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Alternative Investments Explained

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If a financial asset cannot be placed in a traditional investment category, meaning stocks or bonds, then it is considered an "alternative". Given this rather opaque definition, how can we make sense of these assets and more importantly, how can we best use them for our investment strategy? We talked to Blu Family Office, to understand exactly what it means to invest in alternatives and to learn more about the different strategies, their risks, and potential returns.

Mariel Diez for Compare Wealth Managers

A financial asset is considered an alternative investment if it does not fit into one of the traditional investment categories, such as stocks, bonds, or cash. Private equity or venture capital, hedge funds, managed futures, art and antiquities, commodities, and derivatives contracts are all examples of alternative investments. Even real estate is frequently included in the category of alternative investments.

According to Blu, the purpose of investing in alternatives, apart from generating returns, is to diversify our investment portfolios. In other words, alternatives should behave differently to stocks or bonds in the first instance. In an effort to categorise alternative investments, Blu highlighted the following different groups:

Private markets
Private markets, include **private equity, venture capital, property and direct lending.** According to Cambridge Associates, one of the biggest alternatives platforms in the world, *private equity* (an alternative investment class that invests in or acquires private companies that are not listed on a public stock exchange) performs better than public equities. However, if you compare the returns to those of stocks with a small or medium market capitalisation, they seem to perform quite similarly.

Venture Capital invests in start-ups where the risk is higher but the returns on investment are potentially greater. Direct lending (also known as private or alternative credit) is basically non-bank lending where the debt is not issued or traded in the public market. This includes corporate lending, trade finance, supply chain financing, real estate loans, invoice or project financing. *Property* can include both commercial or residential dwellings and represents the largest asset class in the world.

What all private investments have in common, is that you cannot buy and sell them in an instant (as you could with stocks and bonds). This so-called "illiquidity premium", is the reason that we should expect higher returns from making these investments to compensate for the additional risk we take on. The other big risk in making private investments, is the time, energy and money (legal fees) it takes to recover our monies in case something goes wrong.

Pretenders
The second category is called **Pretenders,** since they look like alternatives but really aren't. Mostly, we find investments that are otherwise illiquid, such as *infrastructure* or *private equity funds* that are listed in the stocks markets. Seems like a good idea, but the market is too efficient not to be fooled by these attempts at providing secondary liquidity. Fact is, once something is traded in the public

markets, it behaves like any other stock (albeit at a higher price, as these type of funds still charge large management and performance fees).

There are also so-called *theme* based ETF's which are sometimes labelled as alternatives. This would include investments into alternative energy or the electric car industry for example. However, as before, once something is listed in the stock market, it behaves like everything else, no matter how great the theme may be. As such there is little diversification to be gained from buying into these type of investments.

Idiosyncrats
A very special category according to Blu is the **idiosyncrats,** those that take very specific risks. Here you can find *collectibles* (art, classic cars, fine wine), *cryptocurrencies* or *gold*.
Reserved mostly for the ultra-wealthy, the problem with collectibles is that the valuation is subjective. With art for instance, you cannot just buy one painting, so in order to diversify and buy several pieces the initial investment can be quite high. If you don't know much about art you could stick to the "masters" but acquiring a Monet or Picasso can be quite expensive! At the same time, selling them involves galleries or auction houses thereby generating extra costs. Fine wine has been performing very well over the past few years: the value for some has gone up to 20% but the risk is that you end up drinking it yourself. Classic cars were the best-performing investment in 2021 but the high upkeep costs need to be taken into consideration as well as the need to own more than just one.

As for cryptocurrencies, they were created after the 2008 financial crisis, when people lost confidence in the government and the public sector. If you were one of the early investors, your profits would be astronomical, even after the correction of almost 75% in 2022. However, where things go from here, is a matter of great debate. There are those that think cryptocurrencies are the future of finance, whilst others see no intrinsic value whatsoever. As always it is not what you buy, but how much, and given that cryptocurrencies are liquid and definitely move like nothing else, they represent a viable alternative to investing in stocks and bonds.

Last but not least, Gold is considered one of the most stable and valuable commodities, and people like it as a safe haven investment. However, rather surprisingly, Gold has not performed very well in the past 10 years and that is despite the world going through one of the biggest crises in history. As with cryptocurrencies however, Gold is liquid and tends to behave as you never expect and as such offers some portfolio diversification benefits.

Hedge Funds
One of the best-known alternatives, **hedge funds** differ from other funds in that you can do both buying and (short) selling at the same time, whereas a mutual fund can only buy and hold. The main goal of a hedge fund is to generate returns regardless of what the market does. Among hedge funds, you can find Alternative Investment Funds (AIFs), which tend to be listed offshore, and offer monthly, or quarterly liquidity. There are also so called UCITS investment funds ('undertakings for the collective investment in transferable securities'), which are more restrictively regulated and offer daily or weekly liquidity.

According to Blu, it is important to remember that "guns don't kill, people do" and there are clearly a few bad apples which have given the asset class such notoriety. However, for the most part, hedge funds are a lower risk investment than owning equities outright. There are many different types of strategies, all with different risks and potential rewards. Here we summarise the main categories:

- *Equity long/short strategies* are the most prominent since the investment universe of more than 45000 global stocks offer plenty of scope of matching one with the other. Managers choose stocks according to technical indicators or fundamental valuations and seek to extract excess returns from the relative price performance of the underlying holdings.
- *Relative value strategy* seeks to exploit short term mispricing between bonds, commodities, or other type of securities, including financial derivatives.
- *Trend following strategies* take a directional view on financial securities and asset classes according to momentum factors.
- *Event driven strategies* invest in securities based upon publicly announced undertakings that will have a material effect on the price of the underlying.
- *Macroeconomic strategies* seek to make money based upon the managers' analysis of the global economy, trends in fundamentals or geo-political occurrences.

What outcome can we expect?

As ever, the choice of using alternatives in our investment portfolio comes down to our strategic investment goals and circumstances. If the aim is to make a lot of money without worrying about the potential risk, then venture capital and cryptocurrencies are your game. However, if we are seeking for ways to diversify our risk away from stocks or bonds and have lower drawdowns and volatility in our returns, then we need to take a more measured approach to selecting alternative investments.

According to Blu, there is no point in making investments into the pretenders. It is cheaper to just buy equities and the risks are probably lower, given that the secondary liquidity tends to disappear in times of market duress. Unless our wealth exceeds £100m, there is also less reason to buy into art or classic cars and one should never underestimate the cost of upkeep and security.

The main reason, to buy alternatives is so that it gives us optionality. Remember, we cannot predict the future, but we can rebalance. That means that if we truly have invested into assets that behave differently, we can take advantage of market volatility. In other words, if equities and bonds are down, but alternatives are up, as they were in 2022, then we can sell one and buy the other thereby taking advantage of very attractive trade entry (and exit points).

The trick is to make sure we choose those alternatives that are truly different to stocks and bonds. We also need our investment to be liquid, as we cannot wait years to get our money back to take advantage of imminent market opportunities. That eliminates any investments into privates and offshore hedge funds, and leaves Gold, Cryptocurrencies and UCITS hedge funds to diversify our portfolio risk. Clearly, we need to make sure that we have picked the right strategies, and Blu recommends having several different funds in our portfolios to further minimise risk.

How much should we invest into alternatives as part of our investment strategy? That's another discussion and getting the right people with the appropriate experience to help you in this decision and manage your assets is critical.