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have you made your New Year's investment resolutions?

As you read this, New Year's Day 2010 has come and gone, and for many of us, our New Year's resolutions are all but forgotten. But for a long-term investor, it isn't too late to make some resolutions that can help generate excellent returns in the future.

It's a good time to think about the far horizon of your asset pool and perhaps resolve to recommit to underlying principles with respect to risk that we should all be following. For some, that may not be easy—a little like resolving to lose weight and then fighting the temptation to raid the refrigerator.

It's reasonable to be worried about risk today, after the drop in value suffered by most investment pools. By some estimates, as much as $75 trillion (peak to trough) was wiped out across all sectors of the global capital markets. But investors cannot shun risk forever and protect the purchasing power of their investment pool. So although investors may be hesitant to return to the markets, history has shown that it is extremely difficult to meet long-term investment objectives simply by "owning the market"—that is, by relying just on investment returns from market exposure, or *beta*. It is necessary to commit to investing in ways that can generate excess returns, or *alpha* (see the sidebar "Generating Alpha").

Recent events have validated one enduring investment principle: There is no return without risk.

But taking risk does not guarantee a return, and there also is a risk-return trade-off. For long-term investors, only real returns matter—preserving purchasing power and funding obligations in real terms is of primary importance. In this light, we would do well in this post-New Year's period to revisit principles of investment management that have endured year after year.

Own More than Loan

Fundamental economic growth is the source of real return on invested capital, and long-term investors therefore should have an equity bias. Equity assets derive their return from the productivity of the capital invested—e.g., growth in earnings, appreciation in the value of the asset owned due to economic activity, and growth in rents. In contrast, debt securities or loans are wasting assets, in that investors are paid a current return for the use of financial capital, and the principal, in nominal terms, may or may not be repaid, depending on an assessment of credit risk. Consequently, equity ownership should offer higher real returns than lending against those same assets. But it also will entail greater risk.

Investment Horizon Matters

One reality is inescapable: The future is uncertain, and the longer the time horizon, the greater the uncertainty. The longer an investor is willing to commit capital, the greater should be the expected return to compensate for the increased risk of the investment associated with the heightened uncertainty. It stands to reason that investors can be more confident about what will happen tomorrow or in the near future—say, one to five years from now—than about what will happen in 10 to 20 years or longer. So investment horizon—the time period over which capital is committed—is important. Simply put, investors should have the resolve to stay the course and not be driven by, or be forced to react to, relatively short-term market gyrations.

A corollary to the time value of invested capital that has emerged over the last several decades is the presence of *exploit inefficiencies*. There are

sectors of the capital markets that suffer from a scarcity of capital due to their illiquid nature and long-term uncertainty. Risk is often (but not always) mispriced in these sectors. Consequently, the risk premium to be earned from supplying capital to these less efficient sectors can be significant.

Diversification Matters

Some types of investment risk can be diversified away; other types are immune to diversification. Long-term investors seek to diversify away as much risk as possible to ensure the efficiency of their portfolios over their time horizon. In particular, they want to own asset classes that not only diversify market risk, but also mitigate, protect against, or hedge some fundamental risk, such as inflation or deflation.

It has long been known that in times of great stress or great euphoria in the capital markets, correlations go to one. Clearly, globalization of the capital markets, financial innovation, and abundant and nearly instantaneous market information have blurred the lines of what investors previously assumed to be distinct asset classes. In times of stress, risk aversion abounds and we see a flight to quality. Similarly, in times of great euphoria a rising tide lifts all boats, correlations increase, risk is ignored, and there is a tendency to chase returns.

But these periods do not invalidate the long-term value of diversification of risk. Instead, they affirm the importance of carefully thought-out, mission-specific investment policies and objectives.

The long-term investment pool of a healthcare organization is one of the most important assets on its balance sheet and a vital part of its capital structure that must be managed in a way that supports the organization's unique mission. When setting investment objectives, therefore, you should consider:

> Return targets
> Risk tolerances
> Time horizon (e.g., not sacrificing long-term objectives solely to meet near-term needs)
> Unique (institution-specific) circumstances

There's no better time that now, at the start of a new decade, to think about how you will manage your investment pools to meet the challenges ahead. In my view, two New Year's resolutions are well worth considering: Resolve to remember that there is no return without risk, and resolve to hold to underlying principles of sound investment portfolios. ●

Generating Alpha

A critical question facing not-for-profit institutional investors today is, Where can we deploy capital and earn returns commensurate with the active management risk we are taking? In the final analysis, there are only two enduring sources of excess return (alpha): timeframe arbitrage and skill.

Timeframe arbitrage. Timeframe arbitrage is the ability of an investor with a longer time horizon to exploit market opportunities by committing capital for long periods of time. Alpha may be earned by investing in, and thereby providing liquidity to, the less liquid, less efficient sectors of the capital markets, where there is the greatest opportunity for assets to be mispriced.

Skill. Investment managers with special skills or talents also can generate alpha. For example, they may be able to pick specific securities that consistently outperform a relevant market benchmark, or they may be able to execute strategies that consistently outperform market indexes and/or a peer group of managers executing the same strategies. In short, excess returns accrue to those with the skills necessary to exploit mispricings and market inefficiencies.

When capital is plentiful, as it was before this crisis, it is difficult for even the most skilled managers to earn excess returns from active management, because during periods of "irrational exuberance," risk becomes mispriced and there is little or no risk premium to be earned. Beta becomes the only source of return. Returns from leverage—leverage available as a result of excess liquidity—is often confused with alpha. During the boom, what investors thought was skill was, in reality, just leveraged beta exposure that exacerbated the fall in asset values. Now, with the "end of leverage" and the inability to leverage beta, earning real alpha is of vital importance.

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