



Clive Gilchrist

Branching out with blindfolds on

Almost every day, the newspapers contain stories concerning alternative investments of one sort or another, and often for the wrong reasons. Hedge funds are overexposed to sub-prime mortgages, the collateralised debt market is in turmoil, private equity managers are avoiding tax, infrastructure is in a bubble, real estate is about to collapse (or submerge under a deluge of Noah-like proportions) – the list appears endless.

The range of asset classes available to trustees has increased significantly in recent years, as has the variety of investment instruments. Though keeping pace with this ever-changing environment is difficult, it is not just trustees, but also investment advisers who have their work cut out keeping up with financial market developments. It is crucial trustees have sufficient understanding to be able to monitor both their investments and their investment managers. This is particularly important when considering new asset classes or new investment instruments. Many trustee boards are looking for ways to diversify their equity investments, a subject I have touched on before. Their problem is

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that the alternatives might appear too expensive, too opaque, too complicated – or even all three.

Greater understanding, training, and in-depth research can assist with both opacity and complication. That just leaves expense, which can be interpreted as either high fees or high valuation. New and particularly complex financial

instruments tend to carry large fees that should decline as the market becomes more competitive and efficient (though we are still waiting for hedge fund fees to do so).

Equities and other risk assets are expected to earn a superior return over time to compensate for the greater volatility, as we are currently experiencing the equity risk premium. So how important is it that we avoid investing into a market that is cyclically expensive if superior return will emerge over time? There has been a mere handful of occasions over the past century when the UK market has produced negative returns over a period of five years or more; apart from world wars and their immediate aftermath, it has only happened three times since 1900, the recent bear market, and twice during the 1970s oil crisis. Though that is scant comfort for Japanese investors, whose market, almost a generation later, remains at less than half its peak of the late 1980s.

Mohamed El-Erian, who manages the Harvard Foundation funds, recently expressed concern that “it is yet to be established with a sufficient degree of confidence that, by diversifying across risky asset classes, investor portfolios will continue to mitigate risk.” A counter view was expressed many years ago by Sir John Templeton, doyen of global investment, who said, “history suggests it is not timing that matters, but time.” I am with Sir John, though recognising that sometimes it might be a very long wait before the equity risk premium emerges.