FOREWORD

The theme for Mercer’s Global Investment Forums this year is “Let’s not lose the decade.” Given the volatility of the markets, coupled with uncertainty over economics and even the euro, it is easy to imagine some investors might choose to sit on the sidelines. But this ignores some of the great opportunities that have arisen and will still arise in this environment. It is not all doom and gloom. Indeed, London’s successful staging of the Olympic Games and the final medal tables revealed there is plenty of life in the old Western powers.

We, in the Alternatives Boutique at Mercer, believe that alternative investments have important and significant roles to play in investor portfolios. Those roles are both in return generation and risk management. Some investments, such as private equity, are focused mainly on producing high returns, but others, such as some hedge fund strategies (for example, managed futures), can have a powerful diversification impact on portfolios. Many are expected to bring an element of both return and diversification, and good examples of this are
insurance-linked investments and a number of hedge fund strategies. In essence, alternatives provide access to different sources of return; and the more there are of these in portfolios, the less bumpy the journey and the greater the chances of success.

In this issue of Perspectives on Alternative Investments, a number of members of the Boutique give their thoughts on various investment strategies. Starting with private markets, Ray King, one of our newest members, gives an interview on private equity. Then, Toby Buscombe describes the potential role for real assets (infrastructure, real estate and natural resources) in portfolios. Ryan Bisch fleshes out one of the “exotic” strategies he introduced in our last edition: insurance-linked investments, which span both private and public markets.

Turning to hedge funds, we have a series of articles, starting with one by Dave McMillan and Simon Fox which tackles the important question of what the underlying thesis is for investing in hedge funds. We then take a closer look at hedge fund fees and, with Diane Miller, finally focus in on managed futures.

Let’s not lose the decade!

Robert Howie
Editor
Mercer has further expanded its private markets business with the addition of Ray King, Scott McNally, and Sarah Azzi, formerly of Sovereign Investments Research in Australia. We are pleased to welcome the firm’s founder, Ray King, and the team to Mercer. Robert Howie speaks to Ray about the move and his outlook for private market strategies, focusing on private equity.

Why did you join Mercer?  
There is exceptional merit in effectively employing alternative investments in a well developed investment portfolio. However, one key challenge of investing in alternatives is that the breadth of different sub-classes of assets is significant and the universe of managers is deep.

My previous business was a small boutique consulting company. Mercer, by contrast, has a global investment research platform that is second to none and this is the ideal foundation from which to deliver top class advice to investors in alternative assets.

What opportunities do you see?  
Alternative assets (and particularly private equity) have performed best historically when the fund vintage year coincides with a weak economy and a depressed share market. So we are currently very aggressive in our research and cautious in our analysis.

The better opportunities are where a manager is able to invest in quality companies that can be recapitalized and support some business restructure. In Asia, the reward is more from companies seeking private equity managers to assist them to improve the way in which they operate and to grow their businesses in new directions.

How should investors access the opportunities?  
Obviously we think having an advisor is invaluable. Also, the right investment solution should be customized to a client’s objectives.

One of our investment beliefs is that there is value in having a well developed view on the merit of different sub-classes of alternatives investments and strategies and investors should time allocations. Another belief is to build portfolios that have more concentrated positions but still diversify risk. We like to be very selective with the managers to whom money is allocated and employ a strenuous process of due diligence.
Are there barriers to investing in private equity?
There are no insurmountable external barriers to an institutional investor finding a suitable way to access private equity investments for their portfolio. Sometimes there are internal constraints (such as governing documents) that do not allow or limit unlisted investments.

Director/trustee and management education may sound condoning, but we have found far greater confidence in a private equity program with some sophisticated preparation on this side in advance.

What have private equity investors learnt?
A tough question. Can I answer what investors should have learnt?

First, investors should be much more aware of not investing in a sub class or region where valuations of new investments are excessive. Clearly, in the mid to late 2000s mega buyouts were very overpriced.

Second, investors must be prepared to be contrarian. Quality investment opportunities became very cheap (and great buying) in recent years due to negative investor sentiment. In some cases, this reflected investor nervousness and was not based on fundamentals.

Third, investors should invest with conviction. Consistently good calls are made on investment decisions, but the allocation is too small.

ABOUT RAY KING
As a graduate of Monash University, Ray began his career at BHP in 1974, and his previous work experience includes being Chief Economist for a major public authority. He has worked in the pension/superannuation and investments industry for more than 20 years and has established his credentials as one of Australia’s prominent consultants. In 2000, he founded Sovereign Investments Research, which provided specialist investment advice and management consulting to institutional investors on alternative investments, including early stage and venture components of private equity.

Ray is now a Partner at Mercer, where he leads our private equity efforts in Asian/Pacific, focusing on manager research and assisting clients with strategic allocations, portfolio construction and the selection and monitoring of private equity investments.
What do ground leases, gas pipelines and trees have in common? This seemingly eclectic collection of opportunities form part of a wider universe referred to as “real assets,” which offer the potential to act as a store of value through inflationary periods as well as provide a long-term return on investment.

DEFINING THE OPPORTUNITY

Real assets can be thought of as a subset of the wider universe of assets making up an investor’s “growth portfolio.” They encompass assets that have the potential to enhance portfolio returns over those in a defensive “base” portfolio. Real assets can provide exposure to multiple sources of return, which, when combined effectively, offer the opportunity to improve diversification. Within this universe exists a group of assets that combine hard asset backing, long life durations, and a degree of inflation linking in underlying cash flows and of return stability over time. This loose grouping of opportunities can be thought of as real assets.

“Real assets can provide exposure to multiple sources of return, which, when combined effectively, offer the opportunity to improve diversification.”
Real assets encompass each of the following broad asset classes:

- **Infrastructure**, itself a wide grouping of asset types spanning schools, airports, and toll roads through to gas pipelines.

- **Real Estate**, which covers a wider variety of underlying asset types, from start up property developments through to long-term ground leases and established commercial properties.

- **Natural Resources**, another wider grouping of opportunities, spanning oil and mineral exploration, energy resource ownership through to established farmland and timberland.
A ROLE WITHIN INSTITUTIONAL INVESTMENT PORTFOLIOS

An appropriately constructed portfolio of real assets comprising infrastructure, real estate and natural resources can help meet some or all of the following objectives:

- **Store of value** over the longer term (with enhancement potential)
- **Inflation linkage** for investors sensitive to this factor
- **Cash flow generative** focus
- **Return diversification**

When trying to deliver some of these portfolio roles, individual asset classes will inevitably encounter limitations in some market conditions. Therefore, a diversified portfolio-based approach to investment should be employed wherever possible.

“The final portfolio configuration needs to reflect the requirements of the investor.”

Against this, it is important to have discipline and frameworks in place to ensure effective (rather than naive) diversification. The final portfolio configuration needs to reflect the requirements of the investor. At an overarching level, a factor-based approach to real asset portfolio construction can help to inform the portfolio construction exercise. Profiling investors along a defensive/growth and nominal/real return focus continuum can also help in building out factor exposures that match investors’ requirements, subject to the practical constraints associated with the underlying assets available for selection.
“... a range of pooled vehicles are now available, both within and across each of the real asset classes outlined above, which offer the potential for achieving meaningful diversification without creating an unwieldy portfolio ...”

### Real Assets Portfolio Construction Tools Investor Profiling

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<th>Real/nominal agnostic</th>
<th>Need for yield (defensive)</th>
<th>Need for growth (opportunist)</th>
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<tr>
<td>Would expect majority of investors to place in these sectors</td>
<td>Investor profile 1</td>
<td>Investor profile 2</td>
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<td>Inflation sensitive</td>
<td>Investor profile 2</td>
<td>Investor profile 3</td>
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### Factor Risk Modeling

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<tr>
<th>Factor Risk Modeling</th>
<th>Investor profile 1 (defensive/income)</th>
<th>Investor profile 2 (income and growth)</th>
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<tr>
<td>Economic (GDP) growth sensitivity</td>
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<td>Inflation linkage</td>
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<td>Income/yield-oriented</td>
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<td>Interest rate (duration) risk</td>
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<td>Project/development risk</td>
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<td>Medium-high</td>
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<td>Financing/leverage risk</td>
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<td>Medium</td>
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<td>Emerging market/political risk</td>
<td>Low</td>
<td>Medium</td>
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<td>Illiquidity risk</td>
<td>Medium</td>
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<td>Regulatory risk</td>
<td>Low-medium</td>
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### PRACTICAL CONSIDERATIONS

To maximize the potential for achieving the real asset portfolio characteristics outlined above, we believe that investors should focus, as much as possible, on owning the underlying assets. This suggests a primary focus on less liquid investments. We also believe that effective diversification is key to successful real asset investing.

Against this, a range of pooled vehicles are now available, both within and across each of the real asset classes outlined above, which offer the potential for achieving meaningful diversification without creating an unwieldy portfolio (from a monitoring or governance perspective). There are also a range of steps to help address liquidity requirements, as outlined below. This includes listed investment options for investors requiring these.
CONCLUSION
The uncertain environment facing many institutional investors around the world calls for a more innovative approach to the pursuit of return enhancement, diversification and inflation protection than allocating solely to equities and bonds. A well constructed portfolio of real assets has the potential to form part of the answer in many parts of the world, and, indeed, could also offer long-term enhancement potential. Against this, effective portfolio construction is key to being successful, and this can be a complex and involved process, calling for dedication, discipline and understanding of underlying asset risks and characteristics.

ABOUT THE AUTHOR
Toby is based in London and is a Principal and senior infrastructure specialist within Mercer’s Alternatives Boutique. Toby joined Mercer after over a decade as a partner with a global alternatives asset manager, and leads Mercer’s direct alternatives investment activities in Europe, as well as supplementing its broader infrastructure and real asset capabilities.

“...effective portfolio construction is key to being successful, and this can be a complex and involved process, calling for dedication, discipline and understanding of underlying asset risks and characteristics.”
COUNTING CARDS IN NATURE’S CASINO

INSURANCE-LINKED INVESTMENT – CATASTROPHE REINSURANCE

BACKGROUND

As global investors seek alternative alpha and beta exposures to enhance portfolio return and diversification, Mercer continues to consider the link between how these goals can be pursued by investors in an ever-expanding universe of alternative investments, including insurance-linked investments. This brief article provides a snapshot of the opportunity.

WHAT ARE INSURANCE-LINKED INVESTMENTS?

Insurance-linked investments (or insurance-linked securities/ILS), such as catastrophe reinsurance, involve an event-linked investment for which the return of principal and the payment of interest is contingent on the non-occurrence of a pre-defined “trigger” event, such as a hurricane or an earthquake of a specific magnitude. This investment structure is created when insurance risk is transferred to a capital market-based security, vehicle or fund, separate from that of the insurance originator (either an insurance or reinsurance company). The capital market effectively becomes the insurance provider and is paid an insurance premium as compensation.
MARKET BACKGROUND – REINSURANCE TRENDS

This investment opportunity exists for capital market investors because there is no natural counterparty for extreme catastrophe risks. The securitization or risk transfer process simply transfers the underlying risk; very few participants can adequately hedge exposure to the extreme risk involved in catastrophes. Since the first catastrophe bond was issued in the 1990s, the universe of insurance-linked investments set has grown significantly. The availability of dealflow and market pricing remain linked to the primary insurance and reinsurance markets. There are a number of trends that are continuing in the catastrophe insurance market that are supportive of the opportunity, including:

• Increased regulatory capital requirements of insurers and reinsurers, which may lead to the demand for more institutional capital to support (re)insurers’ balance sheets

• Increased demand for institutional capital due to an increase in potential loss exposures on existing classes of risk, and the addition of new perils (such as floods and crops). These developments may be fueled in part by climate change, though long-term demographic changes have been the primary driver

• Convergence of institutional capital and reinsurance markets. The speed with which capital can be transferred from the institutional market to the reinsurance market appears to have increased, in many instances due to the influence of hedge funds. The increase in the elasticity of capital supply may tend to stabilize catastrophe reinsurance rates, but this could mean that investors will no longer achieve the significantly higher rates that were often available following mega-catastrophes

Current market conditions have had an impact on the availability of reinsurance capacity for the 2012 calendar year, due to capital scarcity among traditional risk capital providers. This has been driven by:

• 2011 insurance losses due to catastrophes ($105bn) – substantial losses resulting from the Tohuku and Christchurch earthquake disasters have led to increased capital requirements for the reinsurance industry causing reinsurance rates to rise in certain segments.

• Recent revisions of catastrophe risk models are expected to lead to more generous spreads and/or higher trigger levels for losses on catastrophe bonds.

• Combination of tighter solvency regulations and low returns on insurance asset portfolios, make the current market environment an attractive time to allocate to the asset class.

“Since the first catastrophe bond was issued in the 1990s, the universe of insurance-linked investments set has grown significantly.”
Overall, these trends suggest that the opportunity set available to capital market investors will continue to grow and that the risk premium will remain attractive over the medium term. However, returns are expected to fluctuate cyclically, with imbalances in capital supply and demand within the wider insurance industry.

**PAST PERFORMANCE – CATASTROPHE REINSURANCE VS. TRADITIONAL ASSET CLASSES**

During the last five years (including the period of the financial crisis) the past investment performance of the catastrophe reinsurance asset class is attractive relative to a number of the traditional asset classes – having achieved a return comparable to government bonds and credit during this period. The Swiss Re BB Cat Bond index, which is a composite of all BB-rated catastrophe bonds, has produced an annualized return of 9%, which was the highest return during this period for the asset classes shown in the chart below.

The “median ILS fund” represents the net of fees performance of the monthly median manager performance calculated across 12 catastrophe reinsurance strategies in the Mercer universe.

“... trends suggest that the opportunity set available to capital market investors will continue to grow and that the risk premium will remain attractive over the medium term.”
It is worth reinforcing that past performance should not be used as a reliable predictor of future performance. While empirical evidence supports the view that diversified portfolios of catastrophe reinsurance can exhibit reasonably low volatility (in the range of 2% to 6% per annum), there are very significant potential tail losses associated with this asset class. Investors have to be able to withstand rare but possibly significant losses. Investments in the asset class can vary considerably with the range of risks covered, time horizon and trigger points, but the one common feature is a strong negative (left-tail) skewness of returns – driven by exposure to event risk. Investment vehicles for this asset class tend to be structured like hedge funds, with similar fees and liquidity.

SUMMARY
We believe this asset class has attractive diversification characteristics and is worth further consideration for investors who are able to tolerate the tail-risk associated. However, investors need to have an appreciation of the risks and complexity of ILS. Therefore, at portfolio level, the allocation to insurance-linked investments should represent only a modest proportion of a diversified asset portfolio.

“Investors have to be able to withstand rare but possibly significant losses.”

ABOUT THE AUTHOR
Ryan is based in Toronto and is a Principal and Market Leader for the Alternatives Boutique in Canada, a unit within Mercer’s Investments business. He leads the manager research and generation of intellectual capital for alternative assets in Canada, spanning hedge fund strategies to private market strategies, including infrastructure. He is also the Global Director for exotic alternatives research and lead researcher for insurance-linked strategies.
INTRODUCTION

In our opinion, hedge funds are ideally suited for a specific and critical role within investor portfolios. Hedge funds provide exposure to non-traditional risk factors. Non-traditional or differentiated risk factors diversify the risks that dominate the traditional portfolio (equity risk in particular). By introducing new risks, the portfolio carries additional return drivers and relies less on the direction of capital markets, resulting in lower risk. It is important to note that this risk reduction capability does not necessarily come at the cost of lower expected returns.

It is critical to note, however, that hedge funds are not an asset class. Rather, hedge funds are a collection of heterogeneous investment strategies. These strategies tend to have disparate risk/return profiles. In fact, individual hedge fund managers implementing the same investment strategy often target and generate contrasting risk profiles. Across the universe of hedge funds, investment terms and vehicle structures tend to have greater commonality than the most basic performance characteristics, such as expected return, standard deviation, and correlation. Clearly, this has numerous implications for implementing a hedge fund portfolio and the role hedge funds play in the traditional asset allocation framework.

Hedge fund heterogeneity is the ultimate qualifier as it relates to any generalizations about this category of investment. Indeed, many hedge funds carry meaningful exposure to traditional risk factors, which limits their diversification benefits. Indeed risk reduction is only achieved through a disciplined, calculated, and informed approach to hedge fund manager selection and portfolio construction. This is very different than a passive equity or bond allocation, which, by definition, provides the desired exposure.
In this article, we seek to define the optimal role for hedge funds in a portfolio. We begin with a discussion of risk factor diversity, define a few key risk factors, summarize many common pitfalls to hedge fund investing, and conclude with practical applications.

**DIVERSIFYING AWAY FROM TRADITIONAL RISK PREMIA**

Traditional risk premia are those that are achieved with broad exposure to traditional asset classes. The equity risk premium is a common building block for many portfolios and, we believe, there is a logical and sensible rationale for that persisting. However, it is also clear to us that if we can identify and capture other sources of return (other risk premia), then we can construct a portfolio with more attractive risk/return characteristics than one simply reliant on the equity markets. It is in this respect that we see hedge funds forming a compelling part of most portfolios.

Hedge funds can be utilized to gain exposure to a variety of non-traditional risks (“hedge fund risks”). Most market participants cite “alpha,” or return that is not attributable to market risk, as the primary reason to invest in hedge funds. We agree with this premise, as alpha is the ultimate diversifier; however, alpha is frequently described as a magical by-product of manager skill. While skill is an important component, we believe that what is often described as “hedge fund alpha” is largely driven by exposure to non-traditional risk factors. Indeed, by definition, alpha is the result of exposure to specific, rather than market, risks.

Hedge fund risks include “bi-directional” security selection, deal risk, and liquidity provision, to name a few. While a detailed discussion of these risk factors requires a long white paper, we would like to provide a few brief examples to illustrate the concept of risk factor diversity. A hedge fund manager invests in securities on a bi-directional – they can go both long and short off a security, and investing on this basis effectively exchanges a degree of market risk for security selection risk.

That is, assuming a well-hedged portfolio, security selection skill, rather than market direction, becomes the primary driver of return. A merger arbitrageur accepts deal risk (the risk of the deal breaking) to earn the return associated with the deal spread (the difference between current and target price) upon completion. This return will be earned, regardless of broad market direction, if the deal closes. Finally, hedge funds are providers of liquidity. While this factor permeates most strategies, it is most obvious in distressed securities, where many investment policy-bound institutional investors are forced to sell defaulted securities. Hedge funds are pleased to provide such non-economic sellers with the liquidity they need, at the right price.

**PITFALLS TO HEDGE FUND INVESTING**

We believe our argument for hedge funds as a risk-reducing element of the total portfolio is simple and defensible, as it is predicated on the most basic concept of diversification. However, investing in hedge funds carries a number of unique pitfalls. At some level, many of these challenges are the direct result of the very nature of the benefits that we seek – non-traditional risks are different than traditional risks, which are reasonably well understood. As a result, hedge funds are by no means a panacea; indeed, investing in hedge funds carries a number of “costs” that should be fully vetted pre-investment.

First and foremost, hedge funds are typically offered as private placements, generally exempt from registration and generally subject to less robust regulatory oversight. While this description varies by fund, region, and manager, it is fair to generalize that hedge funds carry fewer investor rights and protections than traditional investments. In addition, the majority of hedge funds are semi-liquid, offering redemptions monthly, quarterly, or annually, for example. Investors with high spending needs or large immediate or uncertain liabilities should likely adopt lower allocations to hedge funds to better match the duration of their liabilities. Moreover, hedge funds...
implement complicated trading strategies. While reporting and transparency vary by manager and have generally improved over the years, hedge funds are often opaque. Furthermore, the dynamic trading nature of many strategies increases the challenges associated with effective risk monitoring. Finally, it should be noted that hedge funds are a lighting rod for the popular press. Despite best efforts in due diligence, manager selection, and risk monitoring, investors in hedge funds should be prepared for the potential discomfort of negative articles associated with the industry and/or specific managers. This risk also applies to traditional investment strategies, but arguably to a lesser extent.

Hedge funds are concentrated expressions of active management. As such, the results achieved are subject to remarkably high implementation risk. There is no pure passive alternative to non-traditional risk factors and manager skill. While complaints regarding the double layer of fees associated with fund of hedge funds investing are common, we believe that greater value destruction has resulted from inexperienced allocators making uninformed investment decisions. Experience is critical and carries a cost. Past performance is most definitely not indicative of future results.

THE OPTIMAL USE OF HEDGE FUNDS
As we have described, hedge funds are not an asset class. Investing in hedge funds exposes an investor to non-traditional risks, some of which are expected to reward, while others carry no such benefit. A hedge fund investment requires an investor to tap their liquidity budget, active management budget, fee budget, and, potentially, their tolerance for headline risk. For one to carry all of the additional baggage, we believe the reward should be extraordinary. Hedge funds, thoughtfully implemented as a risk reducing element of the total portfolio, offer the prospect of lowering expected volatility without detracting from expected return – an extraordinary reward indeed.

Structured to generate risk-reducing returns through risk factor diversification, hedge funds satisfy a compelling role in a portfolio. Unfortunately, factor-based diversification cannot completely eliminate risk and there will always be periods “where correlations go to 1.” We do believe, however, that factor-based diversification can allow for superior portfolio construction, while minimizing, though not eliminating, risk. A portfolio 100% invested in equities is a high risk portfolio. Introducing a diversified basket of calculated hedge fund risks reduces the overall risk of the total portfolio. As always, the investment world is full of risks; we like the potential diversification benefits that hedge fund allocations bring to portfolios today.

ABOUT THE AUTHORS
Dave is based in St. Louis and is a Partner at Mercer where he directs the firm’s hedge fund manager research effort globally. Dave joined Mercer in 2011 from Hammond Associates when the firm was acquired by Mercer in 2011. He has over 18 years of experience in the financial, banking, and investment advisory industries, including more than 10 years dedicated to hedge fund research and investing.

Simon is based in London and is a Principal at Mercer. As Director of Macro, Currency and Commodity Research, Simon is responsible for developing the intellectual capital and research coverage in global macro hedge funds, currency and commodity strategies. He has nine years of investment experience with Mercer.
Generally speaking, what was once a “2 and 20” industry standard continues to move towards “1.5 and 20.” Following the events of 2008 and generally tepid market performance over the past few years, the industry has continued a rationalization in price, as supply/demand dynamics have meant that managers are more willing to accommodate on fees. Hedge funds have maintained the common two-tier structure (base fee and performance related fee), but most of the fee accommodation has occurred on the base, rather than the performance component.

**HOW IMPORTANT ARE FEES?**

If we perform a basic calculation (without regard to high watermarks or hurdles) and use the HFRI Fund Weighted Composite Index as a representative index of the hedge fund industry (also assuming that the average fee in this index is a fee of 2% base plus 20% performance), we can see the impact of fees in the chart below.

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**Impact of Fees on Returns**

- **Gross**: Full fee, no accommodation
- **1+10**: Reduced base fee
- **2+20 (HFRI Fund Weighted Composite Index)**: Average fee in the index
- **3+30**: Full fee, reduced performance fee

*Source: Mercer, HFRI*

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1 2% p.a. base fee and a 20% performance fee
Over the 22 and one quarter years that the index has been published, an investment of $100 paying “2+20” fees would have compounded to around $1,000 over the period. By contrast, if the fees were only “1+10,” the investment would be worth almost double. The performance fee is an important aspect of this equation.

Another way of looking at fees is to compare the proportions of gross return received by the manager as fees and the net return left for the investor. The chart below illustrates how much of the gross return reverts to the investor for different rates of gross return.

As can be seen, the investor only starts making a positive net return when the gross return exceeds 2% and indeed it is only when gross returns are 10% or more that the investors starts to accrue meaningful proportions.

The situation is further biased in the managers’ favor by the asymmetry of the performance fee, usually payable by the investor to the manager when returns are positive, but not vice versa when returns are negative. Again, managers appear to be learning that this structure may be deterring potential investors and, indeed, a few have started to advocate lower rates. The use of fee structures that include a high watermark (which is quite common) or assessment of performance fee over a longer period (which is less common) can help mitigate these problems. It will be interesting to see whether these features become more widely accepted.
With interest rates around the developed world at low levels, hurdle rates might seem somewhat irrelevant, but if and when interest rates return to more normal levels, the impact of not having a hurdle rate becomes significant.

**TAKING A HOLISTIC APPROACH TO HEDGE FUND INVESTING**

Overall, we do think hedge fund fees are on the high side and we would welcome a continued trend in bringing them down. But we think it is a mistake to focus solely on fees – after all, if the net return is highly attractive, it is worth paying decent fees. Not all hedge funds are created equally, but they do all charge reasonably high fees, so it is critical to conduct careful due diligence, manager selection, and risk monitoring to ensure any fees paid go to managers who deserve them.

Given the impact of fees on net returns, investors should be robust in negotiating fees with managers, but the primary focus should be on identifying managers than can produce the gross returns in the first place. Negotiating a fee structure that better aligns interests (for example, with hurdle rates and longer term incentives) is often better than negotiating an absolute lower fee with a poor structure.

“With interest rates around the developed world at low levels, hurdle rates might seem somewhat irrelevant, but if and when interest rates return to more normal levels, the impact of not having a hurdle rate becomes significant.”

**ABOUT THE AUTHOR**

Rob is based in London, where he is a Principal and European Head of the Alternatives Boutique. He leads the manager research and generation of intellectual capital for alternative assets in Europe, spanning liquid hedge fund strategies to private market strategies such as infrastructure and private equity. Additionally, he advises institutional investors on the use of alternative assets, including manager selections and portfolio construction. Rob has over 15 years of experience within the financial services industry, and has been with Mercer for over 10 years.
What are managed futures managers and why should I be interested?
Managed futures is the name given to a type of hedge fund manager. They are a bit different. In fact, it is easier to say what they do not do. They do not base their investments on economic and financial market analysis like macro managers, or look for undervalued investments like value managers, or take long and short positions in individual stocks like equity market neutral managers. These managers do not do any of the above – but they do take positions in futures markets, hence the name. Actually, they often trade currency forwards as well, and some may trade other derivatives too, but the core is all about managing futures.

They invest in the same instruments as macro managers but they just do it differently. It’s like the Danish pastry that you are eating and my lemon drizzle cake. The ingredients are similar but the outcome is different. And they can both be nice to have.

I heard that they are also called CTAs or trend followers.
CTA stands for commodity trading advisor and dates back to the introduction of the US Commodities and Futures Trading Commission (CFTC) to regulate futures trading in agricultural commodities. The range of contracts has since broadened to include financial futures, but the CTA name stuck.

The managers are also called trend followers because that is what many of them do.

So it is as simple as buying markets that are going up and selling those that are going down? How can managers rationalize that as an investment strategy? And how can I justify investing in a manager who buys just because the price has gone up?
Slow down a bit. That is a big question.

Although investment specialists used to look down on the idea of using price trends to drive investment decisions, these days there is a large body of research that supports the idea. It’s called behavioral finance. The basic premise is that investors behave in certain ways and that price moves reflect this. For example, when new information comes out, some investors are quicker to react to it than others. So if it is positive, they will buy straight away. Others may take a day or two to think about it first. And institutional investors often take even longer. They will want to meet to discuss it and might wait for further corroboration before acting. Some longer-term investors may only make allocation changes once a quarter. So you see how the buying pressure can build up over time, especially as bigger investors become involved. And that can create an opportunity for investors who can identify trends early.
Eventually, the trend might become overdone, which then leaves the price vulnerable to bad news, and maybe a trend in the opposite direction. Or if the news is not conclusive, the price may move sideways for a while (called range trading in the jargon). Some managers try to benefit from identifying different patterns, such as mean reversion (when a price trades within a range) or breakouts (when a price breaks out of a trading range). These techniques are called pattern recognition.

But the real gains are usually to be made from the big price moves, and these are associated with trends.

*If it’s so easy, why doesn’t everyone follow trends, rather than spend time and effort on detailed economic analysis?*

I did not say it is easy. Most managed futures managers expect to get almost half their decisions wrong. But they invest in lots of markets – typically at least 40 and often well over 100 – so they get lots of chances to make decisions. As long as they have a small positive edge, the results will come through. And, on average, they should make more money when they get it right than they lose when they get it wrong, which also helps.

*How can they manage investments in so many markets?*

With the help of very powerful computers, highly qualified researchers and advanced statistics. The only inputs are usually price and volume data. Some managers track every single price change; others might check prices every minute, or maybe even just once a day. The price data are analyzed using sophisticated modeling to detect the patterns they are looking for. The models send trade signals to the dealers and, often, these too are traded automatically with the dealers’ role mainly a monitoring one.

*So they are just black box strategies really.*

There is room for discretion, but it is when setting up the models to begin with or adding new ones, when deciding what patterns to look for and how best to update the models. Trend followers look at trends over a range of periods, encompassing short, medium and long term, and they will have to decide how to define these – for example, is short term measured in days or weeks? Where do they set their dealing triggers? How much should they allow for transaction costs? The same types of decision will also need to be made if a manager is using a different sort of pattern recognition.

Discretion may also be used to reduce risk if markets are behaving strangely, although as the signals are based on price, these strategies are largely self correcting. You do not get the situation where the manager stays with a losing trade because it is better value than before. If the price move does not confirm the position, the manager will exit.

*OK – it all sounds fairly respectable, despite my initial misgivings. How have they done?*

Pretty well, on the whole. Good years can be very good and bad years are not usually too painful, as the following chart shows. Look at the return in 2008 when equity markets crashed. You can not do too badly with an investment profile like that.
What can go wrong?
There is always something unexpected that can come out of the woodwork. One worry is that the success of these managers may somehow set them up for a fall as more and more money tries to follow the same ideas. Some of the most successful managers are the ones most worried about growth in assets managed by the industry and have become more cautious as a result. But managed futures strategies are still a fraction of total markets, and as I said earlier, these managers respond to price, so will be quick to spot anything unusual.

Trend followers also do not do so well when markets go sideways, as they buy into trends that then reverse, incurring trading costs for little or no gain. 2011 suffered from that, although managers with a range-trading approach did better. Counterparty risk has also been a big concern for many managers, not just managed futures. In fact, managed futures managers largely trade exchange traded securities, so as long as their unencumbered cash is safely invested, they are less exposed than most.

It all seems very interesting. Where can I find out more?
Now you’re talking. Let’s meet up later. Did you want to try the lemon drizzle cake before we go back in? It’s very good.

ABOUT DIANE MILLER
Diane is based in London and is Lead Researcher for Managed Futures strategies. She has over 20 years of experience within the pensions and investment industry. Before joining Mercer, she worked as a fund manager, specializing in UK equities and asset allocation for pension fund clients.
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