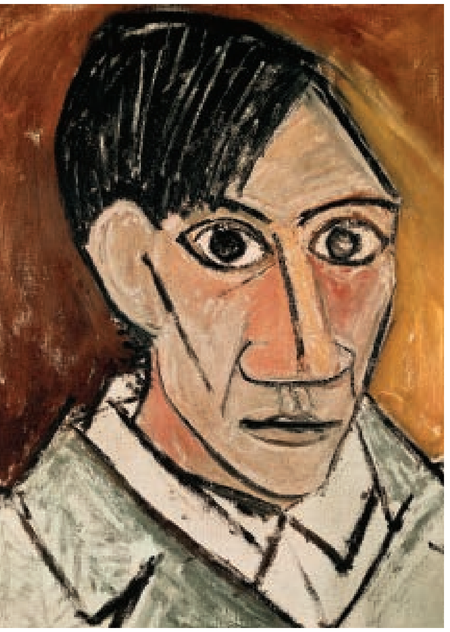

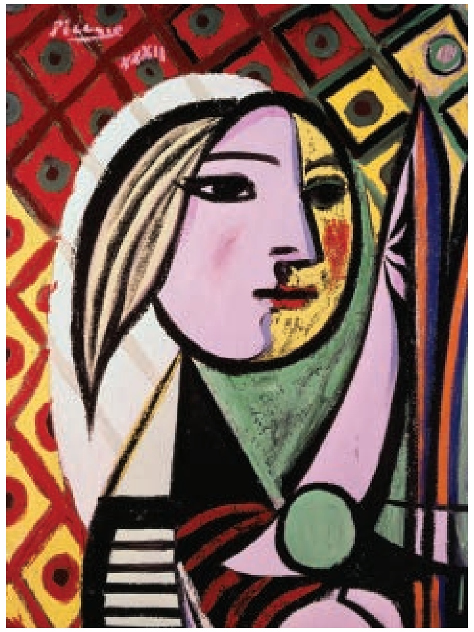

MANY PAINTERS, FEW PICASSOS

There are two keys to building a successful portfolio of alternative investment managers: Know where you are playing, and wait for and collect the best quality managers. There are many painters, but few Picassos. *By Steve McMenamin, Executive Director of The Greenwich Roundtable.*

There are two key points to investing successfully in alternatives. The first, according to The Greenwich Roundtable's Best Practices in Alternative Investing: Portfolio Construction, is that investing in alternatives is more of an access class than an asset class. The quality of the manager matters more than the asset class in making decisions about alternative investments. We should build portfolios from the bottom up by opportunistically identifying and allocating to quality managers, and only quality managers. There are few talented investment groups, and the difference between the top and bottom tiers is substantial.

Finding and selecting quality partners is akin to getting married, not dating. It is hard work. It involves many ups and downs but, ultimately, like all good things, the rewards are well worth the effort. Keeping a longer-term perspective is important. It often is better to have zero invested in an alternative strategy than to have the target allocation invested with a mediocre manager. If we are only able to find quality players in one style, we should not allocate to subpar managers in others just to "fill a bucket." Rather, it is particularly important to be on the lookout for first-rate managers in an underrepresented style.

The second key point is to know what ballpark we're in. Different assets react differently under different economic conditions. We want diversification and hedges against inflation and deflation. We want assets that hold up reasonably well under a wide range of assumptions. Thus, we need to organize our portfolios by how assets behave under different economic scenarios. The way to achieve true diversification with alternative investments is to develop a deep qualitative understanding of the managers—what, how, and why they are making their investment decisions—and form conclusions based on reasoning and judgment.

Sophisticated investors increasingly are adapting traditional multifactor approaches to focus on how different assets behave in terms of risk and returns under different economic scenarios. In building portfolios, investors should think about the basic economic drivers in which we invest, and use three fundamental economic groupings: growth, inflation, and deflation.

What is seldom acknowledged is that getting the environment right matters enormously. The fact is, when it comes to asset allocation, there is no single answer. Principles are needed rather than rules. Sophisticated investors always are anticipating what can go wrong, trying to assess the downside and unintended consequences, and making sure that they minimize opportunity costs. The sophisticated investor is alert to changes in the broad economic environment to anticipate potential shifts between asset groups. As time marches on, environments and relationships change. True diversification is a moving target. It disappears when markets get bad, when underlying fundamentals affect all traditional asset classes the same way.

Unpredictable changes in the investment environment mean that the vintage year matters enormously. We never can be certain how investments made today will perform 10 years out. We should diversify across managers and vintage years, with a preference for weighting better managers more heavily. If we cannot access these top-tier managers, our selections often are wealth-destroying. Committing capital to private equity and venture managers over multiple vintages is important for proper diversification. The better energy partnerships blend private equity techniques to produce historically high returns. As a result, investors often ladder their private energy investments by vintage year, much like venture capital.

Quantitative tools are the primary drivers behind asset allocation, portfolio construction, and selection of managers. They're useful, but they have limitations. They're based on assumptions. No one gets assumptions right. Investing and portfolio construction are more of an art form than a science. Qualitative judgment is the key.

Optimizers are no better than the assumptions that are used. We must recognize that each assumption is the average depth of a river. Returns, volatility, and correlations change drastically as the economic environment changes. Optimizers see historical returns on illiquid assets as low volatility and tend to overallocate to those assets. Illiquid investments rarely trade and prices can become stale. Optimizers are built on the assumption that volatility always follows a bell-shaped curve. We know that tails of the curve—especially on the downside—are much flatter and more dangerous. Overreliance on the normal distribution has proved too simplistic, leaving investors unprepared for times like 2008.

We need to be honest about the needs and the capabilities of our institutions. Is an above-average return required to meet our goals? Do we have the staff resources and board-level buy-in to pursue a complicated and occasionally unconventional approach? The bottom line is that we have to do what's right for our institution.

Portfolio management is about risk management and maintaining control of liquidity. Good governance matters. The key role of the CIO is the education of the investment committee. The board must delegate a lot of responsibility to a CIO. Being a financial expert is not the same as being an investment expert. The CIO should lead the committee, providing continuing education as a first priority and a cohesive approach as the second. The CIO and staff can't be going in one direction and the investment committee another.

Management of alternative investments is characterized by two principles, which we identify as best practices in alternative investment portfolio construction. Both principles have three important subsets:

1. Collect quality partners opportunistically
   a. Listen to and learn from our managers
   b. Be contrarian when appropriate
   c. Innovate

2. Risk management is a key to success
   a. Diversify among asset classes, strategies, and managers
   b. Maintain enough liquidity to stay the course
   c. Accept and plan for the eventuality that we are wrong

Shortcuts that should be avoided abound in each case: filling buckets with average managers or chasing returns; relying solely on statistics to "optimize" the portfolio; letting day-to-day portfolio management get in the way of thinking about how we could be wrong; ignoring the needs of the board; assuming that current liquidity will last forever; failing to engage our managers in a deep dialogue; and following in the footsteps of other investors. While in search of quality managers, we must stick to our mission and objectives, stop looking at what our neighbor is doing, and don't chase returns that might have risks inconsistent with our basic strategy.

Our thinking and planning must be dominated by the possibility of being wrong (about a manager, a market, or a trade) as well as the consequences (cash losses, lagging performance in a rebound, or a sullied reputation). The best long-term investment performance is earned by those who not only survive market crashes, but also have the "staying power" to maintain fundamentally sound positions and the liquidity to invest when others cannot.

Ultimately, after all the reference-checking and due diligence is done, the decision boils down to investor judgment regarding whether the manager is a moneymaker who can maintain a durable competitive advantage, possesses integrity, is personally invested and motivated, is a fair partner, and offers a reasonable value proposition. We need to know where we are, and whom we are with. There are many painters, but few Picassos. ai

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The Greenwich Roundtable, Inc., is a not-for profit research and educational organization located in Greenwich, Connecticut, for investors who allocate capital to alternative investments. It is operated in the spirit of an intellectual cooperative for the alternative investment community. Its 200 members are institutional and private investors, who collectively control $4.3 trillion in assets. The mission of The Greenwich Roundtable is to reveal the essence of both trusted and new investing styles and to create a code of best practices for the alternative investment industry.