for any alternatives allocation. By adopting a longer-term approach, investors can also take advantage of short term market opportunities. Where assets can be locked up, investments such as private equity and infrastructure can also provide access to a longer-term illiquid premium as well.

Balancing internal governance with external support

With or without alternatives, investors have a series of investment decisions to make. A common schematic is as illustrated below. Portfolio objectives (and an understanding of any investor constraints, for example regulatory restrictions) ultimately drive the investment decision making. Underlying this, investors will need to identify the strategic framework that they can allocate within, think about the top-down opportunities and the bottom up investments available. They will then also need to practically implement their decisions.

Figure 2 – Typical investment decision-making framework



By introducing alternatives into the portfolio, investors will need to be able to assess a broader array of strategies in developing their strategic framework and in analysis of the top-down opportunity set. More significantly, manager selection would be expected to be more time consuming – based on our principles above, a well-diversified alternatives allocation would have multiple underlying managers across a range of investment strategies. As well as requiring investment due diligence, operational due diligence would also be critical.

In addition to identifying new investment opportunities over time (and, in particular, looking to reallocate private market exposures as capital is returned), investors should also expect a degree of manager turnover as investment propositions change. This would require not only on-going manager research, but also active portfolio implementation (cash flow management, currency hedging etc.).

In part to deal with these additional governance requirements, clients historically turned to fund of fund managers to help build different parts of the portfolio. With specialist manager research and portfolio management teams, fund of funds have been able to build high quality investment portfolios for specific asset classes. Increasingly these solutions have become more cost effective as well, with fees declining in recent years.

While we continue to see demand for specific fund of fund mandates – be it fund of hedge funds, multi-manager property funds etc. – other governance structures have also become common. Clients have increased their own internal investment resources and are seeking more refined alternatives allocations to meet their specific (and often changing) investment objectives. Partnership agreements and advisory relationships have resulted.

The three approaches can be summarised as follows:

- **Fully delegated mandates**: where we are commissioned to manage a portfolio of investments to achieve a specific risk/return objective. This includes our commingled fund of fund solutions as well as segregated portfolios focused on specific asset classes (e.g. a client specific Asian property multi-manager solution). It also covers pan-alternative solutions, where the responsibility for the underlying asset mix is delegated to us within certain pre-agreed parameters, and multi-asset mandates, where we invest across traditional and alternative asset classes.
- **Partnership agreements:** for clients with either evolving portfolio objectives or with constraints that are hard to codify (for example, some ethical beliefs), a partnership approach can be most efficient. The client's investment team shares the final decision-making (for example via a joint investment committee), although based on our research and recommendations. In these structures the day to day implementation can remain the responsibility of the client, or the portfolio can be wrapped such that we also manage the operational aspects of the investment (such as signing the contracts with the underlying managers etc.).
- **Research and Insight**: Some investors have been able to develop the in house resourcing required to successfully manage most aspects of alternative investing. Often, however, they find value in an additional source of manager research (including investment and/or operational due diligence) or in ad hoc idea generation. Under these relationships, the ultimate decision making and day to day implementation remains the responsibility of the client, but we can provide manager or strategy recommendations to support the process.

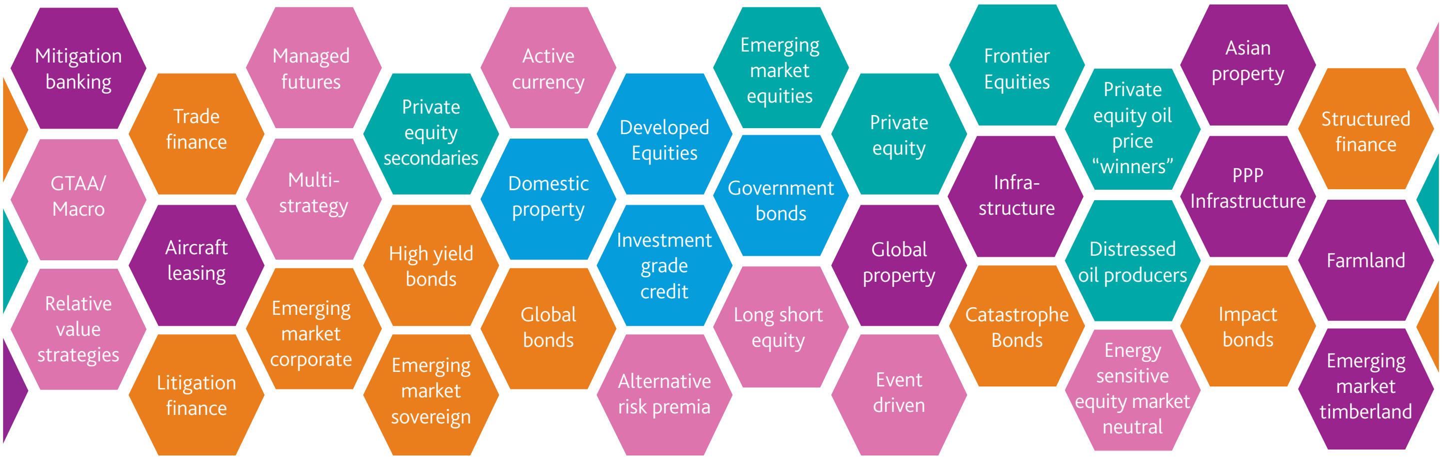
Whichever solution works best for a given investor, the right support is available to ensure that the real value of alternative investments can be realised.

Figure 3 – Possible (common) responsibilities under the different governance structures

	Investor responsibility	Joint responsibility	Manager responsibility
Fully delegated mandates (specific sleeves – e.g. fund of hedge funds)	• Broad portfolio objectives • Strategic framework • Top down analysis		• Manager selection decision • Investment due diligence • Operational due diligence • Implementation • Operational control • Monitoring
Fully delegated mandates (multi-asset or multi-alternative solutions)	• Broad portfolio objectives	• Strategic framework (defining the terms of the mandate etc.)	• Top-down analysis • Manager selection decision • Investment due diligence • Operational due diligence • Implementation • Operational control • Monitoring
Partnership agreements	• Broad portfolio objectives • (Can retain responsibility for implementation and operational control)	• Strategic framework (defining the terms of the mandate etc.) • Top-down analysis • Manager selection decision • Monitoring	• Investment due diligence • Operational due diligence • (Can take responsibility for implementation and operational control)
Research and Insight	• Broad portfolio objectives • Strategic framework • Top down analysis • Manager selection decision • (In most cases implementation, operational control and monitoring will remain with the investor, although this can be outsourced as well)		• Investment due diligence • Operational due diligence • (In some cases implementation, operational control and monitoring will also be outsourced to the manager)

Conclusion

Alternatives are an essential component of most high quality investment portfolios – and their role and remit continues to expand. Investors are using them to diversify their sources of growth and to better focus in on their bespoke investment objectives. While they can increase investment complexity, with the right support structure we believe that alternatives can benefit all investors – increasing the chances that they meet their investment goals.



Appendix – Aberdeen Solutions

Aberdeen Asset Management is a global asset management company listed in the FTSE 100, with over 37 offices in 26 countries, with c.2,700 employees worldwide including some 850 investment professionals. We are a pure asset manager with a broad range of investment expertise.

Operating globally with offices in Europe, US and Asia, Aberdeen Solutions is the home for multi-asset and specialist alternatives investing within Aberdeen.

In a complex world of investments, we seek to provide our clients with simple solutions to meet their needs. Our Solutions group focuses on markets and managers, rather than individual stocks or bonds; this approach enables us to build portfolios to meet a range of client objectives.

- Specialist multi-manager alternatives mandates – we have a track record of over 15 years in building specialist multi-manager products. Our solutions include traditional fund of hedge funds, liquid alternatives strategies, private equity and private markets, property and infrastructure.
- Pan-alternative solutions – as traditional asset classifications become less distinct, our pan-alternative solutions provide more flexibility, combining the experience of our strategy specialist teams to meet the bespoke needs of individual clients. This includes portfolios that, for example, allocate across liquid and illiquid markets, as well as solutions that blend alternative assets and styles to meet specific goals (e.g. real returns).
- Diversified multi-asset solutions – strategies that invest across traditional and alternative asset classes, either with reference to a fixed long-term benchmark or to achieve a specific risk and return outcome. Our flagship Diversified Growth strategy seeks to achieve a Cash+4.5%pa[A] return while controlling risk; alternative investments are a key part of our tool kit to achieve this objective.

Overall we manage almost £100bn in multi-asset and specialist alternative mandates.

[A] This is an internal performance target which the Investment Manager aims to achieve as at the date of this document. This target is not based on past performance, may be subject to change and cannot be guaranteed.

The value of your investments, and the income from them, can go down as well as up and your clients may get back less than the amount invested

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