Alternatives as an Alternative

In my recent paper, "Will Bonds Protect You In the Future?"[i], I challenged the utility of Bonds as a diversification tool. This challenge also reflects a concern I have had for or many years: that Bonds actually often deliver a negative real return[ii].

In this paper I propose that Alternative Assets (or Alternatives) can achieve diversification in a portfolio and, importantly, deliver superior risk adjusted real returns.

First, A Big Caveat

When I suggest that Alternatives can be used as an alternative to Bonds, I am not saying they are the same type of asset class in either risk or return profile. Nor am I suggesting that an investor's entire Bond portfolio should be replaced with Alternative investments[iii]. Bonds and Alternatives are not the same asset class and are not the same risk class. Bonds are generally government or investment-grade corporate credit. Their default rates are low and their income flow is generally fixed. With a few exceptions, Alternatives are equity holdings that may have little or no income stream, are often illiquid and higher up the risk spectrum.

What I am suggesting, rather, is that unlike Bonds, Alternatives have, and will continue to have, very low correlation to listed equities as well as, if invested intelligently, an expected return profile generally much higher than Bonds. Thus, Alternatives deserve consideration for inclusion in a well-structured, diversified portfolio; probably a lot more consideration than they currently get.

What Are Alternatives?

Let's start with a definition of Alternative Assets. According to Investopedia, an Alternative Investment is:

> *"a financial asset that does not fit into the conventional equity/income/cash categories. Private equity or venture capital, hedge funds, real property, commodities, and tangible assets are all examples of alternative investments."*

Two broad investment asset categories are included here:

1. Those that are derivatives of equities or bonds. These include hedge funds, market neutral strategies and leveraged long-short funds; and
2. Those that are direct investments in assets that are not linked to equities, bonds or cash. These include Private Equity, Real Estate and others discussed below.

In the first category, investors or managers use one of a number of techniques (including shorting or derivatives to reduce beta risk[iv] and thus beta return so as to access only alpha returns[v]. I do not favour this style of investing over the second for anyone other than institutional investors or those with very high liquidity requirements. My reasoning is as follows:

A. First, in equity and bond markets the primary component of return is the beta component. This can be seen by comparing the return for any individual stock to its market return or the return of a stock-picking fund[vi] to its comparative index. By way of example the 10-year annual return on the ASX 200 Accumulated index is 10.2%. Against any basket of stocks or any stock picking fund, this figure is the major contributor to its/their performance. Hence any strategy that seeks to reduce the effect of equity beta will over the long-term likely reduce the primary contributor to

return. Why would an investor who does not face liquidity or diversification constraints willingly eliminate the primary driver of an asset class return?

B. Second, and of greater concern, is that many of the strategies that reduce the impact of beta attempt to increase the impact of the alpha performance through leverage. In our fund research, I have come across a number of hedge funds that have leverage of 500%[vii], which means that for every dollar of investor funds they may have up to $5 invested in the market. For an allegedly market-neutral fund, this then means a gross exposure of up to ten times the investor capital. Now, in theory, this should not matter if a fund can perfectly eliminate beta risk and return. However, we have observed many examples, especially in times of crisis, when a specific hedge or market neutral fund has not completely eliminated beta and the drawdowns have been similar or greater to the respective market drawdowns.

All of that is a long-winded way of saying that I am not a fan of Derivative Alternatives and prefer natural or Direct ones.

The Alternatives We Believe Represent Value

When we invest in Alternatives, our list includes

- Private Equity
- Infrastructure
- Litigation Funding
- Venture Capital
- Distressed Credit
- Private Credit
- Commodities
- Direct Real Estate
- Any other non-listed Real Assets.

To avoid any confusion for the remainder of this paper we shall refer to the Alternatives listed above as "Direct Alternatives."

What Are the Benefits?

There are two benefits to incorporating Direct Alternatives into your portfolio: Lower portfolio risk and superior returns.

The benefit of investing in Direct Alternatives is that they represent more than eight separate categories that display a very low level of correlation with each other, especially if you factor in geographic diversification[viii].

It is very difficult to collect data on the correlation of unlisted Alternatives and equity markets[ix]. That said, enough data exist to show that across the direct unlisted Alternative classes, correlations with equity and bond markets are generally below 0.25. A caution here is that correlations between equites and listed Alternatives, such as Real Estate Investment Trusts (REITs) is much higher (up to 0.75) attributable to the beta effect of the Market, in spite of their unrelated nature.

Another benefit of some Alternative Asset classes is that they are a good hedge against inflation. This includes Real Estate, some Private Equity categories, parts of the Private Credit

market, and certain areas of the commodities market. As we face inflation for th efirst time in over 10 years this is a factor worth consideration.

Liquidity premium is yet another contributor to Alternative returns. This is the premium that investors demand to lock up their capital for a set period. If an investor does not require a part of their investment capital for that period of time, then locking it in to achieve that liquidity premium makes good sense, as long as you are satisfied with the expected return.

The Risks and Restrictions?

As with all asset classes there are risks associated with investing in Direct Alternatives. While each asset class has its own specific risks, the major ones for Alternatives include[x]:

Risk and Return profiles differ greatly: Direct Alternatives differ widely in nature. Similarly, their risk and return profiles are very different. It is quite apparent that investing in fully-occupied urban commercial real estate is less risky than early stage venture capital. Similarly, the expected returns are lower, but they all exceed the actual returns for Bonds achieved over the past five years and, in most analysis, the expected return for the foreseeable future. As an investor, one should seek to understand these risks and invest according to ones own risk appetite.

Manager Risk: The investor Howard Marks observed that in listed markets most of the return is attributable to the market (beta), yet in unlisted markets most of the return is attributable to the manager (alpha). As such, having a deep understanding of and trust in the investment manager is critical: they are key to determining whether the manager has the necessary capabilities, integrity and ability to prudently manage your capital and deliver against return targets in a range of macro-economic conditions. Alternative Investments are often more complex and as such command higher fees than other investments, which is another good reason to ensure you are investing with the right team.

Return Variabilty: For some Alternative classes (Venture Capital is a prime example), if you remove the returns of the few top performers, the return for the rest of that asset class is negative. As Alternative Asset returns are primarily alpha-based, accessing beta is difficult, if not impossible. Hence, research into consistent out-performers is critical.

Liquidity Risk: While some Alternatives are listed, most that deliver a superior return are not. Once you have made an investment, your ability to redeem is usually limited. Investors should also be alert to quasi or false liquidity, in which a fund invests in illiquid asstes yet promises a high level of liquidity at the fund level. This type of liquidity mismatch can result in major redemption problems in times of crisis when many investors are seeking liquidity at the same time.

Duration Risk: In addition to liquidity risk, many Alternatives are often in closed-end funds with fund lives of greater than five years. Caution needs to be taken to ensure that your investment thesis will hold up against the expected term of the fund.

Investors also need to be aware of general risk factors including currency risk and, in some instances, geopolitical risk.

Some Investment Hurdles?

In addition to the risks described above, for many investors there are also hurdles to investing in Direct Alternatives:

Wholesale/ Sophisticated investors Only: Many Direct Alternatives are limited to Wholesale or Sophisticated investors. There are very few good uncorrelated options available to

circumvent this and in some respects with very good reason. Fortunately, as a wholesale fund this is not a concern for us at CTE.

High Minimum Investment: In addition to wholesale-only investor restrictions, many Alternatives funds have high minimum investment sums. I am aware of some funds that have a USD 10M minimum, which is obviously beyond the portfolio investment capability of most investors including High Net Worth investors.

Limited Access to the Best Opportunities: Unlike listed markets where investment access is unrestricted, investing in the best Direct Alternative Investments is often heavily restricted to parties that have a preferential relationship with the manager. That makes it difficult if not impossible to gain access to some of the best opportunities.

CTE's Rules for Successful Investing in Direct Alternatives

Direct Alternatives can offer superior returns, but they do not come without risk. At CTE we have been actively investing in Alternative Assets for more than 12 years and these Alternative investments returns have materially outperformed our Equity investments.

Through this time, we have developed a set of guidelines that have assisted in achieving superior results:

1. **People, People, People:** In investing the integrity of the individuals you are investing with is paramount. This is even more pronounced in Alternatives as they will have your money for a long time. So get to know your general partners very well.
2. **Work with specialists:** Most of the return will be delivered by a manager's expertise and once you are in, you are, for the most part, in for the duration. Therefore, we do a great deal of due diligence on the opportunity and the team to ensure that they are truly superior at what they do and have strong capabilities necessary to produce a superior result.
3. **Never invest in Fund 1.0:** It has been our experience that even where managers have successful careers in other companies or funds, there are many unforeseen pitfalls in a first fund. By avoiding that fund and letting the new team prove its capabilities we find we have far more success with later funds.
4. **Diversify effectively:** All investments carry risks and Alternatives are no different. There are literally thousands of opportunities and taking a diversified approach will lower your overall risk exposure. Achieving this diversification and still being able to meet minimum investment sums is one of the areas where an experienced Alternatives manager can really add value for a wholesale investor.
5. **Don't always swing for the fence:** Many Alternative investments market returns above 20%. Some of these investment opportunities, not surprisingly, have very high risk of capital loss. Generally, investment wealth comes from investing successfully over the long term, not from any one opportunity. Targting repeated reasonable returns is a superior investment strategy to always trying to find the next Unicorn.
6. **Understand the investment and harvest periods:** All funds have investment and harvest periods. These are the periods during which they will invest funds and then realise those investments, respectively. In the first they will make calls on your capital and in the second they will return your capital. Ensure that you have a clear understanding of these events and that these are matched with your cash flow availability and requirements.
7. **Invest at the last close:** This is effectively a cheap or free option. In many cases there can be up to two years between first and last close in a fund. While some funds do have a preferred return for early investors, we generally find this preferred return is lower than

the target return for the fund and the value of having the option not to invest far outweighs this. It also reduces the duration risk of the investment.

8. **Invest only in what you understand:** If a rule is good enough for Warren Buffett it should be good enough for you and me. Not all of your investments will pay off and you will really kick yourself if you lose money investing in something you didn't understand.
9. **Be wary of "Asset Accumulators":** At CTE we have always been very focussed on earning superior returns from performance rather than accumulating morefunds under management. We feel the same way about the people we invest in. A key warning factor for us is when a follow-up fund is targeting a materially higher capital raise than its predecessor. This raises concerns that the manager may be starting to focus on management fees rather than investment performance. It is also a warning sign that they may have to move away from the market segment where they have had success in order to deploy all of the capital and, in the process, lose their key competitive advantage.
10. **Invest in smaller markets** – It is our experience that returns in the small- to mid-markets for a broad range of Direct Alternative Assets are superior to those in the mega markets. This fact is often not attributable to higher risk but more the higher level of competition in the larger markets that compresses returns. Smaller ideas may be harder to find but they are generally worth it.

Investing in Alternatives takes time and time builds experience. The ideas presented in this paper do require effort to follow through and require a lot of due diligence, as well as ongoing management. However, in our experience they are worth the effort.

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[i] https://www.livewiremarkets.com/wires/will-bonds-protect-you-in-the-future

[ii] *Return after adjustment for inflation.*

[iii] *As noted in the disclaimer that accompanies this paper,* I am *not offering advice of any nature.*

[iv] *Beta return is the return on an investment attributable to market-related volatility and random fluctuations. Also known as relative or systematic return.*

[v] *Alpha return is the excess return on an investment after adjusting for market-related volatility and random fluctuations.*

[vi] *By stock-picking I refer to a fund that targets absolute or superior returns through stock selection as opposed to an index or relative fund.*

[vii] *One US Treasuries Fund we researched had leverage of 9x.*

[viii] *The level of correlation within non-listed asset classes across geographies is substantially lower than for listed markets.*

[ix] *Part of the reason for this is that unlisted Alternatives, even within the same asset class, are not a single market linked by a set of common risks, like listed markets. Hence collecting data on an Alternative Asset or set of Assets and comparing that to relevant equity markets is quite difficult and of little broad utility.*

[x] *We note that commodities are an exception to most of the risks listed above. They are often in very liquid markets with limited duration risk and in most cases are capable of being traded directly, without manager assistance. They can also fluctuate wildly and we always caution investors in taking investment decisions without the appropriate advice.*