Characteristics and Challenges

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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.

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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 David Swensen, Yale's Chief Investment Officer 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.

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