Multi-Manager Mindset
Quarter 1, 2017
Additional Diversification with STANLIB Multi-Manager
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2016 was a year of big surprises; with obvious examples being Brexit and the Trump win, resulting in another year of low and below average returns for most traditional asset classes. The question from most investors is what will 2017 have in store for us and where will they find inflation beating returns? The question we ask in this edition of Mindset is whether alternative investments is the answer.

For clarity, an alternative investment is an asset that is not one of the conventional investment classes, such as equities, bonds or cash. Alternative investments instead include assets such as private equity, infrastructure, hedge funds, unlisted property and commodities. These investments can be intimidating for most investors as the asset class can be complex. Therefore before investing in this asset class, investors need to understand what alternative investments are.

In this edition of Mindset, our investment team will explore alternative investment strategies by sharing their insights and views about this asset class. Joao Frasco, our Chief Investment Officer, will set the scene for the trend towards alternatives and talk about the current landscape as well as alternative type investment strategies. Chris Roelofse, our Alternative Assets Portfolio Manager will focus on investors’ search for yield and discuss the adoption rate of alternative strategies in South Africa. He will explain the current regulations and how best to invest in alternatives by creating awareness and highlighting the key challenges with this asset class (which include liquidity, risk mitigation and minimum investment size).

Richo Venter, our Head of Research & Development, will explain the different types of alternatives, the risks associated with each of these and will elaborate on the characteristics of the asset class. Kamini Moodley, Head of Manager Research will focus on the work we do upfront to understand alternative asset managers, and their strategies, before investing in alternatives. While last but by no means least, Sanusha Gokaran, our Operational Due Diligence Manager, will highlight the importance of thorough operational due diligence as part of our risk mitigation process before investing in these unique assets.

Investors are increasingly looking for simple cost effective ways to invest in a well-diversified basket of quality non-traditional assets, without the complexity, large investment size restrictions and long lead times.

At STANLIB Multi-Manager, we will continue to provide you with useful research and information to assist you in making the most appropriate investment decision. In an inter-connected world, it is more imperative than ever that asset managers are able to see the bigger connected picture and help their investors navigate a world of investment complexity.

Thank you for your input and feedback. Please continue to send us your thoughts, suggestions or questions and we will address these in the future Mindset issues.

Regards,

De Wet van der Spuy
Managing Director, STANLIB Multi-Manager
Towards the latter part of 2016, STANLIB Multi-Manager launched a first of its kind Alternative Assets Fund-of-Funds. This portfolio offers a single point of access to a variety of attractive investments that have to date been reserved for only the largest and most sophisticated of investors.

This simple solution provides investors with the ability to participate meaningfully in ‘real economic’ growth by accessing, through one channel, a combination of quality non-traditional assets spread across various geographies and diversified by asset class and theme. The portfolio is designed to achieve between (CPI + 6%) and (CPI + 8%) over the long-term with limited short-term volatility and low correlation to traditional asset classes.

Chris Roelofse, who has been involved from the beginning, has led the initiative and now serves as the senior Alternative Assets Fund-of-Funds portfolio manager. His team has extensive expertise managing alternative assets and with a well defined strategy, STANLIB Multi-Manager’s strong market presence and impeccable governance frameworks will be able to provide investors with a cost effective solution with some investment flexibility, optional liquidity and stable pricing.
An Alternative Introduction

By Joao Frasco, Chief Investment Officer, STANLIB Multi-Manager

As far as years go, 2016 will not quickly be forgotten by the people of today and the history books of tomorrow.

The rise of populism on the back of the Global Financial Crisis (GFC) and the plight of the proletariat dealing with high unemployment and stagnant real wages (while the rich get richer), has led to some significant and surprising elections around the world. The two most significant were of course the British vote to exit the European Union, and the US presidential vote for Donald Trump.

Much of the blame for populism has been placed on globalisation and specifically the free movement of labour. Although many people will recognise that globalisation has lifted most of the global population significantly out of abject poverty, many do not care as they have not been the direct beneficiaries of this. They see the rich getting richer and being bailed out when they make catastrophic mistakes, while the poor or middle class are being left behind.

As far as “movements” go, this tide is unlikely to turn very quickly and we will probably continue to see the swell of populism rising for years and decades to come. We therefore need to think about what this means to all of us as citizens and managers of capital in this “new world order”.

Our theme for this quarter is therefore in many ways apropos. Given the changing landscape, we may need to rethink the investment opportunities of tomorrow. More specifically, alternative investments may actually help to address many of the issues that we are grappling with globally.

Let us not waste a great opportunity to create and shape our destiny!

An alternative definition

In investment terms, what are alternatives exactly? Like many other abstract concepts in investments, you will fail to find a single answer, or to get everyone to agree on a single definition. You can however ensure that everyone knows what you mean by a term you use, by clearly defining it upfront. People can then disagree with your definition, but still understand the discussion and arguments presented.

So let me define what I mean by alternative investments before discussing them in more detail. The most basic way of defining alternatives, is to include everything that is not considered “traditional”.

One of the first points of contention is usually whether it refers to asset classes only, or to investment strategies as well e.g. hedge funds (which are definitely not an asset class). I will define alternatives to include alternative investment strategies, which are substantially different from traditional investment strategies. As with any exercise attempting to label “things”, when the number of labels is limited you will always have difficulties. Let us not allow this to stall the discussion here.

Another point of contention is the label for real estate (property) as an alternative asset class, with many correctly arguing that real estate was in fact the first (and hence “most” traditional) asset class.

Most contemporary investors are typically more comfortable including it in their alternatives bucket, especially when it is in the form of direct ownership of land and buildings (instead of wrapped in a listed form).
If you therefore consider that anything other than listed company (including property companies) shares (equity), listed corporate, government bonds, and money market instruments, is defined as alternatives, you will see that the range of investment possibilities is indeed very broad. Alternatives is such a large category, it can itself be sub-classified into more traditional alternatives (like the unlisted equivalents of the traditional asset classes e.g. unlisted or private equity and bonds), and more alternative alternatives: art, wine, and other collectibles (perhaps record labels, stamp and coin collections or even first edition comic books). Other asset classes like land, direct property, and commodities (e.g. precious and industrial metals, energy, food etc.) probably lie somewhere in the middle of the spectrum.

An alternative context and history

Wealthy individual investors have invested in alternatives for a very long time, but institutional investors have been much slower to adopt them for some very important reasons. There is actually an interesting life cycle to markets and investments, whereby alternatives will dominate markets without deep and liquid listed markets (which define traditional investments). As markets become more developed (liquid and deep), more money chases these traditional investments because of the benefits they provide. As these markets become increasingly efficient, many investors look for alternatives to provide some diversification and potential for higher returns (and access to new market segments e.g. emerging technologies). Alternative strategies on the other hand, trade in traditional asset classes (in many instances), but in novel and complex ways, requiring even more mature and developed markets (the derivatives market being a great example of this).

The US alternatives market is amongst the most developed globally, and many prominent investors have had great success by investing in this part of the market (the very large pension funds and university endowments are an example of these). This has led to research investigating the case for alternatives, and the slow adoption by other market participants. The Myner’s Report (in the UK to HM Treasury in 2001 on institutional investors) was a great example of this, and found that advisers (e.g. pension fund trustees) may not have been acting in the beneficiaries’ best interest by not dedicating enough resources into evaluating the case for unlisted equity.

As markets become increasingly efficient, many investors want to look for higher returns in segments of the market with less competition and greater opportunities. The efficient allocation of capital is also an important consideration as listed companies, through their monopoly on raising capital in the listed market, may allocate their assets in less efficient ways (bad projects), and investors need alternatives to penalise these companies and reward those who are allocating capital efficiently.

As bond yields have turned negative, and the economic outlook globally looks muted, investors may feel that traditional assets are overvalued and will want to look elsewhere, for themselves or for those for whom they act as fiduciaries, for higher returns. Sometimes this is as simple as looking at what fewer people are doing (so the implication being that there is more opportunity for information asymmetry on which to act), or where others will not have the ability or appetite to invest. Chris Roelofse and Richo Venter will explore this in more detail in their articles in this publication.

The above, and many other factors, have led to an increase in the allocation to alternatives globally, and although there has been some bumps along the way (GFC was one), the trend of increasing allocation remains strongly in place.

But what about South Africa?

An alternative South Africa

Fortunately, South Africa has a long and very distinguished financial services market, including a stock exchange dating back to 1887 (130 years). It is however a fairly small market by some international
South Africa is a fairly small market by some international standards - although large by African continent standards where it is the largest - and has a well-developed derivatives market.

standards (it is the 19th largest stock market globally by market cap), although large by African continent standards (where it is the largest). It also has a well-developed derivatives market (ranked sixth and ninth for single stock futures and currency derivatives traded respectively in 2012).

This has meant that the need to develop an alternatives market has generally had less priority, although alternative markets have existed in South Africa for some time. The uptake from institutional investors has therefore been fairly slow. It has not helped that the regulatory environment for institutional investors (specifically retirement funds) has not been particularly conducive to investing in alternatives. The fact that boards of trustees in South Africa have predominantly been constituted by individuals without investment expertise has also not helped.

As in the rest of the world, the biggest opportunity from alternatives is for high returns, made possible because of the limited amount of investment capital available. This means that investors can generally be very selective in investing in only the opportunities that have a great chance of success for high returns. This is exactly the opposite of what we find in the listed space, where most professional money managers feel that the highest quality companies are significantly overpriced and therefore offer no margin of safety and hence high risk.

Fortunately, alternatives received a substantial boost a number of years ago with an update to Regulation 28 (of the Pensions Fund Act dealing with prudential limits relating to asset classes, issuers and instruments), where various alternative investments were specifically named and their limits increased above their previous classification in “other assets” which had a limit of 2.5%.

This was all placed at risk recently when national treasury in draft papers began pushing a “passives” agenda and “war on fees” with little recognition that fees on their own offer little in the way of protection of savers, and less in the way of value! From a return perspective, it is net returns that are important, not fees, contrary to the narrative being pushed by passive product providers. More importantly however, are the other benefits that are on offer from alternatives, including less risk (if listed equities have been pushed to valuations that are not sustainable), and the opportunity to re-allocate capital from existing companies in sunset industries to the companies and industries of tomorrow e.g. technology (bio, nano, hardware, software, internet, artificial intelligence, machine learning, predictive analytics etc.). Fortunately, this seems to have been put back on track with the latest draft papers following an outcry from the industry.
The massive opportunity that exists by moving the flow of capital from traditional to alternative investments, lies in the opportunity to develop these markets and create employment and other social benefits, in addition to higher returns which is non-negotiable for most investors. With official unemployment figures for South Africa as high as 27% (the unofficial numbers being well above 50%), this provides a spotlight on the old (and seriously flawed adage) that markets are a “zero sum game”.

By allocating resources and exerting effort on this important segment of the economy, we can truly transform a country for generations to come. Although investors are right to be fearful of government intervention in driving this agenda (because of their lack of credibility across many initiatives), this doesn’t make the case for alternatives any less exciting. We would be serving our investors and the general public and country well by taking these matters into our own hands.

A couple of themes that will resonate with most South Africans today, include investing in energy (rolling blackouts), specifically clean energy (wind farms and solar, on the back of global warming), water/dams (droughts and floods, again on the back of global warming), other infrastructure (roads, bridges, airports, trains/rail, ports), and agriculture (again on the back of global warming).

**An alternative challenge**

Unfortunately, the best things in life are not free, and this is where the balance between costs, fees, and value is important. In this case, the adage that “price is what you pay and value is what you get” is apropos. Alternatives are generally expensive and there are often very good reasons for this. It is very insightful to understand this in detail because it often forms the basis of decision making. I sometimes find that people make bad decisions because they are acting on bad information.

Consider two managers each charging 50 basis points (0.5% per annum) for managing a listed equity mandate. Assume now that one manager has R200 billion in assets under management, while the other manager has R2 billion. The annual fee for the larger manager is R1 billion, while for the smaller manager it is only R10 million. Both managers could be analysing the same shares, and have similar teams of portfolio managers and analysts, yet they make a very different amount of money. Why is this? Surely the fee would be similar in rand amount if it was based on the cost of the underlying function (i.e. managing the money). It is however rather based on the value provided i.e. the opportunity to make returns is shared between the investor and the manager. It is important to note that this is not entirely accurate, as we haven’t addressed why the fee was set at 50 basis points. Clearly this is a function of the potential assets that could be managed, as well as the competition in the market. Great managers can charge more, and managers operating in smaller markets can charge more, than their counterparts in both cases.

This is the same in alternatives, to the extent that the market is much smaller, the fees need to be higher to attract market participants (the money managers), or to make the same rand amount. To the extent that the value provided is much higher, the fees can also be much higher. This is simply the result of demand and supply in free markets. A great example can be found in Renaissance Technologies (manager of the Medallion Fund) which charges a fixed fee of 5% and a performance fee of 44% (numbers that are literally off the charts). Most investors would think that these numbers are ridiculous, and would not invest with this manager if they had the opportunity. Unfortunately, most investors will not have the opportunity as the manager is only open to employees.

Now consider an investor considering the above and the allocation of an additional R1 million. If they gave this money to the large or the small equity manager, do they think that the manager would undertake any additional work to invest the R1 million? Surely no additional research is required as the managers
have already researched all the shares of interest to them. The money is invested without much further consideration into the existing shares held by the manager.

What would this look like for an additional R1 million invested in alternatives? Although it may vary significantly from one alternative proposition to the next, the reality is that the marginal investment in alternatives will need to find new opportunities, along with all the other new flows to alternatives. This could be deployed into new infrastructure or new employment - or both. What value is therefore created with this transaction, even before any return is realised?

The rest of the articles in this publication will explore the challenges in a lot more detail.

**And finally... an alternative conclusion**

It is important for investors and their advisers to realise that the world is changing, and the pace of change is accelerating. Business as usual, and investing as usual, will not be appropriate and you could correctly argue that it has never been appropriate which is why the world has continued to change to reflect these imperatives. We are however seeing some significant moves that will present new challenges and opportunities, and alternatives may be poised to benefit from many of these.

Investors should therefore resist the urge keep things the same, and begin questioning their service providers around solutions for tomorrow. In turn, service providers as experts with the combination of skills and information, should be proactive in finding solutions of tomorrow for their clients. To the extent that these service providers can stand back and appreciate the bigger opportunities, they will realise that the opportunities go way beyond just great returns for their clients, but a better future for everyone.
Alternatives Without Barriers

By Chris Roelofse, Alternative Assets Portfolio Manager, STANLIB Multi-Manager

The “search for yield” has brought various alternative assets to the forefront of many investors’ set of investment choices.

There is a large body of research making the case for investing into a range of alternative assets (see accompanying article by Joao Frasco on page four). This view is emphasized in the current economic environment where investors worldwide hold muted return expectations from traditional assets. The resulting “search for yield” has brought various alternative assets to the forefront of many investors’ set of investment choices.

In line with these sentiments, offshore investors have been increasing their allocation to alternative assets, particularly over the last three to five years. In most cases the allocation has delivered a good result.

Yet, for most retail investors and many South African institutions, while the case for investing may be clear, allocating their investable assets to the alternative asset classes remains off-limits.

So why is that? Many factors are contributing to an environment where access to what should be a sought-after asset class is hindered. Let’s take a closer look.

Minimum investment size

Private equity funds typically have minimum investment sizes of R50 million or more. This is a clear disqualifier for many investors.

Illiquidity

Many alternative assets have lock-up periods of ten or more years. Even though most long-term investors should be able to wait this out, much can change in ten years resulting in the potential need to withdraw from the investment. The lack of a deep secondary market means that investors often have to sell out at a discounted price.

Furthermore, funding the investment is not discrete. Private equity and other funds often require a commitment of capital from the investor, which is called on and invested as and when the fund manager makes an investment for the fund. When the underlying investments are disposed of, cash is gradually returned to the investor (see graph below). This places a liquidity management burden on the investor – something most investors are ill-equipped to manage.

Investment liquidity

![Investment Liquidity Graph](image)

Source: European Private Equity and Venture Capital Association

Simply sitting on enough cash to ensure that capital calls can be met is a rather blunt tool and can result in a significant performance drag. An ideal situation would be to have ten different private equity funds, each at a different stage of their life – this is referred to as ‘vintage diversification’. That way the cash distributions...
coming from the older funds can be used to fund the cash drawdowns from the newer funds. The result is that the portfolio remains more ‘invested’.

**Complexity**

Some alternative assets are complex in nature. Many investors will not have the required expertise to feel comfortable selecting different kinds of alternative assets. Even once the asset category has been selected (e.g. private equity versus hedge funds), selecting the manager is not only difficult but also extremely important due to the increased dispersion of returns between different managers. This dispersion is illustrated in the chart below, showing that the difference between the top quartile and bottom quartile private equity funds have historically been twice as large as the difference between the top and bottom quartile listed equity funds. The same applies to most alternative assets.

It is important to not only consider the explicit fees, but also the implicit fees as there are various frictional costs involved. These include legal fees for the contracting process, specialised advice fees and the ongoing governance costs.

Fee structures also tend to create a conflict of interest whereby the fund manager participates in the upside via a form of performance fees (referred to as ‘carried interest’ in the case of private equity funds), but not the downside. Not only does this incentivise excessive risk taking, but it can also result in orphan or ‘zombie’ funds where the fund manager disregards the fund when it becomes clear that the fund performance is so weak that there is no hope of receiving any performance fees.

**Governance burden**

Monitoring and evaluating alternative asset performance, especially in contrast to traditional assets and within the context of a portfolio, is onerous. Typical examples of challenges that investors are presented will include:

- Infrequent valuations that are based on subjective models rather than prices observed from market transactions.
- Delayed redemptions requiring the investor to wait longer than anticipated to get his money out.
- Portfolio companies experiencing headwinds to the point where they are either written off or require additional capital injections.
- Fund manager failures that may require investors to jointly appoint a new fund manager to take over management (or at least phased liquidation) of the fund’s assets. Examples could be as innocent as the loss of key persons through to fraudulent activity which is hard to uncover.

This results in the investments taking up a disproportionate amount of airtime in the boardroom. It also tends to require that investors participate in oversight of fund activities via a seat on an advisory board.

**Private equity returns dispersion**

Alternative assets are perceived and often criticized for being expensive. Many good arguments are made in defence of the fee structures, yet this remains a deterrent for many investors, particularly those who do not appreciate the complexity and the return profile expectation.

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<th>Returns (%)</th>
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<td>U.S. Fixed</td>
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<td>30%</td>
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Source: Thomson Reuters and Morningstar
Lack of transparency

The perception of opaque and complex structures sits in the minds of many investors and is an immediate deterrent. However, disclosure and transparency in the industry has improved markedly over time. In the early days of alternative asset funds (particularly hedge funds) investors had very little insight into the underlying holdings and risk exposure. The resulting risk (market, fraud, etc.) materialised in well publicised cases. Thanks to customer demand and regulatory development, this has greatly improved and fund managers are providing clear and concise information to investors.

Maturity of our market

Whilst South Africa has an excellent financial market system, our private capital market is well behind that of developed markets. This limits the number of private transactions and credible fund managers.

Ironically the inverse holds for the rest of the continent – their capital markets tend to be less developed which places more reliance on private markets to gain access to many of the attractive investment opportunities.

Regulatory environment

Policymakers recognised the inherent value presented by alternative assets which resulted in Regulation 28 (governing pension fund investments) making allowance for meaningful allocations to alternative assets.

Implementation has however proven problematic. Despite breakthrough hedge fund regulations being released recently, collective investment schemes are still not allowed to invest in these new fund structures. Private investments tend to make use of partnership structures which are onerous to administer, largely unregulated and not suitable for inclusion into collective investment schemes. The implication is that the bulk of the savings industry can simply not participate in the alternative asset market.

So unless you have a large enough chequebook to make segregated investments, the only choice is to invest via a policy of insurance with one of the life companies.

Overcoming the barriers

Listing a fund of private assets is a popular route to overcoming the barriers of liquidity and transparency highlighted above. The best example of this in the South African market is commercial real estate which was popularised through the growth in the listed property market. Infrastructure intuitively lends itself to this model but efficient tax legislation does not yet exist to enable the growth of such a sector on the JSE. There is also a growth in listed Special Purpose Acquisition Companies (SPAC’s) which presents an alternative to private equity funds. Listing does however introduce unwanted volatility and “short-termism”.

Pooling is another effective solution to overcoming the minimum investment size barrier as it involves multiple investors combining their funds to invest in a homogenous collection of investments. Appointing a professional to manage the pool of investments further helps to overcome the complexity and governance barriers. The additional layer of fees introduced is the most common objection to this model, but the economies of scale achieved could more than offset the additional costs. Pooled vehicles are however yet to find innovative ways of providing liquidity to customers.

What the market needs is an investment vehicle that overcomes all the barriers highlighted above without sacrificing the unique benefits that alternative assets are known for. This is not only essential to allow the broader savings community to participate in this category of investments, but it is also critical for the development and prosperity of our country. Most of the capital funding the growth of small-to-medium enterprises and the capital supplementing our country’s infrastructure needs, like roads and energy supply, is coming from alternative asset funds.
Conclusion

Alternative assets present many benefits for longer term investors, yet they are notoriously difficult for many of these investors to access. Barriers to investing include large minimum investment sizes, liquidity constraints and high fees. These investments also tend to lack sufficient transparency and are very complex which increases the governance burden for investors.

Our market is maturing and the regulatory environment is evolving to support the growth of the alternatives market. The onus rests on the financial services providers to make these attractive investments more accessible to the investor community at large.

This can be achieved through pooling vehicles which create the necessary scale and professionalism whilst retaining the unique attributes of private investments. Another solution is listing alternative investments that were previously not available on exchanges. Both avenues help to channel capital to the enterprises that form the bedrock of our economy whilst offering attractive reward to investors.

Our market is maturing and the regulatory environment is evolving to support the growth of the alternatives market. The onus rests on the financial services providers to make these attractive investments more accessible to the investor community at large.
STANLIB Multi-Manager is Largest Collective Investment Scheme in South Africa
Although the label “alternative assets” is broad in scope and nature, there are certain common characteristics that distinguish them from traditional listed assets like equities and bonds. These include diversity of the assets, difficulties in pricing, high due diligence and oversight costs, illiquidity, as well as risk and return attributes. There are three unique considerations when investing in alternative assets, namely the weakness of alternative asset benchmarks, modelling of an alternative assets portfolio and the challenges in accessing these assets.

Diversity of alternative investments

Direct property, hedge funds, commodities, private equity, infrastructure developments and various other assets are defined as alternative assets. Even investment items like rare coins and art are considered alternative assets. There are vast differences between some of these alternative assets and their return profiles can be different to each other and to traditional assets. Some alternatives are unique asset classes (i.e. gold), while others are built using traditional asset classes that are packaged or structured to provide a certain risk and return profile - certain hedge fund strategies are a great example of these.

Within private equity, there are multiple types of private equity funds. Some private equity funds invest in start-ups like venture capital funds that typically invest as a minority stakeholder and these come at a high risk. The rewards can be significant though. Early investors into Google, Facebook or Twitter are great examples of the potential upside. Further examples include leveraged buyout funds that take on a lot of debt to buy a company. Growth equity funds typically invest in more mature businesses that are looking to scale operations and enter new markets.

Infrastructure funds invest in projects that focus on developing infrastructure. These could include roads, solar farms, bridges, water systems or any other developments involved in developing a country’s infrastructure. Projects are often done in close working relationship with governments or local authorities and the investor typically becomes a bond holder, rather than an equity holder.

Hedge funds are pooled investment funds that could invest in a variety of strategies and asset types. They invest using a variety of “styles” and are often very innovative in the financial instruments they invest in, often making use of derivatives. Some of the more common strategies include equity long-short, arbitrage, distressed assets, macro-trends or multi-strategy. Compared to private equity, hedge funds generally have greater redemption frequencies and liquidity, meaning investors can get their money out more often.

Direct property investment (or real estate) is defined as alternative assets, although ironically, it is the original traditional asset type. Property is also a broad investment type and investment opportunities include assets like offices, residential property, shopping centres and even vacant land.

Although we only touched on some of the main alternative assets, there is a broad array of options available and every investment or fund has unique...
attributes. It is this diversity and these unique attributes that provide great opportunities for investors.

**Alternative assets are difficult to price**

In the listed equity space, the prices of shares are determined by the forces of demand and supply on public exchanges. The demand and supply by investors are determined by various factors including expected financial performance of firms, the liquidity of the shares, regulatory constraints or limits on holdings, and many other firm-specific and macro-economic factors.

In contrast, most alternative asset transactions are not public, making it difficult to determine what the last sale price was. Even when these may be available, many alternative assets are actually unique, making other prices of very limited use as comparatives. To use an extreme example, think of a rare Van Gogh painting up for sale. Rare paintings are not sold regularly and determining a price is not an easy task. A physical property is usually unique and determining its value is complicated. Private equity with its limited transparency and multiple assumptions in income and expenses, coupled with limited or no previous price discovery through buying and selling by other investors, makes pricing difficult.

**Higher expected returns**

One of the big attractions to alternative assets is the potential of higher returns. Although certain alternative assets are expected to provide higher returns than traditional asset classes over time, this is not always true - it depends on the specific assets.

As an example, gold has limited economic value. One gram of gold is not going to turn into two grams of gold and there is no income earned on gold. However, gold generally outperforms other assets when markets are nervous. Over the long-term, returns are not great and various expenses are associated with storing and insuring gold.

Some hedge fund strategies are very low risk and expected returns are low, while others are quite aggressive and highly leveraged. Investors in aggressive, highly leveraged hedge funds will naturally require a higher return. As for private equity, one would typically expect higher returns in the long-term to compensate for illiquidity, limited information and other risk factors.

**More risky**

Risk is generally linked to return. The more risk you take, the higher the expected return. Typical risk measures like volatility using monthly returns are not appropriate for all alternative assets and could underestimate the true risk of the investment. The reason for this is because stale pricing and less frequent valuations are often applicable.

As an example, office buildings or private equity investments are often only valued once a year and the investor therefore does not see regular fluctuation in valuations, making pricing difficult. This does not imply that the investment has less risk than a listed property or listed equity investment that is priced on a daily basis.

Some of the main risks applicable to alternatives include:

- Liquidity risk – the inability to convert a security or hard asset to cash without a loss of capital.
- Risk of the actual underlying holdings – some private equity funds like venture capital funds and leveraged buyout funds take on high amounts of risk. Early investors in Google took on lots of risk and there was no certainty at that stage that Google was going to be as successful. Using another example, a hedge fund might employ a long-short strategy or leverage that amplifies the returns, increasing the risk related to the investment. As with expected return, risk will be unique to the type of alternative asset.
- Lack of information and/or corporate governance
However, when managed, monitored and diversified appropriately, alternative assets can be an excellent value adding asset class in an investor’s portfolio. Alternative assets are typically not highly correlated with other traditional asset classes, resulting in improved diversification and lower total portfolio risk. This enhanced diversification should result in better risk-adjusted returns over the long-term.

Modelling of alternative assets

When constructing a portfolio’s “optimal” allocation to asset classes, asset managers often use portfolio construction techniques like a mean variance optimisation or the Black-Litterman model. Key inputs for most of these models are usually historical returns for covariance calculations and expected returns of the asset classes. Whereas historical returns are easy to find for traditional asset classes, it is more difficult for alternative assets as various factors complicate accurate and frequent pricing. Given this, it is important to consider various options when constructing an alternative assets portfolio or when blending a traditional portfolio with alternative assets.

Some of the considerations in the portfolio construction process include:

- Gathering appropriate return data on the alternative assets used in the portfolio modelling process. This information might not be regularly available and interpolation techniques could be considered.
- Potentially using relevant proxies for alternative assets in the portfolio construction process, where data availability is limited. As an example, a specific private equity portfolio could be replaced by similar listed equities to give you a sense of risk in the portfolio.
- Return expectations – estimating the future returns of the various alternative assets is a difficult task and requires expert skills.

- Understanding the fundamental drivers of the alternative assets in order to diversify across these drivers. As limited reliance can often be placed on historical data gathered on alternative assets, qualitative considerations become extremely important when constructing an alternative assets portfolio.

Alternative assets are typically not highly correlated with other traditional asset classes, resulting in improved diversification and lower total portfolio risk. This enhanced diversification should result in better risk-adjusted returns over the long-term.
Weaknesses of alternative investment benchmarks

Performance measurement of alternative assets is critical, especially when performance fees are applicable. Some common industry measures are to compare returns to cash or inflation-plus a specific target percentage, which is not necessarily appropriate for all alternative assets, given the risky nature of some investments.

Asset class specific measures might also be relevant. As an example, for private equity, listed equity could be a fair comparison. Given that private equity typically has more risk facing the investor compared to listed equity, an investor should require a premium above the expected return of listed equity. Some additional factors might also need to be considered for a private equity benchmark comparison, like the fact that a private equity fund typically takes a while to put capital to work. A private equity fund also distributes capital over a long period of time and it might have lumpy payments as the fund matures. Long-term comparisons are therefore essential.

Continuing with the private equity example, a peer comparison of other private equity funds might also be an important measure. For such a comparison, maturity of the investment life cycle and area of specialisation of the private equity investment becomes important. Some well-known international private equity indices that could be considered for benchmarking include the Cambridge Index, Preqin Index, State Street Index and the Global LPE Index. These benchmarks all have pros and cons and should be well understood before being utilised.

Different asset classes exhibit different characteristics and good benchmarks are essential. Some of the characteristics of a good benchmark include that it must be measurable, investable and appropriate. One benchmark will therefore not necessarily be appropriate for all alternative asset classes.

Alternative assets are not available to everybody and the person most recognised with employing alternative assets extensively, essentially said in the introduction to his book Pioneering Portfolio Management, that only premium alternative assets should be invested in, but that such investment opportunities are quite difficult to find. Although 16 years have passed since the publication of his book, accessing high quality alternative assets remains difficult for institutional clients and extremely difficult for retail investors.

Good private equity firms are often very selective of their clients. They require sophisticated clients that understand the long-term nature and potentially higher risks related to alternative assets. Investors are often seen more as partners.

The “ticket size” is big for many alternative assets. In some countries like the United States the historical criteria to invest in private equity was that investors needed to have a minimum (and fairly high) investable net wealth. Another reason for this is that there are many legal and administrative costs for various alternative investment types. It could become expensive and administratively intensive for a hedge fund or private equity firm to build the retail accounting and reporting systems to manage the process.
Conclusion

Alternative assets are a broad category of investments with very specific characteristics and many factors an investor should consider when investing. Although it can often be difficult to access high quality alternative assets, good investment managers are increasingly structuring products to allow retail investors to get a piece of the pie – a trend that is likely to continue in a world where decent real returns are getting more difficult to come by.

Technological advances are increasingly lowering the entry barriers to investing in alternative assets. Investment platforms are making alternative assets more accessible.

When selected and managed appropriately, alternative assets can provide a significant improvement in risk-adjusted returns compared to traditional investment portfolios. Higher expected returns than traditional assets are available from certain types of alternative assets like private equity and certain infrastructure funds, but these investments do come with additional risks and uncertainty. Other alternative assets might not necessarily have higher expected returns, but could still provide good diversification to a traditional portfolio.

When selected and managed appropriately, alternative assets can provide a significant improvement in risk-adjusted returns compared to traditional investment portfolios.
In the traditional space, poking holes in these stories becomes somewhat easier given the vast availability of public information. In the alternative space however our approach is a lot more cautious - with an appreciation for the fact that “the devil is in the detail”. The alternatives space therefore demands a greater level of scrutiny from all perspectives, just as a consequence of its nature.

When one thinks of alternative investments, stale pricing, lower volatility and uncorrelated asset classes comes to mind. However, is there any such distinction from a manager research perspective? The distinction between traditional and alternative asset classes from a risk/return point of view has become more obvious and widely understood. The further distinction of the asset classes within the alternatives umbrella is in itself an illustration of the disparateness within the asset classes, let alone compared to traditional investments. My colleagues would have alluded to a lot of these differences in the other articles in this publication. The question is whether there are any evident or obvious distinctions within the manager research space as a result of the unique features of alternative investments.

The answer to this is both yes and no. While the qualitative aspects of the manager research process remain unchanged; philosophy, process, people and the like; there are aspects within these categories that are of greater importance within the alternatives space than for more traditional asset classes (although these factors still remain important within the traditional space). We will use private equity under the alternatives umbrella as a proxy for alternatives to illustrate some of the differences within the process for ease of demonstration of these points.

Firstly, the people aspect becomes an increasingly important component to understand within alternative assets, even more so than under the traditional space. The traditional space has the benefit of repeatable structured processes that can survive the departure of key individuals. In the private equity space the process is very dependent on the individuals involved at the start of the investment, and whether they remain through exit as these investments are entered into based on the skills of these individuals and their ability to unlock value.

Secondly, managing conflicts of interest and understanding key-man clauses are other aspects that need to be considered more carefully given the compensation structures of these funds and the importance of the individuals within the team as highlighted above. Incentivisation becomes another focal point within the alternatives space in ensuring adequate alignment of interests of the team.

Lastly, in the traditional space a manager’s performance profile provides clarity around the manager’s ability to adequately translate the philosophy and process into an alpha profile with a reasonable degree of consistency. Yet within the alternatives space, this becomes less frequently available and reliance needs to be placed on independent valuation experts to assess the return generated. This occurs less frequently and is also subject to a range of assumptions which makes the assessment more difficult. I will elaborate on all of the above throughout the article.
Understanding the people behind the deal pipeline

Although it is equally important to understand the portfolio managers and investment analysts within traditional asset classes, a lot of these managers have well defined processes. These processes can be translated by another portfolio manager and still achieve the same desired outcome as a result of the entrenchment of the philosophy and process within the asset manager, hence survive the departure of any key individual.

This however is less relevant within the alternatives space and a lot more reliance is placed on the individual members involved. Specific deals are entered into given the skillset of the members involved and their ability to unlock value within these businesses. In the alternatives space this is more dependent on the individual involved than the process behind the selection of the investment. Within the private equity space for example, these individuals would need to have a history of successful deal origination and closing. Equally important is the ability to leverage strong networks within the industry to be at the forefront of these deals.

In addition to the manager’s experience and skills within industries, is their ability to identify businesses that are in the right industry from a thematic positioning standpoint (important given the long term investment horizon of these investments). The manager’s ability to ensure adequate representation on the board, governance committees and remuneration committees (so key individuals within the business are aligned to the same outcomes) is important. Reputation of the manager within the industry and with the investments made is also a crucial component for our team in assessing the manager’s ability to add value to an investment. Understanding how these businesses are turned around and exited attractively by these individuals is also crucial. These “generalist” skills within the manager are key components in the assessment of the manager’s skill.

Within the alternatives space, reliance is placed on the individual members involved. Specific deals are entered into given the skillset of the members involved and their ability to unlock value within these businesses...
Additionally understanding how the individuals determine an adequate fund size is important to distinguish between the overall incentives that drive behaviour. Large funds attract more fees and may not necessarily imply that there is an adequate supply of high quality investments to deploy this capital. Given the limited opportunity set of high quality investments within the private equity space, the manager may then add lower quality investments into the fund to allocate this capital.

Lastly ensuring that these key individuals are adequately locked into the business is very important. As a consequence of the importance of individuals within the team, upon investing into a fund, limited partners will list individuals they deem as key to the fund and explicitly state that should these individuals leave, this would become grounds to exit an investment. As we have emphasised throughout the article, investments in this space are largely reliant on these key individuals initiating the deals and deploying this capital given their level of expertise. It is therefore important to assess the adequacy of this tie-in measure to ensure that these key individuals are tied in for the duration of the investment through to exit.

Managing conflicts of interest

Conflicts of interest exist in the traditional space, but are amplified in the alternatives space and require additional layers of oversight and governance. Some examples are given below of aspects we would need to consider from a manager research perspective.

The Agency dilemma

The principle – agent problem arises when one party (the agent) makes decisions for another (the principal), but is conflicted to act in their own self-interest instead of in the interest of the principle. In private equity, the manager known as the general partner or GP, is able to make decisions on behalf of investors known as the limited partners or LPs. The conflict arises because the general partner is very well incentivised to make investment decisions that could result in excessive risk (because of the leverage created by performance fees). Although this conflict exists in all aspects of investing it becomes increasingly important to understand in the alternatives space given specific features of the asset classes.

For example, it is important to understand the number of funds that are managed by the same teams, as one underperforming fund may create an incentive to act in the best interests of another outperforming fund to the detriment of the underperforming fund, or simply to ignore underperforming funds and focus all resources on the outperforming funds. It therefore becomes very important to ensure that there are legal and other mechanisms that counter this conflict.

Skin in the game for the long term

Understanding the incentivisation structure of managers within the alternatives space is somewhat more important than in the traditional space given that a large part of the decision to invest is taken as a result of the key individuals within the manager. As a direct consequence of this, it becomes increasingly important to ensure that the members of the teams are adequately co-invested and aligned with the performance of the fund. It is however important to understand that co-investment may only have a very limited impact on the conflicts and behaviour. This would be due to two primary reasons. The first would be if the amount invested is small compared to the size of the fund, and the second would be if the amount invested was small in relation to the individuals overall wealth.

Performance fees as call options

Carried interest (performance fees) has the characteristics of a call option. While a deep in the money call option (which would result if the fund’s performance was well above any hurdle above which performance fees will be paid) would provide an alignment of interests between GP’s and LP’s (as these options will have deltas – or sensitivities – close to one). Out of the money call options however,
The underlying premise of manager research is to ensure that we understand managers and what they are attempting to deliver within their unique space.

provide no alignment of interest, and may in fact provide an incentive for excessive risk taking (as option values increase with an increase in volatility of the underlying). Appreciating these conflicts and nuances is therefore important.

Return outcomes are somewhat opaque

While an alpha profile for the underlying manager within the traditional listed space is readily available, the assessment of a track record within the alternatives space is a bit opaque given the long-term investment horizon of these investments and some of the other characteristics of the asset classes. Additionally the Internal Rate of Return (IRR) of the fund and individual investments, supplied by the manager may not be entirely objective and independent. Although valuations are provided on a monthly or quarterly basis, they are typically calculated by the managers and would come with a plethora of assumptions that would need to be understood. Heavy reliance must therefore be put on independent valuations which are typically required at least annually.

Conclusion

Superficially, it may seem like the aspects that are important from a manager research perspective in the traditional asset class remain the same in the alternatives space. I’ve attempted to highlight some of the differences that exist and that warrant a deeper review given the uniqueness of the asset class. The level of depth of review of managers that invest in either the traditional and alternatives space remains the same.

Alternatives as a group of asset classes are very heterogeneous, but so too are many of the individual assets within each sub-asset class. Each of these heterogeneous asset classes would have distinct nuances that require slightly different focus from a manager research perspective. The underlying premise of manager research is to ensure that we understand these managers and what they are attempting to deliver within their unique space, so from this perspective at least something has remained traditional.
Preparing for Operational and Regulatory Change

By Sanusha Gokaran, Operational Due Diligence Manager, STANLIB Multi-Manager

“The most important driver of change in the investment industry is the increased demand for transparency by regulators and investors” (The Future of Alternate Investments, World Economic Forum 2015).

This is a period of change, as managers aim to standardise their business operations. Alternative asset managers are striving to become more institutionalised by building operational platforms and revamping business and infrastructure in order to be more agile and scalable, and to achieve efficiency and operating leverage. Sophisticated investors now expect alternative asset managers to operate beyond required quality standards, more effectively, and also expect them to offer broader capabilities. To meet these demands, alternative asset managers need to revamp their operations in a cost-effective, non-disruptive way in order to attract asset flows. Increasing assets are commensurate with pressures on the asset management industry. These include increased regulatory requirements, rising costs and fee pressures. Alternative asset managers cannot escape these pressures and should instead seek to respond proactively to each of the key areas:

**Regulation**

A big break for alternative assets in South Africa came in July 2011, with the implementation of Regulation 28 of the Pension Funds Act, governing pension fund asset allocation. Within specific limits, a retirement fund can now invest more of its total assets in alternative assets (limits include private equity, unlisted real estate and hedge funds).

The depth and breadth of regulation is expanding, with new requirements on alternative asset managers and more involvement by the regulator. Why is this? Simply put, it is to protect investors.

Positively, this greater transparency brought about by the new reporting requirements aims to drive the industry towards greater openness and building trust between investors and managers. Investors are no longer happy to sit back and let managers “get on with it” as long as returns are good. They now need to understand why returns are good, what did they get right and what did they get wrong.

Over the coming years, asset managers can expect more regulations. These regulations cost asset managers money and if they do not budget for them correctly then asset managers may ultimately pass these costs onto investors.
Compliance

Few managers view regulation as a competitive advantage enhancer. However, if managers want to see change and effective procedures, compliance must evolve from being considered a support service to a value-add. Managers have to buy into a positive case for compliance. The effect of regulation leads to an increase in the cost of compliance. The overall cost of compliance is already substantial, and likely to increase due to necessary investments in compliance related technology and people. Spending on compliance can be justified by the potential consequences of failing to comply. New regulations aimed directly at the alternatives industry require managers to improve infrastructure, transparency and reporting, however, the cost and complexity of new legislation creates barriers to entry for the industry, which may reduce innovation in ways that decrease long-term returns.

The investment industry is experiencing vast change as a result of regulatory reforms (including the Foreign Account Tax Compliance Act (FATCA), Common Reporting Standard (CRS) and the Retail Distribution Review (RDR)), that require asset managers to provide greater transparency into operations, upgrade their risk and governance structures, and utilise third-parties to maintain client funds. The transformation from a lightly regulated niche to a well-regulated entity, will change the industry. These new requirements force managers to upgrade their institutional infrastructure and processes, in order to comply with new reporting requirements. Although many alternative asset managers recognise that reporting requirements are increasing exponentially, for many, regulatory reporting is not yet at the required level.

Managers can build more dynamic compliance functions by:

- Building controls and processes around regulatory reporting, as for all other critical business activities.
- Investing in compliance resources with multiple skills extending beyond compliance, into analytics, reporting and technology. Technology can support

The cost of establishing and maintaining such a system could affect the industry in four critical ways:

1) Increased costs may reduce returns
2) It could serve as a barrier to entry for new managers
3) It could drive consolidation in the industry, as larger managers find it easier to distribute the costs across a larger pool of assets
4) It could reduce innovation in the industry, affecting returns in the long-term
compliance by enhancing data-gathering techniques and using dashboards.

- Developing centralised data capturing.
- Pushing responsibility of routine compliance activities into business.
- Rationalising reporting requirements.
- Creating compliance programmes, checklists and summaries of information for review.
- Shifting from a ‘rules-based’ approach to a ‘principles-based’ approach to compliance.

Benefits of this include: savings from eliminating duplicated efforts and over-spend on compliance, operational efficiencies arising from the implementation of unified administration systems and the potential for better investor reporting. Further, embedding compliance tasks into business procedures can reduce delays in client on-boarding.

By integrating controls into business so that compliance becomes second nature, business can accurately monitor and manage risks, and can practice risk management rather than risk avoidance, and the compliance function can move from being business support to a business enabler. Delivering such transformation requires commitment and significant changes to both business and compliance functions, with both parties viewing compliance as more than just a box to tick, but rather an integral part of business process.

Key considerations

- Regulations such as FATCA have significant implications for managers and can vary widely based on jurisdiction. Implications around these regulations drive the need for increased reporting, better data and processes.
- Anti-money laundering compliance programs must do more than just identify money laundering but must be designed to detect financial crime.

3. Operations

Operations supporting alternative asset management need to be agile to accept new products and assess new service requirements. Operations also needs to be adaptable to changes in product mix, provide customised solutions to investors, support new asset classes and products, and keep up to date with regulatory requirements. All of this, in a cost effective way, that is not disruptive to day-to-day business, as investors and regulators have raised their expectations of the standard of quality. To meet these expectations and reach the next level, managers need to realise that incremental change is not the solution. Rather, transformational change is necessary. An agile, scalable, efficient operating model is what is expected. This operating model requires process improvements of streamlining operations aggressively, automating processes and removing inefficiencies.

Swamped with regulations, Managers face three major areas of concern:

- The impact of business diversification
- Increased data pressure, in meeting risk management, reporting and reconciliation demands
- The need to achieve operational effectiveness
In response to regulatory oversight, alternative asset managers need to enhance valuation processes through the use of independent valuation advisers and increasing disclosures surrounding valuation estimates. Support for judgments, policies, third party validations to estimates and enhancing overall control processes, all demonstrate to investors that a rigorous process is in place and that the manager is delivering the most pragmatic fair value estimate possible, in a cost effective way.

As alternative assets are bespoke in nature, there is no scale to automation and operational processing. This leads to information or data challenges unique to the management of the specific asset type. A low number of transactions in many alternative asset classes make performance measurement and pricing difficult to measure. Data is difficult to get, difficult to use, and often those responsible for managing the data are the same people making the investment decisions. Further, data for some alternative assets may not be available at the same time frequency, or mismatched to the valuation frequency, causing pricing anomalies.

**Key considerations**

- Investors, advisors, operations, and fund administrators all have different data requirements.
- Identifying operational and technology risk poses challenges due to manual processes which lack formal governance processes and system generated data.
- Due to a high level of manual efforts, account maintenance and client reporting issues are prevalent.
- Difficulty in obtaining accurate and timely data from funds that lack transparency and trade in less liquid or more complex investments.
- Manual reconciliations are performed and human approval is required.
- Individual funds have complex processing requirements. Transactions such as capital calls, redemptions, transfers, valuations and distributions require significant knowledge of fund agreements to process accurately and timeously.

**Culture fit**

An alternative asset manager’s culture is the most important governance factor for avoiding regulatory problems, assuming of course that governance holds the highest place in business.

On the one hand, there is a need for rules, to ensure senior management perform effective governance and oversight, and improve professional standards and culture within the business. On the other hand, overly strict rules impose an unfair burden and liability to senior managers who take reasonable steps to prevent and detect problems, and ultimately may deter qualified individuals to take up senior roles. The skill set managers look for when hiring compliance and operations teams, needs to focus on technical knowledge of the regulations, practical experience in trading and operations, leadership as well as management skills. If business is to achieve cultural change, this cannot be achieved without such skills, especially without leadership to drive change efforts.

Only by weighing out the benefits and costs of compliance, can alternative asset managers begin to implement incentives for a cultural transformation, a transformation that regulators are demanding, and that the industry is seeking.
Diversification Beyond Asset Classes with STANLIB Multi-Manager