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Alternatives

Greenwich argues against too much trust in models

By Barry B. Burr

Pension funds, endowment and foundations investing in alternative investments should avoid too much reliance on mathematical risk models to set asset allocations and place more emphasis on the current economic environment, according to a set of best practices issued by Greenwich Roundtable.

"We relied too much on quantitative techniques to tell us about the future to the exclusion of good judgment," Steven McMenamin, executive director, said in an interview about the 74-page report, "Best Practices in Alternative Investing: Portfolio Construction."

Aleks Weiler, senior portfolio manager of the C$105.5 billion (US$93 billion) Canada Pension Plan Investment Board, Toronto, and leader of the working group that created the report, said in a statement: "If there's one thing we learned last year, it is that reliance on traditional, asset allocation portfolio construction techniques, which are based on historical returns of asset classes, is not sufficient. The current economic environment must be factored in as well."

When investing in private equity, real estate, venture capital, hedge funds, and natural resources, overreliance on portfolio optimizers that neglect wide swings in volatility, especially on the downside, "has proved too simplistic, leaving investors unprepared for times like 2008," the report said.

The investment committee of a fund sponsor should "understand the predictive value of the manager's track record, including its relevance to the current environment."

Fund sponsors should "avoid the slavish adherence to a singlepoint allocation," the report said. "We should be aware of the limitations of our tools and maintain some flexibility as we allocate actual assets. ...We could profit by modeling both" a normal state of the economy "where recessions are possible, with normal return, risk, and correlation assumptions," and "a depression state, where a different set of assumptions prevails."

"Most asset allocation exercises tend to mine historical data with a heavy reliance on the past 25 years, or less in the case of alternatives," the report said. "This means that most programs are based on the analysis of a single economic regime -- disinflationary growth, the best economic environment for risk assets. Extrapolating risk, return and correlations from the last 25 years is dangerously simplistic for any asset class."

The report had critical recommendations on oversight of alternative managers. "Bringing managers to the (investment) committee for performance reports is rarely helpful ... The reports are superficial and myopic," the report said. "A cogent, concise report by the staff can do a better job of surfacing issues and placing things in a helpful perspective for making decisions."

The Greenwich Roundtable is a forum of fund sponsors and investment managers and seeks to develop guidelines for best practices for investing in alternative investments.

MORE ONLINE The Greenwich Roundtable report "Best Practices in Alternative Investing: Portfolio Construction," is available at **www.pionline.com/greenwichroundtable**