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Why alternatives must matter for HNW portfolios

Oliver Wiedemeijer of Credit Suisse explains the approach he and the Credit Suisse team take to providing alternative strategies for clients to diversify and protect their portfolios – a much discussed topic amidst the rich valuations in traditional asset classes.

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THE LIQUID ALTERNATIVES TEAM within Credit Suisse is in charge of investment due diligence for hedge funds and alternative risk premia strategies. The team also advises and manages clients' liquid alternatives allocations with over USD 13bn under management and advisory. Since starting in 1994, it now comprises over 50 professionals with the longest live track record running continuously since 1998. In his role, Wiedemeijer manages portfolios for institutional clients and provides investment due diligence of hedge funds based in Asia. He also manages hedge fund discretionary mandates for private clients.

While the Liquid Alternatives (LA) team has historically worked closely with institutional clients, they also serve private clients through its regional private bank partners. Credit Suisse's investment consultants and relationship managers within the private bank leverage off the due diligence the LA team conducts. "We do due diligence to find the best managers, while taking into account clients' demands and needs" Wiedemeijer explains. Such needs may vary between client types or among different locations.

In many developed markets, for example, diversified hedge fund products are required to deliver steady absolute returns while the focus is on downside protection and the uncorrelated nature of the return in a portfolio context. Other clients are looking for a higher target return while accepting somewhat higher volatility. "They

buy hedge funds predominantly for the returns and tend to be involved in the investment process and therefore prefer advisory relationships", says Singapore-based Wiedemeijer. The Liquid Alternative team aims to provide diversified solutions with returns that are balanced in terms of underlying return drivers.

Yet achieving such diversification is easier said than done in an environment that is dominated by low volatility and a prolonged bull market across traditional asset classes. Only slowly do clients get to grip with the fact that there might be times when both equities and fixed income could be down at the same. As a result, they are looking for some alternatives to protect their portfolios. "Active and unconstrained investment strategies such as hedge funds can provide this diversifying element" Wiedemeijer says.

DUE DILIGENCE MATTERS

The Liquid Alternative team's due diligence process is disciplined, rigorous and is designed around committees with checks and balances in place. The process consists of dedicated investment, operational, legal as well as market risk due diligence. All strategies and funds have to meet the same strict standards without exceptions. Some of the most important elements of due diligence relate to a fund's operational set up and processes. On the investment side, apart from investment talent, team expertise and risk management, liquidity is one of the key concerns when assessing a strategy. "Whether we due diligence offshore hedge funds or alternative UCITS funds, a fund's liquidity terms need to correspond to its underlying investments" Wiedemeijer emphasizes.

Credit Suisse's disciplined due diligence was the main factor ensuring that there have been no exposures to the prominent fraud cases such as Madoff and that post-crisis in 2008, none of the clients were gated and no products were suspended. Wiedemeijer says that "Taking such a disciplined approach to due diligence is important as a way to help clients protect their capital in an environment of liquidity withdrawal and stress. We understand that for clients return of capital is just as important as return on capital."

DUE DILIGENCE IN ASIA

Ultimately, all the funds the Liquid Alternatives team conducts due diligence on and advises their clients on have to meet the same due diligence standards, all around the world. However, Wiedemeijer stresses that the quality of the operational set up is not necessarily at the same level for all funds in all regions given the difference in maturity among local hedge fund markets. If the team identifies fund managers with proven investment talent and expertise, but without the proper operational set up, the Liquid Alternatives team might work with the manager to help improve the operational side of the business. "Especially in Asia, our operational due diligence team has to deploy extensive resources and sometimes work closely with hedge fund managers to improve their processes and structures," says Wiedemeijer.

These efforts can pay off. For example, the Liquid Alternatives team discovered a talented China long-short equity manager, which had exciting prospects, but whose business set up was not institutionalized enough to pass the team's due diligence. "We helped the fund hire a COO, and reorganize the operational procedures to make sure proper segregation of duties was in place and all our operational concerns were being addressed." he explains.

Most hedge funds are willing to work with a seasoned investor like Credit Suisse, as they benefit from advice that might help them attract further institutional capital. Furthermore, many alpha-focused strategies in Asia are capacity-constrained given the depth of the market, says Wiedemeijer. This requires investors to invest at earlier stages of a fund's life cycle.

SERVING LOCAL CLIENTS

The need for absolute returns, correlation benefits and protection in market stress periods sits at the heart of discussions with clients. Institutional and private clients might have different requirements. The different client requirements also result in different time horizon with some investors losing patience with a strategy much earlier than others given their focus on absolute returns, while others appreciate an investment's role in a bigger portfolio context. Wiedemeijer mentions that it is important to take the client's requirements into account and agree on the role hedge funds or risk premia are playing in a client's portfolio. "It's important to not sell hedge funds as something that they're not; they are a longer-term investment," he adds. "We strive to align our solutions with the expectations that clients have." The reason this becomes particularly important, says Wiedemeijer, is for the simple reason that neither clients nor hedge funds are all the same.

"Active investment strategies have struggled to keep up with traditional asset classes amidst the multi-year rallies in bonds and equities that saw volatility across markets being depressed to record-low levels" says Wiedemeijer. "Hedge funds should find it easier to show their merits when volatility comes back to markets.

However, managers are keenly aware that they have to be able to demonstrate their added value if volatility does come back." Overall, clients seem aware of the rich valuations in traditional asset classes with more and more of them voicing interest for hedge funds. Some are specifically asking for tail risk hedging or long volatility biased strategies. Wiedemeijer says he works with a few interesting macro managers that have tail-risk or convex risk profiles as part of their strategy, but that the LA team does not believe investing in long volatility or tail risk strategies gives investors a good risk/reward. "If investors are willing to invest with a macro fund that is able to identify and pick up small tail risk optionalities along the way - e.g. volatility skew or swap spreads - they can make some money in times of volatility."

However, he cautions that a dedicated tail risk strategy is unlikely to be interesting in a portfolio context, rather the team prefers to partner with fund managers who embed tail risk trades within their overall active management approach.

OTHER LIQUID ALTERNATIVES

Another trend that has gained traction among investors is the demand for alternative risk premia. Wiedemeijer says investors can also get diversifying return streams by investing through such quantitative algorithms providing exposure to alternative risk premia. This would typically involve buying risk factors such as momentum, value or minimum variance. Such investments are liquid and transparent and can be held on a stand-alone basis or in a portfolio context.

The Liquid Alternatives team helps investors obtain best-in-class risk premia exposure across factors or within a certain factor across asset classes. For example, instead of investing in a trend following a managed futures strategy, an investor might opt for a basket of momentum factors across asset classes thereby gaining access to pure momentum in a diversified way, while keeping liquidity high and costs low. Clients invest in such factors as part of hedge fund portfolios, on a stand-alone basis or as part of their overall asset allocation. The solutions suits fee-sensitive investors who are not willing to pay hedge fund fees for certain factors. In these cases, risk premia investments might be an interesting solution, as they aim to give straight forward factor exposure in a cost-effective way. The Credit Suisse Liquid Alternatives team believes that such as an approach should be open-architecture and that risk premia should be sourced by the leaders in the field. Specialist investment banking desks have developed such strategies for years, and there is increased momentum from alternative asset managers to develop such strategies as well.

As investors look for guidance on how to construct such portfolios, the Credit Suisse team can add value by applying the same rigorous due diligence and portfolio management that it follows for hedge funds. In the current market environment, Credit Suisse sees increased demand for such strategies in both, institutional, as well as sophisticated private clients' portfolios. ■

CRITICAL SELECTION CRITERIA

The Credit Suisse operational due diligence analysis covers five key areas:

■ **Personnel & Infrastructure** – experienced people, adequate infrastructure, segregation of functions, independent service providers & counterparties

■ **Trading & Valuation** – trading, matching, settlement, reconciliation, pricing, valuation, net asset value (NAV) calculation, administrator involvement

■ **Cash & Risk Management** – cash wires, account opening, counterparty diversification, liquidity

■ **Legal, Compliance & Governance** – fund structure, policies & procedures, conflicts of interests, regulatory history, background checks

■ **Information Technology** – systems, tools, IT, BCP, DRP, cybersecurity