

# MyConsultant

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## How are alternatives faring during the storm of 2011?



**Gareth Abley,**  
Head of Capital Markets &  
Alternatives Research

The globe has been battered by strong forces over the past year. Christchurch was devastated by earthquake, Queensland flooded by Cyclone Yasi, Japan double punched by earthquake and tsunami (with a nuclear knockout narrowly avoided), and the US endured an intense tornado season plus the recent impact of Hurricane Irene.

Global investment markets were also rocked by fault lines in European sovereign debt markets and the failings of leadership in both the US and Europe.

To help our clients weather the increasingly turbulent investment environment, we have deepened our research into diversifying alternatives to complement our long and successful heritage in private equity. One benefit of this research has been the

introduction of the Low Correlation Real Return strategy (LCRR) which aims to deliver returns which are not correlated with equity markets, thereby increasing diversification and lowering risk. LCRR includes an exposure to Insurance Related Investments (IRIs) which involves providing capital to the insurance industry covering major natural catastrophes. It also includes an exposure to Bridgewater High Alpha, (a Global Macro hedge fund) and Ruffer (a long only multi-asset class manager).

The past year has proven an interesting test of these types of assets, given the extreme events in terms of both natural disasters and market volatility. **Exhibit 1** shows the performance of mainstream equity, bond, hedge fund and catastrophe bond indices, plus LCRR and our Private Equity strategy.

**Exhibit 1: Performance of asset classes vs MLC Private Equity & LCRR to 31 August 2011**

	3 months	6 months	1 year	3 years
Global Shares Hedged	-9.8%	-8.4%	+11.8%	-0.7%
Australian Shares	-7.6%	-9.1%	+2.1%	-1.4%
Australian Bonds	+4.3%	+6.8%	+7.1%	+8.0%
Hedge Funds	-2.2%	-4.6%	+3.7%	-0.6%
Catastrophe Bonds (IRIs)	+3.9%	+0.5%	+7.6%	+10.0%
MLC Global Private Equity	+6.9%	+15.9%	+24.4%	+7.5%
MLC Low Correlation Real Return (LCRR)	+3.4%	+6.3%	+18.8%	+13.6%

Indices used are the MSCI AC World (hedged), S&P/ASX 300 Acc, UBS Composite Bond (All maturity), HFRX Global (A\$ hedged), Swiss Re BB Cat Bond (A\$ hedged). LCRR returns are shown net of manager fees but gross of MLC fees.

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We now drill deeper into the hedge fund and catastrophe bond sub-sectors to explore the dynamics driving performance.

## How much of a hedge are hedge funds?

The HFRX Global index shown in **Exhibit 1** is a measure of the average performance of hedge funds which number in the thousands. Despite the industry sales pitch that hedge fund managers rely on skill to generate alpha, hedge funds are, *en masse* at least, creatures of markets. Many hedge funds are exposed to similar risk factors to listed markets, such as equity, credit and liquidity risk. Hence it does not surprise us that hedge funds *on average* have struggled in the current choppy environment and have not provided as much downside protection as advertised. What is perhaps more surprising, is that despite most hedge funds disappointing their clients over the period of the GFC, investors have moved back into hedge funds *en masse* in the last couple of years, with total hedge fund assets currently in the region of \$2 trillion. This

perhaps says as much about concerns with traditional markets as it does about hedge funds.

Our research efforts focus on drilling deeper to understand the various hedge fund strategy types, or 'buckets', which underpin the 'average' result for the hedge fund industry. This provides insights into which hedge fund managers truly add value relative to markets, and under which conditions.

**Exhibit 2** shows the different level of dispersion of returns for managers in various hedge fund buckets. This shows that for a bucket like Global Macro (Macro-Discretionary) hedge funds, there is a wide dispersion of manager returns due to very differentiated strategy types. This reflects different risk profiles, volatility targets, leverage levels and, of course, each manager's positioning. At the other end of the spectrum the relatively homogenous nature of Merger Arbitrage strategies results in a relatively tight pattern of manager returns within this bucket – this reflects

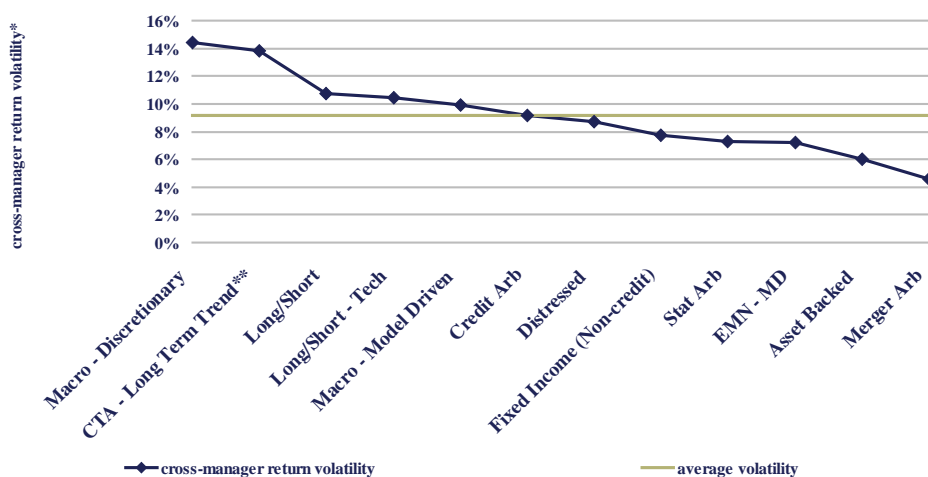
the very similar strategies employed by managers (to go 'long' the shares of a company being acquired and to sell 'short' the shares of the company doing the acquiring).

These various buckets also behave differently to each other in different market environments. For example, Managed Futures hedge funds were generally slightly positive over the last 6 months, compared to Distressed hedge funds that were down -6% over the same period. It is also important to understand that what looks like uncorrelated performance in 'normal' markets, can quickly become highly correlated at the worst possible time in bear markets.

Bridgewater Pure Alpha hedge fund, which falls under the Global Macro bucket, is one strategy we have carefully selected within LCRR. Bridgewater seeks to deliver genuinely uncorrelated returns, regardless of equity market performance, through a fundamental understanding of economic market drivers. They have performed deep research into the impacts of deleveraging cycles and sovereign debt crises, and these insights have enabled them to add significant double digit returns annualised over the past three years, despite the global turbulence.

Our research aims to identify hedge fund strategies that can demonstrate true manager skill, and also returns which are uncorrelated with equity markets and with other strategies within LCRR. This will further enhance diversification and help reduce risk in our clients' portfolios.

**Exhibit 2: Dispersion of manager returns for each type of hedge fund 'bucket'**



Source: Neuberger Berman

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## How have catastrophe bonds fared?

Insurance Related Investments (IRIs, otherwise known as catastrophe bonds), currently constitute one of the sub-strategies within LCRR. Catastrophe bonds are a means for investors to provide capital to the insurance industry to share in the risk of natural disasters in return for an attractive yield (see **Exhibit 4**). Our view is that this is a mutually beneficial and economically logical relationship. From the insurers' perspective, they are able to offload some of the risk of these low probability, but high impact, events and so use their capital more efficiently. The attraction for investors like MLC is that the returns are very lowly correlated with equity markets, as was proven during the GFC.

The last year provides an interesting test case for this asset class as we have seen greater economic losses from natural disasters than normal. **Exhibit 3** highlights the economic losses incurred so far this

year through the New Zealand earthquakes, Australian's Cyclone Yasi, Japan's Great East earthquake and an above average US tornado season. This was before the impact of Hurricane Irene, which would have added several more billion dollars of losses. (Please note that **Exhibit 3** refers to *economic* losses, and not *insured* losses. Insured losses are much lower as not all homes and businesses are insured.) The question is – what do these losses mean for investors in IRIs? It partly depends on what particular events your portfolio was exposed to – but generally, the key risks that will materially impact portfolios are a very big loss caused by a US hurricane or California earthquake. As a result, despite the very sizeable losses for the insurance industry in 2011, so far our IRIs strategy is currently roughly flat year to date (hedged into A\$). This compares favourably with equities and the average hedge fund.

We have included some frequently asked questions about IRIs at the end of this article.

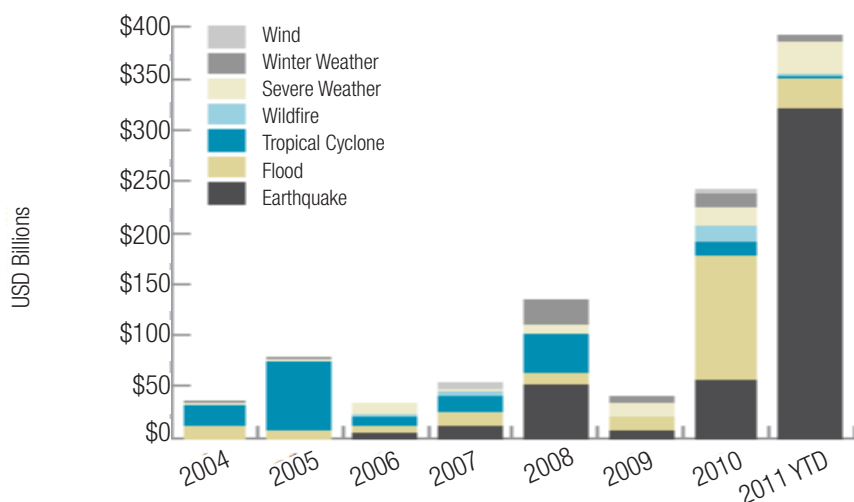
## Conclusion

The increasingly turbulent global environment makes it increasingly important to seek out alternatives that offer true diversification from listed market forces. The very selective approach we have taken historically has proven effective, as evidenced by the performance of LCRR. This performance has been at the high end of expectations and we think returns of cash plus 3-6% p.a. are more realistic going forward.

Alternatives are diverse and complex and often come with beguiling stories. It is important to be mindful that alternative assets, like hedge funds and IRIs, have weaknesses and risks like any asset class. Often there are issues around illiquidity, transparency, fees and hidden tail risks that need to be carefully analysed and addressed. The amount of capital that flows into these strategies will also influence prospective returns. IRIs are a prime example of an asset class where yields might contract over time as institutional investor comfort grows. This highlights the need to avoid becoming emotionally attached to specific strategies or managers, and the need for ongoing research to continue to uncover those scarce alternatives that offer true diversification.

Our research team is working hard, with a perspective of open minded scepticism, to identify attractive and complementary new strategies.

**Exhibit 3: Economic losses for natural disasters**



Source: Aon Benfield Analytics

# Some frequently asked questions about Insurance Related Investments (IRIs)

It has been interesting to talk to clients about IRIs over the last couple of years and I include here answers to some common questions.

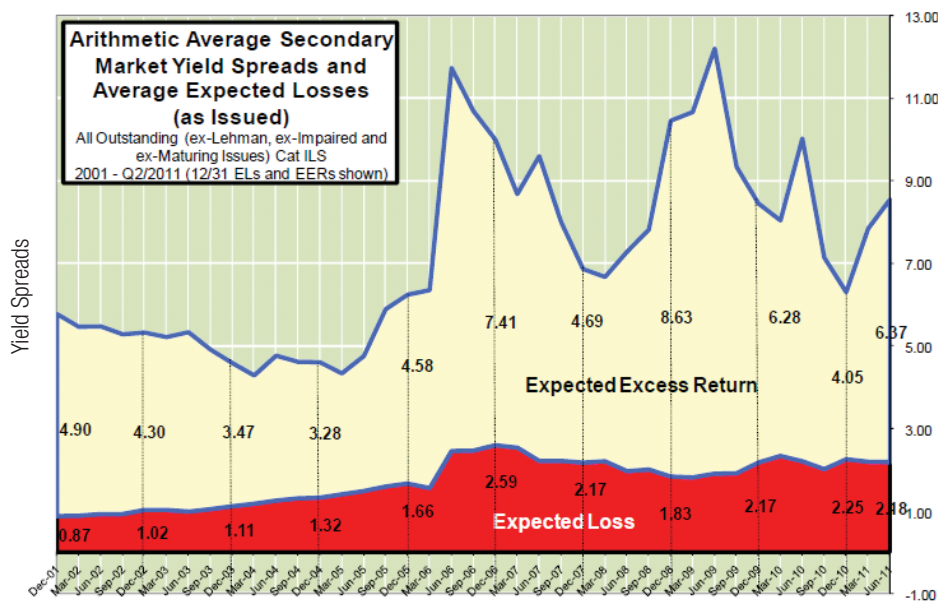
*Q Is investing in IRIs exploiting other people's suffering after a catastrophe?*

The answer is a big 'no'. When there is an event, this money goes to pay the people who have suffered. Without this capital provision, the cost of this insurance to the consumer is likely to be higher or, worse, people who want insurance may not be able to get it. Hence we firmly believe that supporting insurance markets is a social good.

*Q Could a major natural catastrophe cause a fall in equities?*

A major 1 in 100 year Florida hurricane or California earthquake would cause huge economic losses, which may impact markets. Historically, after events like Hurricane Andrew, the Kobe earthquake, Hurricane Katrina etc there hasn't been a direct impact on markets as other factors dominate. The recent Japan quake was an interesting case study, as at one stage Japanese equities were down -20%, while cat bonds were only down -2% (as few bonds were impacted). So despite Japan 2011 being a natural catastrophe induced equity market fall, cat bonds outperformed. This won't always be the case, it just highlights that the outcome is far from certain. The one thing we know is that IRIs are not correlated with sub-prime lending habits or EU sovereign debt shenanigans, which is one of their key attractions.

**Exhibit 4: Expected yields versus losses for catastrophe bonds**



Source: LaneFinancial

*Q How can anyone know whether you're getting a fair return for taking on these risks— aren't these catastrophes very unpredictable?*

There are independent modelling firms, staffed by hundreds of seismologists, geologists, property valuers, actuaries etc who do a very credible job using historical evidence and the latest science. However 'model risk' is arguably the biggest risk for IRIs.

There are a couple of important conclusions from this. Firstly, be aware of the uncertainty and that events could be more frequent and bigger than modelled. As a result, ensure the premium is sufficient to compensate for the model risk. **Exhibit 4** shows that yields remain attractive, particularly when factoring in the

diversification benefits, and have increased post the natural disasters experienced by the industry year to date.

Secondly, we need to have a balanced perspective on the level of uncertainty of IRIs relative to other mainstream asset classes. For example, Icelandic equities fell 90% from their peak in 2007. And the last 13 years has seen – in roughly chronological order - the Asian crisis, the tech bubble, the tech bust, the 'Chindia' driven commodity boom, the leverage driven bull market from 2003 to 2007, the GFC, the post GFC rebound... and now the European sovereign debt crisis. All of these were big impact events, all were hard to predict and all have had a big impact in listed equities and bond markets. The important thing is that IRIs offers an attractive return stream which is likely to be uncorrelated with listed markets.



With you

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