Alternative Investment: A Comprehensive view

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Abstract:

A CNBC article noted "With the Stock market bland and the bond market bubbling, investors may have to search elsewhere in the months ahead for return".(Sara Nunnally,2010). For the investors, who have been tired of the stock markets wrench and their volatility and who have been looking out for innovative investment options, Alternative Investments come in a very handy way. In any time in the past decade, Investors have been just walking away from the stock market, making an attempt to venture in to alternative investments. The reason behind such a bold step; the results for long term investors from the stock market is not encouraging; the rewards are not enough for their patience or risk tolerance. It has been proved that, over the past 10 years S & P 500 has been over only by 10% or more, approximating 1% per year.

The aim of this paper is understand the investment avenues available for the investors apart from conventional avenues like bank deposits, government instruments etc., or investing in stock markets, which is again a traditional method of investing. In this article, only the secondary data has been used, collecting the information from various articles from journal, websites and other sources. The article makes an attempt to provide a comprehensive view of investment avenues, its performances in the past and its trend in the future. It is interesting to note that those which were considered as hobbies can produce returns to the investor and make it a worthwhile investments.

Key words: alternative investments, performance, returns, trend

Introduction:

The term, Alternative Investments, is a financial classification, hard to be defined, especially in the volatile market (Elliot Feldman). It is a broad term and can be defined as investment product, other than traditional products like shares, bonds or cash. Liang (2003) has seen the alternative investments as complex investment strategies, complex and illiquid nature and creates returns in excess of returns typically available with traditional investments. They differ from traditional investments in terms of low correlation with traditional asset classes, dynamic trading strategies, and use of a wide range of techniques and instruments. He proceeds to define the reasons for popularity of Alternative Investments thus: the special features, lack of regulatory oversight, and demands from both wealthy and institutional investors. Because of this, many institutional investors like investment banks, insurance companies and private endowments like university endowments are flocking to the alternative investment funds. This paper makes an attempt to provide a comprehensive view about the various alternative investments, which have been illustrated in various articles, researches, journals and websites. The most popular alternative investment is gold and silver. The various investments, perhaps gaining more popularity in recent times, includes hedge funds, managed funds, private equity, currency funds, limited partnerships, futures, options, and leaps. Interestingly, investing in real estate, coins, stamps & books, jewelry, fine art, wine, commodities, vehicles and antiques has gained momentum.

Objective:

1. To understand the conceptual framework of the various alternative investments through explanations from various books and through the literature reviews.
2. To understand the performance of these investments during the previous years and expectations for the forth coming year.

Methodology:

This article has been divided into two parts: Part A deals with various alternative investments and their features and Part B deals with the present scenario and the forecast about these investments in the forth coming year.

Secondary data has been used to understand the performance of these investments.

Part A: The Investments

A.1: Hedge Funds

Among the set of potential investment tools, the most popular investment vehicle among institutional investors and high net worth individuals is hedge funds. François-Serge Lhabitant, Michelle Learned, (2002) in their paper, have referred hedge funds as the most preferred in the investment industry; their success being fuelled by the long bull market and supported by the highly volatile and difficult environment prevailed since 2000. They have also quoted the strong reason for using them in wealth management is providing much needed diversification to portfolios. They advocate to the investors that, for the returns to be stable and decreasing the standard deviation, adding more funds to the portfolio is the good choice and follow "skilled naïve diversification" i.e., carefully choosing the hedge funds wisely across different stated investment styles, publicly available information. Harry M. Kat (2003) comes with a little caution while dealing with diversification. Although combining hedge funds into a basket will substantially reduce the standard deviation, it can also be expected that the skewness will be lowered and the correlation will be raised in the stock market.

A.2: Private Equity

Over the last two decades, the Private Equity industry around the world has experienced a dramatic growth. The working of Private Equity, as explained by Metrick and Yasuda, (2009) is thus:

Generally, the private equity firms serve as the General Partner (GP) and the institutional investors and the wealthy individuals provide the bulk of the capital as Limited Partners (LP). The two main characteristics of Private equity in comparison with public equity is that; 1. No liquid secondary markets and 2. very restrictive disclosure policies of market players. The partnership is expected to last for 10 years and the partnership agreements signed at the fund's inception clearly define the expected payments to GPs. Typically a PE consists of two types of investment: namely Venture capital and Buyouts. The success of PE firms determines their stay in the business and is able to raise funds every 3 to 5 years. If the current fund performs well, it has been viewed as "skill" rather than "luck" by LPs, their earnings is just the cost of capital after payments to the GP.

Metrick and Yasuda (2009) further stated that fund managers of Venture capital earn more than Buyout managers. It can be implied that the investors' earnings are not in par with the earnings of fund managers.

A.3: Venture Capital

Financing for small businesses have grown in the last few decades. Manigart, S., Baeyens, K. and Van Hyfte, W. (2002) "Venture capital is thought to be an important alternative for companies that have difficulties accessing more traditional financing sources". Kleberg (1998) has affirmed that venture capital is a strong financial injection for early-stage companies that do not have evidence for persistent profitability yet. In the words of Petreski (2006), while feeding the small, innovative and fast growing firms, the venture capitalist (investor) becomes the active mentor for the entrepreneur, as the firm's destiny turns out to be his concern too. Consequently, the role of venture capitalist becomes multi fold. The venture capitalist not only provides the fresh capital, but also provides the expertise, help and basically the reputation for attracting further finance.

A.4: Managed Futures

Cerraholu and Pancholi (2003) have defined thus: "The term managed futures represents an industry comprised of professional money managers known as commodity trading advisors (CTAs) who manage client assets on a discretionary basis, using global futures and options markets as an investment medium". Schneeweis and Pescatore, (2001) have asserted that investors appreciation of the investment benefits in managed futures are well founded in financial theory and empirical evidence. The real benefit to managed futures is that they provide sources of returns that are uniquely different from traditional stock or bonds or even hedge funds. Cerraholu and Pancholi (2003) have compared CTA in par with hedge funds and FOF, yet they conclude that CTA differ from other two classes in several ways. The correlation between CTA and other two classes and also with that of equity market index is necessarily negative or zero. Due to the negative correlation, CTAs provide significant diversification benefits to other investment classes: adding CTAs to investors' hedge fund portfolio or fund-of-fund portfolio can significantly improve their risk-return trade-off.

A.5: Real Estate

The backing of brick and mortar has made investment in real estate more attractive than stocks and bonds. The main purpose of investing in real estate is stream of future income; ie., the rental income accruing over the long term. The diversification potential makes it more attractive as investment. The real estate has low and in some cases, negative volatility with major asset classes. Thus, adding real estate investment to the portfolio of diversified assets lowers portfolio volatility and provides a higher rate of return (Source: www.investopedia.com). Georgi (2002) has also confirmed that diversification benefits are provided by real estate investment when compared to stocks and bonds. The real estate returns are determined by factors different from those of other assets and hence provide diversification benefits.

A.6: Gold

Perhaps the last two to three years would have seen the largest alternative assets namely Fine wine and gold. Though Gold has been favoured by all since early days, the last decade saw a tremendous growth in the price of gold. As per the World Gold Council, portfolio performance certainly increases, if gold is allocated a portion in the portfolio, and also reduces the potential loss in the portfolio, by decreasing VaR (Value at Risk). The Council proceeds to authenticate that, when there is a ready, deep and liquid market, gold is essentially viewed as an alternative investment with no default risk.(www.gold.org). The preference for gold comes from the fact, that it exhibits lower volatility, less exposed to swings in business cycles

and more robust at times of financial distress. Gold's religious and cultural significance around the world make it a sought after good for reasons beyond direct financial worth. The research team of Gold Council further proceeds to assert that jewelry, in the form of gold, is sought after during the economic growth, whereas recessions promote buying gold as a store of value.

A.7: Wine

While many people consider buying wine and aging it for future consumption, few have historically viewed wine strictly as a financial investment. The characteristics possessed by wine allow it to be considered and analyze as a financial investment. An unique feature about Wine; generally there is no dividend payment for wine, investors pay for its storage and the amount is got back on maturation of wine, which may take 20 to 40 years. The time required to liquidate the wine is 5 to 6 months. Lee W Sanning, Shaffer Sherrill,and Jo Marie Sharratt (2007) have concluded that investment grade wine provide, on average, positive returns in excess of those forecasted by well accepted models that have been shown to explain much of the variation in average stock returns. Lee W Sanning et al., have also found out that investment grade wine assets benefit from low exposure to market risk factors and, as a result, provide a valuable source of diversification for investors seeking hedge investments.

A.8: Art

Art, an aesthetic good, is unique. Two art objects cannot be same or perfect substitutes, even if produced by the same artist. The market for art is heterogeneous. Secondary market does not exist for art; as there is no resale of same art objects is not frequent (Aylin Seçkin and Erdal Atukeren). The returns of art object are twofold; both psychic and financial. Empirically it appears that the average rate of return on objects of art (paintings, sculpture, prints, antique furniture, etc) is rather modest. Baumol (1986) characterized art market as random and unpredictable. He estimated that the returns of paintings averaged less than 2% of the capital markets. Frey and Pommerehne (1989) also concluded that investing in art is a net loss to the investors. The reason for attractiveness in investing in Art is the 'psychic returns', the enjoyment of owning the work of art and viewing and looking at it. In the words of Roman Kraeussl and Jonathan Lee, art does not seem to be an interesting alternative asset to hedge returns of the global equity index. Based on the above, Arie L. Melnik and Steven E. Plaut examined that art as an financial investment may play an important investment or hedging role for certain kind of investors holding constrained portfolios. They conclude that art adds little for diversification effect but certainly, has a space in constrained portfolio optimization.

A.9: Collectibles

Collectibles, as the name suggests, refers to anything that is collected, and has an aesthetic sense. A collective noun, which generally includes art and paintings, stamps, coins, ceramics, photography, furniture, books, wines, etc. In this section, a brief account about stamps collection is illustrated. Previously, stamp collection was just seen a hobby and the philatelic literature has suggested that "deliberately making money from one's hobby was a perversion of the proper reason to collect" (Gelber, 1992). Elroy Dimson and Christophe Spaenjers have researched on British stamps and concluded that stamps have outperformed bonds but less than equities. In times of inflation, it could not be held that stamps can be a good hedge.

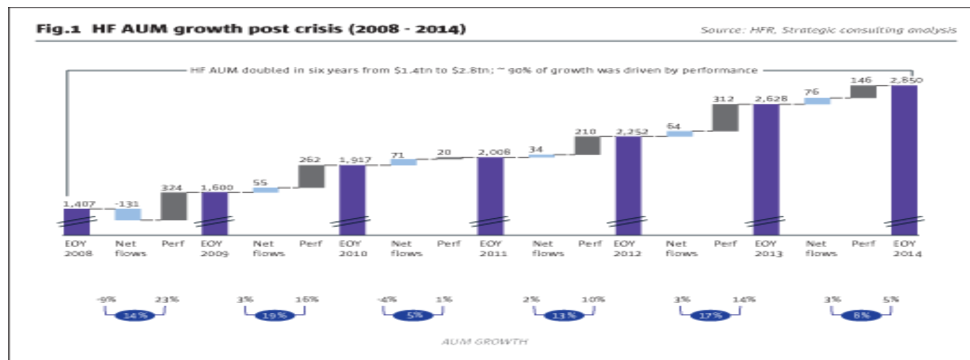
B. The practical (Indian & global) scenario

Hedge funds:

From the extracts of a report from Barclays Capital Solutions Group published on 5th March 2015: According to HFR, hedge fund AUM has more than doubled during this period, from $1.4 trillion at the end of 2008 to $2.85 trillion at the end of 2014. The analysis shows that despite concerns about asset gathering, ~90% of this growth ($1.2 trillion) was attributable to performance, and only ~10% (~$170 billion) was attributable to net flows into the industry.

The returns over this time frame were supported by two broad market rallies: the credit rally in 2009 and 2010, and the equity rally in 2012 and 2013, during which the industry garnered ~$590 billion and ~$520 billion in performance gains, respectively. In contrast, net flows have been growing at 3-4% per year, a relatively sedate pace of growth, which seems to go against the grain of the thesis of 'asset gathering' at the industry level.

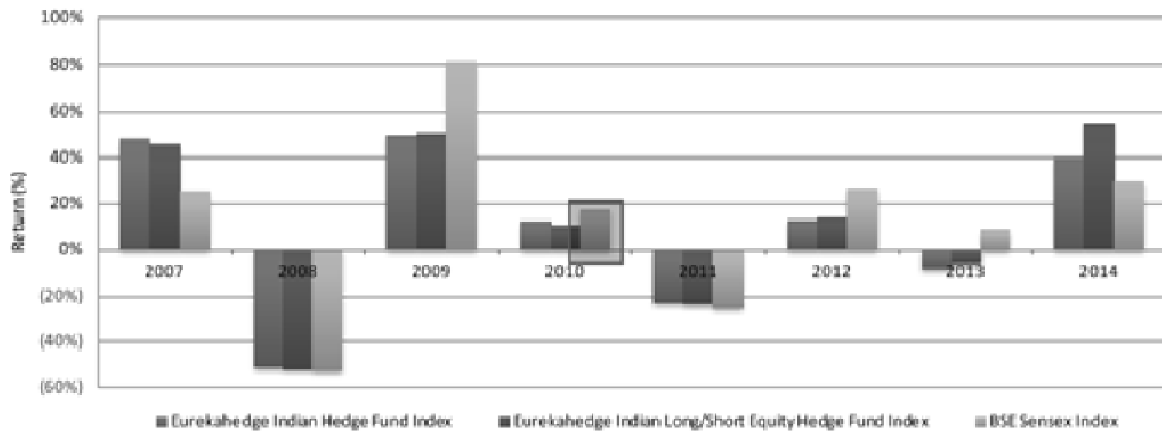
Figure below also shows that 2014 saw more flows than any other year since 2008 ($76.4 billion in total). This appears to support one of the key hypotheses: 2014 has potentially been a 'bet on hedge funds' year for many hedge fund investors, and the industry's performance in 2014 is likely to strongly influence how investors perceive the value added by hedge fund managers to their portfolios.



Source: http://www.thehedgefundjournal.com/node/10031#sthash.zf8kbFsG.dpuf

Indian hedge funds were the top performers with gains of 6.8% while Eastern Europe and Russia mandated funds delivered the worst results down 2.46% in the month of January 2015. India focused hedge funds have posted spectacular returns in 2014 against the backdrop of rising domestic equity markets, and a renewed sense of confidence in the Indian economy which is being led by Narendra Modi. The Indian hedge fund industry delivered 38.95% return in 2014, but in the last quarter of the year, that growth rate was just 5.93%. Indian hedge funds assets under management (AUM) are currently at a seven-year high of $3.45 billion, though roughly 36% below their 2007 peak of $5.36 billion. The average Indian hedge fund was down 50.66% during the 2008 financial crises. Since 2009, Indian managers have posted a six-year annualised return of 10.89% and barring 2011, their AUM continues to trend upwards albeit at slower pace compared to the broader Asian hedge fund space.

Figure 1: Historical performance of Indian hedge funds



Source: Eurekahedge

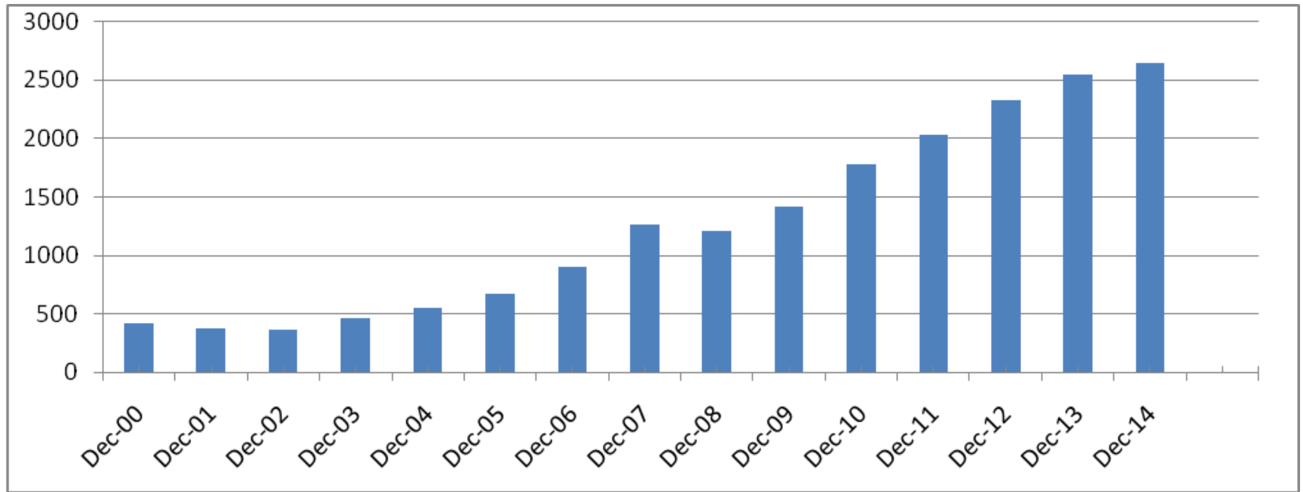
In terms of asset growth, Indian hedge fund assets under management (AUM) are currently at a seven year high of US$3.45 billion, though roughly 36% below their 2007 peak of US$5.36 billion. The average Indian hedge fund was down 50.66% during the 2008 financial crisis, witnessing steep performance based losses and investor redemptions from which the Indian hedge fund industry is yet to recover.

Since 2009, Indian managers have posted an eight year annualised return of 10.89%, and barring 2011, their AUM continues to trend upwards albeit at slower pace compared to the broader Asian hedge fund space. Managers have raked in roughly US$700 million in performance based gains in 2014 while seeing net inflows of US$215 million during the year. While investor flows have not kept pace with manager performance in 2014, going forward one should expect an uptick in investor allocation towards India as the country remains a much better value proposition for investors compared to some of its emerging market peers and a clear beneficiary of the lower oil prices. Structural weaknesses within the economy and the risk of capital flight following a rise in US rates could potentially upset the prospects of the Indian markets in 2015.

Private Equity

The private equity industry has seen a healthy recovery since the market turmoil of 2008 and 2009, becoming an integral part of institutional investors' portfolios. By choosing the best performing fund managers, investors can generate premium, long-term returns in order to boost the performance of their overall portfolio; therefore for fund managers, being able to stand out in the crowd and demonstrate a strong and consistent performance track record is imperative when raising capital for new vehicles.

Notably, in the past few years, the private equity asset class has been steadily growing in size. Figure below, highlights the growth in terms of capital invested in the industry year-on-year. The data shows that during 2013, the total value of unrealized investments grew by 9.2% and by a further 3.9% during the first half of 2014, as favourable market conditions during this time saw rising valuations for portfolio companies lead to further increases in the value of assets owned by the industry, despite the continuing high rate of realizations. Favourable conditions and continued investment in the industry has produced sustained growth in the asset class, despite record distributions during 2013. Recent market conditions combined with high levels of distributions over the last 18 months are driving short-term performance within the asset class.



Source: The 2015 Preqin Global Private Equity & Venture Capital Report

A Report on PE in India by The Times of India on Dec 2014: Private equity (PE) investments in India touched $10 billion even as a record number of profitable exits this calendar revved up the momentum for global private capital, which hardly had reaped significant returns after a decade of heavy investing.

PE investor's scripted 95 exits during the first 11 months, unlocking $3.6 billion in investor returns, said a JM Financial note on the sector. This was slightly behind $4.4 billion harvested in 2012, but set a new high in the number of exits. Two years ago, the number of exit deals stood at 65.

New investments during the calendar almost touched $10 billion—first time in four years and second time since the Lehman collapse and the ensuing global financial crisis.
But clearly the exit story is warming the hearts of long-term risk investors who have ploughed over $80 billion into the country since 2004. India has had a poor run in returning investor money with rupee's decline against the dollar shaving off the incremental mark-ups.

"A record number of PE exits this year shows that the market is agile and active with lots of block deals as well as secondary transactions between PE investors," said Bhavesh Shah, MD, JM Financial. "The economic recovery would enable improvement in the operational metrics and valuations of the investee companies which would motivate the funds to exit through capital markets or other strategic routes."

Managed futures:

The S&P 500 indices are designed to reflect all sectors of the U.S. equity markets. The S&P 500 includes 500 blue chip, large cap stocks, which together represent about 75% of the total U.S. equities market. Companies eligible for addition to the S&P 500 have market capitalization of at least US$3.5 billion.

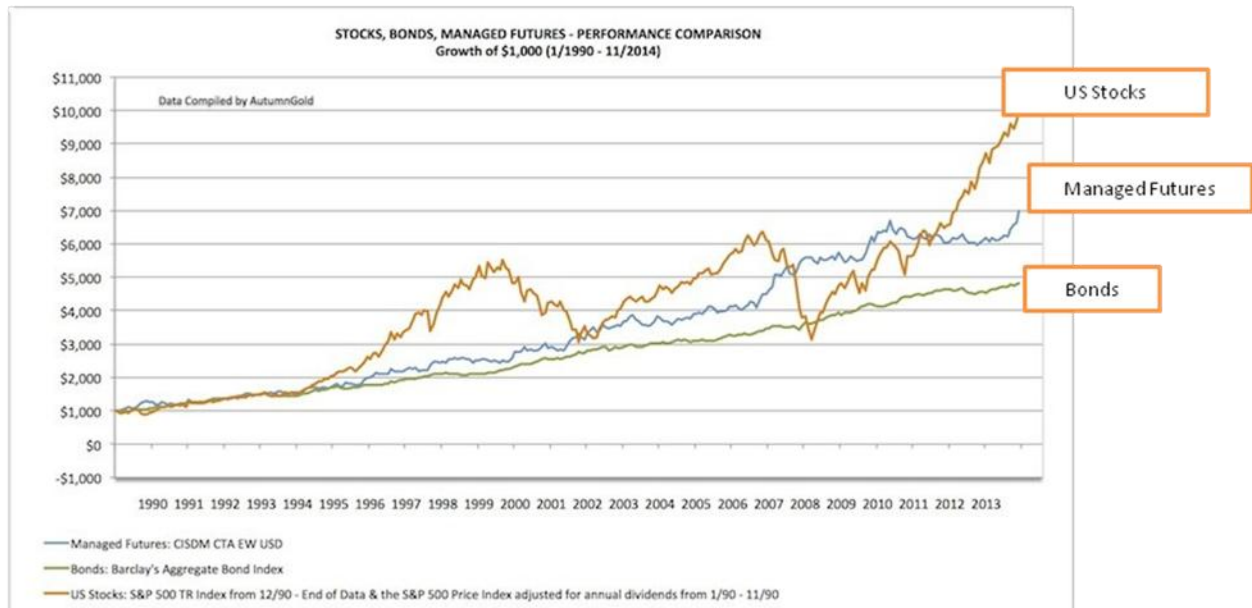
Bonds are represented by the Barclay's US Aggregate Bond Index (formerly known as the Lehman US Aggregate Bond Index). The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS

Managed Futures: The CISDM Equal Weighted CTA Index is an equal weighted index of CTAs maintained by The Center for International Securities and Derivatives Markets at the University of Massachusetts Amherst. It reflects the average performance of Commodity Trading Advisors reporting to the CISDM Hedge Fund/CTA Database. Each CTA must have at least $500,000 under management and at least a 12-month track record. The indicator started in January 1980.

From the figure, it is evident that the Managed Futures managed to give stable returns when compared to the volatility of the stocks and the low returns of bonds.

Figure 1.

Performance Comparisons - Managed Futures vs. Stocks vs. Bonds



Source: www.managedcap.com

India focused funds started the year 2015 with great returns at 5.62% in January, still experiencing excellent results which led to their overall outstanding performance in 2014.

Real Estate

Michael Keogh observes thus:

2014 has been the strongest year of performance for commercial real estate and investment activity since 2006. In spite of low-growth, low inflationary global economy, the real estate has shown sharp improvements and shown stellar returns. The reason for such speedy recovery has surprised many and also the low bond yields, selective economic recoveries; improved lending terms have all combined to propel the industry.

. With the fears in the equity and bond markets, whether it's government debts, or inconsistent growth, real estate has become as the attractive asset class for 2015. The prospect of divergent Central Bank policy stances will be a key determinant in capital flows, transactional volumes and pricing in the coming year.

Real estate has become the sought after asset in a multi-asset investor's portfolio for three fundamental and rather traditional reasons: the high income component of return, the relative risk-adjusted return, and diversification benefits.

Based on the study of India Brand Equity Foundation, the following report has been presented for the Indian Realty Sector. The Indian real estate sector is one of the most globally recognised sectors. In the country, it is the second largest employer after agriculture and is slated to grow at 30 per cent over the next decade. It comprises four sub sectors - housing, retail, hospitality, and commercial. The growth of this sector is well complemented by the growth of the corporate environment and the demand for office space as well as urban and semi-urban accommodations.

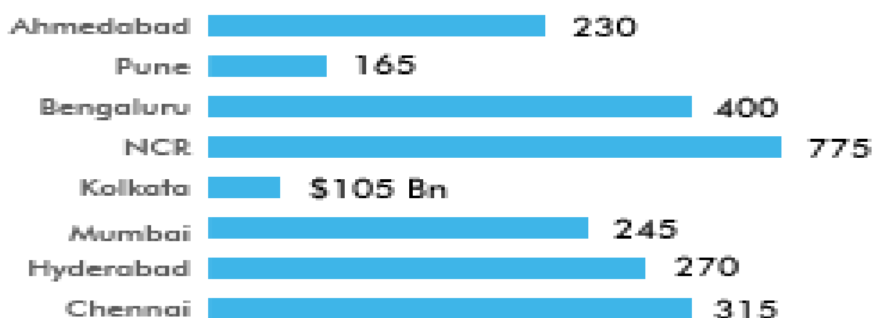
It is expected that the real estate market size will touch US$ 180 billion by 2020. The housing sector alone contributes 5-6 per cent to the country's gross domestic product (GDP). Also, in the period FY08-20, the market size of this sector is expected to increase at a compound annual growth rate (CAGR) of 11.2 per cent. Retail, hospitality and commercial real estate are also growing significantly, providing the much-needed infrastructure for India's growing needs.

Real estate has emerged as the second most active sector, raising US$ 1.2 billion from private equity (PE) investors in the last 10 months.

According to a study by Knight Frank, Mumbai is the best city in India for commercial real estate investment, with returns of 12-19 per cent likely in the next five years, followed by Bengaluru and Delhi-National Capital Region (NCR). Also, Delhi-NCR was the biggest office market in India with 110 million sq ft, out of which 88 million sq ft were occupied. Sectors such as IT and ITeS, retail, consulting and e-commerce have registered high demand for office space in recent times..

Demand analysis of top 8 cities ('000 units)

Demand to grow at a CAGR of 2 per cent over the period 2013-17 across top 8 cities in India.



Source: www.ibef.com

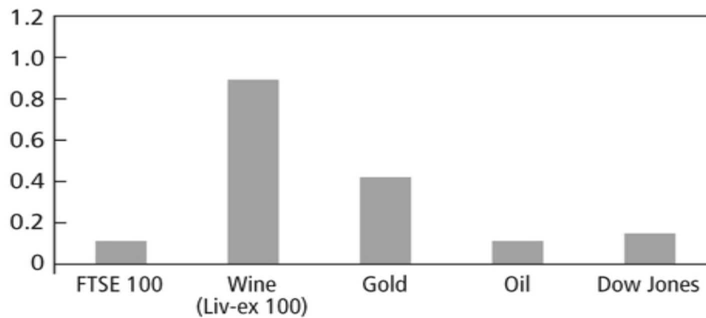
Gold:

The future is unknowable and uncertain; Gold has been the preferred money for the past 5000 years. It has been tested time and again over the millennia; the proven record continues to make it the most preferred investment. The rising price of gold is certainly a warning signal for the all the monetary problems facing the global economy. And in 2012, it is expected that the gold prices will continue to increase, provided the same reasons for the yester years' economy are likely to continue. A snapshot of the gold prices, starting Jan 1995 to Mar 2015:

Source: GoldMoney

Wine

Fine wine, as an alternative investment, has always been preferred for its low risk. A simple comparison of wine with other investments using Sharpe ratio is shown below:



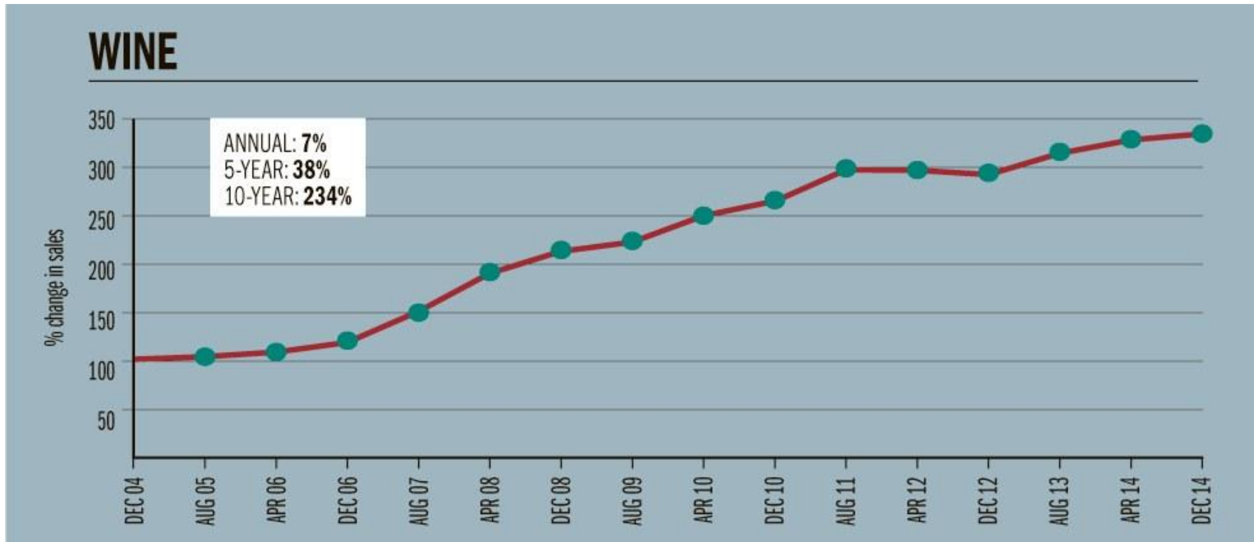
Source: Cult Wines Ltd

Elizabeth Pfeuti discovers,(in a report in Racounter), Low interest rates hitting cash savers and European equity markets failing to boost portfolios – the FTSE 100 made a loss of 2.71 per cent in 2014 – have made owning tangible assets increasingly popular. However, if you thought stock and bond-picking was tricky, in the world of art, cars and wine, it pays to be even more discerning.

World Record: Sotheby's broke the world auction record for the most expensive wine lot last year and it wasn't for selling a Bordeaux. It sold the Romanée-Conti Superlot from Burgundy for just over £1 million, equivalent to £1,000 a glass.

"There has been huge price uplift for wine from other regions," says Tom Mann, director at LHK Fine Wines, an independent merchant. He points to this change in market sentiment as a good reason to use reputable, established dealers.

Investing in fine wine in India is yet to take its roots, though it promises high returns and this investment is only for high net worth individuals. While wine advisory companies evaluate the global market for fine wine to grow at approximately $3 billion annually, it will be some time before India can be part of this global study. (Kymberlee Fernandes)



Art

Massimiliano Subba, in his article, in PrivateArtInvestor, observes that: The art market will remain solid in 2015, with no signs of a bubble forming, let alone bursting, according to Massimiliano Subba, managing director of Anthea Art Investments and creator of the Anthea Contemporary Art Investment Fund. He says the vitality of the market is also due to the influx of wealthy investors from Asia and confirmed recognition on a worldwide basis of art investments as valuable assets. There is very strong interest in art funds at the moment. Art allows very efficient investment diversification– if you look at what has happened with the Russian market recently, a combination between political tensions and the free fall of oil price has triggered massive wealth destruction.

Collectibles (STAMPS):

Collectibles, the stamps, have actually shown an average annual return of 11% over the last decade, though researchers have given a different view about returns. GB30 Rarities Index, an index that charts the increments of the top 30 GB stamps available on the open market over the last 40 years and which is quoted on Bloomberg Professional. The snapshot of GB 30 rarities Index; in the recent crash

of 2008, when the value of traditional asset classes plummeted, GB Index rose by 38.6%.

With a compound average annual increase of 11.1% versus 9.4% for property investment, it's fair to say that rare stamps are safer than houses. There was coverage by BBC, where it reported about the sale of a rare British stamp for an amount of £ 40,000, when the whole world was gripped with global economic crisis.

Conclusion:

Low correlation is an important positive attribute when considering assets for inclusion in a portfolio. The advantage gained by owning alternative assets (that are relatively uncorrelated with both stocks and bonds) is the reduction in exposure to systematic market risk factors.

As the capital market segment is being hit worse in the year 2011, the capital market players have no option but to attempt Private equity only. Private equity firms have to ensure that they would have deeper understanding with their portfolio companies to beat the downturn and create saleable businesses. Investing in Gold has to be done cautiously, as any investment trending faster will have strong pull backs. As a standalone alternative to traditional asset classes, investment-grade art displays quite a low correlation with other traditional asset classes, such as shares and bonds. This makes fine art a suitable candidate for diversifying an investment portfolio, and as a tangible 'real' asset, art acts also as a hedge against inflation in much the same way as other 'real' assets such as farmland and gold. Stamp values are backed by historical data, with stamp prices charted annually back to 1880s, so increases are transparent and can be tracked.

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