INTRODUCTION

MOVING FROM THE FRINGES INTO THE MAINSTREAM

Having been burned by a downturn in equity markets, by 2003 investors were looking for a method of diversifying their portfolios. Since then, the rise in interest in alternative asset classes has seen these products move towards the mainstream end of the market, writes Elisa Trovato

The sharp downturn of the equity markets from 2000 to 2003 was a harsh eye-opener for most investors, when they realised investing in benchmarked products offered no guarantee of capital preservation. The heavy losses in equity products drove wealthy investors towards alternative investments such as commodities, hedge funds, property and structured products. Investments in these asset classes were initially perceived as a form of portfolio insurance, as they are typically uncorrelated with traditional asset classes. They are also considered attractive because they employ an absolute return approach, aiming to generate positive returns, regardless of any benchmark.

The strong recent performance of some of these alternative financial products, such as funds investing in raw materials and property, has led many investors to review their strategies, with these products increasingly seen as viable, performance-driven investments. "What we call today alternatives will become much more mainstream," says Julian Ide, head of products, marketing and third-party distribution at ABN Amro Asset Management. "And they will take up an increasingly large proportion of money flows."

The new regulatory European environment has also played an important role. "With the Ucits III regulations, a lot of the so-called traditional funds are moving towards the hedge fund space in terms of investment objectives and policy guidelines," says Mr Ide. "I think we will see hedge funds also moving towards the more traditional Ucits style of management."

This strategic market move towards alternatives has had a clear impact on the recommendations that private banks are making to their clients. Major global market players are advising their clients to have an allocation to alternatives of up to 20 per cent of their total portfolio.

"In larger portfolios, whether it is private banking clients or institutional clients, you want to have an allocation that may vary between 10 per cent to 25 per cent to alternative investments," says Martin Vogel, head of the product management and asset pooling business unit at Julius Baer Asset Management.

The recent run-up in equity markets does not seem to have affected market players' positions. Mr Vogel believes that unless the rally in equity markets lasts for 10 or 15 years, "there will always be a certain quota in asset allocation of alternative investments, which may vary depending on how good or bad market conditions are".

BNP Paribas' global exposure to the suite of alternative asset classes is between 15 per cent and 25 per cent, explains Alan Mudie, head of investments at the global private bank. "Currently, asset allocation to hedge funds, commodities, precious metals and property for an unconstrained portfolio with a balanced profile takes us to 23 per cent of assets," he says.

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Mr Mudie explains that the bank has been reducing its exposure to global equity markets after taking profits. But this has not translated into an increased exposure to alternatives. "The substantial run-up that we had in equity markets from very attractive valuation levels in late 2002 to early 2003 means that, from today's levels, expected performance is less attractive than it has been for several years. This is not necessarily the best time to take on additional risks in portfolios," says Mr Mudie.

BNP Paribas forecasts that a correction will be experienced in equity markets this year. This will provide an interesting entry point for building exposure to equity again. "However, rather than increasing our exposure to alternatives, we have preferred to place money on deposits waiting for those opportunities to emerge," he says.

The ideal asset allocation to alternatives for a private client depends on a number of factors, explains Mr Mudie: the risk profile, the investment horizons, the need for liquidity and the client's familiarity with the instruments. "There is no one ideal allocation that we would revert to, but rather it would be the conclusion of a very thorough discussion of the private banker with the client," he says.

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Also, when selecting the type of alternatives the risk profile of the client has to be taken into account. He says: "For example, we would be allocating to more defensive alternative assets for more risk-averse clients, such as more diversified multi-strategy funds of hedge funds, which tend to have lower levels of volatility than those of some very focused strategies."

The different jurisdictions often impose restrictions on the type of alternatives that can be used in investors' portfolios. This is the case with hedge funds, for example. In Italy, the minimum investment in hedge funds for a private investor is €500,000 and investments are allowed only in hedge funds registered in the country.

"The challenge with hedge funds is that although regulations generally are becoming more favourable, we are still going to have to look at different ways to access some retail markets, because you cannot simply do it with a regular Ucits fund," says Mr Ide. And he admits that in Germany, which is still dominated by local funds of funds, the sale of their products has not been as strong as expected.

"It is also a very complicated capability to set up," admits Mr Ide. "This is why we need to make sure that we continue to focus on those areas where we can build significant scale." Mr Ide makes reference to alternative ways of making hedge funds of funds available in those markets where regulation imposes restrictions in selling cross-border funds. Note structures are one way, and ABN Amro has sold them in Asia, says Mr Ide. In this case, funds are not sold as funds but with a guarantee around them, for example.

MOST DEMANDED PRODUCTS

If there is a common consensus that alternative asset classes will continue to occupy an important role in investors' portfolios, market players are positioning themselves, establishing partnerships and launching new funds.

Earlier this year, ABN Amro bought International Asset Management (IAM), a fund of hedge funds manager, to strengthen its own fund of hedge funds offering. "[Acquiring IAM] is clearly a strategic play to get ourselves greater critical mass in the hedge funds of funds business. We already have a medium-sized presence and this will get us up to around €4.5bn to €5bn in assets. That has put us in a much stronger position from a European perspective," says Mr Ide.

"We continue to see big growth opportunities from hedge funds of funds as well as single manager of hedge funds. We see this trend existing through both distributor type of clients and institutional clients," he says.

Property funds are also attracting a lot of interest among distributors because of their recent strong performance. The Standard & Poor's Offshore and International Property funds sector have delivered, on average, total returns of 34.7 per cent in the last 12 months. Average total returns of European property funds during the same period are even higher at 42.6 per cent.

To address this increasing demand, later this year ABN Amro will launch a global property fund within its open-ended Luxembourg Sicav range. The fund will leverage on the Dutch house's track record of managing property securities funds in its home market.

Mr Ide believes that sustainable investment will also draw increasing levels of interest. Although they cannot be considered strictly alternative, as lack of correlation with traditional asset classes is not their key characteristic, he says they will become an integral part of most portfolios and many investment processes.

"There are broadly two types of what I would call SRI [socially responsible investment] funds. Those funds investing in sustainable industries, for example renewable energy, which is an area we are looking at very seriously, and that would have a low correlation of return," he says. "The other aspect is introducing sustainability screens into our mainstream portfolio management and that would supplement, or integrate with, our existing mainstream management." ABN Amro plans to launch sustainable funds in the near future, including a Brazil equity fund and a corporate bond fund.

Ide: looking at different ways to introduce cross-border funds to new markets

Mudie: Constantly assessing where diversification opportunities exist

Vogel: ignoring benchmark funds to focus on achieving real returns for clients

Forecasting future client demand for alternative investments, Mr Mudie says that these instruments will remain a logical means of diversifying assets. "We spend a lot of time looking at whether correlations are changing and using that as part of our thinking in asset allocation," he says.

For example, he explains, there has been an increasing correlation between energy prices and emerging market equities. And if some of the emerging market equity regions are viewed as attractively priced, the price of many types of energy has moved well above where they think is justified by fundamentals. In this case, given this analysis, BNP Paribas would prefer to concentrate exposure in emerging market equities rather than energy and commodities.

Currently, the agricultural commodity is one of the areas offering less correlation with traditional asset classes, according to Mr Mudie. "We have a bullish view on the outlook for agricultural commodities and have structured some investments to get clients exposure to that," he says.

Price performance of commodities has been extremely strong over the last few years which, fuelled by media attention, has generated high interest in this asset class, says Mr Mudie. "Today, interest we hear from product clients in Europe is more in areas like commodities and less in areas such as hedge funds, which were very much in demand two to three years ago," he says, disagreeing with Mr Ide's view.

In the hedge fund arena, the BNP Paribas team is focusing on the directional trading and the stock selection strategies, with a particular focus on the Asian and Japanese long-short managers, where conditions are particularly attractive, says Mr Mudie.

Strong perceived demand for funds of hedge funds has led Julius Baer to acquire GAM, UBS's fund of hedge funds specialist, at the end of last year. The acquisition of GAM, together with wealth management subsidiaries Ehinger & Armand von Ernst, Ferrier Lullin & Cie and Banca di Lugano, made Julius Baer the largest Swiss wealth manager focused exclusively on private banking and asset management as its two core operating divisions.

GAM offers its clients diversified fund portfolios where the percentage of hedge funds (or funds of hedge funds) can reach up to 50 per cent of a total portfolio. "The rationale behind that is that most private clients want an absolute return, they want at least 7 per cent to 8 per cent performance every year. They do not want to have 20 per cent one year and minus 15 per cent the year after. Following a benchmark is not really the right way to manage a portfolio," says Mr Vogel.

To meet increasing demand for commodities, in April Julius Baer launched what are, according to Mr Vogel, the "first actively managed Luxembourg-domiciled commodity funds". Designed for cross-border distribution, the two funds, one euro denominated, one US dollar-denominated, have approximately two-thirds of assets linked to the RICI (Rogers International Commodity Index). The remaining third is active overlay, that is funds tactically invest in those commodities seen as having the most potential.

High fees are the only element that can stop alternative asset classes to become more widely accepted in investors' portfolios, according to Mr Vogel. "Generally speaking, alternative investments do a good job, but in order to establish themselves as a mature asset class they need to become a bit less expensive. But, because the volumes have increased as well, this is also not a problem."