

Buttonwood | Investing for kicks

The quixotic appeal of exotic assets

NEXT time a defender for your local football club scores an own goal, take a quick look around the ground. The people booing loudest may not be the die-hard fans in the replica shirts but the pension-fund managers who have acquired a share in the player.

Taking a punt on the football transfer market is just one of the ideas being peddled to jaded investors eager for something new. Pension funds, for example, are tired of relying on the stockmarket for capital gains, and wary of the low yields available from corporate bonds and property. By looking further afield, they hope to earn excess returns and narrow their gaping deficits.

In the world of finance no new idea is complete without its Greek letter. In the dim and distant past, picking the best stocks was just seen as being clever; now that skill is known as “alpha”. The letter “beta” is reserved for the boring, old strategy of simply tracking the market. But what if you can find exciting, new markets to track—markets that do not move in step with shares or government bonds? That could be extremely valuable. Hence the phrase “alternative beta”, which refers to non-traditional sources of return, such as taking advantage of changes in market volatility, or exploiting gaps between the spot and futures prices of commodities.

“Exotic beta” represents the wilder fringes of this trend, the equivalent of an art collector buying old comics or baseball cards. Daniel Gore of Orthogonal Partners, a firm that specialises in the area, says the aim is to find managers who are inventive in fields that are not congested by existing investors and in markets that may suffer from mispricing. Uncovering that mispricing may require specialised knowledge that few investors possess, creating profitable barriers to entry.



One of the earliest exotic assets was the catastrophe bond, the provision of back-up capital to insurance companies dealing with earthquakes or hurricanes. But by now, the catastrophic is arguably too familiar to be truly exotic. More recent ideas include managing distressed power stations and buying delinquent credit-card debts from banks. Any of these brainwaves might turn out to be duds. But the hope is that large profits from the few winners will offset the inevitable losers. The approach is akin to that of a venture capitalist spreading his bets among new ideas in fund-management.

The football idea involves providing money to second-tier clubs (not Chelsea or Arsenal) to buy stakes in younger players. The fund then reaps a share of the rewards when the player is sold later in his career (footballers generally become more valuable as they approach their mid-20s). Why should clubs agree to this? Because they are usually short of money and can buy new players only by selling existing ones. By creating shares in their footballers, clubs can realise some of the equity in their human assets, without damaging

the prospects of the team.

The very fact that investors are even considering these approaches shows how difficult their life has become. Fifty years ago, safety was the watchword for pension funds, insurance companies and endowments; they bought the bonds of governments and blue-chip companies. Then it was noticed that a diversified portfolio of shares was a lot less risky than most people thought and delivered superior returns over the long term. The cult of the equity was born.

But the bear market of 2000-02 showed how dangerous it was to rely on stockmarkets alone. Now the models for modern investment institutions are the endowments of Harvard and Yale. They long since moved into alternative assets such as hedge funds and private equity, and have reaped handsome returns.

The trouble is that, in aggregate, investors suffer from a version of Tantalus's curse; they may be able to see attractive returns but they cannot all get hold of them. As more money flows into an investment category, prices rise and the scope for excess returns diminishes. This already seems to have happened with hedge funds and commodities, and it may be about to happen with private equity, given the amount of capital that it has recently raised.

Hence the search for exotic beta. It is all rather reminiscent of the drive into emerging markets in the 1990s, as investors moved from the aristocracy of the asset class—places like Hong Kong and Singapore—into wannabe economies like Indonesia and Ecuador. A series of mishaps followed, as countries lurched into default or devaluation. The future of exotic beta is likely to be similar. Some investors will end up buying the football skills of Victoria, rather than David, Beckham.