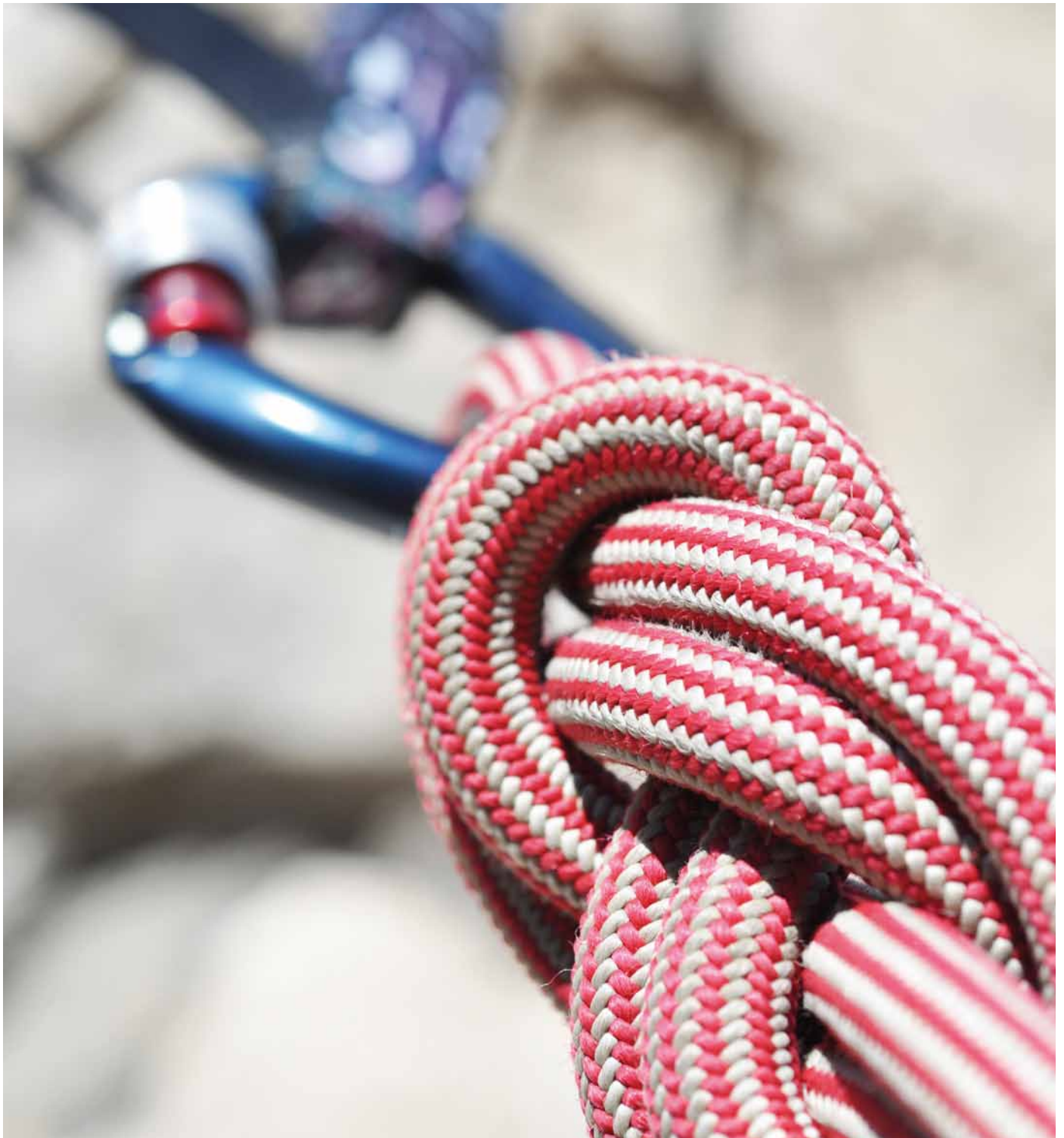


Protecting against alternative investment risk

How to manage the risks associated with non-traditional investments

by Matthew Botein



A properly designed and managed set of alternative investments can play an important role in enhancing institutional investor portfolios. However, many institutional investors have concerns over the inclusion of alternative investments in their strategy. Comprehensive and thorough risk management is key to allaying these concerns – but it is something that must be deeply embedded within the entire investment process rather than implemented as an overlay after the fact.

In general terms, alternative investments include all investment strategies outside of long-only equity, fixed income and cash instruments. Four of the broadest alternative asset strategies for institutional investors are hedge funds, private equity, real estate and commodities. These can offer two distinct benefits to an institutional portfolio: diversification through exposure to non-traditional beta or risk premia that are unavailable via traditional products; and alpha, or excess returns from manager skill.

During the recent global financial crisis, diversification offered limited protection as correlations between many ordinarily unrelated asset classes increased sharply. Furthermore, a lack of in-depth risk management meant that many investors did not fully understand the underlying return drivers of alternative asset classes and their changing patterns over the economic cycle.

Since the crisis, the regulatory environment in which alternatives managers operate has changed considerably. For example, the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US is expected to limit the proprietary investing

activities and sponsorship of alternative asset providers managed by banks and certain other regulated financial institutions. In Europe, the Alternative Investment Fund Managers (AIFM) Directive will impose registration, reporting and initial capital requirements on alternatives managers.

However, these developments – and the market stresses that preceded them – have not diminished the case for alternatives. Rather, they have highlighted the need for more dynamic and comprehensive risk management processes that truly reflect these underlying drivers and the shifting world they inhabit.

THE FOUR MAIN TYPES OF RISK

There are four broad categories of risk facing investors in alternative assets: investment risk, liquidity risk, operational risk and organisational risk.

1) Investment risk

Investment risk can be further subdivided into three broad categories: primary risk, secondary risk and idiosyncratic risk. Primary risks include movements in interest rates, equity markets, foreign currencies and commodity prices. Secondary risks are more nuanced as they result from exposures that a portfolio may exhibit to sub-segments of a particular asset class. For hedge funds, these risks may emerge from exposure to equity market volatility or credit spreads. Secondary risks relevant to private equity include exposures to a particular industry or vintage year, whereas real estate may include geography as well as economic and demographic trends. Idiosyncratic risks are specific to certain investments, such as the approval of a merger or acquisition or change in company management,

Comprehensive risk management is essential to alternative investing – but it must be embedded within the entire process, not added as an overlay.

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which may be unrelated to primary or secondary risks.

It is essential that alternatives managers have the necessary experience and skills to avoid unintended investment risks. Investors should use managers that demonstrate that portfolio exposures are deliberate, diversified and appropriately scaled.

2) Liquidity risk

Liquidity risk occurs when an investor is unable to meet its liabilities due to a lack of immediately available funds in its asset portfolio or when the selling of liquid assets results in a portfolio that is misaligned with its strategic target. During the credit crisis, liquidity risk became virtually a household term, particularly in relation to alternative assets.

Risk management for alternative investments affected by liquidity risk should include initial due diligence and monitoring to ensure that a fund has the appropriate liquidity for the investment strategy employed and the manager has a history of adhering to withdrawal requests. It should also include consideration of sources of contingent liquidity risk, such as the nature of one's co-investors in a given fund, which may affect the demands on a fund's resources. Structural changes in the availability of leverage for hedge funds should also lead investors to choose managers with access to sufficient liquidity and the capability to cope with a fall in liquidity.

3) Operational risk

Operational risk is the risk of loss resulting from inadequate controls, people or systems, or from external events. The shocking scope and scale of Bernard L Madoff's fraud raised serious questions about the ability of regulators to limit operational risk and sharpened investors' focus

on the paramount importance of operational due diligence. A proper assessment of the operational risks at Madoff's organisation would have highlighted issues such as the lack of a credible auditor, irregularities in his business model and an unknown (or implausible) investment strategy.

A vital aspect of operational risk is the soundness of the operating and internal control environments. Standard practices such as the segregation of duties, requiring two signatures on key documents, reconciling key financial balances and statements, and the use of independent auditors, custodians and administrators, are all part of this.

The financial crisis also pushed counterparty and collateral risks up the agenda for investors, particularly within the hedge fund space, as previously impregnable financial institutions suddenly looked vulnerable. Investors should identify hedge fund managers that are able to negotiate competitive terms of trade with counterparties and are able to maintain strategic relationships with them in times of market stress. Any potential over-reliance on a single broker should be identified, as should excessive levels of leverage and associated counterparty risk. In addition, the reduced availability and higher cost of financing in recent years has made it increasingly important to monitor the impact financing can have on fund returns.

When investing directly with a quality institutional fund manager, robust internal controls and procedures tend to mitigate operational risks. Nevertheless, investors should still conduct appropriate levels of due diligence across the key areas outlined above. (Article continues on page 26.)



Matthew Botein is head of BlackRock Alternative Investors, the firm's dedicated alternative investment platform. Below, he shares his views on the impact of regulatory reform on alternatives, how the 'barbell' investment trend will affect the industry and why BlackRock is different from its competitors.

How has financial regulation impacted alternatives?

Regulatory reform – specifically the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act – puts significant limitations on the proprietary investing activities and sponsorship of private equity and hedge funds managed by banks and certain other regulated financial institutions. Beyond the letter of this law, large financial institutions appear to be focused on de-risking and shedding activities that look like proprietary trading and investing. Increased regulation and changes in investor demands following the financial crisis have also raised the barriers for entering (or staying) for many historically less-regulated firms like hedge funds.

BlackRock's longstanding position in the market as an independent asset manager, whose entire business model is based on delivering returns to our investors, positions us very favourably as the world adjusts to these changes. We are seeing talented teams from bank proprietary trading desks and boutique hedge funds that want to align themselves with a platform that gives them access to corporate contacts, information flow, and industry-leading risk management capabilities and client relationships, and yet allows them to be responsive to the changes that investors and regulators have dictated must take place in the investment world.

What will the current 'barbell' investing trend mean for alternatives?

I think it's a very exciting thing for alternatives. Barbell

may not be the right option for every investor, but many are taking the view that they want to separate beta from alpha and they want to purchase optimal beta from efficient providers who can produce at competitive costs and with minimal error. I think BlackRock is one of the best-positioned providers of such beta. Our opportunity now is to similarly show that we're also among the pre-eminent manufacturers of alpha streams, that we do so across \$100 billion of assets and that we are able to identify exceptional managers and exceptional manufacturers of that alpha.

How do you differentiate BlackRock's capabilities from that of other competitors?

I think there are at least two differentiating characteristics. First, we have no conflicts between our proprietary trades and those of our clients – every dollar we invest is client money. We co-invest alongside clients but we do not have a single strategy where there's BlackRock house money invested without our clients' money. Second, we bring a level of intellectual capital, relationships and market prominence that arms our investment professionals with more information – and more specific investment opportunities – than they could have as a boutique investment manager. There are many examples I have seen of opportunities that reach our fund managers that they simply wouldn't have access to elsewhere.

4) Organisational risk

Organisational risk relates to the ability of an organisation to withstand a significant economic or market downturn. The financial crisis demonstrated the importance of partnering with a large institutional alternative solutions provider that can cope effectively with periods of major market disruption. In-depth due diligence and scenario-testing can help investors assess the robustness of an organisation during such periods.

SEEKING BEST PRACTICE

When determining whether a potential partner undertakes best practice in risk management, investors can use a number of criteria. For example, the institutional partner should never trade against or ahead of its clients. It is also vital that the platform has a strong team of talented, experienced individuals with a deep knowledge of alternative investments, a strong risk management culture (which operates independently of the investment team) and sophisticated systems to analyse and manage investment risks on a continuous and dynamic basis.

In order to control factors such as counterparty risk, investors should seek an investment partner that is able to demonstrate strong experience in handling counterparty risk through negotiation, management and diversification. In the same way, the partner should manage liquidity risk by ensuring that the underlying investment strategies have suitable liquidity and any restrictions, such as gates and side pockets, are used appropriately.

Furthermore, the ideal alternatives platform should feature an alignment of interests between the investors and the partner. There should also be sufficient transparency to ensure that investors can understand the risks relevant to their investment.

Above all, investors need to seek a partner who can provide them with the assurance of an alternatives allocation where positions are deliberate, diversified and appropriately scaled in order to increase the long-term risk-adjusted return potential of their portfolio.

THE MULTI-ASSET CLASS OPPORTUNITY SET IN ALTERNATIVES

For those investors who are able to identify partners with these attributes, the new financial landscape looks favourable for many alternative assets.

In hedge funds, the uncertain economic and market environment is creating some compelling opportunities for managers with the requisite skill and insight at a time when proprietary trading desks have been decapitalised as competitors.

In private equity, corporate spin-offs and deleveraging are increasing, while the changing regulatory environment with respect to healthcare, financials and energy also presents attractive investment potential. Opportunities in real estate are appealing in the current low-yielding environment, while commodities remain useful as an inflation hedge.

These factors add up to a strong case for long-term investors having an appropriate allocation to alternative assets. However, in order to maximise the potential of a strategic allocation to alternatives, it is vital that investors seek a partner with a focus on risk management, strong compliance procedures, transparency and expertise in a wide range of asset classes – in other words, a partner that can be trusted to identify the right solutions for a client and manage them appropriately within a diversified portfolio. ♦

To maximise the potential of an alternatives portfolio, investors need a partner with solid risk management, strong compliance procedures, transparency and expertise in numerous asset classes.

For more on risk management and alternative investments, please see BlackRock's *Alternative Investments: Risk Analysed*