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Alternative assets

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.

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

Contents

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