

ALTERNATIVE INVESTMENTS — EMBRACED BY THE MAINSTREAM ?

by Jon May,
Business Solutions Manager,
Odyssey Asset Management
Systems

It is nigh impossible to scan a page in the financial press today without encountering an article or advertisement relating to alternative assets. The products in question might be referred to as ‘absolute return’ or ‘guaranteed equity’ but this is purely a matter of terminology – the interest lies in the underlying ‘alternative’ investments. It is not the objective of this paper to distil all of this commentary in to a couple of pages, instead it aims to focus on a specific definition of ‘alternatives’ and consider the market evolution that led to the present situation, all with a view to establishing some trends for the future. Investors’ needs and expectations are considered paramount throughout, but the likely impacts on financial service providers are perhaps more interesting. It is generally accepted that alternatives are now penetrating the ‘mainstream’ of investment management to some degree. This is a problematic concept as, technically, an investment should probably cease to be classified as alternative once it enters the mainstream. So, without getting wrapped up in semantics, it is firstly important to define which classifications are used as they can have a dramatic effect on any resultant conclusions.

As this article considers two axes – the mainstream market and alternative investments, it is firstly important to say that the two are intrinsically linked and that their definitions are largely driven by the part of the market studied. For example, a traditional European private banker and a North American pension fund manager will have quite different views on how to classify an agency mortgage backed security. For the sake of clarity then, it is important to firstly define our target as private client investment management.

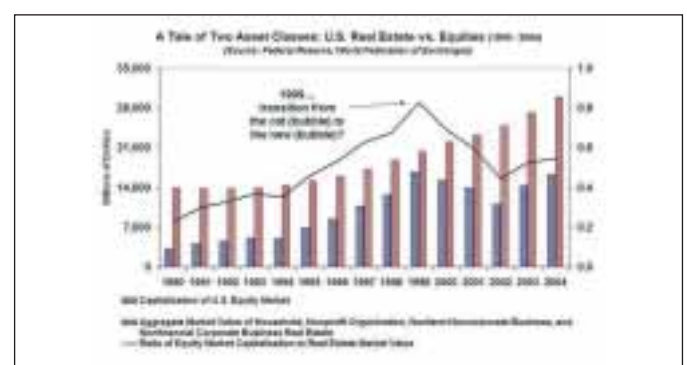
It is frequently stated that it is easier to define what an alternative investment is not, as opposed to what it is, with the simplistic conclusion that any instrument outside of the broad scope of ordinary shares, bonds, funds and cash is alternative by nature. However, there are challenges to this approach; when does a traditional fund become a hedge fund, does the answer lie in the constraints applied? Is an ordinary stock alternative if it is sold short? Is it reasonable to consider all derivatives as alternative – does a simple index future have any relevant characteristics?

One could simply describe alternative assets as those with risk-return characteristics that differ from traditional investments. This is a useful definition because it encourages focus on two subsets within this group: those assets that are well understood and those that are considered more innovative.

There are several types of alternative investments that are well understood by the market on the whole and have been available to the mainstream for some time. As the traditional precious metal of choice, gold is the first example to consider. Gold has long been considered an effective store of wealth as a result of its scarcity and durability. Unusual because it represents both a commodity and a monetary asset, gold is seen as an efficient diversifier as its performance tends to move independently of traditional investments and key economic indicators. Most importantly today perhaps, gold is viewed as a good hedge against geo-political stress and inflationary risk, and is also associated with relatively low price volatility.

“It is frequently stated that it is easier to define what an alternative investment is not, as opposed to what it is, with the simplistic conclusion that any instrument outside of the broad scope of ordinary shares, bonds, funds and cash is alternative by nature”

Within this ‘well understood’ category, managers frequently gain exposure to commodities, fine art, antiques and wine. Again, each of these benefits from low to negative correlation with stocks and bonds. With commodities, this exposure to the raw materials of economic growth frequently offers a haven against inflation as their own value tends to accelerate in step. With the ‘wasting assets’, it is true that tax advantages are often attached to such investments, but such incentives tend to be cyclical and country-specific. There are several ways for an investor to gain exposure to these asset classes. Investment in forestry, for example, can be used to provide UK investors with significant tax advantages (capital gains, income and inheritance.) However, a direct forestry holding is not practical for many investors so exposure can be gained through collective investment schemes or derivatives. Such instruments (including exchange traded funds) are used to enhance liquidity, reduce volatility and provide greater flexibility in terms of taking short positions.



In conclusion, these assets are certainly 'alternative' in as much as they exhibit diversifying risk-return characteristics. However, the real interest today is in some specific alternative assets: property, private equity, hedge funds and structure products.

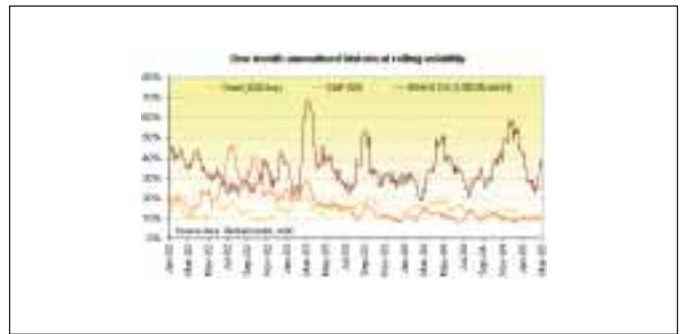
Property is associated with several key characteristics: low correlation with equity and bond markets, long term returns and volatility between these asset classes, relatively high gross yields and providing an effective hedge against inflation. These features are more visible across indirect vehicles such as Real Estate Investment Trusts, mutual funds, partnerships and property index derivatives. It is probably true to say that indirect property is on the verge of becoming 'well understood' or mainstream, largely as a result of impressive returns in recent years leading to increasing strategic allocations. Typically viewed as a substitute for bond allocations, many analysts are forecasting healthy returns for the next three to four years.

As with property, the private equity sector has experienced significant growth in recent years. Borrowing costs have been low, while corporate profits and market confidence have been buoyant. Frequently viewed as a substitute or complement for traditional equity allocations, private equity investments have attracted new funds at an increasing rate over recent years. Most large financial organisations now have private equity departments covering leverage buyouts, structured

“The traditional markets are more transparent today, data is priced more competitively and investors are generally more sophisticated in terms of knowledge and expectations.”

and mezzanine vehicles, venture capital and investments in other funding constructs. It is generally agreed that there is significant capacity for growth in private equity investments across Europe and Asia, and many managers today are comfortable with the different risk characteristics associated with such vehicles. With private clients, there is also the feeling of having more control of the risk and participating more visibly in economic growth.

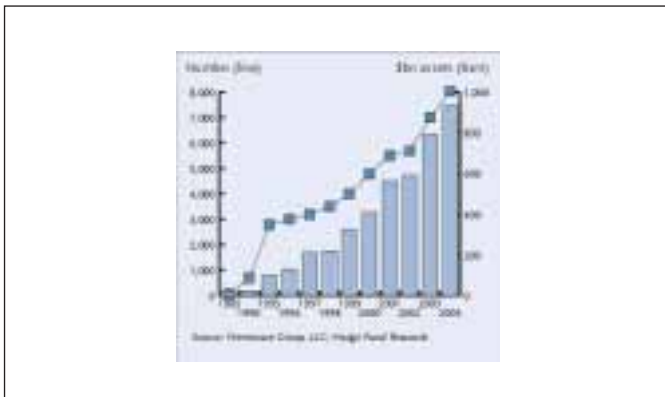
Hedge funds are widely perceived as the eponymous alternative investments, aiming to provide absolute returns with reduced volatility regardless of market conditions. Of



course, hedge funds do not represent an asset class in themselves as they cover such a diverse range of investment strategies. As an aggregate though, the growth of these vehicles has been exceptional in recent years but significant objections remain that hedge funds are cyclical by nature, they represent a bubble on the verge of bursting, that many of them are selling beta as real alpha, etc. There is no doubt that some of the core investment strategies used by hedge funds can bring real value to diversified portfolios. From a conceptual perspective, it is perhaps sufficient to view them as a 'testing ground' for the mainstream market. As with natural selection, the weaker hedge fund strategies fail whilst the more robust evolve and contribute to the conventional markets. A key challenge for investment managers remains in understanding when hedge funds are suitable for their clients and to what extent.

In some ways, structured products are the acceptable face of alternative investments. Representing more of an exposure enabler, structured products have been extremely successful in the past decade. To date, the growth has come primarily through retail channels but now private clients are flocking towards this blend of innovation and, increasingly, simplicity in presentation. One of the historic barriers to take-up has been the perceived complexity and opacity of these vehicles, with Warren Buffett's description of 'financial weapons of mass destruction' summarising the fear and mistrust in certain areas. Perhaps the most interesting aspect here is that, today, structured products are being manufactured for different objectives, providing exposure to other alternative investments and across more 'exotic' geographic regions. Cross-asset class structures offer the additional advantage that underlying diversification leads to cheaper derivatives in general, providing investors with higher participation rates per unit of capital security.

There are several factors behind the current interest in alternative investments. The advent of the 'information technology age' has influenced the capital markets and the investors themselves, which in turn has implied change within investment management organisations. The traditional markets are more transparent today, data is priced more competitively and investors are generally more sophisticated in terms of knowledge and expectations. Over time, this has led to increasingly widespread dissatisfaction with relative return strategies and this has been exacerbated by recent bear and stagnant markets. On the other side, a great deal of coverage has been given to the recent success stories with alternative investments. As a result, most managers today have some mechanism for providing their clients with



alternative exposure. The larger institutions have assembled significant departments dedicated to the research, selection and build of alternative investments. For the smaller and medium sized firms, exposure is most frequently achieved through platform links to specialist providers, investments in fund of funds and/or structured notes.

When considering the future of alternative investments, it is firstly important to recognise that current trends are part of the mainstream's evolution. Even if some of the reasons for interest can be traced to cyclical factors, this is not an investments fad. It is always dangerous to generalise about hedge funds but, as an example, the proliferation of successful funds has tended to improve the efficiency of their underlying markets. In turn, this has squeezed opportunities in the first market and forced the managers to innovate and locate the next openings. As a result, the mainstream is continually evolving to reflect these shifts and it is always useful to remind oneself of the wisdom of Markowitz and Sharpe, 'Investing in any asset class with positive returns and low correlation to other assets improves the risk/reward characteristic of the entire portfolio.'

In the past, real opportunities have been limited by regulatory structures, lack of knowledge on the part of financial intermediaries, fear of the unknown, high fees and lack of transparency. Most of these barriers are being broken down. Regulators have been busy in recent years analysing the behaviour of these vehicles and building legislation. In addition, the market is increasingly informed about them and

the financial press, as an example, presents a far more balanced view of alternative investment than was historically the case. There is mounting evidence to suggest that the two sides of the market are adjusting towards viable and sustainable fee structures, and the same can be said of transparency to a lesser extent.

Within alternative investments, the boundaries between the vehicles continue to blur. Private equity and hedge funds have clear synergic opportunities, in turn these vehicles have been increasingly attracted to property investment and structured products are now available with reference to all of these strategies. Innovation is the key to alternative investments and here, logically, there is a great deal of capacity for investors shifting their allocations from traditional asset classes. The investment management market is playing a zero-sum game of course and, as always, a balanced approach is recommended. Detecting that this balance was not being fully respected by some markets, the vice chairman of T Rowe Price recently stated, 'I would caution investors from becoming over reliant on strategies that are characterized by short-term focus, very high fees, limited liquidity and for many, lack of any meaningful performance track record.'

In summary, it is quite apparent that investors are increasingly embracing alternative investments as an effective way to improve the overall risk/return profile of their portfolios. Consequently, it is critical that advisors and managers have the capability to respond to their clients' interest in this area. This need will continue to drive change through the landscape of the market, and the operations of the financial institutions themselves. Technology has a large part to play in this process as there are many critical aspects of managing alternatives that benefit from computational potency and efficient communications. Relevant subject areas include but are not limited to; direct market access, security construction, algorithmic trading, complex valuation rules, proactive risk and performance management. One of the main challenges for managers looking to extend their reach in this area lies in understanding the extent to which their existing applications and technology partners can support them with their initiatives.

