GIC

THINKSPACE

FUNDAMENTALS

Seeking Alpha in an Uncertain World

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28 AUG 2020

This article describes GIC's approach to generating alpha, or returns beyond the benchmark, by leveraging our top-down and bottom-up capabilities and comparative advantages.

The rapid rise in global uncertainty, due in large part to the COVID-19 pandemic, alongside unprecedented low interest rates and very high valuations, have made the hunt for "*alpha*"[1] more important and more competitive than ever before. While volatility brings new opportunities, strong headwinds to global growth, including uncharted policymaking, rising debt levels, geopolitical strains, and lower population growth, complicate how investors will make meaningful returns from their portfolios. Given the lower market return outlook, global long-term investors like GIC are constantly looking for new ways to find returns beyond their benchmark, or alpha, while strengthening the resilience of their portfolios.

THE CHALLENGE OF ALPHA

Achieving consistent alpha over the long term is far from easy. Indeed, alpha is a zero-sum game, with one investor's gain marking another's loss. This challenge is often observed in the public markets which are deemed to be fairly efficient based on information flow, high liquidity, and market transparency. Even then, performance differs depending on how investors assess fair market value as a result of their interpretation of new market information.

A recent study[2] on active management funds in the US found that only 23% of such funds managed to beat their benchmarks over the 20-year period. For fixed income funds, only 8% beat their benchmarks. The study also highlighted that past performance does not guarantee future performance, as most funds in the top quartile of past five-year returns did not repeat their ranking over the next five years.

While some studies have shown more persistent alpha performance from private equity fund managers, this has also fallen[3] in recent years as the sector has matured, grown and become much more competitive.

ALPHA AND BETA AT GIC

At GIC, our *"beta"* is represented by our Policy Portfolio (PP), which comprises a diversified combination of six core asset classes, namely Developed Market Equities, Emerging Market Equities, Nominal Bonds and Cash, Inflation-linked Bonds, Private Equity, and Real Estate. Each asset class has its own risk and return profile, and through the diversity of asset classes, the PP is expected to generate optimal risk-adjusted returns over a 20-year period.

GIC's alpha is represented by our Active Portfolio (AP), which comprises an overlay of active strategies. Each active strategy replaces part of the passive investment exposure in our PP with a skill-based, value-adding investment opportunity. The active strategy seeks to ***generate alpha or excess returns*** above its "cost of capital", which is the expected return from the investments in the PP that would have to be sold to fund this strategy, plus other risk premium for any additional risk taken. The intention is to increase the potential return while understanding and managing the additional risks taken against that of the PP.

The combination of the PP (beta) and AP (alpha) overlay gives rise to GIC's actual portfolio exposures and returns, whilst adhering to the risk parameters set by our Client, the Government of Singapore.

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[1] *"Alpha" is the additional or excess returns achieved by active, skills-based strategies, over and above passive buy-and-hold market returns (or "Beta"). Alpha is also often described as the value-add by a portfolio manager, above a relevant benchmark with a specified risk/reward profile. Based on the relative performance on a risk-adjusted basis, alpha can be positive or negative.*

[2] *Source: Dimensional Mutual Fund Landscape 2019*

[3] *Source: How persistent is private equity performance? Evidence from deal-level data, Reiner Braun, Tim Jenkinson, and Ingo Stoff, December 2015*

Other research[4] indicates that individual investors' skills and networks are a significant driver in explaining outperformance, especially for venture capital funds where sourcing attractive deals, building the right equity syndicate, and bringing helpful capabilities and expertise to portfolio companies are key.

At GIC, we see multiple sources of alpha: getting better information, processing it faster and more intelligently, having greater access to opportunities, and executing and managing investments more successfully. Sustaining a competitive alpha edge requires skilled teams, a disciplined, learning and agile mindset, supportive strategies and processes, and a robust digital infrastructure.

> **WE BELIEVE THERE IS ALPHA TO BE FOUND, PARTICULARLY BY SKILLED INVESTORS IN AN ENVIRONMENT WITH HIGH UNCERTAINTY.**

However, strong competition for fewer deals at rising prices presents an ongoing challenge to finding alpha opportunities. A growing "highest bidder" mentality has resulted in some businesses focusing more on fast capital, with less consideration for investors that can provide funding to support the long-term growth of their organizations. This mindset poses a hurdle for investors like GIC who leverage their ability to support a company through different stages of its life-cycle to negotiate alpha-generating deals.

Still, we believe there is alpha to be found, particularly by skilled investors in an environment with high uncertainty, ongoing structural shifts, and likely episodic market volatility.

SEEKING ALPHA AT GIC

At GIC, we seek alpha with our mandate in mind – to preserve and enhance Singapore's foreign reserves. Given the lower beta returns outlook and rising uncertainty in recent years, GIC has been working hard to find attractive alpha opportunities and increase the overall resilience of our portfolio. To do so, we are continually strengthening our top-down and bottom-up capabilities and competitive advantages, including:

Managing the portfolio with a long-term horizon

Being a long-term investor with a flexible mandate has allowed us to reap illiquidity premia from investing in alternative asset classes, non-traditional sectors and less mature markets. GIC was amongst the earliest institutional investors to move into the illiquid alternatives space, investing in real estate and private equity from the mid-1980s. Today, we are well-diversified in our range of alternative investments with our exposure spanning other areas like infrastructure, private debt, bespoke financing, hedge funds, and more – all of which we invest directly in as well as indirectly through funds and other platforms.

Alternatives remain a strong source of alpha for GIC globally and we seek investments with good risk-reward. For example, we see opportunities in infrastructure assets (e.g. utility-based) that provide long-term contracted incomes, downside protection and steady returns, and real estate sectors (e.g. senior living, manufactured housing, data centers) which are outside most traditional institutional investor mandates.

We also target structural trends like technological disruption, sustainability, and the growing middle-class in the emerging markets, to generate more alpha over time.

Amidst the uncertainty, our long-term horizon also enables us to better withstand market fluctuations, and take advantage of market dislocations when attractive risk-reward opportunities arise.

[4]Source: *McKinsey Global Private Markets Review 2020: A new decade for private markets*

Flexible, cross-asset class mandate and expertise

Our flexibility to invest across the public and private markets, capital structure and life-cycle of a company, enables us to be adaptable to the evolving and diverse needs of businesses.

Our private markets expertise provides an information advantage in the credit and public equity markets. It helps us to underwrite the fair value of underlying assets in public deals, as well as identify where the best value is across the investable universe as each asset class is subject to their own cycles. Being able to pivot between various capital markets in the search for value can be a key source of alpha.

At the same time, our public markets expertise allows us to add value as a long-term private equity partner for companies seeking to list their businesses. We share our perspectives on best practices as well as our contacts with our portfolio companies, and have even stayed invested in several companies many years after their IPO.

GIC's Integrated Strategies Group (ISG) was created specifically to seek out unique opportunities that do not fall neatly into any one investment group. Through bespoke capital solutions for family offices and listed companies, alternative deal sourcing via family offices and family-owned businesses, and investments in niche sectors and specialty funds, ISG seeks to enhance GIC's alpha-producing capability and capacity.

Established local presence and networks

Having a long-term presence and investment experience in key financial hubs in both developed and emerging markets have helped us grow strong relationships with our partners, fund managers, investee companies, and other best-in-class business leaders. This gives us invaluable access to market insights and deal flow.

As one of the largest institutional investors in the private markets, GIC has an extensive global network of businesses that significantly benefit from being connected and providing growth opportunities for one another. Similarly, we generate alpha indirectly by leveraging a select group of prominent industry experts within our Global Investment Advisory (GIA) programme, who are strategically placed on the boards of our investee companies. These experts share industry insights and assist with strategy and direction for the companies.

Technological resilience

With the COVID-19 crisis accelerating the use of technology at every level, digital transformation is crucial in defining how businesses remain relevant and forward looking. In addition to seeking attractive tech-related investments, we must accelerate the adoption of technologies like cloud and automation at the enterprise level as legacy infrastructure becomes obsolete. This also helps to defend our portfolio from disruptive forces.

At GIC, we embed tech specialists in our investment departments to develop relevant models for each asset class, as we continually improve our algorithms and investing strategies. Technologies like machine learning and artificial intelligence augment our teams' abilities to draw unique insights from our large portfolio database and market data. We believe this improves idea generation, investment decisions, and efficiency across the asset management and execution process.

> **IT IS ESSENTIAL TO HAVE HIGHLY SKILLED TEAMS THAT CAN ASTUTELY PROCESS INFORMATION, GENERATE UNIQUE INSIGHTS AND IDEAS, AND ULTIMATELY TRANSLATE THESE INTO ALPHA RETURNS.**

Highly skilled teams

Finally, the most important driver of alpha is our people. It is essential to have highly skilled teams that can astutely process information, generate unique insights and ideas, and ultimately translate these into alpha returns. Finding alpha requires a deep, fundamental understanding of the business and industry, a willingness to seek diverse skills and perspectives, the drive to learn as much as possible and the ability to remain adaptable. One way we do this is by tapping the diverse perspectives of our team members to assess the long-term viability of business models and products.

GIC has nearly 40 years of global investing experience and our colleagues around the world are united by a shared purpose and strong set of values. Our collective experience and vision guides everything we do, improving our resilience and response to challenges, thus sustaining our performance over time.

BEING PREPARED FOR AN UNPREDICTABLE FUTURE

Amidst profound uncertainty, high valuations and lower future beta returns, the global investment landscape has never been more challenging. Investors not only risk overpaying and suffering permanent impairment, but must also seize opportunities that can go above and beyond their benchmarks, and increase the resilience of their portfolios.

The COVID-19 crisis has highlighted GIC's role and mandate to protect and grow the reserves under our management. Despite recent market turmoil, GIC's performance[5] has been resilient, but the journey has not been easy. By leveraging our comparative advantages, and sticking to our investment principles of focusing on the long-term and being prepared for an unpredictable future, we have been able to generate alpha for our portfolio. While this will not be the last crisis that we will face, the lessons learnt will continue to shape our alpha playbook for the future.

[5] *Read more in the GIC Report FY2019/2020.*