

Characterize the common features of alternative investments and their markets and **discuss** how they may be grouped by the role they typically play in a portfolio.




LOS 36.a

Common features of alternative investments include:

- Low liquidity.
- Good diversification potential.
- High due diligence costs.
- Difficult to value.
- Limited access to information.

Alternative investments can provide:

- Exposure to asset classes that stocks and bonds cannot provide.
 - Exposure to special investment strategies (e.g., hedge and venture capital funds).
 - Special strategies and unique asset classes (e.g., funds that invest in private equity and distressed securities).
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LOS 36.b

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SS 13

Explain and **justify** the major due diligence checkpoints involved in selecting active managers of alternative investments.

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LOS 36.b

- **Assess the market opportunity offered:** Are there exploitable inefficiencies in the market for the type of investments in which the manager specializes?
- **Assess the investment process:** Does the manager seem to have a competitive edge over others in that market?
- **Assess the organization of the manager** and their operations. Is it stable and well run? What has been the staff turnover?
- **Assess the people** by meeting with them and assessing their character.
- **Assess the terms and structure** (amount and time period) of the investment.
- **Assess the service providers** (i.e., lawyers, brokers, ancillary staff, etc.) by investigating the outside firms that support the manager's business.
- **Review documents** such as the prospectus or private-placement memorandum and the audits.

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Explain the special issues that alternative investments raise for investment advisers of private wealth clients.

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- **Tax issues** can be unique to the individual because the characteristics of private-wealth clients and their investments can vary greatly. For individuals there can be partnerships, trusts, and other situations that make tax issues complex.
- **Suitability:** Time horizons and wealth of individuals can vary a great deal. With individuals there is also the emotional aspect, like preferences for, or aversion to, certain types of assets.
- **Communication** with the client helps determine suitability of recommendations and the overall management process.
- **Decision risk** is the risk of irrationally changing a strategy. For example, the advisor must be prepared to deal with a client who wants to get out of a position that has just declined in value.
- **Concentrated positions:** Wealthy individuals' portfolios frequently contain large positions in closely held companies. Such ownership should be considered with the overall allocation to alternative investments like private equity.

Distinguish among the principal classes of alternative investments, including real estate, private equity, commodity investments, hedge funds, managed futures, buyout funds, infrastructure funds, and distressed securities.

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LOS 36.d (Part 1)

Real estate can be broken down into direct and indirect. Examples of direct investment in real estate include ownership of residences, commercial real estate, or agricultural land, and it involves direct management of the assets. Indirect real estate investments include:

- Companies that develop and manage real estate.
- Real estate investment trusts (REITs).
- Commingled real estate funds (CREFs).
- Separately managed accounts.
- Infrastructure funds.

Private equity subgroups include start-up companies, middle-market private companies, and private investment in public entities. A direct investment in private equity is when the investor purchases a claim directly from the firm (e.g., preferred shares of stock). Indirect investment is usually done through private equity funds, which include venture capital (VC) and buyout funds.

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Distinguish among the principal classes of alternative investments, including real estate, private equity, commodity investments, hedge funds, managed futures, buyout funds, infrastructure funds, and distressed securities.

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LOS 36.d (Part 2)

(Continued from previous card)

Commodity investments can also be grouped into direct and indirect subgroups. Direct investment is either through the purchase of the physical commodity or the purchase of derivatives (e.g., futures) on those assets. Indirect investment in commodities is usually done through investment in companies whose principal business is associated with a commodity (e.g., investing in a metal via ownership of shares in a mining company). Many commodities have a low correlation with stocks and bonds and a positive correlation with inflation.

Managed futures funds share many characteristics with hedge funds. The primary feature that distinguishes managed futures from hedge funds is the difference in the assets they hold. Managed futures funds tend to trade only in derivatives markets, while hedge funds tend to trade in spot markets and use futures for hedging. Also, managed futures funds generally take positions based on indices, while hedge funds tend to focus more on individual asset price anomalies. In other words, hedge funds tend to have more of a micro focus, while managed futures tend to have a macro focus.

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LOS 36.d (Part 3)

(Continued from previous card)

Buyout funds are the largest segment of the private equity market. Middle-market buyout funds concentrate on divisions spun off from larger, publicly traded corporations and private companies that, due to their relatively small size, cannot efficiently obtain capital. Mega-cap buyout funds concentrate on taking publicly traded firms private. In either case, the target represents an investment opportunity through the identification of under-valued assets, the ability to restructure the debt of the firm, and/or improved (i.e., more efficient) management and operations.

Infrastructure funds specialize in purchasing public infrastructure assets (e.g., airports, toll roads) from cities, states, and municipalities. Distressed securities are securities of companies that are in or near bankruptcy. As with managed futures, analysts often consider distressed securities to be part of the hedge fund class of alternative investments. It may also be part of the private equity class.

LOS 36.e (Part 1)

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Discuss the construction and interpretation of benchmarks and the problem of benchmark bias in alternative investment groups.

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LOS 36.e (Part 1)

Real Estate: *Benchmarks:* NCREIF, NAREIT; *Construction:* NCREIF is value-weighted, NAREIT is cap-weighted; *Biases:* Measured volatility is downward biased. The values are obtained periodically (annually).

Private Equity: *Benchmarks:* Provided by Cambridge Associates and Thomson Venture Economics; *Construction:* Constructed for buyout and venture capital. Value depends upon events. Often construct custom benchmarks; *Biases:* Repricing occurs infrequently which results in dated values.

Commodities: *Benchmarks:* Dow Jones-AIG Commodity Index, S&P Commodity Index; *Construction:* Assume a futures-based strategy. Most types considered investable; *Biases:* Indices vary widely with respect to purpose, composition, and method of weighting.

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Discuss the construction and interpretation of benchmarks and the problem of benchmark bias in alternative investment groups.



LOS 36.e (Part 2)

(Continued from previous card)

Managed Futures: *Benchmarks:* MLMI, CTA Indices; *Construction:* MLMI replicates the return to a trend-following strategy. CTA Indices use dollar-weighted or equal-weighted returns; *Biases:* Requires special weighting scheme.

Distressed Securities: *Benchmarks:* Characteristics similar to long-only hedge fund benchmarks; *Construction:* Weighting either equally weighted or based upon assets under management. Selection criteria can vary; *Biases:* Self-reporting, backfill or inclusion bias, popularity bias, and survivorship bias.



Evaluate and **justify** the return enhancement and/or risk diversification effects of adding an alternative investment to a reference portfolio (for example, a portfolio invested solely in common equity and bonds).



LOS 36.f

Over the long term, in most cases, a 20% investment in alternative investments would have improved both the absolute return and the risk-adjusted return of a stock/bond portfolio. Over the 1990–2004 time period, adding managed futures to a portfolio of stocks, bonds, and hedge funds increased the return and the Sharpe ratio. Private equity provided less diversification than the other classes but provided return enhancement. Distressed securities have been found to provide both diversification and return enhancement.

