

# HEDGE FUNDS

THE VOICE OF THE ALTERNATIVE INVESTMENT INDUSTRY **REVIEW**

## Portfolio offers transparency and pure alpha



One of the largest investment houses has decided to launch a product offering investors a range of market strategies in a single product with a lower fee structure. US Editor Kris Devasabai talks to Invesco about its Multi-Strategy Investing Portfolio.

Scott Wolle (*pictured*), chief investment officer for global asset allocation at Invesco, believes the Multi-Strategy Investing Portfolio (MSP) managed by his team is an indication of the shape of things to come in the hedge fund business.

The aim of the product is to isolate and provide exposure to pure alpha returns within Invesco's range of absolute return-orientated investment funds. Wolle says it offers greater transparency and liquidity than a traditional hedge fund, and is available at a lower price point.

"The MSP brings together what we believe to be the best of Invesco's public market strategies in one product. It is similar to a fund of hedge fund, but without the additional fee layer," says Wolle.

Wolle says the MSP is defined by its return profile which in turn is reflected in its fee structure. He believes investors will pay close attention to these attributes following a turbulent year in which many hedge funds failed to deliver on their promise of absolute returns.

The performance fees should mirror the alpha

generated by the fund, Wolle says. These he relates back to the skill employed by the manager. Pointing to academic research that indicates that on average hedge fund returns are principally driven by simple exposure to the equity and bond markets, he argues hedge funds were overpaid during the bull market years.

"Hedge funds have historically got a lot of their returns from capturing risk premia. These types of returns are not entirely skill-based. In my view if the manager is generating most of their returns from beta exposure to the market, he should not charge hedge fund fees," he says.

He thinks the days of the traditional 'two and 20' fee model are numbered. "Fees are going to be driven down to a more reasonable level. Funds of hedge funds will come under the greatest pressure to cut fees, given that many of them did not prove effective in allocating assets in a way that minimized drawdowns," he says.

The standard fee schedule for the MSP includes a 1.2% base fee and performance fees of 20% on returns above cash plus the base fee.

Performance fees are only on returns above cash.

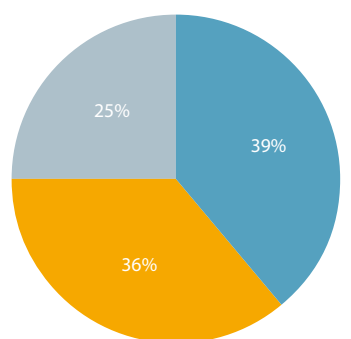
"A lot of hedge funds start charging fees as soon as they have positive returns. We think it is more appropriate to charge performance fees after having surpassed cash returns. There is no skill required to hold cash collateral," believes Wolle.

In addition to the MSP, earlier in 2009 Invesco launched Premia Plus, which the company describes as an alternative beta strategy designed to capture risk premia. The fund relies on beta exposure for around 80% of its returns with the remainder attributable to alpha. Wolle says this product is priced "at a much lower point" than hedge funds that produce comparable returns.

### Lower fees

Wolle contrasts Premia Plus with the MSP, designed to be market neutral where "all the returns can be classed as alpha". The MSP has a higher price point than Premia Plus, but Wolle emphasizes that the fees are still much lower than a fund of hedge fund.

### Initial strategies



■ EU market neutral  
■ US market neutral  
■ GTAA (made up equally of commodity, EM FX, Dev FX, EM equity, Dev equity, Fixed Income, Cross market)

Source: Invesco

Invesco is “ahead of where the hedge fund industry is going to have to move” in a number of areas, Wolle says. In addition to pricing he highlights transparency and liquidity. “We can give investors a view of the underlying holdings at any time and provide daily pricing.” The company uses independent administrators, auditors and custodians to verify returns and keep safe assets.

Public market strategies like long/short equity, market-neutral and global macro hedge funds will have to implement investor-friendly practices and robust infrastructure in order to attract capital in the future, believes Wolle. “The hedge fund industry has become more institutionalized over the past decade and the financial crisis will accelerate this. In a few years from now hedge funds will resemble the large institutional investment houses rather than the cottage industry that existed before 2008,” he says.

In building the MSP the global asset allocation group at Invesco homed in on strategies that could contribute uncorrelated alpha to the portfolio. Identifying the underlying strategies for the product was a huge undertaking.

The Atlanta, Georgia-headquartered investment company has around \$350 billion in assets under management. Close to \$60 billion, over 15%, is in alternative investment strategies, a higher percentage than many of its peers.

The initial universe of underlying products assessed by Wolle and his team comprised over 50 strategies, including private investment vehicles and relative return products pegged to a benchmark.

The team considered relative return strategies for inclusion in the MSP if it were possible to short the benchmark relatively cheaply to capture the excess returns. Products expected to generate excess returns of at least 4% after removing the benchmark exposure were deemed to be eligible for inclusion in the portfolio. Funds that could

be affordably levered to produce excess returns above 4% were also viewed as eligible.

Wolle says some very attractive products were ruled out because the cost of shorting out the benchmark exposure brought the excess returns below the 4% excess return requirement. He explains that shorting the benchmark is important in spite of the cost because it ensures that all beta exposure is weeded out of the MSP.

“We are aiming for very low correlation with the main public markets. Including beta returns in the portfolio would tie the returns to a benchmark. This is one of the main reasons that many funds of hedge funds are not truly market neutral – they incorporate low cost beta in their returns,” says Wolle.

Products with relatively high excess return expectations that exhibit strong style biases were also ruled out for the MSP. Wolle uses the example of a fund that is value orientated. “We would be reluctant to invest in that type of product unless we could offset the value exposure. Otherwise our returns would be heavily influenced by whether value stocks are in favor versus growth stocks. We don’t believe we can charge hedge fund fees for that type of return,” he says.

### Assessing track record

Wolle and his team also considered the track record and liquidity of the individual strategies before deciding on the portfolio.

The team settled on Invesco’s European and US market-neutral strategies and global tactical asset allocation (GTAA) product for inclusion in the MSP. “These strategies had not only the risk/return profile we were looking for, but also a long track record and attractive underlying characteristics, such as the transparency of holdings, simplicity of pricing and reasonable fee structures,” says Wolle.

Asset allocation within the MSP is designed to ensure that each strategy contributes an equal amount of risk to the overall portfolio. “That means the underperformance of a single product is less likely to have a severely damaging impact on overall returns,” Wolle says.

Given their lower risk profile, the market-neutral strategies account for 70% of the dollar weight in the portfolio, with GTAA making up the remainder. Each portfolio contributes one third of the total risk in the MSP.

The portfolio is rebalanced if it deviates from its target risk profile. Invesco has created thresholds based on a Monte Carlo simulation of the

risk contributed by each strategy. The simulation looks at the weights of the strategies rather than the return environment to determine the risk balance of the portfolio.

Invesco does not seek to tactically manage the allocation to each underlying strategy based on return expectations. “The research we did on the persistence of returns convinced us that there would be little value in doing that,” says Wolle.

An interesting aspect of the portfolio is the lack of any significant correlation between the European and US market-neutral strategies. Wolle says because the strategies are focused on security selection within separate baskets of stocks, there is very little overlap or correlation between the strategies. “The historic returns of the two strategies had a correlation close to zero. That is also true at the individual position level,” says Wolle.

The MSP was launched into the market for third party investors in August 2008. At the time the HFRI Fund Weighted Composite Index was down just 3.55%, while the S&P 500 had fallen 11% since the start of the year. The markets plummeted and the S&P 500 finished 2008 down over 30%, while the HFRI hedge fund index fell 19.02%.

Wolle says market conditions in the second half of 2008 provided a “real stress test” for the portfolio. The strategy is down 3% for the seven months to the end of February 2009. “It is not what we aimed for but the performance to date has given us confidence that the strategy will be able to generate returns consistent with expectations going forward,” says Wolle. Nevertheless, the strategy has performed well in the first few months of 2009, he adds.

He says the US market-neutral has performed well since the MSP was launched, while the European market-neutral and GTAA strategies have not performed to expectations. GTAA in particular was hurt by an emphasis on Asian markets in the latter part of 2008.

Wolle is cautious about making predictions about the future performance of the MSP. The diversified, market-neutral profile of the underlying strategies makes it difficult to forecast short-term performance, he says, and the team does not seek to tactically allocate between the various strategies.

The performance of market-neutral funds is typically determined by the effectiveness of the factor models used to forecast price movements. Invesco’s US and European market-neutral

## FUNDAMENTALS OF INVESCO MULTI-STRATEGY PORTFOLIO

Name of management company:	Invesco
Full name of strategy:	Multi-Strategy Portfolio
Address of manager:	Two Peachtree Pointe, 1555 Peachtree Street NE, Suite 1800, Atlanta, GA 30309
Contact:	Carey Millikin
Inception date of composite:	August 31, 2008
Portfolio size:	\$21 million
Average annualized return:	-3.56%
Average annualized volatility:	7.08%
Vehicles:	separate account and commingled fund
Fee schedule	1.2% base fee plus 20% of return above cash and the base fee
Minimum investment:	\$100 million for a separate account; \$1 million for commingled fund
Lock-in/up:	no lock-ups for MSP mandates
Redemption period:	daily NAV with weekly liquidity unless otherwise agreed with client

equity strategies use four categories of factors – valuation, price trend, earnings trend and management action – to evaluate stocks.

“There were some factors in the European market-neutral strategy that proved to be relatively ineffective in 2008,” says Wolle. He points to valuation as the best example of this. “Having any type of value bias was painful in 2008.”

Valuation spreads in a number of asset classes are now at abnormally wide levels, which has historically been an indicator of attractive returns to come for market-neutral strategies that incorporate valuation factors.

The GTAA strategy, which has been managed by Invesco since 2001, relies on four sets of macro factors: valuation; financial conditions; economic outlook; and sentiment. The strategy

takes directional positions and spread trades in global equity, fixed-income, commodity and currency markets. It uses primarily exchange-traded futures and currency forwards.

GTAA strategies typically seek to be responsive to the outcomes for the broader economy. Wolle believes the global economy faces a great deal of uncertainty but thinks the broad set of factors and markets incorporated into the strategy should give it the ability to generate positive returns.

Wolle is optimistic about the likely performance of the MSP in the long term. He says the product is designed to evolve over time as Invesco introduces new strategies that fit the MSP criteria.

“We have a formal link with the firm’s product committees so that we are aware of new capa-

bilities. We will consider the new capabilities but would constrain the risk contribution of any strategies that have a limited track record. The goal is to always have the MSP contain the most attractive public market alternatives that the company offers,” he concludes. ■

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