The allure of the outlier: A framework for considering alternative investments

Vanguard Research Brief August 2015

Key Points

- Private alternative investments are a more complex form of active management, not separate asset classes.
- Investors considering private investments and other alternatives should expect a wide array of potential results.
- The average private investment has underperformed the public markets.
- Bottom-up manager selection, rather than top-down asset allocation, should drive the process for using private alternative investments.

Widely recognized institutional endowments like Yale’s and Harvard’s have had extraordinary results using alternative investments. But are they simply outliers?

This brief, based on research by The Vanguard Group, Inc., outlines a framework for understanding alternative investments and strategically implementing them into a portfolio.

What are alternative investments?

Alternatives differ from traditional assets in two ways: They are either physical assets (such as real estate or commodities) or private investments (hedge funds, private equity and private real assets).

Private investments are a complex form of active management. Compared with public investments, they can lack transparency and consistent performance measures, and can put investors in a weaker legal position. They’re also typically less liquid and cost significantly more than similar public active funds.

Because they typically hold the five major asset classes, private investments are not considered separate asset classes. Figure 1 outlines the relationship between traditional asset classes, physical asset classes and private investments.

Figure 1. Relationship of asset classes to alternative investments

Private Asset class Equity Fixed income Cash Real estate Commodities

Public Stocks Bonds Money market instruments Equity REITs Commodity futures

Private equity Private real assets

Hedge funds

Source: The Vanguard Group, Inc.

1 The allure of the outlier: A framework for considering alternative investments; Daniel W. Wallick, Douglas M. Grim, CFA, Christos Tasopoulos, and James Balsamo, August 2015.
How have alternatives performed?

Hedge funds
Hedge fund returns have weakened over time and, on average, have underperformed the public markets. More than 75% of funds-of-hedge-funds underperformed a traditional portfolio (60% stock/40% bond) between January 1, 2000, and October 31, 2013. While some managers have outperformed, returns have varied widely. Figure 2 compares the range of returns between several alternative investments and traditional asset classes over 20 years.

Don’t confuse the difference between the best- and worst-performing managers with the likelihood of selecting a winning fund. The wide range of returns is simply a sign of the higher degree of active manager risk and doesn’t speak to the challenge of choosing better-performing managers. Success depends on not only selecting a superior manager at a reasonable cost but staying patient with that manager.

Private equity
Similar to hedge funds, the average private equity fund has underperformed the public market. Figure 3 compares venture capital (VC) and leveraged buyout (LBO) fund returns with public equity market returns from 1980-2012.

The median VC fund underperformed public equity by a substantial margin, while the median LBO fund was more comparable to public equity. But both show a wide range of returns. Funds in the top 5% of performers delivered outstanding performance; however, these funds could be considered outliers since this level of outperformance was not near as strong at other percentiles.

As with hedge funds, finding a manager with consistent performance is difficult. LBO fund managers with a previous fund in the top quartile landed their next fund in the top quartile only 28% of the time, and above the median a little over half the time. Given that LBO funds make up two-thirds of the private equity market, most investors would have experienced inconsistent results.

Real estate and physical commodities
For investors comfortable with potential short-term volatility, a low-cost, passive real estate investment trust (REIT) can be an effective, long-term vehicle for holding commercial real estate. Private real estate funds, on average, underperformed a public equity REIT index. And the evidence is conflicting as to whether private real estate managers that have outperformed will continue to do so.

Commodities can play a diversification role for investors willing to accept the traits of the asset class. While holding physical assets is impractical for most investors, one way to gain exposure is through a long position in a commodity futures contract. Owing to the differences between a commodity’s current and future prices, investors should be prepared for returns that may be significantly different from holding a position in physical commodities directly.

Start with a thorough, bottom-up approach
Traditionally, portfolios are constructed using a top-down process. Using this method, investors focus on broad asset allocation and diversification within sub-asset classes before selecting a specific fund manager. But private investments are complex actively managed investments with limited transparency and regulation, reduced liquidity and higher risk and manager fees. So investors considering hedge funds, private equity and private real assets should take a bottom-up manager-selection approach.

A final thought
We believe that public, market-cap-weighted index investments for traditional asset classes are a valuable starting point for all investors. They provide broad diversification, transparency, low costs and competitive performance over time. Investors allocating to private alternative investments should consider their circumstances, resources, risk tolerance and confidence in their ability to successfully access these types of investments.

2 The Vanguard Group, Inc., based on data from Lipper TASS.
4 The Vanguard Group, Inc. calculations, using data from Preqin.
Figure 2. Manager dispersion with private alternative investments is significantly higher than with traditional asset classes

Notes: Public U.S. active fixed income and active equity distributions were based on data provided by Morningstar, Inc., for mutual funds domiciled in the United States from January 1, 1994, through July 31, 2014. Equity-market neutral, dedicated short bias, fixed income arbitrage, convertible arbitrage, event-driven, global macro, managed futures, long/short equity and emerging markets’ distributions were based on data provided by Lipper TASS, for hedge funds in existence from January 1, 1994, through July 31, 2014. All funds are U.S.-dollar-denominated, adjusting for survivorship bias in each category. Leveraged buyout, real estate and venture capital distributions based on data provided by Preqin. Each distribution was based on an IRR (internal rate of return) calculation from a series of annual cash flows from each fund. For private equity funds that had not yet distributed 100% of the fund’s capital back to the limited partners, IRR calculations were based on an ending NAV value. Each distribution has been adjusted so that the median resides at point zero, to isolate the dispersion.

Sources: The Vanguard Group, Inc. calculations, using data from Morningstar, Inc., Lipper TASS and Preqin.

Figure 3. Private equity results are highly dependent on quality of manager-selection decisions: January 1, 1980, through December 31, 2012

Notes: Performance results are for January 1, 1980, through December 31, 2012. Total sample size excluding funds with only one cash flow observation was 2,177. Annualized total return from January 1, 1980, through December 31, 2012, as represented by Dow Jones U.S. Total Equity Market Index (formerly known as the Dow Jones Wilshire 5000 Index) through April 22, 2005; MSCI US Broad Market Index through December 31, 2012. Private equity returns are calculated using a standard IRR (internal rate of return), a dollar-weighted return approach based on aggregated annual cash flows for each private equity fund. The public-market-equivalent (PME+) figures are based on an approach that calculates the hypothetical dollar-weighted return that would have been achieved by investing in a public equity index when the private equity fund makes a capital call and selling a public equity index when capital is distributed back to the investor (Rouvinez, 2003; Ellis, Pattni, and Tailor, 2012).

Sources: The Vanguard Group, Inc., based on data from Preqin.