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Experts: Investors may not be safe as they think

By **Joel Chernoff**
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A widespread shift into alternative investments — hedge funds, private equities, real estate, emerging market stocks and bonds, commodities and structured investments — could end up exposing institutional investors to more risk instead of less.

With the U.S. housing market slipping and signs of a recession on the horizon, institutional investors might be a lot less safely positioned than they may think, some experts said.

These experts worry that institutions might have added to their total risk exposure, investing in assets that are leveraged, illiquid or more volatile than they appear. That could make some alternatives just as vulnerable to shocks as publicly traded stocks.

"I think there are a lot of people who keep talking about alternatives as diversifying or risk-reducing. There's a lot of wishful thinking out there," said Richard M. Ennis, chairman of Ennis Knupp + Associates, and incoming editor of the Financial Analysts Journal.

"You need to look at the underlying equity exposure and the underlying leverage" of these alternative investments, Mr. Ennis said.

Another severe market decline, such as the 1998 Russian ruble crisis that triggered the near-collapse of Long Term Capital Management, could expose investors to risks they don't know they have.

"If we have a flu pandemic, if a terrorist event happens on U.S. soil, if we have another series of weather-related disasters, each of these could set off a global flight to quality," said Andrew Lo, Harris & Harris Group professor and director of the Massachusetts Institute of Technology Laboratory for Financial Engineering in Boston.

Of course, some institutional investors might have carefully calibrated their risks, implementing hedges to protect against various scenarios. Even then, it's not easy to hedge against the unexpected.

"The issue is the risks we don't know about," Mr. Lo said.

Investors are piling into alternative asset classes and strategies in an effort to boost returns above limited expected returns from traditional stocks and bonds, to add diversification to their portfolios, or both.

Institutional investors have largely shifted assets from fixed income. Average allocations to fixed income dropped to 22.8% in 2005 from 27.7% in 2002, driven almost entirely by corporate pension funds, a survey by Greenwich Associates, Greenwich, Conn., found.

U.S. stock allocations even

In contrast, U.S. stock allocations have stayed virtually even, at 46.7% in 2005, according to Greenwich data. However, up to one-fifth of U.S. institutions plan to make significant cuts to their domestic equity allocations in the next three years, according to the Greenwich survey.

They plan to reallocate their assets to equity real estate, private equity and hedge funds, and, to a lesser extent, international stocks.

In particular, 34% of pension funds and endowments plan to boost their hedge fund allocations in the next three years, while 30% of corporate funds, 41% of public funds and 48% of endowments expect to hike their allocations to private equities.

Some experts are particularly concerned about the high levels of leverage that are used by certain strategies.

Robert Arnott, chairman of Research Affiliates LLC, Pasadena, Calif., explained: "There is a lot of leverage out there. It's beyond anything seen before in our economy. To the extent that investors have collateral to back that leverage, they should be fine."

But the current amount of leverage sets the stage for the next market crisis, he said. "I've long been of a view that the next LTCM was inevitable; (it's) just a question of when it would happen, not whether it would happen," said Mr. Arnott, who is the current editor of the Financial Analysts Journal.

In the early part of the decade, low short-term interest rates encouraged the use of leverage. For example, low short-term rates allowed hedge funds and bond managers to pick up easy returns through carry trades — borrowing at short-term rates and lending at higher long-term rates. With a flat or inverted yield curve, this source of return has dried up.

The loss of the carry trade suggests some managers might increase leverage in order to generate the same level of expected returns, said Campbell Harvey, a finance professor at Duke University's Fuqua School of Business, Durham, N.C., and editor of the Journal of Finance.

Higher interest rates

Higher short-term rates — now at 5.25% after being as low as 1% in June 2004— have raised the hurdles for some strategies. Most hedge funds use a benchmark of Treasury bills plus 300 or 500 basis points. With a T-bill rate of 2%, the benchmark return might be 5%. With cash now returning 5%, the hurdle rate would be 8%.

Subtracting a management fee of one percentage point means the investor has paid one-third of the return above the cash return in fees. "You're getting a relatively small return for the effort involved," said Maarten Nederlof, a managing director at K2 Advisors LLC, a Stamford, Conn.-based hedge fund-of-funds manager.

So far, hedge fund managers have outpaced their benchmarks, said Stephen Nesbitt, chief executive officer of Cliffwater LLC, Marina del Rey, Calif., an alternative investments consultant.

Higher rates have also changed the math on leveraged buyout and real estate transactions, which typically rely heavily on debt financing. Many experts believe rates of return for buyouts will decline from the combination of higher financing costs and too much money committed to the area.

"There's so much money chasing the deals right now," said Jay Klopfer, senior vice president, Callan Associates Inc., San Francisco.

Plus, if the stock markets decline, it will limit the ability of buyout funds to exit from their investments, explained Caroline Aboutar, principal and research consultant, Mercer Investment Consulting, Chicago. The longer a buyout fund holds its investments, the lower its internal rate of return will be, she added.

Many pension funds have been reallocating real estate assets to opportunistic strategies from core portfolios. But opportunistic strategies typically have much higher leverage levels. For example, the $142.2 billion California State Teachers' Retirement System, Sacramento, uses 35% leverage for its $5.2 billion core real estate portfolio, but employs 73% leverage for its $4 billion tactical portfolio, according to a memo to the fund from consultant Pension Consulting Alliance.

Dangers in the credit market

Institutional investors have also poured money into credit strategies such as high-yield bonds, emerging market debt and collateralized debt obligations in recent years.

But spreads between those instruments and Treasury bonds have narrowed dramatically. That means investors are being paid much less for the risk they are taking.

(Greenwich Associates, however, showed the average institutional allocation to high-yield debt slipped to 6.8% in 2005 from 8.4% the year before as spreads have narrowed.)

Those bets could backfire if the economy were to slow or go into recession.

"Without a doubt, the risk-adjusted returns have declined, and, without a doubt, funds tend to be more focused on absolute returns. That could bite them if markets take an ugly turn," said Julia Coronado, senior U.S. economist at Barclays Capital, New York.

Some experts think a bigger risk lies with junior tranches of CDOs and the credit default swap market, with more than $17 trillion in notional value.

"Some of the CDOs and default derivatives have never been tested in a real market downturn. Watch out. The market is huge, but we don't know if liquidity could vanish in a downturn," Duke's Mr. Harvey wrote in an e-mail to Pensions & Investments.

Referring to credit default swaps and dubious paper issued by small companies, Theodore D. Seides, director of investments at Protege Partners LLC, a New York-based hedge fund of funds, wrote in a recent newsletter article: "When the liquidity tide goes out, as it always does, a large volume of this paper may turn to sand or even worse, quicksand."

Recession prospects

Barclays Capital economists are more concerned about inflationary prospects than a recession, but others see ominous signs.

MIT's Mr. Lo said: "It really looks like the housing market is in a bubble situation, and it might be set to burst. If we're fortunate, it will happen over three to five years. If it happens on a faster basis, it might be a problem."

Mr. Harvey said the stalled housing market is just the beginning of the problem. He said the inverted yield curve, near-record-high energy prices, a limited government ability to respond because of the budget and trade deficits, and higher geopolitical risk spell bad news for the economy.

Mr. Arnott thinks the Federal Reserve might have pushed the economy into a recession. He said the Fed has hiked short-term rates in response to inflationary factors over which they have no control, such as geopolitical risks that jack up energy costs and rising commodity prices.

With the prospects for recession heightening, some investment experts favor higher allocations to safe assets.

Mr. Arnott has heavily overweighted the All Asset Fund he subadvises for Pacific Investment Management Co., Newport Beach, Calif., into Treasury inflation-protected securities, which offered a 2.3% real yield, and local developing market debt as a non-dollar play.

"Cash hasn't looked so good in a long time," said Michael Rosen, principal and chief investment officer of Angeles Investment Advisors, Santa Monica, Calif., who favors a "barbell" strategy weighted between safe assets at one end and riskier assets, such as Asian infrastructure, at the other.