

ALTERNATIVE ALTERNATIVES

ALLOCATING TO ALTERNATIVE ALTERNATIVES

What is the role of alternative alternatives within a portfolio?

Alternative alternatives provide an unrelated and uncorrelated return stream to an institutional portfolio of equities and fixed income. Moreover, alternative alternatives have a low correlation to hedge fund and fund of funds returns. Capital markets have attracted a lot of investment capital over the past five years. Strategies revolving around traditional hedge fund strategies, whether capturing market beta or traditional alpha, have unattractive risk/return profiles looking forward.

A portfolio of investments in sectors where capital markets have not penetrated yet, can and does, still deliver attractive risk-adjusted returns. Additionally, alt alt strategies deliver "portable alpha."

A portfolio of alt alt investments can be bolted onto any traditional institutional investor's portfolio to enhance returns or add diversification benefits. Our internal research indicates that an allocation of between 5-10% to alt alt investment strategies benefits most institutional investors' portfolios. Also, these investments look just fine on their own. They create absolute return streams of between 10-15% net of fees.

Does your research indicate a conclusive % that needs or should be allocated to alternative alternatives to improve the overall risk/reward profile?

We have done a lot of research on what is the "right" % allocation of alternative alternatives in a portfolio, and have uncovered that all institutional investors can benefit from an allocation to the alt alt investment strategies. The actual benefit depends on their current portfolio. For example, for an institution currently holding stocks, bonds, commodities, and hedge funds, the benefits of allocating 5-10% to alternative alternatives are tremendous.

We have found alternative alternatives to have low correlations and betas to the traditional beta and alpha products. In summary, the less aggressive an institutional portfolio is, the more benefit the portfolio can achieve through an allocation to alt alts.

How does one sieve the choices and identify the "relevant" alternative alternatives that would achieve the above?

We believe the "relevant" alt alt sectors and strategies are investments where one does not need to take large amounts of business or operational risks. Examples of investments with the "right" balance of operational risk and pure investment risk are strategies that revolve around cash flow producing assets. The cash flow from the assets produces a "base" rate of return. To the extent an investor can identify ways of enhancing the cash flows from the assets they own through operations, the return potential from these assets increases significantly. Most of our investments revolve around asset acquisition, asset "exploitation" to enhance cash flow, and an exit strategy to "unleash" the return potential at an appropriate time. We generally invest with a three to four year time frame and this lock-up constraint creates an additional "sieve" for what we can invest in.

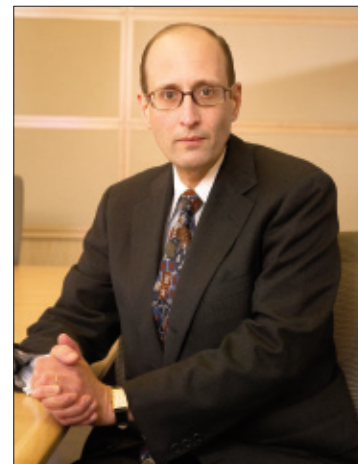
How does one effectively implement these allocations?

The most effective way of implementing these allocations is to create a portfolio adhering to strict investment guidelines. Wood Creek employs a formal investment process to identify investment sectors of interest and then focuses on strategies within those sectors which match up our constraints (on operational risk, market risk, liquidity, etc.) Finally we seek a manager to deploy capital with. If we cannot find an existing manager available to manage capital in our preferred strategy within a sector, Wood Creek may create one *de novo*.

How do you overcome constraints imposed by: liquidity; headline risk; size and track record, capacity?

We believe the best way to extract returns from an alt alts portfolio is through a 3-4 year lockup. Giving up liquidity is an easier trade-off as long as there is a commensurate return for the illiquidity. As alt alt investments are relatively new, there is lack of a meaningful track record.

There is a dearth of true alt alt investments currently available in fund format. As the market evolves, this situation will change. In the mean time, we often create from scratch, new investment vehicles that offer institutional investors the opportunity to deploy their capital. We negotiate capacity for our investments such that our portfolio offers investors capacity in capacity-constrained sectors.



Brett D. Hellerman is the CEO of Wood Creek, which focuses exclusively on the alternative alternative (alt alt) investment space

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Performance measurement (relative and absolute)

Performance measurement for alt alt investment strategies is a challenge. As there are relatively few other investments with a similar mandate, it's difficult to assess relative performance unless one is completely focused on evaluating these investments. Also, most of these funds have short and statistically meaningless, track records. We have created customised benchmarks to understand the performance drivers for the different alt alt investment strategies we invest in. We also employ peer group analysis and other measurement tools to assess individual investments and model the portfolio.

These strategies impose distinctive risk management challenges. Elaborate.

Alt alt is a new and distinctive asset management space and, as you say, risk management creates some unique and distinctive challenges. We think of risk management in alt alt as a continuum between extremes. For instance, we seek to limit our operational risk (what I call "business plan risk"); as we want to take our risk more in the underlying asset or sector inefficiency than in a given manager's business plan to exploit it.

Yet if we take too little operational risk, we end up with a pure play asset cash flow that many financial investors will want to bid for, making the returns likely unattractive. On the other hand, if we take on too much operational risk, we may jeopardise receiving a good current return and may end up in an illiquid private equity investment with no coupon.

We have chosen to work along the risk continuum for other risks such as liquidity, market risk and efficiency of sector.

Eventually, these decisions about where to position our fund along the risk continuum are qualitative decisions driven by fundamental research and insight that are confirmed by quantitative methods. The investment process requires a lot of time and is far from a typical fund of funds' "allocation" process to traditional hedge fund strategies.

Is it possible to "customise" a skilled specialist in the alternative alternatives space? How?

If by customise, you mean focus on a particular area of the alt alt space, sure. For instance, there are firms that focus on sectors like asset-based lending and infrastructure among others. Such exposures, present a very effective way to corral assets in a "pure play" kind of approach.

In terms of specific underlying managers in our portfolio, it is certainly possible to customise investments. We may see a manager that we like but the fund he manages takes too much risk outside our mandate. We would seek out a separate account with the manager, to take risk in just the area which we prefer. We can establish separate accounts with the manager or seed a new fund for him/her. Our goal is to get the exact slice of risk for our investors and investments.

There is tremendous opportunity to exploit the inefficiencies borne by alternative alternative strategies and very little global "installed capital" dedicated to investing in them.

Performance differential that can be expected in a portfolio with and without alternative alternatives

An alt alt portfolio can potentially deliver over 12% net return to investors while keeping the annual portfolio volatility below 3%. Adding 10% of a portfolio of alternative alternatives to a conservative (30% equity and 70% bond) portfolio enhances portfolio returns by over 6% and lowers the overall portfolio risk by 2%. Adding 10% of a portfolio of alternative alternatives to a more aggressive (30% equity, 20% bonds, and 50% alternative investments) portfolio enhances portfolio returns only marginally but still lowers the overall portfolio risk.

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