

Products will become more sophisticated

Until recently, the investment fund management industry has been focused almost entirely on measures of return, though, only a small percentage of 'active' managers have been able to beat their respective benchmarks.

Historically, the market has always been able to provide a hot fund, or a strong sector trend, but finding a fund with **consistent long term performance** and an ability to navigate through a succession of market environments has been very difficult. And while returns will vary slightly, the truth is that the average manager correlates 80% - 90% with the appropriate country benchmark. Investors are becoming increasingly aware of this and there is now a growing move away from actively managed funds toward less expensive, and often better performing, index funds. Index funds allow investors to track a given market's returns and risk through a single portfolio.

Over the short term, top performing 'active' funds tend to be those that take on the most risk and are in the right place at the right time. Most funds bend in the wind. Even for strategies that are supposedly well-defined, such as Large Cap Value or Small Cap Growth, managers often contort, either knowingly or not, in an effort to keep pace with or conform to recent trends. On a long-term basis, only a small percentage of products maintain a **consistent risk profile**.

Investors have moved more money into international funds to achieve higher returns and lower the risk of their portfolios. But globally equity markets are becoming more correlated. For example, global markets now correlate 75%

with the S&P500. And while correlations were lower 20 years ago, as global integration, stock exchange harmonization and cross listings proliferate, correlations will continue rising. Higher correlations mean that benefits from diversifying a portfolio this way are greatly reduced.

The investment management industry has given virtually no thought to the issues of correlation as less than 1% of products are designed to be non-correlated. While there has been explosive growth in the number of mutual funds on the market, the selection of options offering true diversification for both institutional and individual investors is actually narrowing. Not only are most pooled funds essentially tracking the broad market indices but international markets are becoming more correlated, thereby reducing the benefits offered by investing in a variety of markets. Investors, both professional and personal, require options. This area offers the greatest potential as absolute return strategies that offer **low correlations** to traditional equity products provide the best method for diversifying an equity or balanced portfolio.

From a market panic or stress perspective, less than 1% of products offered even acknowledge that market stress occurs. During periods of extreme stress, such as October '87 or August '98, Japan in the 90s, Mexico in '94, East Asia in '97, or Russia in '98, markets tend to fall by dramatic percentages. Subsequent to the stress, markets have often spent four or more years underwater. Japan is currently at 11 years and counting. For the most part, investors must bear the risk of the market. They take their chances that the market will rise – or they keep their funds in cash. Less than 1% of products offer



investors the ability **to preserve their capital** or even attempt to **profit during periods of market panic** or bear markets.

Descriptions of Product Offerings will become less vague

In this environment, managed investment products must either cater to investors' *different risk and return preferences* or offer a meaningful and *non-correlated* complement to an investor's core index portfolio. Firms that can provide these products will thrive, commanding larger portions of the market as well as much higher fees.

This is why alternative strategies – or hedge funds – are continuing to grow in popularity.

Alternative strategies offer investors five differential features: higher returns, consistent return profiles, consistent risk profiles, non-correlated return profiles and/or profit opportunities in a down markets.

Contrary to popular belief, hedge funds are not by definition wildly speculative instruments only suitable for the rich and infamous. Rather, they seek to hedge risk; that is, to guide the amount of risk in a portfolio. Often hedge funds have less risk than that of the market as a whole.

Importantly, unlike index or most actively managed funds which follow markets that are largely correlated, hedge funds offer investors an opportunity to build a portfolio that has a very different risk profile – one of their own choosing.

The average US private client now has about 5% of his or her assets in hedge funds. As measurement techniques make risk/return characteristics more transparent to investors and as existing US hedge mutual funds educate

investors about the benefits of alternative strategies, the move to alternative investment strategies will continue growing. There is a decided shift to higher weightings even among the more conservative institutional investors as evidenced by CalPERS recent policy change allowing up to 25% of its actively managed portfolio to be invested in alternative strategies. There are many reasons for this shift, not least of which are extreme equity market valuations.

In Canada the average private client does not own hedge funds. But recent changes to Canadian regulations allowing limited use of hedge fund strategies, the potential relaxation of rules to allow more private investors to participate and, of course, the prevalence of such alternative vehicles in the US open the door to greater use of alternative strategies in Canada. As more investors learn of this opportunity and as investors seek protection amid extreme high market valuations, these figures are expected to grow. Alternative strategies are the next generation of investment vehicles.