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Alternative assets

Investments for a Post-Crisis World

GUY FRASER-SAMPSON

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Investments for a Post-Crisis World

Guy Fraser-Sampson

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Preface

The events of 2007 and 2008 have had many consequences, shattering as they have many of the old "certainties" by which the world's investors were happy to live out their lives. Fundamental questions are now being asked, throwing into question the very validity of much traditional finance theory. Even more fundamentally, we are being forced to confront disturbing new issues, such as the very meaning of words such as "return", "risk" and "value".

In truth, though, many of the world's investors were not even applying the precepts of traditional finance theory, though they may have paid them lip-service. The requirement for a properly diversified portfolio, for example, while a matter of simple common sense, was routinely ignored, even by those, such as UK pension funds, who had a legal, rather than simply a professional, duty to comply.

Yet it can be mathematically proven that what has become known as a "Yale type" approach (which really means little more than having a properly diversified portfolio), a concept much closer to that practised by North American pension funds, would have dramatically lessened the impact of the various financial shocks and stresses of the last quarter century or so.

Whatever the case, the recent financial crisis must surely have brought home to even the most obdurate investor that the "all your eggs in one basket" approach really is as foolish as it sounds, and that the imperative for a sensibly diversified portfolio of different asset types can no longer be ignored.

That means Alternative Assets, at least if we are going to apply that label (as most investors seem to do) to anything other than bonds and quoted equities, and here we run into an immediate problem. There is an old adage,[1] and a very good one, that you should never invest in

[1] Usually attributed to Warren Buffett.

anything you do not understand. Well, no real level of understanding of any Alternative Assets currently exists in the vast majority of the world's investment institutions. That means that unless they are going to invest blind in Alternatives then they need to gain such knowledge, and quickly. Those who actually possess that knowledge, particularly across various asset types, will cease to be regarded as mild eccentrics roaming the outer reaches of the investment world, and begin to be recognised as useful and, therefore, valuable individuals.

This book is an attempt to pass on at least some of that knowledge. Each chapter provides useful background knowledge on a particular asset type, including a discussion of whether a satisfactory beta return level exists and, if so, the different ways in which it might be accessed. While the author is a well-known advocate of Alternative Assets, it is in no way the intention to showcase their merits, nor to downplay their potential drawbacks. To suggest that all Alternative Assets offer exciting opportunities for all investors at all times would be nonsense. There are some that struggle to justify themselves on a returns basis, and others that offer significant difficulties of implementation. These issues can only be resolved by individual investors around the world having due regard to their own particular circumstances. There can be no valid "one size fits all" approach.

This introduction will be brief, not least because experience suggests most readers will have turned straight to Chapter 1, but four important points fall to be made.

The first is that all this book can do is to impart "knowledge", not experience. There is an important difference between the two. As a hugely successful investor[2] once pointed out, no fish can imagine what it is like to be a mammal. One day of walking around on land is worth two thousand years of writing about it. As business school students quickly realise when they go out into the world of investment, there are certain situations in which financial theory seems to work very well, and certain situations in which it seems not to work at all. Understanding that theory offers certain guidelines, rather than a rigid framework within which the "one right answer" can be calculated is an important step, and one which sadly many investors are never able to take.

The second is that readers will find certain issues popping up in more than one chapter. While it would have been preferable to split these out into separate sections of their own, this has not always been possible, since the same issue can impact different asset types in different ways, or raise different practical implications. Thus, while every effort has been made to discuss as much common matter as possible in Chapter

[2] Warren Buffett again.

2, there are some things which will regularly intrude. In particular, the issues around (1) counterparty derivative risk, (2) difficulties of physical possession and/or use of spot pricing, and (3) the inappropriateness of using a basket of operating businesses as a proxy for asset or project exposure.

The third is that, while what might be called traditional financial theory, which may be loosely described as everything and anything which is based upon the assumption that the risk of an investment and the volatility of its historic returns are one and the same, appears to the author to be, at the very least, open to many objections, its validity will be assumed for the purposes of this book. Thus, investors will be able to move freely within their chosen world, in which volatility is uniformly bad and liquidity is uniformly good, in which the past is always a good guide to the future, and in which normal distribution will always apply. Those who have been diligent enough to read this introduction will, however, be punished for their thoroughness by having these sentiments repeated in the body of the book. It is only fair to point out, though, that anybody who slavishly follows these precepts will find it difficult ever to countenance an allocation to many Alternative Assets.

The fourth and final point to record is that in this book there will generally be reference to “asset types” rather than “asset classes”. In part this is a desire to avoid loose terminology. There are many who now question whether Private Equity and Hedge Funds, for example, are really “asset classes” at all. While this may prove a fascinating discussion, it is not one which we need to pursue between the covers of this book.

In part though, and more importantly, it is an attempt to bring home to readers that actually it almost certainly is not important what any asset is called. That is part of the human compulsion for classification, to apply a label to something and place it in its appropriate pigeonhole. A compulsion, incidentally, which has caused great problems in the area of Asset Allocation. No, what is really important is not what an asset is called, but how it might perform within an investor’s portfolio.

Guy Fraser-Sampson
Cass Business School, City of London
October 2010

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However, all views expressed, and any mistakes which remain, are entirely my own.

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1

What are Alternative Assets?

The world of finance and investment is full of unfortunate terms and phrases. Unfortunate in that they are unclear, unfortunate in that they may actually be used in different senses in different situations, or unfortunate in that they evoke emotional responses which may not in fact be justified in the cold light of day. "Alternative assets" is one such term.

Dictionary definitions of "alternative" as a noun range among the following:

- "something different from";
- "able to serve as a substitute for something else";
- "either one of two, or one of several, things or courses of action between which to choose".

Yet the conjunction of "alternative" with "assets" suggests that it is here doing duty as an adjective (qualifying a noun, for the grammatical purists out there), in which cases dictionary entries would include:

- "different from and serving, or able to serve, as a substitute for something else";
- "of which only one can be true, or only one can be used or chosen, or take place at any one time";
- "outside the establishment or mainstream, and often presented as being less institutionalised or conventional";
- "ecologically sound and/or more natural or economical with resources".

In other words, as a noun "alternative" seems to be capable of at least three meanings, and as an adjective of at least four, which might be summarised as: "serving as a back-up", "mutually exclusive", "unconventional or non-traditional", and "green" (in its socio-political meaning). Of these, at least three are unhelpful, the first two in particular. There is no suggestion that we should invest in alternative assets *instead* of something else, or that they represent a mutually exclusive choice so that we may invest *only* in alternative assets. In any event, in neither case would we be able to make any sense of the situation unless we knew instead of *what*; what might the other alternative or alternatives be?

It is the third meaning that we are going to have to adopt, and yet even here we must be careful, for this usage would include overtones of being marginal, or even downright cranky such as when used to describe alternative medicine. Roget's *Thesaurus*, for example, offers "conventional" as an antonym, and "unorthodox" and "unusual" as synonyms. It is perhaps these overtones which can give weight to the pejorative resonance with which the phrase "alternative assets" is often uttered.

It is not even particularly helpful to look at the way in which the phrase is used in practice by investors, since there seems to be no common agreement on this. People can agree on examples (private equity, hedge funds and real estate (property), for example) but not on a universal definition. There seem to be at least three different ways in which the phrase is used to distinguish certain types of assets.

Illiquid

Many say airily "oh, alternative assets are illiquid. You know, not like bonds or equities – illiquid." However, this possible definition runs into trouble straight away.

For a start, not all bonds and equities are liquid, or at least not all the time. Anyone who may have tried to sell even good quality US corporate bonds in September 2008 will appreciate the force of this comment all too well. However, let that go. The definition still does not work.

Active currency rates are an alternative asset, and what could be more liquid than currency? Similarly gold, which many rightly regard as the ultimate defensive asset. Why? Precisely because one can take it anywhere in the world and turn it instantly into cash. In an Armageddon-type scenario one could even use it as a unit of purchasing power in its own right. So here are two "alternative" assets which we can identify straight away as being arguably even more liquid than bonds and equities.

Unquoted

This definition too runs onto the sandbanks as soon as we set sail in it. It is true certainly that private equity funds, or at least the limited partnership variety, are unquoted. However, all the commodities are "quoted" in the sense of having a price which is available for trading on public markets from one moment to another, as are energy assets, such as oil and gas, and of course currencies. We should also note, without necessarily having to pursue the point further at this stage, that adopting this definition would create some serious ambiguities which it might prove very difficult to resolve. How would you classify 3i, for example? As a private equity fund, or as a public company and major constituent of the FTSE 100 index?

Not Bonds or Equities

I have never heard this definition suggested, save in my own investment modules and workshops, but it seems to me to do the least violence to the situation, since it is both more difficult to attack linguistically and a closer fit for the instinctive attitude of most investors towards such assets. Certainly, one often sees a portfolio divided between "fixed income" (bonds), "equities", "cash" and "alternatives".

However, even here there are problems. For example, many investors include "real estate" (property) as an asset class in its own right and then have an allocation to "alternatives" alongside it. Some others include private equity within their allocation to "equities". There are even some who argue for a still more restrictive definition, which would only cover what one might term "exotics" or "collectibles" such as musical instruments, paintings, etc.

This is one of those situations where no sizeable group of people are ever going to agree on a common solution. It is, however, submitted that "not bonds or equities" is less open to debate than any of the other candidates, and will therefore be adopted for the purposes of this book.

ARE ALTERNATIVE ASSETS REALLY "ALTERNATIVE"?

This may seem like a really pointless question to be asking, the posing perhaps of some arcane academic distinction, but it is not. On the contrary, it exposes a very serious and controversial issue.

The fact that these assets are commonly referred to as "alternative" reinforces the view that they are somehow peripheral to the whole business of investing or, even worse, that there is "proper" investing and "other" investing. "Proper" investing being of course bonds and equities, which should occupy the bulk of your time, and "other" being what you might take a quick look at if you have the time once the main business of the day is done. In other words, that alternative assets are somehow inferior to bonds and equities, which might be thought of as "mainstream". It would be unthinkable, under this view, for anyone to invest *only* in alternative assets, since they become by definition something extra which one goes in for only if one has the time and inclination after first setting one's allocations to bonds and equities.

With very few exceptions indeed, this worldview flows over into actual asset allocation in practice; it is for precisely this reason that we should take this issue so seriously. An automatic or unconscious assumption is being made which is capable of skewing decision making very badly indeed.

It became briefly fashionable during the dot com bubble to talk about "a whole new paradigm", or "a paradigm shift". By this was meant that as a result of the information and communications revolution brought about by the advent of the internet, a completely different belief system had come into being, and that it was necessary for finance and investment thinking and practices to be brought into line with it. Should you, for example, be so square and un-hip to ask how a business with no prospect of earnings for many years could be worth several hundred million dollars, you would be met with a pitying smile and the news that "you just don't get it, do you?"

In fact, at the risk of being thoroughly un-hip, the use of the word "paradigm" was probably itself misguided. As used initially by Thomas Kuhn in his book *The Structure of Scientific Revolutions*,[1] it was confined to the scientific community. It was a system of scientific beliefs, and scientific only. What the internet pundits were talking about was actually not a paradigm at all, but an episteme.

An episteme, a concept coined by the flamboyant French thinker Foucault,[2] is a system of thought which embraces all aspects of culture and society, not just science. It also embraces the concept of "zeitgeist", the spirit of the times. In the sudden readiness of consumers to make purchases online, for example, we see not a new paradigm but a new episteme.

One of the features of an episteme which Foucault identifies is this very issue of unconscious assumptions. In the field of literary criticism, for example, Foucault's work had a huge impact, as people realised that it was impossible properly to analyse or comment upon a book without understanding the episteme within which the author lived and worked.

There is for example a very early Hitchcock film called *Murder*, made in 1930 starring Herbert Marshall and based upon a novel by Clemence Dane and Helen Simpson. It does indeed feature a murder, the title being a bit of a give-away here, the motive for which, it tran-

[1] Thomas Kuhn, Chicago University Press, Chicago, 1962.
[2] Michel Foucault, *The Order of Things*, Routledge, London, 1974.

spires, was blackmail. The information in respect of which the individual concerned is being blackmailed is that he is of mixed blood or, as he is dismissively described in the film, “a half-caste”. A modern audience of course finds this incomprehensible. Many people today are of mixed race, and the fact that somebody is would not excite even comment, let alone prejudice or disdain. Yet we are not living in the 1920s and 1930s as the authors of the novel and the original audiences of the film were respectively. Clearly things must have been viewed differently in those days or there would be no point to the film, and Alfred Hitchcock was not the sort of man to make a film which had no point to it. So, it must have been the case that the prevailing episteme of those times included the unconscious assumption, no matter how incredible and objectionable it may seem to us today, that to be of mixed blood was somehow to be inferior, undesirable or untrustworthy, and certainly not the sort of cad to whom one might wish one’s daughter to get married.

So, let us be aware of unconscious assumptions, and of the very important part which they can play.

For, just as with films and literature, we cannot properly understand investment practice unless we understand the episteme within which it takes place, since this will colour instincts, reactions, thoughts, discussions and decisions alike. It is here that we encounter the real problem with the word “alternative”. While this is difficult precisely to articulate, it is part of a system of unconscious assumptions which includes elements of being “more difficult”, “more risky”, “dangerous”, “cranky”, “optional” and “unnecessary”. No better evidence is required of all this than the very low allocations made to alternative assets relative to bonds and equities, at least outside the US.

The view is very much that bonds and equities are essential, while everything else is an optional extra, and quite possibly an unnecessary luxury. This has led in turn to some dramatically undiversified portfolios, particularly among pension funds who, ironically, are often the only class of investor actually to be under a legal duty to diversify their assets.[3]

The reader should therefore be aware that alternative assets in general are subject to a great deal of unconscious prejudice, and that their supporters are required to justify them both constantly and in great detail in a way which is never demanded, for example, of quoted equities.

At the other end of the scale, there are very few institutional investors who have eagerly embraced alternative investments as a source of

[3]In the UK, for example, see Pensions Act 1995 s.36(2)(a).

diversification across asset classes which hopefully offer lowly correlated returns. The Yale Endowment probably enjoys the highest profile of these, and in recent years alternative assets have generally totalled about 65% of their total asset allocation.[4] If only for this reason, the question which serves as the section heading is clearly relevant and valid. If alternative assets can make up about two thirds of the portfolio of one of the best investors in the world, how can they really be said to be "alternative" at all?

THOUGHTS ON CLASSIFICATION

Having established that we are going to assume that any assets other than bonds and equities can be "alternative", let us see if we can identify some different asset types, and consider how we might further discuss, and possibly classify them.

First and most obviously, if we are going to say that bonds and equities are not "alternative", then what about things which are not bonds or equities and which yet represent them, such as futures, options and swaps positions over individual bonds or stocks (shares), or groups or markets which include them? There is a yet further complication here, of course, since hedge funds routinely deal in such instruments, and yet by most people's reckoning are firmly in the "alternatives" camp.

It is probably best to treat these not so much as an asset type as a way of investing, a means rather than an end. They are thus an investment technique, or a means of replicating or synthesising a particular investment, rather than the investment itself. As we will see, it is in fact often the case with the asset types which we will be considering in this book that synthetic coverage of this nature is the only practical path to take.

Private Assets

On one view, alternative assets fall for the most part rather neatly into two separate categories, but with Hedge Funds hovering uneasily with more of their weight on one side of the line than the other.

Many alternative assets are publicly quoted and highly liquid, thus making it rather difficult to see what is really so "alternative" about them at all. Commodities, energy, gold and currency assets all definitely fall into this category. On the other side of the dividing line stand three which are very different: private equity, real estate (property) and infrastructure – we might term "private" asset types for two important reasons.

[4] See for example the Yale Endowment Annual Report 2009.

The first and most obvious reason is that the things in which they invest cannot by any stretch of the imagination be described as quoted assets or instruments. Private equity funds may invest in shares, but the shares in a private company have few of the characteristics (as investments, not as legal instruments) of their quoted counterparts. They can neither be openly traded nor can they be offered to the public. There may even be important legal differences; in the UK, for example, the Takeover Code applies to public companies but not to private ones.

Real estate funds invest in buildings, which may well from time to time have an advertised price when they happen to be on the market for sale, but these periods are infrequent, and in any event there is no guarantee at all that even then the advertised price has any connection with the building's real value, however we might measure that. Property assets are illiquid, whereas bond and quoted equities are not. Property assets require care and maintenance, which bonds and equities do not, and their value can be enhanced by improvement or development, actual or potential.

As for infrastructure funds, these are perhaps the furthest removed from bonds and equities of all, since they invest in projects, albeit these might be legally structured for funding purposes into companies. On one analysis, an infrastructure fund is paying agreed capital sums in return for the right to share in a stream of future cash flows. What could be more illiquid than the contractual right to share in a project's income stream for perhaps the next 30 years or so? What could be further removed from the concept of legal instruments which can be traded instantly on the world's financial markets?

So, they are "private" asset types in the sense that their underlying investment entities are not publicly quoted. But there is something else as well: this is that the overwhelmingly popular ways in which such assets are accessed are themselves private. Yes, there are quoted private equity vehicles, such as 3i, and doubtless there will sooner or later be an infrastructure equivalent of this FTSE 100 monster, but the vehicle of choice for sophisticated investors has always been the limited partnership.

Real estate is more problematic in this regard, for there are of course hundreds of quoted property investment vehicles around the world ranging from mutual funds to REITs; this is, for example, how most European pension funds have chosen to structure their property exposure. However, private real estate (often wrongly and confusingly called private equity real estate or PERE[5] for short, simply because it employs a private equity type fund structure) has always been a significant part of American investment portfolios and recently

[5]Or even, still more confusingly, sometimes PERA.

crossed the Atlantic and seems set to be a growing part of the European scene.

There are of course those who question why anyone would want to access assets through a private vehicle when they could have the lower fees and comforting liquidity of a public vehicle. As we discuss elsewhere, however, this should increasingly be recognised as a double edged sword. First, that liquidity may be more imagined than real. Second, in turbulent equity market conditions such vehicles can easily give rise to both man-made volatility and man-made correlation as their unit or share prices ride up and down with stock market beta rather than necessarily with the value of the underlying assets.

So, we might classify as "private", those asset types which satisfy both these criteria. There will always be investors who seek out quoted private equity exposure, and for such people then there are certainly proxies such as 3i investing at the company level, or fund of funds equivalents readily available. The bulk of private equity capital is, however, deployed through private vehicles.

With infrastructure the problem is more complex since when investors talk of investing in "quoted infrastructure", they frequently have in mind buying shares in companies which undertake infrastructure activity, the drawbacks of which approach will be fully explored in later chapters.[6] "Quoted infrastructure", in the sense of listed funds which invest in projects, do exist, but given that the underlying assets (projects) are themselves illiquid, then something like a limited partnership will often be the vehicle of choice for any sophisticated investor looking to access this asset class too, not least because of various tax advantages. Stand-alone partnerships are also used by investors to access individual projects.

With real estate the situation is more problematic and "private real estate" is simply a sub-set of "real estate". However, something which is often overlooked is that many of the world's biggest investors choose to build their own direct portfolios of property assets, and this activity too would form part of private real estate. After all, what could be more "private" than simply buying something yourself and keeping it as your own personal property?

So, it does seem to be the case that there is indeed a category of alternative investments which we can classify as private assets, and these would comprise almost all private equity and infrastructure, and all that real estate investing which is conducted either directly or

[6]For what it's worth, some research carried out a few years ago in Australia, admittedly on very limited data sets, suggested that private infrastructure funds had strongly out-performed "quoted infrastructure" even after deduction of all fees. See the chapter on infrastructure for more details.