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Commentary

BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Alternative Investment Opportunities

With the prolonged decline in US equity markets, many institutional investors are seeking opportunities in non-traditional asset classes. Rebalancing asset allocations to increase weightings in bonds and reduce weightings in equities has been a commonplace strategy to reduce risk and take advantage of the substantial decline in interest rates. Although equity markets continued to rise after Federal Reserve Chairman Alan Greenspan's initial reference to irrational exuberance to describe the state of overvaluation then prevalent in many sectors of the equity markets, short-sellers have succeeded in generating opportunistic gains as the irrational exuberance bubble deflated. Consequently, long/short hedge fund managers have found ready listeners among traditionally-oriented institutional investors.

In general, investors have been giving increasing attention to fixed income securities, convertible bonds, real estate investment trusts and a broad array of hedge fund strategies. We have noted with interest the now conventional usage of the previously somewhat arcane terminology of investment risk management, hedging strategies and modern portfolio theory. A decade or so ago, pension fund sponsors exhibited a natural reluctance to explore the world of hedge fund strategies, deeming it to be too complex and too risky. But now that long/short hedge fund strategies have gained a greater degree of acceptance in the institutional market place, there is evidence emerging of a greater willingness to explore the whole range of hedge fund strategies.

Convertible arbitrage has become one of the most popular types of hedge fund as the market for issuance of new convertible bonds has grown in recent years. A convertible bond may be viewed as a bond with an embedded option on the issuer's equity shares. Equity investors regard convertible bonds as an equity investment with the added protection of an underlying bond. The typical strategy employed by hedge funds is to buy the convertible bond and hedge the equity risk by selling short the underlying equity. The Japanese market for convertible bonds is the largest in the world exceeding the combined issuance of convertible bonds in the United States and Europe. Generally US convertible bonds are below investment grade whereas Japan and Europe's convertibles are mostly of higher investment grade credit quality.

Another popular type of hedge fund utilizes event-driven strategies. These include merger arbitrage funds and distressed debt funds. The former type concentrates on equity-related opportunities such as mergers, acquisitions and tender offers. The latter type focuses on opportunities arising from bankruptcies, liquidations and financial restructuring. Perhaps best known are the global macro hedge funds that utilize long or short strategies, invest globally in several different markets and hold equities, fixed income securities, commodities and currencies while employing strategies involving leverage, derivatives, options, futures and a diverse array of hedging methods.

Hedge funds have historically performed relatively well in times of poorly performing investment markets because they typically have low correlation with other asset classes. Carefully constructed pools of hedge funds are gaining attention and becoming a subject of increasing focus in the institutional asset allocation management process. It is now widely accepted that hedge funds will continue to play an increasingly significant role in investment management and will change the traditional conventional approach to pension fund management that has been prevalent over the last several decades.

There are presently some interesting developments taking place in institutional investment in the United Kingdom following publication of the Myners Review, a report to the UK Chancellor of the Exchequer on recommended changes to current investment practices. Of particular note is a proposed set of principles to be adopted as a code of best practice without being enforced by statute. This set of principles includes the establishment of fund-specific investment objectives, emphasis on the asset allocation process to include a full range of investment opportunities, explicit written mandates to fund managers, selection of appropriate benchmarks and encouragement of active management. The result is likely to be a more rational approach to UK pension fund asset/liability management, a greater role for investment consultants, a greater degree of responsiveness and openness on the part of investment managers and more accountability in terms of meeting mandate objectives.

What is particularly noteworthy from a US perspective is that with the implementation of the Myners principles in 2003, UK pension fund management will become much more like conventional US best practice. The influence of US practice is very much in evidence throughout the Myners report even to the point of recommending that the UK Government incorporate the US ERISA principles on shareholder activism into UK law, making it a duty for both trustees and investment managers to intervene in companies when it is in the interest of shareholders and beneficiaries, following the US Department of Labor Interpretive Bulletin on fiduciary obligations and duties.

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