



THE BOSTON CONSULTING GROUP

# The Rise of Alternative Assets and Long-Term Investing

*Strategic Asset Allocation for Large Institutional Investors*

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# The Rise of Alternative Assets and Long-Term Investing

## *Strategic Asset Allocation for Large Institutional Investors*

### 1. Introduction

The 2008 Global Financial Crisis (GFC) had a lasting effect on both the capital markets and the global economy. Weak recoveries in developed economies and many rounds of monetary easing in the post-crisis years have led to intensive competition for funding and downward pressure on returns globally. Even with “Trumpism” in the U.S., investors clearly understand that “low growth and high volatility” are likely to remain the New Normal for quite an extended period of time.

This report aims to provide guidance for large Chinese institutional investors under these New Normal conditions. We analyze the recent investment strategies and management practices of leading institutional investors around the world. (Please note that the term “institutional investor” in this report refers to the asset owner, not the asset manager – institutions such as the central governments, sovereign funds, social security/pension funds, insurance companies, and endowment funds.)

### 2. Investment Trends of Large Institutional Investors

The investment strategies of institutional investors vary with their source of capital, liquidity requirements and risk appetite. However, three overarching global trends have emerged over the past five years: a rising allocation to “alternative assets”; the growing belief in “long-term investment”; and a greater emphasis on “post-investment management”.

#### 2.1 A rising Allocation to Alternative Assets to Counter the Impact of Low Interest Rate on Return

Broadly speaking, “alternative investments” are investments in assets other than stocks and bonds traded over public markets, with underlying assets of private equity, real estate, infrastructure, and natural resources, etc.

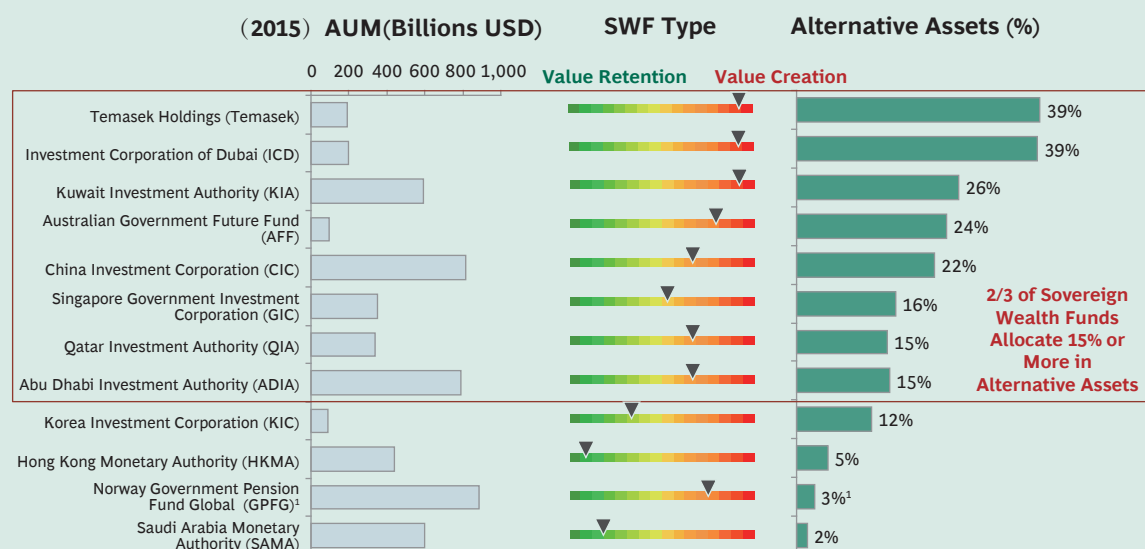
Before the GFC, alternative investment was the “secret weapon” of a few pioneering investors. For example, the Yale Endowment, which is the second largest endowment fund in the world, allocated one third of its funds to private equity, real estate, lumber, oil, and other alternative assets as early as the 1990s. Private equity aside, alternative asset classes were then unpopular among large institutional investors. The Yale Endowment’s alternative investment strategy delivered outstanding annual returns of nearly 20 percent on average in the ten years prior to the financial crisis.

With falling interest rates and subdued returns on public markets following the financial crisis, growing numbers of large institutional investors have turned to private markets and alternative assets in search of better returns. Greater volatility in public markets has had significant impact on the performance of large institutional investors, resulting in the performance decline of many sovereign funds and pension funds last year. In order to deliver higher returns with more stability, many institutional investors have increased their allocations to alternative investments. According to a recent study by BCG and Citibank, over the past five years, nearly half of new investments by institutional funds have been in alternative assets.

Some investors’ portfolios have seen dramatic increases in the portion allocated to alternative assets. For example, the Yale Endowment has increased its allocation to alternative assets from 30 percent to 53 percent (of which private equity and venture capital account for 33%), with a superior ten-year annualized return of 10%, and the return of last year was 11.5%. The Canada Pension Plan Investment Board’s (CPPIB) allocation to alternative assets grew from 4.3 percent of its portfolio (of over USD 200 billion) in 2005 to 47.6 percent in 2016, a tenfold increase over a ten-year period. Even Norway’s Government Pension Fund Global (NGPFG), which previously preferred secondary markets and allocated its entire portfolio to public market securities, began to invest in real estate assets in 2010, with a target portfolio allocation of 5 percent. According to Preqin, the average asset allocation of sovereign wealth funds in private equity increased by approximately 70 percent from 2011 to 2016.

In short, alternative investments have become part of mainstream asset allocation strategies. The top twelve largest sovereign funds globally all have allocation to alternative assets (See Exhibit 1) with varying allocations depending on their fund objectives. Funds which have a greater focus on value retention, i.e. aiming for stability in currency and finances, tend to have higher requirement on liquidity and security, and therefore lower percentage of their assets in alternatives. Funds that focus more on growth, i.e. with the objective to generate cross-generational wealth, increasing the nation’s capacity for future welfare payout or improving returns from excess foreign exchange reserves, tend to have

### Exhibit 1. Asset Allocation of the Top 12 Sovereign Wealth Funds (Where Publicly Available)



Sources: Various company websites; the SWF Institute; BCG analysis.

<sup>1</sup>The Norway GPF is one of the few large sovereign wealth funds that do not allocate any assets into private equity. The Norwegian has maintained a very conservative risk profile since the fund's inception, only requiring relatively low yearly returns (less than 4%). After the financial crisis management at the fund (the NBIM) has submitted multiple petitions to the ministry of finance asking for less investment restrictions and suggesting allocation in private equity, but currently this remains unchanged. The only alternative assets the fund is currently allowed to invest in are real estate and infrastructure.

higher tolerance to risk and therefore a higher mix of alternatives.

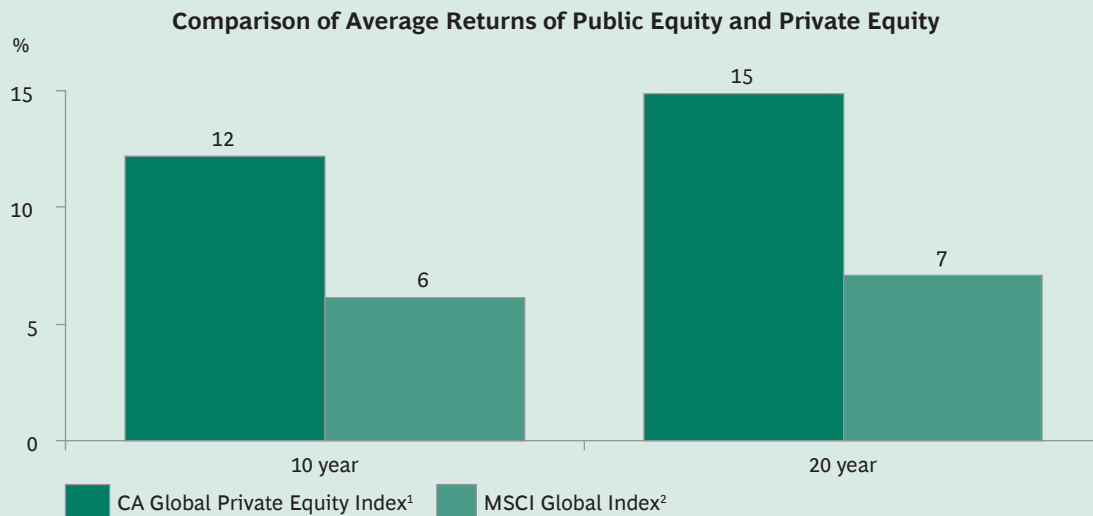
Two-thirds of the largest sovereign wealth funds allocated 15 percent or more of their investments to alternative assets in 2015. We expect this allocation ratio to continue to rise in the future. For example, China Investment Corporation (CIC) now allocates only 22 percent of its portfolio to alternative assets, but has publicly stated on many occasions that this ratio could reach 50 percent in the future.

Alternative assets have risk/return characteristics that differ from traditional publicly-traded assets. This means that an increased investment in alternatives can improve returns for the overall portfolio and increase stability of returns.

Consider private equity investments. In Exhibits 2, 3 and 4, we compare investing in private equity with investing in publicly traded stocks.

- **Private equity can produce more attractive long-run average returns.** As illustrated in Exhibit 2, according to statistics from the Cambridge Associates, the 10-year and 20-year average annual compound returns for private equity funds around the

## Exhibit 2. Comparison of Average Returns of Public Equity and Private Equity



Source: Cambridge Associates.

<sup>1</sup>The CA Global Private Equity Index is the average net return (minus management fees and carried interest) of all the PE/VC funds around the world tracked by its database.

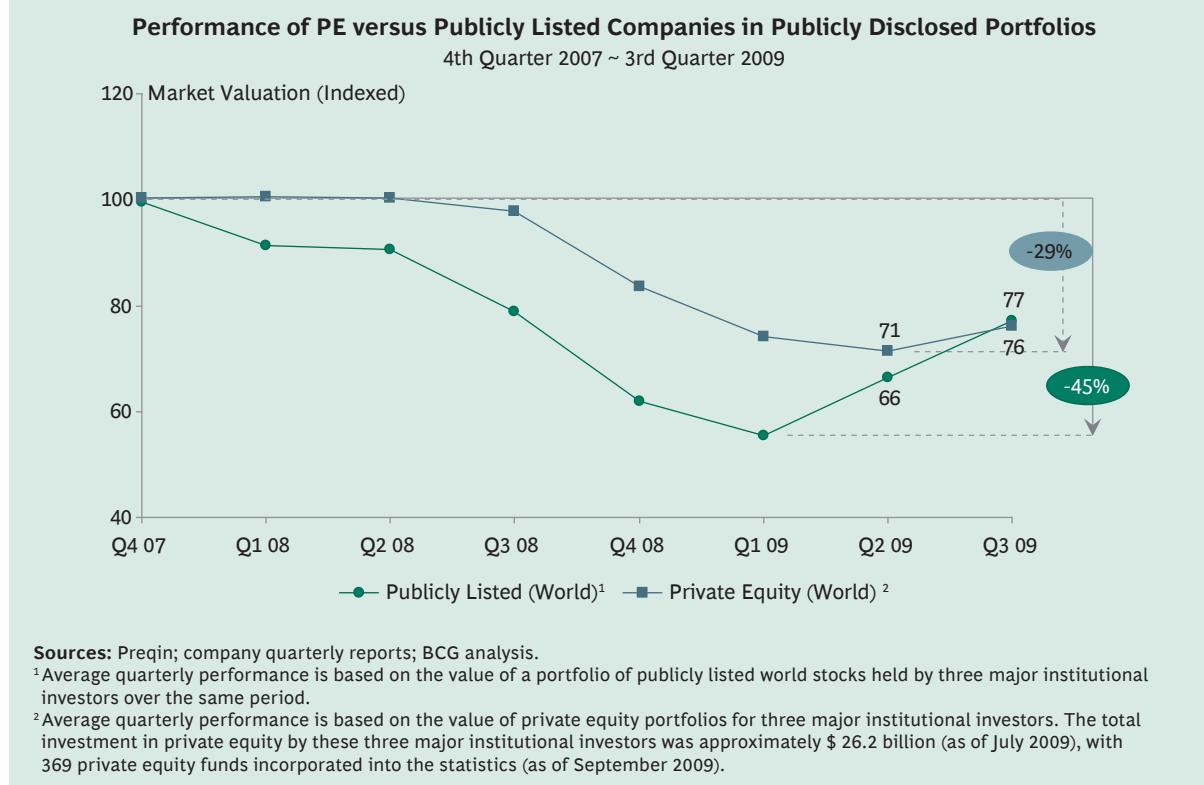
<sup>2</sup>The MSCI World Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets. It covers approximately 85% of the free float-adjusted market capitalization in each country.

world were 12 percent and 15 percent respectively, while average annual compound returns for the leading equity indices around the world were only 6 percent and 7 percent for the same periods, only half the returns for private equity funds.

- **Private equity is less impacted by extreme market volatility and therefore can experience less value loss.** As seen in Exhibit 3, analysis of the investment portfolios of some of the world's largest institutional investors reveals that, during the GFC, the value decline of their private equity investments was only 60 percent that of their publicly traded stocks.
- **Private equity is negatively correlated with the performance of secondary markets and the economic cycle.** As shown in Exhibit 4, the  $\alpha$  from private equity compared with secondary markets is most evident when economic conditions are tough. When the economy is growing rapidly, private equity underperforms secondary markets.

As the environment becomes more volatile and growth slows down, investors should consider allocating more of their assets into private equity and other alternative assets.

### Exhibit 3. Performance of Private Equity vs. Public Equity During the Global Financial Crisis

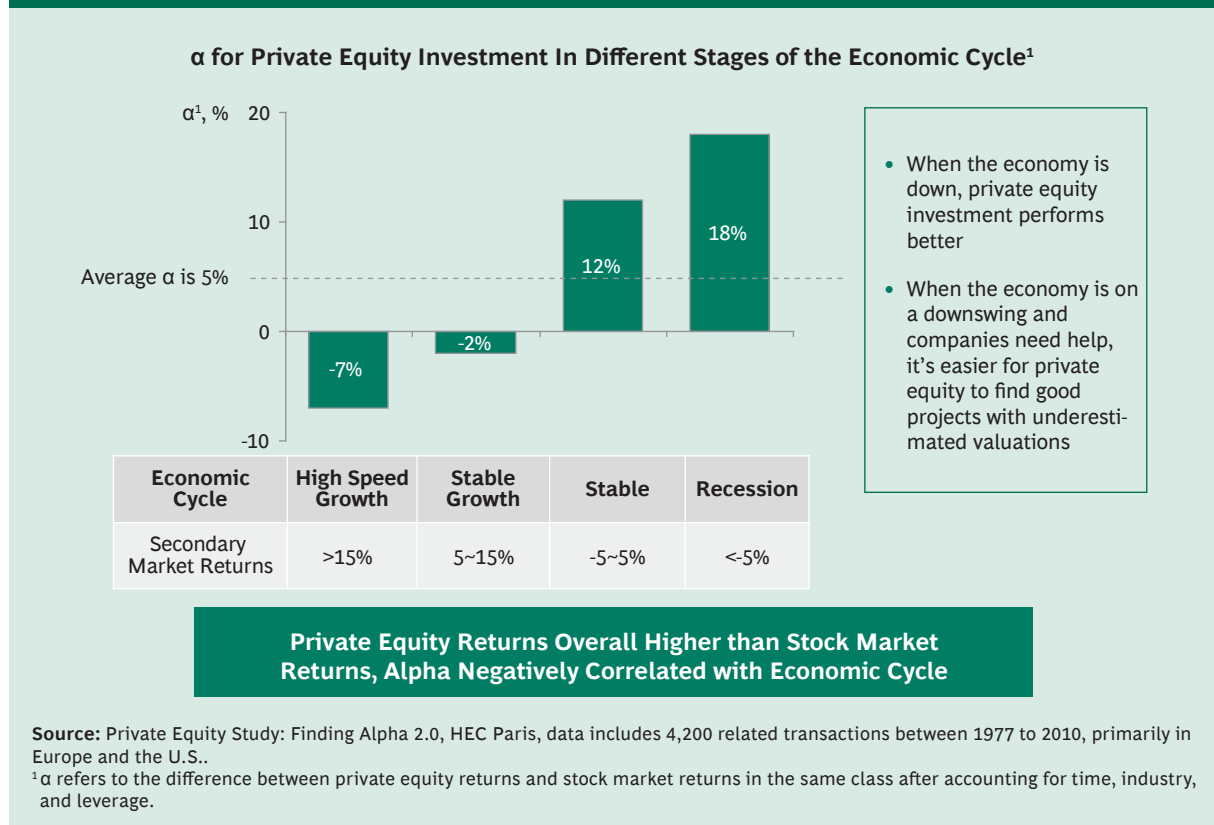


Private equity funds also have the following three advantages: (1) the market-oriented business model can attract investment talents. Co-investment (1 to 5 percent from GPs) ties the interests of investors and managers, forming highly effective incentives and controls; (2) rich social capital is accumulated over years, including investment experience, relationship networks and industry influence; (3) professional post-investment management teams are able to manage value of investment and to generate operational value.

Other than private equity, real estate, infrastructure, natural resources and other alternative investments on physical assets can also offer attractive returns with stable income returns throughout the holding period.

According to MSCI's IPD real estate index and the Preqin Infrastructure Index, the average annual compound returns from investing in real estate around the world were 9.2 percent and 6.4 percent over the past five and ten years, respectively. Average annual compound returns for investments in infrastructure worldwide over the past five and seven years were 10.3 percent and 6.7 percent, respectively. Real estate and infrastructure

### Exhibit 4. Investment in Private Equity Is Negatively Correlated with Performance of Stock Markets and Economic Cycles, Can Help Hedge Against Risk for Investment Portfolio



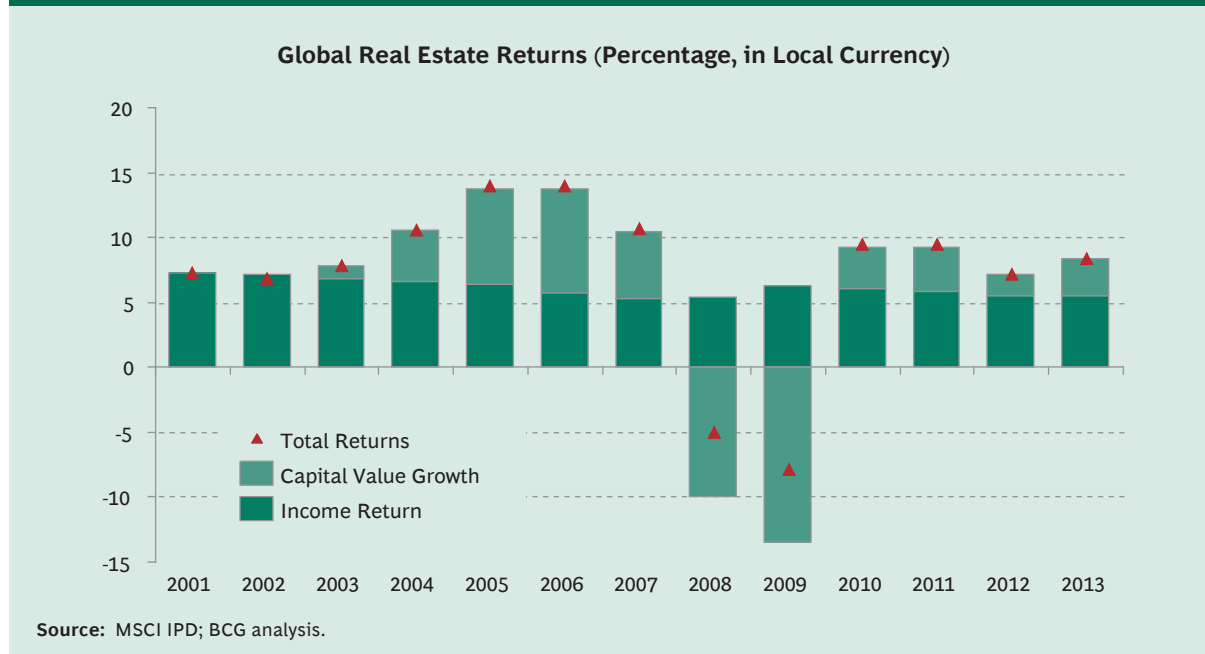
assets contribute to an investment portfolio not primarily from the return rates, which are often below private equity returns, but from highly stable and continuous cash inflow over the long run. These assets also tend to retain their value better and can serve as a hedge against inflation. As Exhibit 5 shows, although the total returns from real estate investments (including changes in capital value) fluctuate from year to year, their income return is very stable at little over five percent and barely affected by the financial crisis. Real estate is thus an attractive asset for institutional funds pursuing stable returns and working with a minimum income return requirement.

## 2.2 Mining for differentiated investment opportunities to invest for the long-term

Long-term and short-term investments are different in terms of investment horizon. Short-term investors plan their strategy and evaluate their performance in a 1 to 2 year period, whereas long-term investors usually plan for horizons of more than five years, or



### Exhibit 5. Global Real Estate Returns (Percentage, in Local Currency)



even 10 to 20 years. Long-term investors are concerned about overall performance for the entire time horizon rather than any particular 1 or 2 years within it.

Such different investment horizons lead to different return drivers. Short-term investors focus on short-term factors on price fluctuations, such as unexpected events or irrationality in the market. Long-term investors are more focused on sustainable and predictable growth drivers over time, i.e. improved fundamentals of underlying companies and assets. Hence, value growth is typically the cornerstone philosophy for long-term investing.

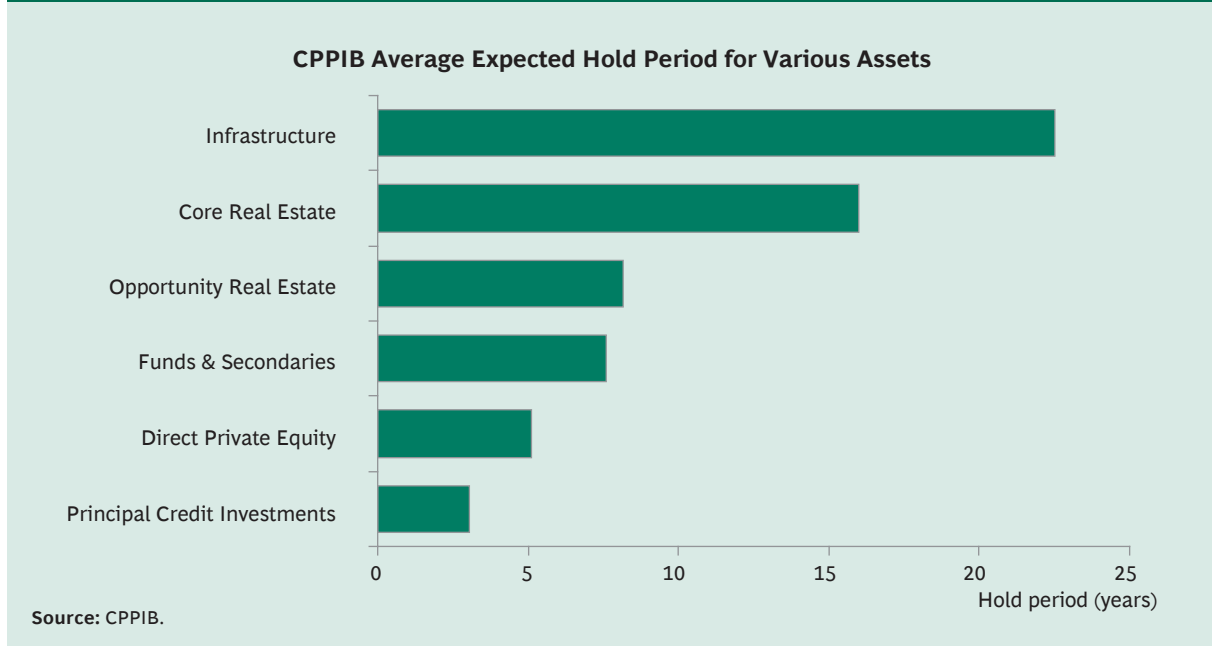
In recent years, long-term investments have been rising. For example, alternative investments tend to show two major trends: institutional investors increasing their allocation to these assets which have naturally longer horizons, as well as extending the holding period of these investments.

- **Increasing allocation to assets with naturally longer horizons**

Over recent years, sovereign funds, pension funds, endowment funds, and even tightly regulated insurance companies, have invested heavily in physical assets such as real estate and infrastructure.

The income return characteristics of real estate and infrastructure assets naturally

### Exhibit 6. CPPIB Average Expected Hold Period for Various Assets



makes them long-term investments. Consequently, many large institutional investors have an inclination towards these “longer-term investments”. As an example, Canada Pension Plan Investment Board (CPPIB) holds infrastructure assets for more than 20 years and core real estate assets for more than 15 years – far longer than other alternative asset categories. (See Exhibit 6.)

- **Extending the holding period of investments**

Investors are also holding some other types of assets longer than they used to. The evergreen fund structure in private equity is a noteworthy example. Private equity funds have always been fixed-life vehicles with a five or ten-year term, but in the last two years, the terms of some of these investment vehicles have been significantly extended.

For example, Carlyle set up a US\$ 3 billion fund at the end of 2015 with a 20-year lifespan. The fund invests in quality assets with excellent fundamentals but cannot exit via IPO within 3-5 years. Another example comes from Blackstone, which has raised more than US\$ 2 billion to experiment with its “core private equity model” which focuses on long-term investing with a 20-year horizon. Blackstone has said that returns for this model could be 1.8 times that of a normal strategy (i.e. investing sequentially in three normal PE funds over the 20 years). KKR founder, Henry Kravis,

has said that private equity should invest more in the style of Warren Buffett, calling it possibly “the perfect private equity model.”

Private equity institutions are experimenting with these long-term investment strategies in response to increased upstream demand from large institutional investors for long-term investments, and opportunities created by asset owners’ new perceptions of third-party asset managers in long-term investments.

The growth of long term investing is driven by two factors.

**Factor One: Large institutional investors began to realize that amid the shortage of quality assets, long-term investments can have differentiated advantages, enabling them to reach more diversified investment opportunities, better identify entry/exit timing, and therefore achieving higher returns.**

Long-term investment strategies have several characteristics that make them attractive to institutional investors, especially in the current environment:

- Long-term investors have a higher tolerance for liquidity risk and market risk. Asset valuation analysis shows that increase of these two risks is accompanied by higher returns.
  - Long-term assets have longer lockup periods and lower liquidity, and therefore enjoy higher premiums for non-liquidity risks.
  - Long-term investors can tolerate the loss from short-term market volatility, which implies higher market returns. Even on financial statements, investors do not have the short-term trouble from mark-to-market approach.
- Long term investors can choose better market entry and exit timing.
  - Since the investment horizons of long-term investors can exceed the length of market cycles, they can make investment decisions based on fundamental value and implement contrarian investment strategies. Short-term investors, by contrast, cannot hold positions through difficult periods and are often forced to sell to cut losses when prices are falling.
- Some opportunities, especially those with large value growth potential, can only be captured by long-term investors, while short-term investors find it difficult to invest or profit in the short run.

- Long-term investors can fully profit from the mega trends that span over decades. Examples are early investment in healthcare and the internet of things aimed, respectively, at benefiting from an aging population and the rise of artificial intelligence.
- Compared to short-term investors, long-term investors can gain higher value from post-investment management.
  - Post-investment management of the assets or underlying business is an important source of value creation in equity investment. However, it takes time to deliver upside of the managerial transformation. Long-term investors are better positioned to actively participate in the process and therefore gain higher returns it can yield.
- Long-term investments may have lower transaction costs and portfolio management costs.
  - With the same asset class, long holding periods reduce the need for frequent trading, thereby lowering the portfolio management fees and transaction costs. The smaller number of investors able to commit funds over long run may also reduce the bidding price of long-term assets relative to short-term assets, for which there is an abundance of bidders.

### **Factor Two: Higher demand on financial capital to truly support real economy**

Direct equity investment by financial capital is an important driver to the development of real economy. Studies show that short-term investors can place unnecessary short-term pressures on an enterprise, often creating incentives for management to make decisions against the long-term interests of the company and therefore its sustainable profitability. For example, a reliance on short-term capital could make a company reluctant to make bold investments on long-term trends, thereby missing out on opportunities to exploit long-term opportunities for industrial restructuring<sup>4</sup>. A company may also be deterred from making sufficient investment in environmental protection and social responsibility, thereby increasing operational costs and risks in the long run. That is why sound development of the real economy requires financial capital to focus more on long-term investments.

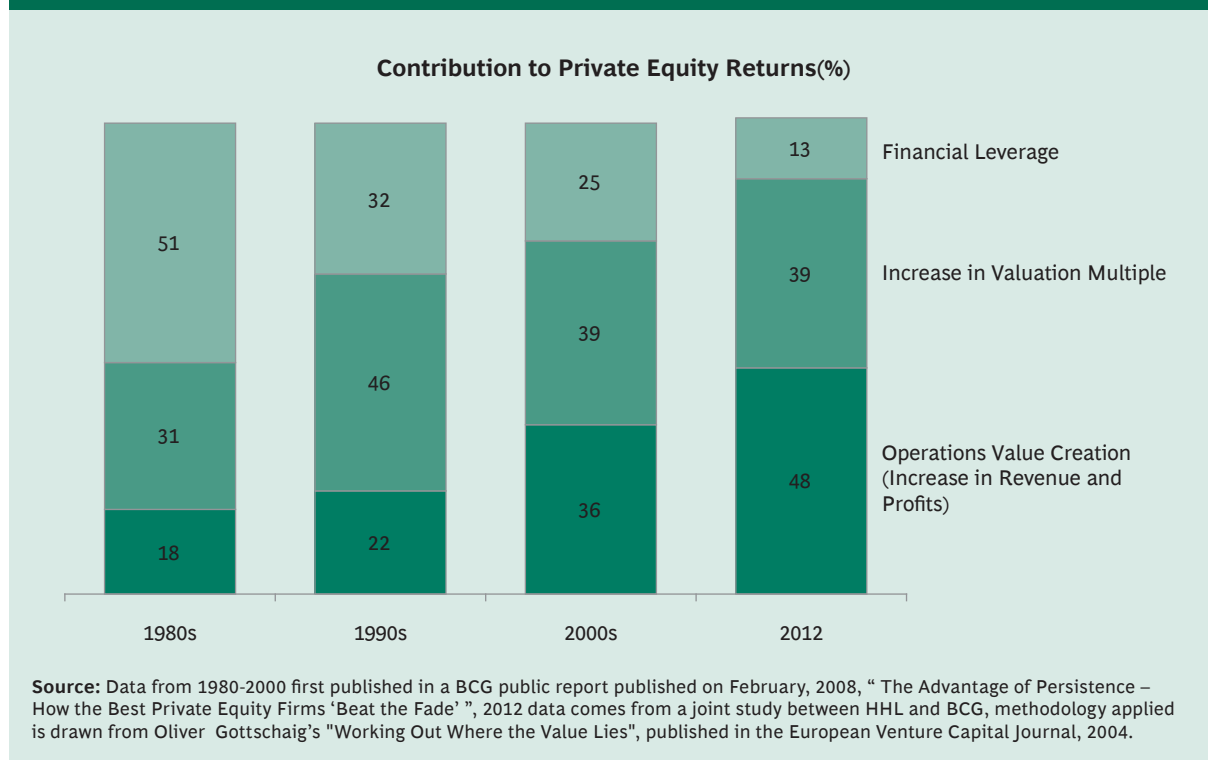
## **2.3 Strengthening Post-Investment Management to Increase Underlying Value**

As investors increase their allocation to private equity and other alternative assets, com-

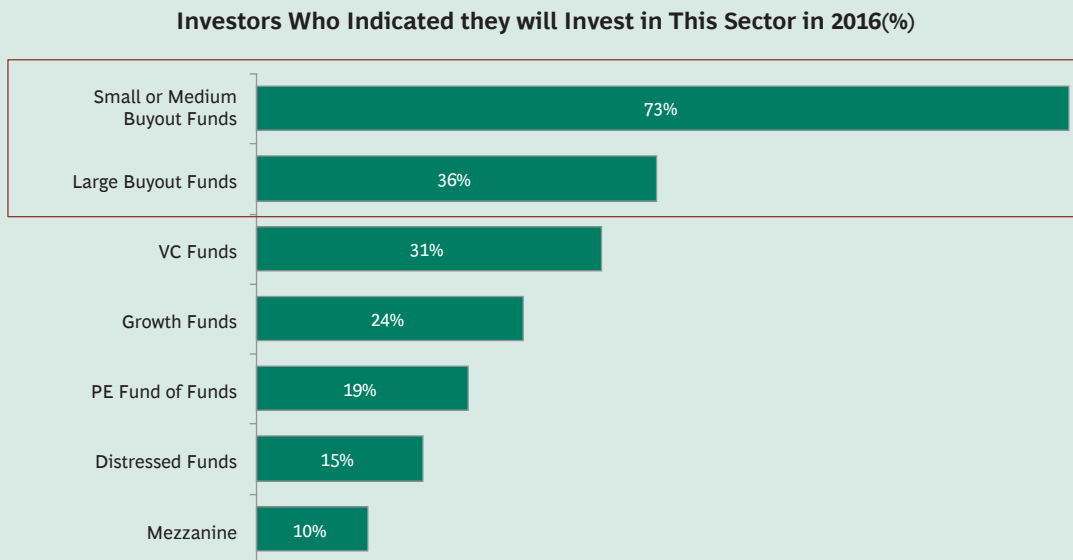
petition for these assets is intensifying. Leaders in the field have said that their advantage in the discovery and evaluation stages is shrinking. Post-investment value creation has become the key to pulling away from competitors.

Post-investment management should not only complement the good projects, but more importantly, help with underperforming ones. The percentage of private equity investments below the original target return is rather high. Even for well performing private equity funds, loss rate (return multiple is less than 1) is around 30 percent. Experienced institutional investors therefore greatly focus on the post-investment management capabilities of private equity funds in due diligence. A particular focus is the crisis response capabilities, i.e. helping with turnaround when the investment falls below the target return. Consider private equity. Over the past three decades, its primary approaches to obtain higher returns have changed fundamentally. BCG analysis shows that, in the 1980s, private equity achieved high returns mainly through high leverage and multiple arbitrage; increases to the value of the operation contributed less than one fifth of returns. (See Exhibit 7.) This ratio has gradually increased in the past 30 years. Since the financial crisis, improved operations are contributing almost half of overall returns.

### Exhibit 7. Source of Value Creation for Private Equity Funds Have Undergone a Fundamental Change over the Past 30 Years



### Exhibit 8. Investors Currently Favor Buyout Private Equity Funds that Emphasize Post Investment Management



**Source:** A Preqin private equity market report in the first half of 2016, which is based on a Preqin survey in December 2015 covering more than 100 medium or large limited partners spanning different countries and regions across the globe.

Improving the value of the operation has become the most important factor in a private equity investment's success.

In recent years, large institutional investors have paid more attention to post-investment management for equity investments, be they commissioned to an external party or invested directly by an in-house team.

When commissioning an external party to make investments, data shows that large institutional investors allocate more capital to funds that emphasize post-investment management. Among the many different kinds of private equity funds<sup>5</sup>, buyout funds and integration & upgrading funds require the most post-investment management and, therefore, strongest post-investment management capabilities. A 2016 Preqin survey covering more than 100 limited partners (LP) found that buyout funds are most favored by institutional investors nowadays. Institutional investors indicating that they will invest in a small/medium-sized buyout fund and a large buyout fund account for 73 percent and 36 percent respectively, compared to only 24 percent that will invest in growth funds. (See Exhibit 8.)

Leading institutional investors making direct investments continue to strengthen their

post-investment management capabilities. For example, Canada's CPPIB created an in-house portfolio value creation group dedicated to post-investment management for private equity and infrastructure investments. This group begins to play a role from the pre-investment due diligence phase. It devises a 100-day post-acquisition transition plan, assists in improving governance structures, and oversees the execution of various value-creation opportunities, among other things.

### 3. Management Practices of International Institutional Investors

These strategic shifts – from public markets to alternative investments, from short-term to long-term investing, from mere target selection to post-investment management – have significant implications for the way institutional investors are organized and run. They need clear philosophies and strategies, and the governance model, the talent profile, the performance management and incentive system, the corporate communications and culture: all will need to change in line with these changes in investment strategy.

Taking “how to commit to long-term investments” as an example, we outline the key approaches taken by leading institutional investors. As some assets require long holding periods (e.g. Core real estate investments with above-10-year horizon), large institutional investors, alongside commissioned investments, also began to establish in-house teams, which projects the importance of internal management.

#### 3.1 Investors Need Clear Long-Term Investment Mindset

Long-term investing isn't simply about “buying and then holding for a long time” or “high allocation to illiquid assets”. It should be based on hypotheses about the way prices change over time and how risk is related to return. These hypotheses determine that the investment strategies must have long-term horizons.

For example, Singapore's GIC Private Limited (GIC) and Norway's NGPFG follow a value investment philosophy. They believe that prices will eventually regress to the underlying valuation, and therefore pursue returns by growing value in the underlying company and by arbitraging the difference between price and the underlying value. Both strategies require long investment horizons, and sometimes more patience and time to wait for the deviation to close, and even invest against the overriding trend.

Besides returns, the philosophy of long-term investments is also reflected in the different understanding about risks. Long-term investors do not see short-term price fluctuations as real risks. The only real risk they see is “permanent economic loss” arising from poor financial performance of the underlying business. Diversification in long-term investment portfolios is not, therefore, aimed at reducing market volatility, but rather diversifying risks that affect the fundamental cash flow. Mark Wiseman, former CEO of CPPIB, once wrote<sup>6</sup> that unlike many pension funds, CPPIB generally doesn’t hedge its foreign currency exposure. This is because, while hedging might smooth out the fund’s performance on book from year to year, it comes at a significant financial cost with no expected value creation over the long term. In 2010, depreciation of Canadian Dollars (CAD) resulted in currency exchange loss of 10 billion CAD to CPPIB, but the fund realized 16.1 billion CAD in the following years when CAD appreciated.

A precise, detailed description of the long-term investment philosophy should be the foundation of an investment strategy and process. It can also aid communication between investment institutions and their stakeholders. Many successful long-term institutional investors, such as the CPPIB, GIC, Temasek and NGPFG, have stated their investment philosophy in a manifesto available to stakeholders through their websites and annual reports.

### 3.2 Sound Corporate Governance

Implementing a long-term investing philosophy may seem simple but in reality can present great challenges, especially amid market volatility when investors often need to take positions that might seem “obstinate”. Affected by public opinion, individual interests and lack of professionalism, shareholders and boards often turn the pressure into unnecessary influence on the investment team to change direction. A good corporate governance structure protects the independence of the investment team, ensuring full play of its professional expertise and preventing good decisions from being reversed by shareholder interference.

CPPIB, GIC, and Temasek exemplify the required governance structure. In overview, their successful experience are about three key words: independence, professionalism and market-oriented.

- **CPPIB:** The CPPIB is commissioned by the Canadian government to manage the assets of the Canada Pension Plan. However, it operates at arm’s length from Canada’s federal and provincial governments, with the oversight of an independent and highly qualified board of directors. The CPPIB Board approves investment policies for the



CPP fund and hires senior managers to run it. Except for appointing the board, Canada's federal Finance Minister cannot directly influence the investment decisions in any other way. Mark Machin, newly appointed CEO of the CPPIB in 2016, once explained the institution's success<sup>7</sup>: *"An important reason why the CPPIB has been able to maintain relatively high returns is the high level of independence and purity of its investment operations. On one hand, the CPPIB is not politically responsible and is not subject to administrative intervention, which makes investing a relatively simple question... On the other hand, a relatively high level of independence means the CPPIB can, to a certain degree, determine its own compensation. Pension fund management institutions in most markets around the world cannot afford the high compensation it takes to attract the most talented teams. The CPPIB has enough freedom to determine its own compensation, which means it can hire the best talent. This is an important element of the CPPIB's competitiveness."*

- **Temasek:** The governance structure of Temasek once drew broad acclaim from Chinese academic as a role model for state-owned enterprises. In Temasek's dual-layered structure, there is a clear border between the Singapore government and Temasek's operational management. The role of the Minister for Finance of Singapore is limited to appointing the president and board of Temasek, auditing annual financial reports, and calling a meeting when necessary to discuss the company's performance and strategic plans. The Minister participates only when Temasek acquires or sells stakes in a state-owned enterprise. Otherwise, Temasek's daily operations are completely independent.

Most of Temasek's board members are private sector businessmen, which ensures their professionalism. In 2016, for example, only two out of Temasek's 14 board members were government officials, the other being independent, private sector business leaders. By contrast, most of CIC's ten directors are government officials. Only three are business leaders, and they all come from state-owned enterprises.

- **GIC:** The Chief Investment Officer of the Government of Singapore Investment Corporation (GIC) has said that, from his experience, two things are helpful for the governance of long-term investing<sup>8</sup>. The first is the "no surprise" principle, which means the investment team is proactive in raising issues relating to risks and performance challenges as a way of keeping the confidence of their clients and the board. The second is establishing a professional advisory board of business leaders and famous scholars to study trends that will unfold over the next few decades. The support of this external brain trust will help the board make confident decision while keeping it in the know and focused on important long-term trends.

### 3.3 Long-Term Investors Need Long-Term Performance Evaluation and Incentives

Using long-term quantitative metrics for performance evaluation encourages long-term investing. For example, GIC uses 20-year rolling real returns as the primary measure of overall investment performance. (The rolling rate of return in 2016 = the average rate of return from 1996 to 2016.) For every asset class, GIC has clear target returns, risk limits and authorization agreement of investment. For all asset classes, even when it comes to public market investments, the shortest term for an investment performance evaluation is five years.

Investment manager performance management also needs to balance both long-term and short-term considerations. Some funds use multi-interval formulas which encompass both short-term and long-term factors. For example, a leading U.S. fund evaluates the performance of its investment managers using the weighted average of rolling return rates over one year, four years, and eight years as a base metric. The four-year and eight-year numbers are given more weight.

Although long-term investors seek long-term performance from their staff, they are competing for talent in the same pool with short-term investors. If short-term performance incentives are too small a portion of overall compensation, long-term investors may find it difficult to attract talent. Multi-interval evaluation helps to incentivize long-term performance while keeping the company competitive in the talent market.

Long-term investment can also be encouraged by making “process” metrics part of performance evaluation. At Aberdeen Asset Management, for example, staff gives scores to each other for their contribution to the investment process, e.g. detailed metrics include the quality of due diligence reports on target companies. Such metrics can promote compliance to standard processes necessary for long-term investing by investment managers. GIC’s CEO put it thus: “We believe what we can control is the investment process; investment performance is just what naturally comes after completing the process.”<sup>9</sup>

Possible incentives include higher percentage of performance-linked bonuses and deferred bonuses. Many current practices promote long-term investment. For example, performance bonuses for external investment managers are often tied to net returns over five years, with no bonuses paid until the end of the five-year period. Some funds defer annual performance bonuses, paying a small portion at the end of the year concerned and spreading payment of the rest over three or four years. Incentives should be designed to ensure that investment managers implement long-term investing strategy, and encourage them to act in the long-term benefit of the overall investment institution.

## 4. Recommendations for Large Chinese Institutional Investors

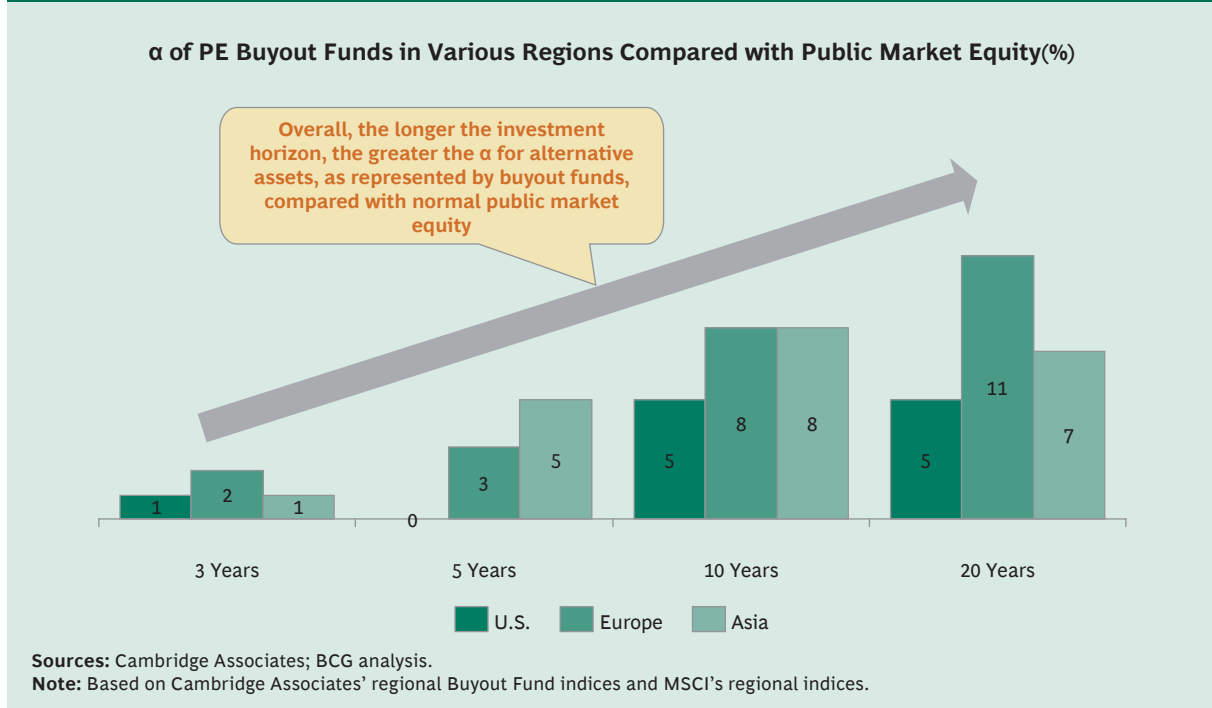
### 4.1 Investment Strategy: Relying on Long-Term Development with Focus on Strengthening Alternative Investments, Returning to Value and Better Post-Investment Management

Among large Chinese institutional investors, sovereign fund, social security fund and some insurance companies have liabilities with long duration or non-fixed term, which are highly suitable for long-term investing. As the public market is experiencing greater volatility and pressure on return, funds suitable for long-term investing should firmly re-pivot to long horizons, focusing more on investment strategies that can produce differentiated advantages. On the one hand, it helps long-term fund obtain more stable and sustainable returns. On the other hand, the giant size of the funding from these large institutions can have profound impact on the financial market and the real economy. Only by giving more attention to long-term investing strategy will help with greater stability of the financial market, and promote the sustainable growth of the real economy in the long run.

Of course, implementation of long-term investing strategy is still based on satisfying basic liquidity and payout requirement. Consider foreign exchange reserve. Investment management should first aim for maintaining sufficient liquidity and security, before pursuing higher returns with controllable risks. Meanwhile, strategies for retention and creation of values should be managed separately, for example, in different funds run by different institutions. Long-term investing strategy should be used mainly for funds with the core objective of “value creation”. In Singapore, for example, investment of foreign exchange reserve is conducted in three parts: the Monetary Authority of Singapore mainly invests on sovereign bonds for value retention; Temasek manages its investment with long-term strategies to pursue high returns and focus on value creation; GIC manages the portfolio with the strategy and risk appetite in between. The three institutions have clearly differentiated positioning and strategies, which ensures multiple goals of foreign exchange reserve management.

In asset allocation, investors can consider increasing allocation to alternative assets. It is the natural choice amid the overall environment of low growth and high volatility. Long-term investors are actually more suitable for holding alternative assets. Historic data shows that as time goes by, buyout private equity funds have higher alpha than public market equities, which is true to U.S., European and Asian market. (See Exhibit 9.)

### Exhibit 9. $\alpha$ for PE Buyout Funds Becomes More Pronounced over a Longer Period of Time



Large Chinese institutional investors should follow the trend, and increase allocation to alternative assets while keeping risks controllable. Investment on private equity funds, especially, has great potential. Investment on real estate and infrastructure also needs increase, while allocation to hedge funds should not be too high. Currently, the 3-trillion-foreign exchange reserve in China is mostly allocated in public market, while alternative investment only accounts for 5%. We suggest that the percentage of alternative investment could be increased to 10-15%, with private equity funds, real estate and infrastructure each taking up 1/3. In alternative investment, Chinese investors should also consider using long-term investing strategies, so as to maximize the returns.

In either public market or alternative assets, we advise investors to return to value-based philosophy in equity investment. During economic transition when many assets are to be revaluated, investors need to strengthen the ability to analyze long-term fundamentals of underlying assets and make judgments, so as to find out the real undervalued assets.

Finally, investors should pay more attention to post-investment management, managing portfolios like enterprise owners. Alternative investments require hugely different thinking patterns and capabilities from that of traditional public market. In public market,

investments rely more on calculation models and machines; a fund manager is able to invest on more than 100 stocks, and the interaction with underlying companies is limited to getting information. In direct equity investment as a kind of alternative investment, investors need to have in-depth understanding of business operation of the invested company, and directly participate in or influence key decision-making for business development and operation. “Investment contributes 30 percent while management contributes 70%”—investors must possess high interpersonal skills, especially the capabilities to solve difficult issues such as restructuring (this is usually one of the key considerations in choosing GPs). Only investors with deep understanding of business operation, thinking patterns, insights and entrepreneurship like that of outstanding entrepreneurs can make successful direct equity investment. That is exactly why an investment institution that used to focus on public market equities need to have a new set of capabilities in turning to alternative investment as another focus, which presents huge challenges.

## 4.2 Supporting System: Focus on Corporate Governance, Talents and Incentives

Because of different principles in allocating assets, alternative investment is different from liquidity- and security-oriented public market investment in terms of staff mix, performance evaluation and incentives. We advise a separate management of these two types of investments. Practice of foreign leading large institutional investors shows that, on the basis of clear and specific investment philosophy and strategies, it is crucial to have independent corporate governance structure, evaluation and incentives in line with the characteristics of long-term and alternative investments respectively, as well as highly professional talents throughout the institution.

However, a look at the major institutional investment funding shows that a sizable part is under the management of purely state-owned institutions, which inevitably sets “institutional” shackles in building an enabling environment.

While it is easy to imitate and learn investing strategies and philosophy, the difficult thing is to develop an enabling environment. In future competition of investment, investors that take earliest steps to strengthen the environment will seize the opportunity and take the lead.

## 4.3 Development Path: Collaboration Based on Local Realities

In general, large Chinese institutional investors are not yet competitive with global lead-

ing investors in long-term and alternative investments. Thus, investors can consider the following three models to implement investing strategies accordingly.

**1. Self-reliance.** Investors recruit staff and train in-house investment teams all on their own. This model is more challenging, with higher costs and difficulties. The institutions should be sufficiently market-oriented and able to recruit top talents. They should also recognize that some capabilities are difficult to be developed overnight. As mentioned above, direct equity investment requires large input of post-investment management to be successful, while such capabilities are hard to build.

**2. Commissioning.** Investors completely rely on commissioning external managers to make investments. For example, to carry out long-term investment strategy, institutions can consider allocating part of the investment to ultra long-term funds such as “Evergreen Funds”, fully commissioning external asset managers to run. This model is simple and direct, but quality asset managers focusing on long-term investments of over 10-year-horizon are quite few in China.

**3. Collaboration.** There are two ways for this in-between model. The first one mainly relies on commissioning, while doing co-investment to strengthen the control over transaction and improve own capabilities. This has become more common in alternative investments. The second one is setting up joint ventures with large institutional investors that have extensive experience in global markets. We believe that joint ventures can greatly assist with long-term investing strategies. On the one hand, investment through joint ventures will not have limit on terms as it does with funds, ensuring truly long-term investment. On the other hand, by closer capital cooperation, Chinese institutional investors can move along the learning curve more quickly. For purely state-owned funds, introducing external investment institutions as shareholders can help break away from institutional shackles and introduce more market-oriented operation.

## 5. Summary

Alternative and long-term investing are not new, but are becoming increasingly important in the investment environment of today and days to come. These investing strategies require higher capabilities for implementation, especially the post-investment management capabilities.

Chinese institutional investors are yet competitive with their western, well-established counterparts. Even in a complete market economy, it generally takes 10 to 15 years or longer to go through the learning curve. During this long journey, either through self-reli-

ance or collaboration, it will be impossible for Chinese investors to establish the required capabilities overnight. The benefits of a long-term investment strategy, especially one with over 10-year horizon, will be visible only after a period long enough. Choosing and committing to alternative and long-term investing under the new normal will definitely be challenging, but that is exactly why we believe that institutional investors with patience, determination and perseverance to see alternative investing strategies through till the end will reap a bounty in both returns and competitiveness.

**Notes:**

1. In this report, we referred to Top 15 sovereign funds by AUM in SWF Institute, and selected the 12 funds with publicly disclosed data.
2. The MSCI IPD Global Property Index measures investment returns in 25 of the largest real estate markets around the world. Unlike the REITS index for the secondary market, the IPD index measures returns for directly held properties in private markets.
3. Preqin Infrastructure Index tracks the investment portfolios of the biggest investors in infrastructure around the world. The index began tracking this sector on December 31, 2007.
4. “Comparing the investment behavior of public and private firms”, Asker, Farre-Mensa, Ljungqvist.
5. Private equity funds include Buyout, Integration & Upgrading Funds, Venture Capital, Growth funds, Distressed, Mezzanine, etc.
6. <http://www.theglobeandmail.com/report-on-business/rob-commentary/investors-need-to-focus-on-the-long-view-not-a-single-record-year/article24700609/>.
7. <http://m.yicai.com/news/4729250.html>.
8. Source: GIC’s Long Term View, Lim Cow Kiat; <http://www.fcltglobal.org/insights/publications/perspectives-on-the-long-term>.
9. Ditto.



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