

## **Reconciling alternative and long-only investment approaches: the best of both worlds?**

### **The alternative approach does exist: I have come across it.**

Special alternative-investment newspaper supplements, special issues on hedge funds, countless articles dedicated to alpha's victory over beta or vice-versa: the observer's eye is almost constantly attracted to new publications on the issue and it can no longer be denied that alternative investments have become an integral part of the financial landscape. Rising numbers of legislative advances in such countries as France, the US, Luxembourg, more recently Spain and more nations in the foreseeable future merely add strength to the fact.

What could have happened to enable the alternative-investments universe to shift from darkness, where it was only within the reach of a narrow fringe of *cognoscenti*, to the broad daylight of less-sophisticated private investors acting via pension funds or asset management firms?

Is performance the correct answer? Only in part: from the viewpoint of most investors, the perception of performance is dissymmetrical in that spells of disastrous performance will be more lastingly remembered. Strong performance, such as that recorded over 2005, may reassure, but only up to a point; whereas after a bad year, the whole concept of alternative investing may be much more irrevocably put into question owing to the complexity of certain of its features. The general public has, for instance, still not fully digested the LTCM debacle.

Does part of the answer lie in the decorrelation of hedge fund performances compared to traditional markets? Some may agree. However, opponents to alternative investing adamantly claim that this decorrelation does not apply in the event of high market volatility, that hedge funds produce Beta in disguise, etc.

This near-official acknowledgement of alternative investment is maybe more closely linked to the fact that hedge funds and alternative funds are capable of reducing volatility and tend to stabilise the distribution of returns. As they now benefit from the hindsight needed to support this argument's validity, hedge-fund promoters' and distributors' ongoing didactic efforts have significantly strengthened this specific perception of reality.

With its legitimacy apparently no longer in question, is alternative investment now meant to indefinitely remain statically opposed to the universe of traditional investments?

### **The collapse of a barrier?**

After the convergence of hedge-fund and private-equity strategies, another barrier seems about to be overrun.

This new revolution involves an alliance between the traditional and alternative universes, which, up to now and from a dogmatic viewpoint, were deemed irreconcilable. Indeed, one has lately witnessed the emergence of long-only asset managers aiming to generate absolute returns.

Investors may now opt for traditional investment vehicles and directly buy funds (or invest via long-only funds-of-funds) that are not tied to classic benchmark indices. The fact that certain prominent long-short managers have detected the new trend and launched long-only funds is by no means a happenstance development. Indeed, their expertise in long investment will be put to good use in this context. In particular, one will not be in a position to compare a long-short manager's approach with that of an equity manager aiming to measure his performance by comparison with that of a given index.

Three important elements are worth pointing out in this new development:

Firstly, only certain long-only strategies are likely to generate truly absolute returns: such is the case, for instance, with activism, market-timing, deep-value or thematic approaches. Indeed, owing to their markedly different sources of returns, each is capable of generating gains at specific points in a market cycle. The difference lies in the fact that these managers do not resort to leverage, use practically no derivatives and do not go short like their alternative-management counterparts. One may also note that liquidity constraints are comparable to those of traditional managers and are hence quite limited compared to those affecting the alternative universe.

Secondly, it is advisable to favour a multi-management approach (or alternatively that of a fund of traditionally managed funds). Indeed, a well-balanced diversification of the above-mentioned strategies is likely to generate a much stronger performance than that of market indices, whereas the downside risk may, if required, be reduced by limiting exposure.

Finally, institutional clients remain a favoured target for this approach. Indeed, this client base will now have an opportunity to replace part of its equity managers with these new long-only investment vehicles, which are likely to benefit from the absence of a certain perception of hedge-fund-related risks, as well as from the fact that many institutions' investment quotas in the alternative segment are now full.

The universe of finance evolves more and more rapidly and offers new, better-adapted solutions to specific investor needs. Thus, the emergence of traditional investment vehicles aiming to generate absolute returns will obviously relieve certain investors caught in their hesitations between long-only and alternative approaches. With this wider and more finely tuned new range of solutions, such choices are less and less mutually exclusive.

What does not change, however, is the necessity for these investors to rely on infrastructures that possess the resources needed to select and monitor the best-performing funds. This is all the more true as selection must be performed among more than 60'000 long-only funds, compared to approximately 8'300 in the alternative universe.

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