

# Russell Research

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## Constructing an alternatives portfolio

In the search for increased portfolio returns and reduced risk, investors are constantly on the watch for new market segments or new strategies for exploiting opportunities in existing categories. The roster of these alternative investments evolves through time, and incorporating members of the collection into portfolios is typically more challenging than is the case with traditional stock and bond asset classes.

### Introduction

Complications arise from the difficulty in predicting return behavior based on data with limited histories or data that may not be representative of existing opportunities; in understanding liquidity profiles and fee structures; and in evaluating and gaining access to attractive products as investors compete for the often limited capacity of some strategies.

While there are different ways to organize the alternative investments, we tend to group them into “listed real assets,” “private investments” and “alpha-driven investments.”

Listed real assets provide exposures distinct from those in stock and bond markets. Private investments usually have significant illiquidity, and they will often target segments of markets that are disadvantaged by the pressures of daily trading and pricing. Alpha-driven investments offer opportunities for returns that are strongly premised on the skills of active managers, and they may contain virtually no systematic components.

There are certainly gray areas. Our main purpose in this paper is to provide a logical framework by use of which investors can appreciate the characteristics of these investment opportunities, and to give our thoughts on the weighting of these strategies within a portfolio.

Our specific allocation choices are driven more by an evaluation of the general characteristics of alternative investments than by a purely quantitative assessment of their expected future performance. It is useful to consider quantitative models, but they ultimately serve as one source of information out of several. The allocation weights we provide may be well suited to a given institutional investor or may require modest tailoring. They map out an effective, balanced implementation, but in the end the specific circumstances of each investor will be the key driver of the investment decision.

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## Definitions

"Alternatives" is a category often defined in terms of what it doesn't contain, rather than what it does. Traditional exchange-traded stocks and bonds are clearly outside the definition of Alternatives, while hedge funds and private investments are universally acknowledged to fit the category. The gray area typically arises for listed assets that are neither stocks nor bonds, and for categories of stock and bond markets that have not been widely adopted. The relatively recent inclusion of commodities and listed infrastructure holdings in typical portfolios nudges them into the Alternatives camp, but listed real estate is more problematic. Despite the fact that Real Estate Investment Trust (REIT) positions have been common for decades, listed real estate plays a similar role within the portfolio, and its allocation should be coordinated with those of other real assets. Within our market breakdown, listed real estate is considered an alternative investment.

Recognizing the existing ambiguity, for current purposes we adopt a taxonomy using the banner "Alternatives" for all holdings other than listed global stocks and bonds. Our bias is to include less-common segments of these listed markets in the "non-Alternatives" listing. Examples include high-yield and emerging markets debt, which are very common though not universal exposures. We also view rules-based, non-capitalization-weighted exposures to traditional asset classes as being members of the non-Alternatives category.

Alternative investments are often characterized by their liquidity, their availability to a limited set of investors (e.g., private equity is not widely available to retail investors with lower levels of assets), their greater reliance on manager skill as a component of total return, and their familiarity to a wide spectrum of investors. In addition, greater resources and oversight is required of investors in the evaluation and management of alternatives.

A breakdown of the investment universe is shown in Exhibit 1, with Alternatives including, as noted above, (nontraditional) Listed Real Assets – such as commodities, REITs and infrastructure – as well as Private Investments and Alpha-Driven Investments that may rely primarily on manager skill, rather than on systematic return components, for their growth. The Private Investments segment includes equity, real estate, infrastructure and structured debt products. Alpha-Driven Investments includes the full variety of hedge funds strategies, global tactical asset allocation (GTAA), active currency and portable alpha.

Even this reasonably well-delineated breakdown of markets is not without its gray areas. For example, although frontier markets may reflect a basket of listed securities, investors' limited ability to trade in these securities – as well as the liquidity provisions of some frontier markets products – causes the investment to be similar to private holdings. For the moment, we consider frontier markets to be a part of the global listed equity positions, but the decision does suggest the possibility that familiarity and available packaging may cause migration out of the Alternatives category over time. For example, if hedge funds become widely available in formats accessible to retail investors, their Alternatives designation may lose much of its meaning.

It is possible to rework the paradigm to distribute the Alternatives categories to various buckets. Equity long/short and equity market neutral hedge fund strategies are primarily focused on trading equity securities and might naturally fall into a broad equity category. While we don't have any fundamental disagreement with this outlook, we find it more helpful to maintain separate Alternatives categories to highlight the common challenges that most members of the category face, including liquidity, fee levels, familiarity, and benchmarking challenges, as well as the importance of active manager skill as a component of total return.

As investors seek new sources of return, diversification and market insights, the entire Alternatives collection should be targeted in a coordinated manner. The choice of particular segments to emphasize will depend on the particular goals of each pool of assets as well as the preferences and resources of the investment managers. It is helpful to parse the

Alternatives bucket into underlying components, but it is also critical to understand how the composite improves the prospects of the investment portfolio.

Exhibit 1: Asset class categories

		Alternative Investments									
		Global Equities	Global Fixed Income	Listed Real Assets			Alpha-Driven Investments <sup>1</sup>				
				Commodities	Real Estate	Infrastructure					
Public Markets	Regions (developed, emerging, frontier)	Sectors (govt, sovereign, corporate, mortgage, Asset Backed Securities)	Maturity (cash, short, intermediate, long)	Commodities Collateralized Commodity Futures	Real Estate Investment Trusts	Listed infrastructure stocks	Traditional alpha				
	Cap (large, medium, small, micro)							Credit (inv and non-inv grade)	Direct holdings (gold, natural resources)	Master limited partnerships	Hedge Funds (low/mod/high)
	Style (growth, value, core, rotating)										
Convertible Stocks/Bonds		Timber	Core, Value & Opportunistic Real Estate	Greenfields	Relative Value						
Preferred Shares						Mineral Rights	Farmland	Core	Event and Credit		
High Yield										Agriculture	Brownfields
Listed Private Equity					Active Currency						
					TAA/GTAA						
Private Investments	Venture Capital	Mezzanine					Opportunistic <sup>2</sup>				
	Leveraged Buy Out (LBO)	Distressed									
	Secondary						Hybrid (Private Equity, Hedge Funds)				
Protective Strategies	Low Volatility Equity Options	Interest Rate Options					Collectibles (Artwork, Wine)				
		Dynamic Strategies, Insurance Products					Absolute Return				

<sup>1</sup> Returns are primarily (alpha) skill-based, but may include systematic (beta) components

<sup>2</sup> An evolving and potentially endless list

While it is true that Treasury Inflation-Protected Securities (TIPS) and Real Assets may be considered by investors with inflation-related investment goals, we include TIPS as a fixed income investment and do not put it in the Listed Real Assets category.

It is important to note that some investors, notably defined benefit pension plans, have well-identified liabilities. Their concern is not purely investment growth, but rather surplus management. Investors such as these are likely to dedicate a significant portion of total assets to investments that hedge their liabilities. The current discussion and weight recommendations focus on the return-seeking investments: that portion of assets which is not dedicated to hedging.

### Survey

The allocation to alternative investments varies both geographically as well as for different investor types. It is instructive to understand the exposures that investors currently hold and what might be driving any differences among the investor categories.

Results from a number of surveys of institutional investors are summarized in Exhibit 2. In addition to the overall allocations to global (listed) equities, global fixed income and alternative investments, the ratio of alternative investments to total non-fixed income

investments is shown. This is helpful, because reporting categories are not identical across the various surveys, and there is insufficient information for an understanding of whether all reporting investors aspire to the same risk/return trade-off. Furthermore, DB plan investors are likely to dedicate a portion of their fixed income investments to liability hedging, rather than simply to being part of a well-diversified return-seeking mix.

## Exhibit 2: Alternative asset exposures for different investor types

	Global Equity	Global Fixed	Alts	Alts / Non-Fixed
<b>U.S. DB Pension Funds</b>				
BNY Mellon Pension Fund Universe Average (Jun. 2010)	44.0%	40.0%	7.0%	14%
BNY Mellon Taft Hartley Universe Average (Jun. 2010)	57.0%	31.0%	5.0%	8%
BNY Mellon Public Fund Universe Median (Jun. 2010)	47.0%	34.0%	11.0%	19%
Public Fund Survey Universe Average (2009)	52.1%	33.4%	14.5%	21.7
Greenwich Public Funds Universe Average (2009)**	50.1%	29.7%	20.2%	29%
Greenwich Taft-Hartley/Union Universe Average (2009)	46.5%	36.6%	16.8%	27%
Russell Consulting Client Universe Policy Average (Jun. 2010)	53.5%	36.0%	10.5%	16%
<b>Non-U.S. Pension Surveys</b>				
UK William Mercer (Dec. 2009)	54.0%	39.0%	7.0%	11%
Netherlands Watson/UBS Study (Dec. 2009)	28.0%	48.0%	24.0%	46%
Japan Corporate Pension Fund Average (2010)	42.5%	53.5%	4.1%	9%
Canadian Member Composite (2009)	43.9%	33.0%	23.2%	35%
Australia SAA High Growth Average (2010)	71.3%	7.8%	20.9%	23%
Australia SAA Conservative Average (2010)	22.5%	63.4%	14.3%	39%
<b>Nonprofit Investors</b>				
NACUBO Universe Average (2009)	32.0%	17.0%	51.0%	61%
NACUBO Endowments > \$1B Universe Average(2009)	26.0%	13.0%	61.0%	70%
NACUBO Endowments \$50M – \$100M Universe Average (2009)	51.0%	27.0%	22.1%	30%
BNY Mellon E&F Universe Median	39.0%	16.0%	32.0%	45%
Greenwich E&F > \$1B Universe Average (2009)	44.9%	20.6%	34.5%	43%
Greenwich E&F < \$500M Universe Average (2009)***	46.3%	21.6%	32.2%	41%
Endowment AM Book Oxford Colleges Average (2007)	55.0%	21.0%	24.0%	30%
Endowment AM Book Cambridge Colleges Average (2007)	53.0%	17.0%	31.0	37%

Sources: BNY-Mellon; Greenwich Associates; Russell Investments; William Mercer; Watson Wyatt/UBS; Pension Fund Association, Japan; Pension Investment Association of Canada; NACUBO; *Endowment Asset Management* by Acharya and Dimson (Oxford University Press, 2007).  
Data is as of the specified dates. Current data may be different.

DB plan investors appear to maintain a relatively smaller exposure to alternative investments compared to nonprofit investors. Results are survey-dependent, but it would appear that U.S. DB plans hold 15%–25% of non–fixed income investments in Alternatives (data is insufficient for identifying trends for pension plans outside the U.S.) and that nonprofit investors tend to hold 35%–45% of non–fixed income investments in Alternatives categories – those nonprofits with greater total assets may hold a majority of total assets in Alternatives.

It is interesting to note the variation across surveys, but we should also be careful, in consideration of the recent economic turmoil. It is difficult to ascribe much precision to any comparisons, given that surveys are not contemporaneous and that it is difficult to adjust exposures when selling into illiquid markets; it's possible that these values may be as representative of circumstance as of investment policy.

It is also interesting to consider which segments of the Alternatives categories investors favor. Exhibit 3 outlines the “habitats” for these investor surveys.

**Exhibit 3: Allocations within Alternatives for different investor types**

	Total Alts	Allocation as % of Total Alts		
		Listed Real Assets	Private Investments	Alpha-Driven Investments
<b>U.S. DB Pension Funds</b>				
BNY Mellon Pension Fund Universe Average (Jun. 2010)	7.0%	85.7%	14.3%	0.0%
BNY Mellon Taft Hartley Universe Average (Jun. 2010)	5.0%	60.0%	40.0%	0.0%
BNY Mellon Public Fund Universe Median (Jun. 2010)	11.0%	72.7%	27.3%	0.0%
Public Fund Survey Universe Average (2009)	14.5%	40.6%		
Greenwich Public Funds Universe Average (2009)	20.2%	0.0%	74.8%	25.2%
Greenwich Taft-Hartley/Union Universe Average (2009)	16.8%	2.4%	57.7%	39.9%
Russell Consulting Client Universe Policy Average (Jun. 2010)	10.5%	0.0%	39.0%	61.0%
Russell Global Survey on Alternative Investing Corporate Pensions (2009)	12.0%	14.0%	49.0%	36.0%
Russell Global Survey on Alternative Investing Corporate Pensions (2012 estimate)	16.0%	15.0%	50.0%	36.0%
Russell Global Survey on Alternative Investing Public Pensions (2009)	18.0%	13.0%	65.0%	22.0%
Russell Global Survey on Alternative Investing Public Pensions (2012 estimate)	29.0%	21.0%	60.0%	20.0%
<b>Non-U.S. Pension Surveys</b>				
UK William Mercer (Dec. 2009)	7.0%	0.0%	100.0%	0.0%
Netherlands Watson/UBS Study (Dec. 2009)	24.0%	0.0%	41.7%	58.3%
Japan Corporate Pension Fund Average (2010)	4.1%	0.0%	0.0%	100.0%
Canadian Member Composite (2009)	23.2%	0.0%	81.5%	18.5%
Australia SAA High Growth Average (2010)	20.9%	24.9%	51.7%	23.4%
Australia SAA Conservative Average (2010)	14.3%	22.4%	46.2%	31.5%
<b>Nonprofit Investors</b>				
NACUBO Universe Average (2009)	51.0%	12.0%	40.0%	48.0%
NACUBO Endowments > \$1B Universe Average (2009)	61.0%	12.0%	43.0%	45.1%
NACUBO Endowments \$50M – \$100M Universe Average (2009)	22.1%	10.0%	26.2%	63.8%
BNY Mellon E&F Universe Median	32.0%	96.9%	3.1%	0.0%
Greenwich E&F > \$1B Universe Average (2009)	34.5%	0.0%	44.6%	55.4%
Greenwich E&F < \$500M Universe Average (2009)	32.2%	0.0%	36.3%	63.7%
Endowment AM Book Oxford Colleges Average (2007)	24.0%	0.0%	95.8%	4.2%
Endowment AM Book Cambridge Colleges Average (2007)	31.0	0.0%	96.8%	3.2%
Russell Global Survey on Alternative Investing Nonprofit (2009)	19.0%	17.0%	41.0%	43.0%
Russell Global Survey on Alternative Investing Nonprofit (2012 estimate)	23.0%	16.0%	53.0%	31.0%

For sources, see Exhibit 2

Data is as of the specified dates. Current data may be different.

It is particularly difficult to distinguish patterns within the Listed Real Assets category, as some of the surveys include REITs within listed equities and some record it in a separate category. A comparison of exposures within Private Investments and Alpha-Driven Investments reveals no clear trends, but if UK and Japanese data are indicative, there clearly are differences in the ways investors construct their Alts portfolios.

### Overlap

As suggested earlier, REITs and listed infrastructure represent equity securities already included in broad equity benchmarks. This makes it difficult to separately track exposures, and also raises the question of whether they merit a distinct allocation. After all, aren't we already obtaining exposure through the listed equity positions?

Exhibit 4 provides a description of the overlap of the broad equity market indexes with the REIT and listed infrastructure benchmarks. While virtually all of the global REITs benchmark members and the majority of the global listed infrastructure benchmark members appear in

the Russell Global Index and regional indexes, they represent a fairly small slice of the overall market.

Investors with a home country equity bias may find themselves overexposed to domestic REIT and listed infrastructure opportunities while lagging in exposure to nondomestic positions. The impact of this imbalance will vary depending on the concentration of listed real estate and infrastructure in each market, but none of the individual markets capture a majority of the REIT or listed infrastructure opportunities.

#### Exhibit 4: Portion of equity indexes comprised of REIT and listed infrastructure positions

	Global REIT		Global Listed Infrastructure	
	% of index	% of benchmark in index	% of index	% of benchmark in index
Russell Global Index	2.2%	99.5%	2.1%	95.8%
Russell 3000® US Equity Index	2.2%	40.7%	1.8%	24.5%
Russell Global UK Index	1.7%	5.8%	3.3%	6.5%
Russell Global Europe ex-UK Index	1.5%	9.7%	3.8%	31.3%
Russell Global Australia Index	6.0%	8.6%	1.4%	7.2%
Russell Global Japan Index	2.8%	10.4%	2.0%	6.6%
Russell Global Canada Index	1.1%	4.3%	3.2%	10.3%
Russell Emerging Markets Index	2.8%	0.4%	5.9%	0.3%

Global REIT = FTSE/EPRA NAREIT Developed Index

Global Listed Infrastructure = S&P Global Infrastructure Index

Data is as of December 31, 2010. Current data may be different. Indexes are unmanaged and cannot be invested in directly.

While REIT and listed infrastructure securities appear in equity benchmarks, Russell research of typical active manager holdings indicates that they are often ignored or at least significantly underweighted in most actively managed equity portfolios. It should also be noted that REITs and listed infrastructure typically provide a larger portion of their total return in the form of dividends than do other equity investments. Investors emphasizing income will find these exposures useful in meeting cash flow goals.

Over shorter investment horizons, it is likely that REITs and listed infrastructure returns will be strongly influenced by the patterns in broader equity markets. For strategic planning periods, they provide a somewhat distinct return pattern and long-term diversification benefits. For this reason, and because it is important to recognize the need for exposure to these investments and to be able to track that exposure (even if some of it occurs within an equity position), Russell treats these investments as categories distinct from other available asset classes.

#### Pricing and liquidity

One of the key characteristics of many alternative investments is limited liquidity. While those in Listed Real Assets typically provide for daily pricing and liquidity, those in Private Investments usually involve multi-year lockups. Liquidity profiles within Alpha-Driven Investments vary, but many hedge fund products require redemption notices and can usually be redeemed on a quarterly basis.

As recent events have highlighted, the liquidity provisions described in offering documents may not always be consonant with the actual liquidity during extreme market volatility. The promise of daily or quarterly liquidity may not be realized without a severe haircut on asset value.

Because alternative investments (with the exception of those in Listed Real Assets) do not represent uniform packages behaving similarly to some benchmark, their unique compositions and lack of frequent trading make it difficult to precisely assign prices. In some

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cases this can be advantageous, providing the appearance of lower volatility, but can make it difficult to precisely target a desired investment exposure or to reduce overweight positions.

Investors with higher tolerance for illiquidity, and those for whom frequent performance reporting is less critical, can take advantage of the premia associated with lower liquidity and pricing transparency. The overall level of these factors can also be managed through manager guidelines and coordination with similar investments in listed markets.

For investments that have both a listed and a private version, it is often helpful to coordinate those allocations by using the listed portion to provide liquidity and facilitate rebalancing against the illiquid private position. It is an imperfect substitution, as asset class segments available in the private arena may not have listed counterparts.

### Recommended allocations

Allocation to Alternatives will depend on a number of factors, including an investor's liquidity needs, familiarity with the various investment types and ability to identify, access and monitor appropriate opportunities. It is difficult to prescribe a one-size-fits-all strategy.

The recommendations for Alternatives are based on an assumption that more highly skilled managers in the Private Investments and Alpha-Driven Investments categories can be identified. These categories do not lend themselves to passive investment approaches, making active the only game in town. Furthermore, the "average" returns represented by manager universe returns and category benchmarks do not tend to be particularly attractive. The careful identification of, and access to, stronger managers is a necessary prerequisite for exposure to Private Investments and Alpha-Driven Investments.

During portfolio construction, a range of return levels is available within each category. Generally, more aggressive portfolios will have not only a larger exposure to Alternatives, but also greater representation in the more aggressive components.

Forecasts of returns to various categories of Alternatives (particularly Private Investments and Alpha-Driven Investments) are not precise enough to simply allow an optimizer to sort out and recommend an allocation. We believe that on a passive basis Listed Real Assets will provide returns intermediate to those from stocks and bonds, but that returns for Private Investments will depend not only on an illiquidity premium of 3%–5%, but also on the structure within the category. Core, value and opportunistic components can be blended to target returns similar to those from listed Alternatives, or returns several percentage points above those from traditional equity markets. Specific return outlooks will vary, and will be associated with the level of manager aggressiveness and use of leverage.

Opportunities in Alpha-Driven Investments have a broad range of potential return levels. Given their role as a diversifier of traditional and listed market returns, these investments are often appealing even at return levels close to those from fixed income investments. Directional strategies often provide returns comparable to, or in excess of, equity returns.

Because of the typically higher fees and oversight expenses associated with alternative investments, it is important to keep in mind that the relevant measure of return is a net-of-fees assessment. The relatively lower fees available to larger pools of assets is one reason these investors tend to maintain higher exposures to Alternatives. Smaller institutional clients may also have greater difficulty in researching and accessing these potentially higher-performing products. In conjunction with illiquidity limitations, fees and manager selection are the most significant reasons that smaller institutional clients tend to have lower exposure to these investments.

Asset allocation is a combination of art and science. The art is in understanding which markets typically favor one investment over another; in judging how future outcomes may

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mirror or differ from past performance; in evaluating hypothetical tail-risk scenarios; and in deciphering the logic that leads investors to their current allocation exposures. The science is associated with the development of quantitative assessments of past return patterns, and development of risk and reward frontiers. Quantitative support for the science aspect is more difficult to precisely determine within the realm of Alternatives than within traditional asset classes. Rather than proceed simply from our best assumptions, we feel it is important to incorporate this ambiguity in the development of portfolio weights. In this arena, guidance from standard sources is also less readily available – for most categories, only a rough assessment of market capitalization is available. Market capitalization can be calculated for some categories, but even then, leverage complicates the calculations. In the end, an equal-weighted strategy (particularly within categories) may have a lot to recommend it.

Given the limits to what is knowable regarding future performance, it is important to establish investment constraints that take into account not only the tremendous return possibilities if our assumptions are prescient, but also the downside if performance does not reflect our forecasts, as well as the possibility that we may simply experience a bad draw from the range of potential outcomes.

Our approach is to map out an allocation that we believe will serve a broad range of institutional investors and, at least as importantly, to outline the logic underlying the suggested structure. Investors working from different assumptions can develop tailored structures following a similar line of reasoning. Investors' specific objectives, investment resources and governance practices are at least as critical as peer allocations or any assessment of future returns in determining an appropriate allocation.

## LISTED REAL ASSETS

Investments in Listed Real Assets (commodities, REITs and listed infrastructure) provide highly liquid exposures to return patterns that are distinct from those of traditional stocks and bonds. REIT and listed infrastructure investments typically provide significant dividend cash flows as a component of total return. This can be advantageous for income-oriented investors, but may be less tax-efficient as well.

The expected return levels of these investments are similar and suggest fairly equal exposures. We recommend a slightly higher weight for commodities, which may not be quite as strongly influenced by the patterns of listed equity markets on which REITs and listed infrastructure investments typically trade. Assuming that institutional investors are able to access each of these asset classes, we recommend considering a mix of 4:3:3 in commodities, REITS and listed infrastructure, respectively. That is, an overall allocation of 10% to Listed Real Assets could be segregated into 4% commodity exposure and 3% exposure in each of REITS and listed infrastructure. For investors in economies such as Australia's and Canada's, which are more strongly linked to commodity return patterns, we remove this preference for commodities relative to other listed real assets.

For asset classes such as real estate, where listed and private investment opportunities exist, a holistic approach is necessary to coordinate allocations for the two components. For example, we typically recommend a larger allocation for private real estate than for REITs, but each investor must determine an appropriate balance based on return potential, liquidity, governance and access concerns as well as the desire to obtain a diversified exposure to underlying market segments. The 4:3:3 mix suggested above should be evaluated in light of decisions within the private investment category.

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## PRIVATE INVESTMENTS

Securities in the Private Investments category typically have associated listed counterparts, although segment (investment type, geographical distribution, etc.) representation may differ. Private markets generally provide access to higher-returning portions of each asset class to compensate for the more limited liquidity of the investments, and investments can also benefit from a higher degree of active management. However, our allocation recommendation is premised more on portfolio liquidity limits than on anticipated returns.

Investors can access private markets through separate accounts, direct holdings, open-end funds and closed-end funds. In the Private Investments category, the entry and exit process for investments made through closed-end funds is distinct from that in other categories. Investors must make commitments to provide capital, but the funds are typically drawn down over a number of years (often three to five). The redemption period starts not long after the investment period closes and results in a forced redemption each time an underlying portfolio holding is sold. The result is that the investor is rarely fully invested early and suffers from reinvestment risk later. It is usually necessary to overcommit to Private Investments in order to reach target weights.

While it is difficult to get out of commitments that have not yet been funded, it is possible – at a deep discount, which makes it all the more difficult for investors to change their minds after the initial decision. Private equity products generally include provisions to extend the life of the fund in the case that all investments are not liquidated by the end of the term (commonly, 10 years after the initial commitment), often extending the investment an additional two or three years.

Private equity and private real estate are the most common components of a Private Investments portfolio, though private infrastructure, which has been popular in Australia for several years, is becoming more widely available, and private commodities (less-liquid portions of publicly traded commodities) may be future entrants. We recommend considering a fairly even split between these components, with a slightly higher weight to private equity due to its anticipated higher levels of return.

## ALPHA-DRIVEN INVESTMENTS

Like the overall Alternatives category, Alpha-Driven Investments may be defined by what it does not include. It serves somewhat as the catch-all category for alternative investments that do not fit into the Listed Real Assets or Private Investments buckets. Even those divisions are not completely black-and-white.

The primary components of Alpha-Driven Investments are hedge fund strategies, global tactical asset allocation (GTAA) and active currency. As indicated in Figure 1, there may be other investment strategies that find their way into this bucket, particularly opportunistic investments, which are designed to take advantage of market imbalances that may not persist on an indefinite basis.

A common characteristic of Alpha-Driven Investments strategies is their reliance on manager skill rather than systematic market beta as the dominant source of return. That isn't to say that portfolios won't realize returns based on systematic exposures, but that these exposures are unlikely to be static through time.

It is not enough to merely invest in alpha-driven markets. Passive investment strategies are neither available nor particularly desirable in the Alpha-Driven Investments arena. The ability to recognize and access skilled managers is critical to structuring a successful portfolio. Currency can often be implemented as an overlay on other positions, making it particularly attractive. The use of an overlay allows investors to access active currency

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returns with zero or low reduction in exposures to other asset classes. Anticipated returns are enhanced (in expected-value terms) by the leverage implicit in such overlays.

Hedge fund investments span a range of underlying strategies,<sup>1</sup> suggesting potentially greater diversification across active managers and investment strategies. On the other hand, hedge funds may also include lockups and limited contribution and redemption schedules. While they do not typically suffer from the years-long liquidity concerns associated with private investments, they often allow for only quarterly rebalancing.

GTAA evolved from earlier tactical asset allocation efforts that were often confined within the borders of a single economy and that allowed for the tilting between domestic stocks and domestic bonds. GTAA provides the manager with a broader set of asset classes among which to tilt. In many ways, GTAA is similar to global macro or systematic macro hedge fund strategies, and it is an accident of history that distinguishes GTAA (and TAA before it) from the hedge fund category. For allocation purposes, we advise that the GTAA exposure be assigned within the context of the hedge fund allocations.

We recommend exposure to a diversified mix of the available alpha-driven strategies. If only limited categories are available, a decreased allocation should be considered. The relatively lower fees for active currency suggest that a modestly higher allocation is warranted when this investment is available.

#### ALTERNATIVES PORTFOLIO WEIGHTS

Often the performance assessment of Alternative Investments supposes such favorable return, risk and diversification levels that the question of whether to invest in this category is a foregone conclusion. Given the difficulty in formulating reliable estimates of future returns, we believe it is more appropriate to focus on liquidity needs and the availability of promising products and to avoid putting all eggs in one basket.

In some cases, there may not be an effective hedge for investors' liabilities. This may be because no hedging asset exists, or because the size of the liabilities exceeds that of the assets, and leverage would be required to effectively hedge. For these investors, the returns or cash flows of some asset classes may be better suited than others to correlate with changes in liability values, and it may be advisable to "tilt" the portfolio toward these more highly correlated asset classes in a step toward effective surplus management.

In a purely academic world, we would propose that all institutional investors with a common risk tolerance pursue the same allocations to alternative investments. After all, the best risk-adjusted portfolio (assuming a purely quantitative calculation based on data which we've already decided is not fully reliable) to obtain a given level of return is probably the same whether you are a pension plan or a nonprofit organization. Of course, more aggressively positioned portfolios will likely hold more aggressive weights than those of more conservative investors, but – again, in a purely academic world – two investors with the same investment goals and similar investment restrictions should hold the same portfolio.

Practical considerations prevent our dispensing such broad and strictly theoretical recommendations. The difference in portfolio composition for pension plan and nonprofit investors is undoubtedly influenced by a tolerance for illiquidity as well as familiarity and the avoidance of maverick risk. Individuals don't have access to the economies of scale that allow institutional investors to achieve diversified mixes of Alternatives. We strive to keep the number of variations of investor situations to a minimum and summarize candidate mixes in Exhibit 5 based on the portfolio's overall exposure to Alternatives.

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<sup>1</sup> Equity long-short, equity market-neutral, merger arbitrage, distressed securities, special situations, convertible bond arbitrage, relative value arbitrage, asset-backed securities arbitrage, structured debt investing, managed futures, global macro and commodities long-short.

Conservatively positioned portfolios and portfolios of investors in the early stages of building up an alternatives program are likely to have an overall lower allocation to Alternatives and are recommended to focus on more liquid segments and those with systematically driven return patterns. Moderately positioned portfolios will likely increase exposure to Private Investments and Alpha-Driven Investments relative to Listed Real Assets at the same time increasing the overall Alternatives allocation. More aggressive investors are recommended to hold a greater share of the total portfolio in Alternatives as well as pursuing higher exposures to Private and Alpha-Driven Investments.

Taxable portfolios benefit from the diversification of Listed Real Assets, even with only small exposures to these categories. However, commodities receive particularly disadvantageous tax treatment in the U.S. and are less attractive for taxable investors.

The three portfolios in Exhibit 5 don't cover the entire spectrum of risk tolerance levels that may be considered. As further guidance, we have considered upper ranges on the exposures we would recommend.

For most institutional investors we recommend a limit of 15% to Listed Real Assets. This recommendation is primarily influenced by an assessment of what the market is likely to accept. Liquidity is not typically an issue for these investments; thus, our advice for an upper limit does not vary with the size of the asset base or with the type of investor.

For most institutional investors we recommend Private Investment exposures up to 20% of the total portfolio, but only for experienced investors who can withstand significant illiquidity and who have the understanding and resources needed to manage the allocation. Those with smaller asset bases and fewer resources for identifying and managing promising investments are advised to dedicate no more than 10% of their total portfolio allocation to Private Investments.

The allocation to Alpha-Driven Investments is very dependent on the availability of underlying components. Assuming no restrictions on availability, we suggest up to 20% exposure for the most aggressive portfolios. A range of 5%–15% of the total portfolio may be more typical, with lower allocations for more conservative portfolios and those of organizations with smaller asset bases.

As we map out specific portfolios, we don't typically reach the upper limits of the allocation ranges discussed above, even for the most aggressive multi-asset portfolios. Aggregating the upper limits of each of the category ranges leads to a portfolio containing up to 50% Alts exposure. While we have not attempted to set a specific limit on total allocation, we have tried to outline the logic behind our approach to these investments in a way that allows each investor to evaluate the needs of a particular portfolio.

**Exhibit 5: Alternative investment mixes: Example starting points for portfolio construction**

<b>Total Alternative investments</b>	<b>40%</b>	<b>25%</b>	<b>15%</b>
Listed Real Assets	10%	7%	7%
Commodities	4%	3%	3%
Global REIT	3%	2%	2%
Global Listed Infrastructure	3%	2%	2%
<b>Private Investments</b>	<b>15%</b>	<b>8%</b>	<b>3%</b>
Private Equity	8%	4%	0%
Private Real Assets	7%	4%	3%
<b>Alpha-Driven Investments</b>	<b>15%</b>	<b>10%</b>	<b>5%</b>

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These starting points should be tailored to the particular needs and preferences of each investment portfolio. Investor's with a greater tolerance for illiquidity or greater resources for researching and assessing manager skill should consider greater exposure to private and alpha-driven categories.

Of course, this paper doesn't provide the full granularity necessary to fully implement an Alternatives portfolio. In particular, the roster of strategies within hedge funds and along the Private Investments spectrum must be determined for each investor. Additional categories may be added to the list.

## Conclusions

Investors have long sought allocation exposures beyond the bounds of listed equity and bond markets. Alternative investments provide an opportunity to enhance portfolio returns while managing overall risk. While the future behavior of these evolving investment opportunities can't be precisely forecast, even a ballpark assessment indicates promise for a carefully implemented Alternatives portfolio.

The well-balanced allocations we recommend recognize the varying resources and expertise among different investors and acknowledge the advantages that institutional investors with larger asset bases and larger investment staffs may have in developing and maintaining exposures in this space.

These investments are rarely available in passive or benchmarked implementation and, in fact, an "average" outcome is typically not worth the trouble. Taking full advantage of opportunities in the Alternative Investments space requires the ability to identify, access and monitor strong managers in each of the asset categories.

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