TARGET RETURN STRATEGIES

PORTABLE ALPHA GIVES HEDGE FUNDS A RUN FOR THEIR MONEY

By taking advantage of low cross correlations, this concept can focus on delivering pure alpha

Many investors are beginning to recognise the need to consider viable alternatives to traditional investment strategies, as projected returns from conventional asset classes begin to moderate. Also, investors are now far less willing to tolerate negative or volatile performance from standard relative return products that often constrain the investment manager and limit possible alpha returns.

Instead, they are now seeking absolute return strategies that can generate consistent positive performance and provide a haven from stock and bond market volatility. One way to achieve this is by increasing a portfolio's exposure to assets whose returns are less correlated to traditional markets. In search of such investment vehicles, investors are increasingly turning to alternative investments such as private equity, hedge funds and real estate products.

POPULARITY

Their growing popularity has seen investors raise their overall allocations to alternative investments from 4.4 per cent in 1999 to 7.5 per cent in 2002, and forecasts indicate they will increase further.[1] (See Chart 1.)

According to one study, from 2003 to 2005 the average allocation to private equity from US investors will rise from 7.5 to 8.2 per cent, while the allocation to hedge funds could jump from 5.0 to 7.5 per cent.[2] The latest figures now suggest over $1000bn has been allocated to hedge funds alone, with European investors also increasing their exposure to these asset classes.

However, many alternative investment strategies come with an array of considerations that can sometimes mitigate their appeal for use as alpha generating products. For example, the growing popularity of hedge funds can in part be attributed to an assumption that these products have no market correlation. In reality, the relation between hedge funds and conventional assets can be relatively high. According to the CSFB/Tremont Index the correlation of hedge funds to stocks and bonds was 0.57 and 0.45 respectively over the last 10 years.[3]

CORRELATION

One reason for the strong correlations over this period is that many hedge funds are predominantly invested in financial assets and tend to be net long in their positions. It is only during periods when markets are falling that short positions are more likely to be taken and correlations fall.

Despite their growing popularity, many hedge fund strategies also suffer from low degrees of transparency and regulation, and fees that can reach beyond 20 per cent of profits and 2 per cent of invested capital.

Furthermore, the risk/return and correlation assumptions made for these products need to be put into perspective given their short performance histories. Finally,

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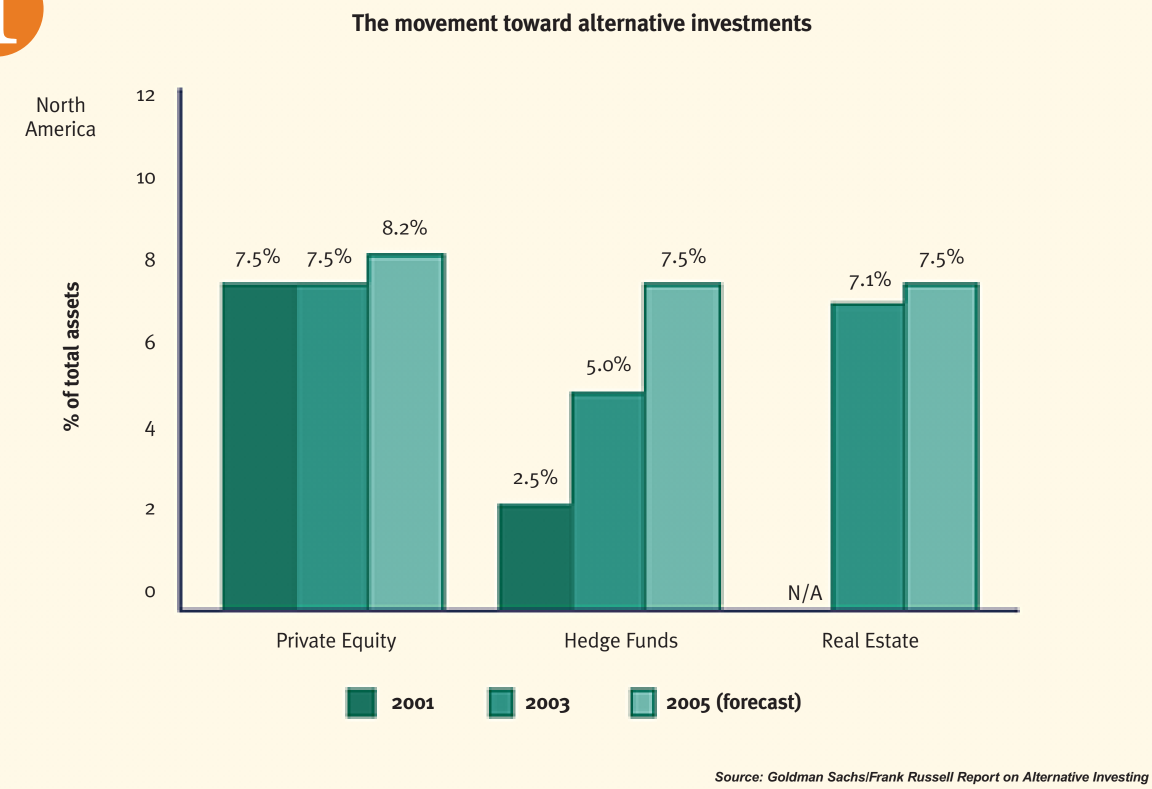

possible illiquidity is another issue that investors need to take into account when considering exposure to these assets.

Fortunately, a new investment approach now exists that enables investors to gain exposure to higher yielding asset classes to deliver their alpha returns and avoid the need for leveraged exposure that comes with hedge fund products. The Portable Alpha strategy is an investment concept that provides a real alternative to traditional long only strategies that are often constraining and fail to deliver an improvement to alpha returns. The concept centres on replicating a benchmark index by means of swaps, options, futures or other derivatives and freeing up the underlying cash assets to be invested in an active investment strategy.

ADVANTAGES

Within the fixed income world, pension funds are becoming increasingly familiar with this concept, using derivatives such as inflation and interest rate swaps to match their liabilities and including an absolute return fixed income product as an alpha overlay.

This concept has the significant advantage over traditional benchmarked investment strategies in that the investment manager can focus on delivering a pure alpha return without the usual tracking error constraints of a benchmark. In addition, by using derivatives to provide the benchmarked market return, cash assets can be used to generate an entirely unrelated and uncorrelated alpha return. With this in mind, the key for the investor is to find which available product produces the most consistent and uncorrelated source of alpha.

CONCERNS

Alternative investments such as hedge funds are commonly thought of as ideal alpha generators, and whilst they may be appropriate for some investors, the concerns and issues discussed earlier mean that they may not

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LOW CROSS CORRELATIONS IN FIXED INCOME 2

	EMBI	Convert	EMU Govt	US Tsys	CE	US HY	US A	US BBB	US Libor	Euro/$
EMBI	1.00									
Convertibles	0.43	1.00								
EMU Govt	-0.19	-0.13	1.00							
US Treasuries	-0.24	-0.15	0.98	1.00						
Central Europe	0.46	0.52	-0.01	-0.06	1.00					
US HY	0.51	0.44	0.00	-0.05	0.40	1.00				
US A	0.11	-0.14	0.72	0.71	-0.03	0.23	1.00			
US BBB	0.35	0.06	0.48	0.46	0.14	0.59	0.84	1.00		
US Libor	0.00	0.16	-0.10	-0.10	-0.05	-0.06	-0.09	0.00	1.00	
Euro/$	0.02	-0.39	0.26	0.23	-0.22	-0.08	0.32	0.23	-0.24	1.00

Source: CSAM Monthly data from December 1994 to end of December 2004
(From January 98 for Central Europe - JPM EMU used for EMU Govt - AA, A, BBB and High Yield are US based)

always the most suitable option. Fortunately, different products to hedge funds do exist and absolute return bond funds provide one such possible solution. The Target Return concept provides a useful example of the features investors can benefit from by "porting" the returns of an absolute return bond fund onto a replicated benchmarked index.

Alpha that is derived from a source demonstrating low correlation to the benchmarked return is a key feature of any portable alpha strategy. Within the fixed income world, investors are often surprised to learn that the universe actually enjoys quite low, or in some cases, negative correlations.

Absolute return bond products such as the Target Return concept take advantage of low cross correlations, as shown in Chart 2, by investing across a wide range of fixed income asset classes. This long only strategy offers a range of benefits to investors that include high liquidity and an investment grade fixed income product with exposure to higher beta asset classes such as emerging markets and high yield.

TRANSPARENCY

Furthermore, in contrast to hedge funds, absolute return bond strategies such as Target Return Concept provide full transparency to investors, with monthly reporting of exposures and risk data to enable investors to keep track of their investment. Full transparency also offers the advantage of clear communication of risk processes that can focus on preservation of capital and downside risk protection. Due to a lack of transparency from many hedge funds, it is often difficult to understand what level of protection is offered and for some investors in portable alpha strategies, this could have a negative impact on aggregate returns.

'In contrast to hedge funds, absolute return strategies can provide full transparency of positions to investors'

In summary, the Portable Alpha concept offers many investors a new route to higher investment returns. Absolute return products can used within this concept to provide a genuine alternative to hedge funds, by improving portfolio returns whilst delivering low correlation and low volatility benefits and a capacity to focus on downside risk protection. Importantly, these products can also provide the advantages of liquidity, transparency and lower costs that are becoming increasingly important in today's discerning marketplace.

Target Return Team,
Credit Suisse Asset Management

1 Greenwich Associates.
2 Goldman Sachs/Russell Report on Alternative Investing, 2003.
3 CSFB, Ibbotson, Lehman Brothers. Monthly total returns from 01/01/94 to 01/07/04.

CORPORATE STATEMENT

Credit Suisse Asset Management (CSAM) is a leading global asset manager focusing on institutional, mutual fund and private client investors, providing investment products and portfolio advice in three regions (Americas, Asia-Pacific and Europe) around the world. CSAM has $341.7bn of global assets under management and employs 1885 people worldwide as of 31 December 2004.

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