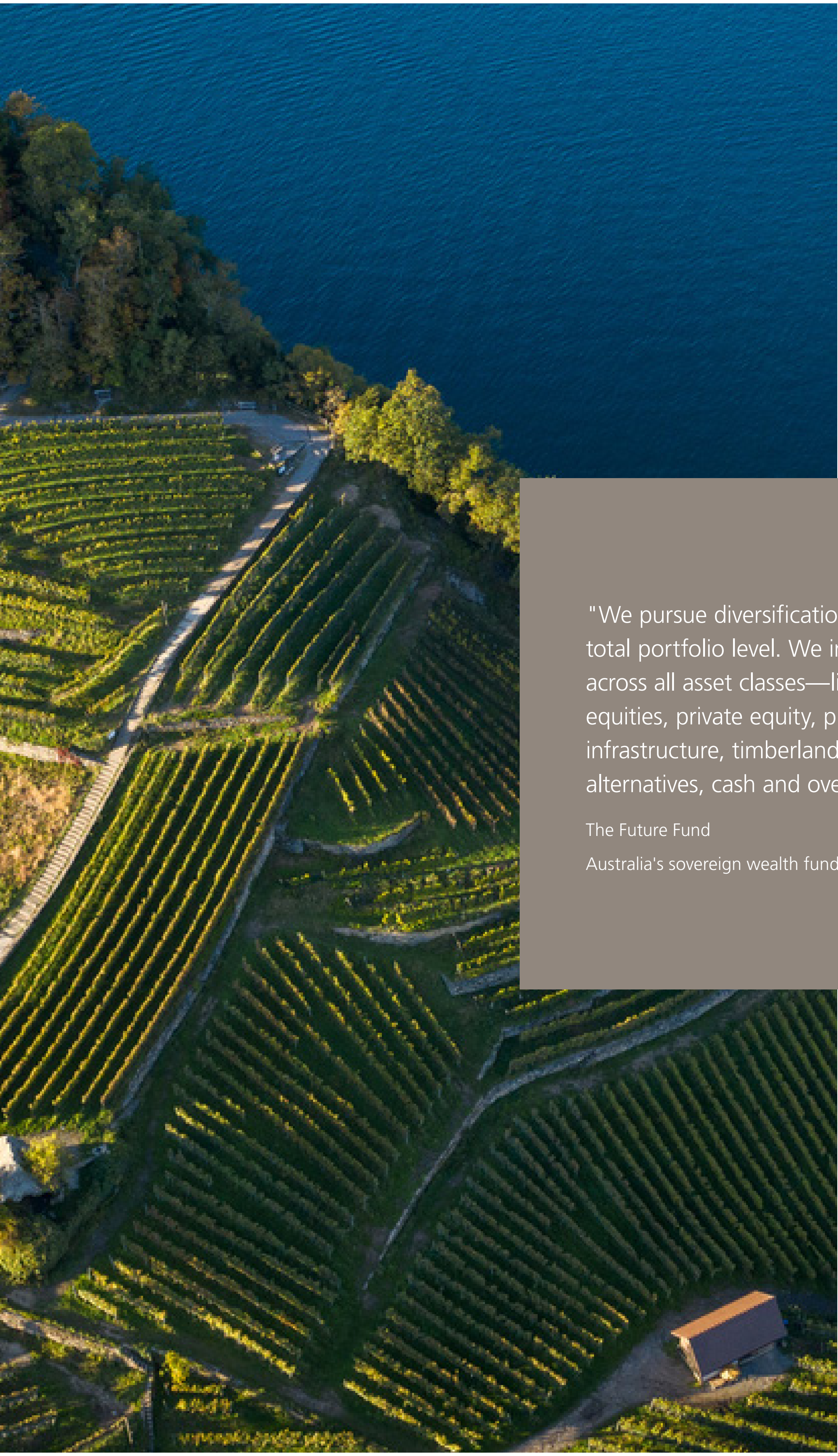
Broadening the opportunity set

An introduction to alternative investments



"We pursue diversification at a total portfolio level. We invest across all asset classes—listed equities, private equity, property, infrastructure, timberland, debt, alternatives, cash and overlays."

The Future Fund

Australia's sovereign wealth fund

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What are alternative investments?

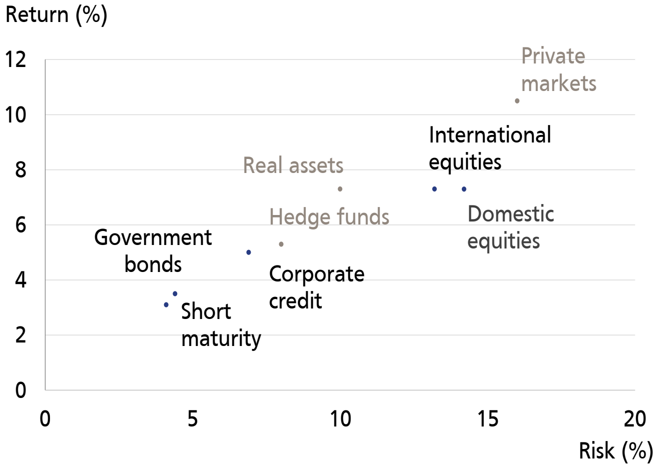
Alternatives are best thought of as a diverse range of assets that exists outside traditional investments like publicly-traded equities, fixed income securities and cash. Given the differing return characteristics and drivers of risk among alternatives, they can add a variety of features to a portfolio. In particular, they can increase the return potential of a portfolio and also enhance diversification. This is because their return profiles are typically uncorrelated, or have a lower correlation, to broader market swings. They can also be used to facilitate specific outcomes or themes—such as liability matching, cash flow stability or inflation protection.

The main sub-sectors of alternative investments are hedge funds, real assets, private equity, private debt, and structured products. At LGT Crestone, we currently split alternatives into three key categories—hedge funds, private equity and real assets (which focuses mostly on unlisted real estate equity and debt, but includes other assets such as infrastructure).

How do they compare to other asset classes?

The following chart shows long-term capital market assumptions for cash, fixed income, equities and alternatives (hedge funds, private equity and real estate). While alternatives are considered higher risk than fixed income and cash, they have, historically, generated stronger investment returns over the long term. Compared to equities, alternatives have generated less return, but also exhibit less risk.

How alternatives compare to other asset classes



How do they fit into my diversified portfolio?

Alternatives can have either growth or defensive characteristics, which means they can feature in either the growth part or defensive part of a diversified portfolio. An alternative investment's classification as growth or defensive will depend on its specific risk-return characteristics. As an example, some absolute return strategies can be growth, while others can be defensive.

Growth alternatives tend to have high-return targets of CPI plus 5% per annum or more, and have risk profiles that are broadly similar to equities. While these assets may exhibit volatility similar to equities, they generally have a low correlation to equities.

Defensive alternatives tend to have more moderate return targets of around CPI plus 3% per annum or lower, with a steady and predictable income yield and have a volatility profile similar to fixed income. These strategies also tend to have a low correlation to traditional asset classes.

Source: LGT Crestone.

Why invest in alternative investments?

In this section we discuss some of the benefits of investing in alternatives, such as higher return opportunities and enhanced portfolio diversification. While alternatives can provide investors with a number of benefits, there are also some specific risks that should be considered before investing. We discuss these in greater detail later on in this document but, in summary, these include not only some of the same risks faced by public markets (such as economic factors, as well as changes in interest rates and inflation), but also idiosyncratic risks. These include company-level risks, higher manager return dispersion and risks around entry and exit of underlying assets. In addition to this, investors in alternatives also typically need to deal with issues surrounding greater complexity and illiquidity.

Higher return opportunities

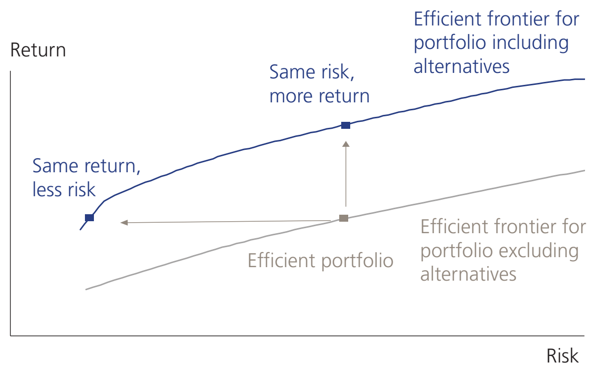
Alternatives can increase the return potential of a portfolio through access to a broader set of investment strategies. Over the past decade, many institutional investors and family offices have been increasing their exposure to alternatives by shifting from peripheral or satellite exposures to more core positions. This significantly reflects the current lower-return environment globally in traditional asset classes, and the ability for alternative investments to enhance risk-adjusted returns.

Enhanced portfolio diversification

With a low correlation to traditional asset classes, an investment in alternatives can be a beneficial way to enhance diversification within your portfolio. The following chart shows the efficient frontier for a portfolio that does not invest in alternatives, as well as the efficient frontier for a portfolio that does. The aim of the efficient frontier is to demonstrate which combinations of asset classes will generate the maximum return for a given level of risk. The chart shows that, by investing in alternatives, diversification can be increased, which can lead to a more desirable risk-return profile for a balanced portfolio.

In a simple way, alternative investments are largely skills-based strategies that are expected to diversify away from traditional market 'betas' and generate most or all their return from 'alpha'. Beta is the return generated by passively investing in a traditional asset class, whereas alpha is the return generated in excess of beta or traditional market exposure.

Investing in alternatives can improve the risk-return profile



Source: LGT Crestone. For illustrative purposes only.

Hedge funds—A focus on absolute return

What are hedge funds?

Hedge funds are a diverse set of actively-managed strategies predominantly invested across a wide range of traditional assets, such as listed equity and fixed income. Hedge fund managers typically aim to limit market exposure (beta) and target secondary or idiosyncratic sources of risk (alpha). Generally, they are not tied to a market benchmark, which means the manager can follow a broader set of investment approaches and opportunities.

The main types of hedge funds are macro and managed futures, event-driven, relative value, equity and fund of hedge funds. Some of the common sub-sectors within these strategies are global macro, merger arbitrage, distressed, equity long-short and market neutral. Investors can also invest in strategies that are specific to certain regions.

Performance, risk and correlation can vary significantly across and within the different strategies. However, hedge funds do possess some common attributes, such as a focus on absolute return, significant investment and asset flexibility, and the ability to run single or multiple strategies. Most hedge fund managers charge management and incentive-based fees.

Some common hedge fund strategies

Event driven—These are strategies that capitalise on major corporate events, such as takeovers, bankruptcies or special cash distributions (i.e. share buy-backs of special dividends). The direction of the overall market should have minimal impact on the performance of these strategies.

Relative value—These strategies seek to exploit valuation discrepancies between the price of the same or similar securities. They usually involve buying one security and selling another (pairs trading).

Long-short equity funds—These strategies maintain long and short positions in individual equities. They can be broadly diversified or narrowly focused on specific sectors and can range in terms of levels of net exposure, leverage employed, holding periods, and concentrations.

Global macro—These strategies seek return from a broad range of asset classes, including equities, fixed income, currencies, and commodity markets, focusing on directional and relative value trades.

Managed futures—These strategies are dominated by options, forwards and futures, and typically focus more on commodities, currencies, equity indices and fixed income. These strategies typically involve an element of momentum or trend-following, and often employ quantitative signals.

What are the key benefits of investing in hedge funds?

Hedge funds are designed to protect investment portfolios from market uncertainty. They are not necessarily dependent on market direction and can generate positive returns in both up and down markets. Relative to traditional investments, the key differentiators of hedge funds are their ability to access a broader set of opportunities, leverage off less efficient markets, and to act as diversifiers.

Where do hedge funds source their return?

Hedge funds are highly dependent on manager skill to generate their returns. Managers focus on delivering non-traditional beta and alpha, often utilising liquidity risk, tail-risk events, or trading high-yield assets against their low-yielding peers (such as foreign exchange trading).

Hedge funds typically retain a long bias to traditional risk premia, particularly long-short strategies. The Hedge Fund Research Fund of Funds Composite index currently has a beta of 0.25 to equity markets. This indicates much lower volatility compared to equity markets, although it likely varies widely across specific strategies.

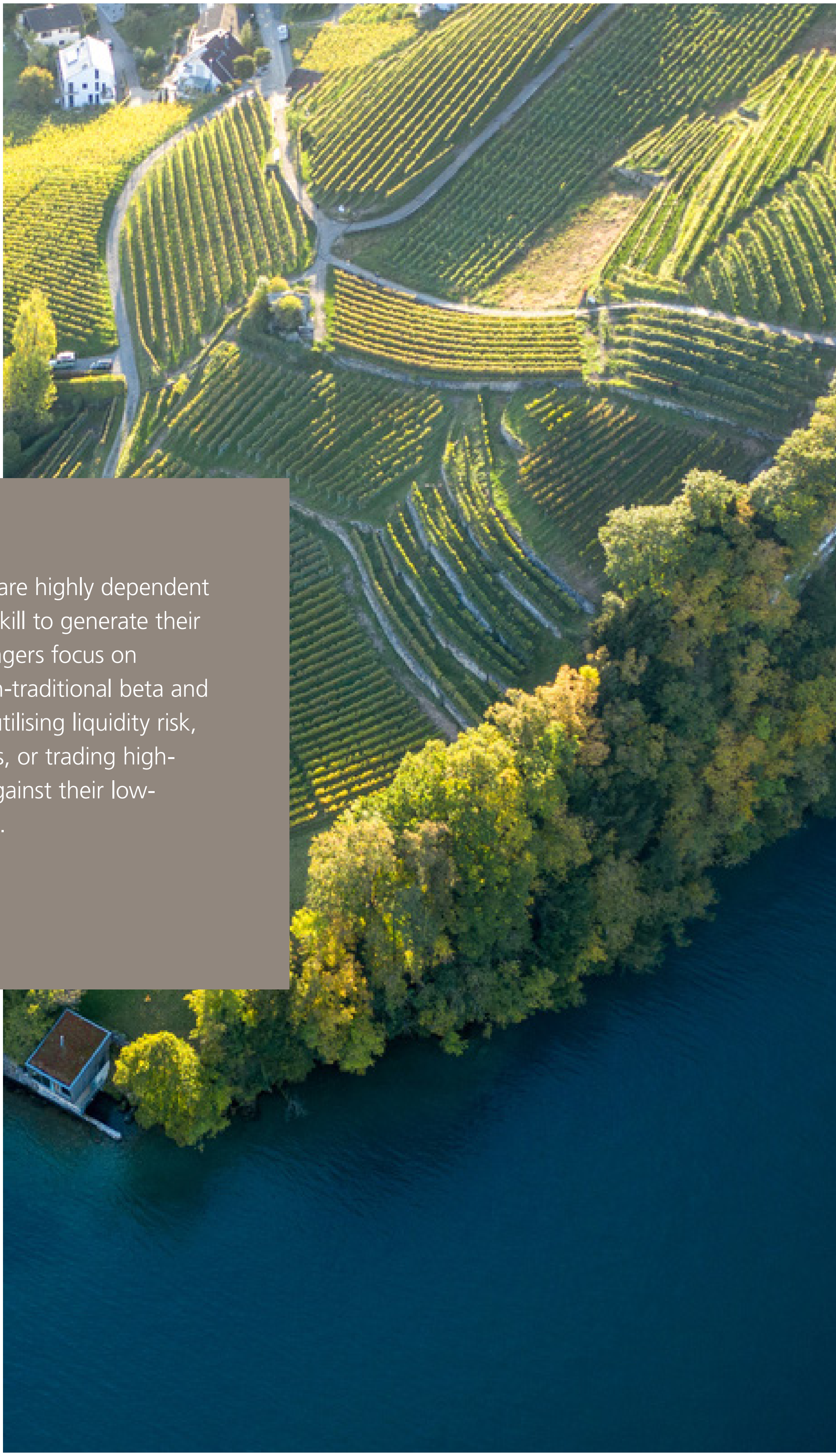
How liquid are they?

Most hedge funds invest in relatively liquid assets and offer monthly or quarterly redemptions. However, lock-up periods can range from one day to several years. It's also important to note that liquidity can be subject to redemption suspensions or the enacting of 'gates' during periods of crisis or high withdrawals. A gate provision is a hedge fund manager's right to limit the amount of withdrawals on any withdrawal date to not more than a stated percentage of a fund's net assets.

What are the key risks?

As hedge funds are complex investments, they carry more operational risk than traditional asset classes. According to BlackRock, a diversified portfolio of hedge funds has an estimated standard deviation (or volatility) of 8%. This can lead to varied performance between managers, which heightens the importance of appointing a diversified portfolio of hedge fund managers.

Like other alternative investments, hedge fund managers have a relatively wide dispersion of performance relative to traditional asset classes. This highlights the importance of manager selection and of using fund-of-fund structures.



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Private equity—Harvesting the illiquidity premia

What is private equity?

Private equity typically refers to investing in the equity of businesses that are not traded or listed on a public exchange. These investments generally involve allocating capital to investment partnerships or private equity firms which, according to BlackRock, "source capital and financing to create change in a business".

Private equity firms often take private a company that was previously publicly-listed or purchase a family-owned business or company that is already private. As noted by alternative investment management firm Hamilton Lane, the ability to create value in private equity often involves "restructuring, refocusing and revitalizing inefficient operating companies".

Private equity is a close substitute for public equity, but it typically utilises significantly more leverage and is more illiquid than public equity. This, in turn, can lead to a greater level of risk and greater return, which is often referred to as an illiquidity premium.

As with public equity, private equity is exposed to economic cycles and the dynamics of specific industries. Valuations of listed markets can also impact the price at which private equity can enter and exit transactions.

Areas of focus over coming years are likely to be firms leveraged to technological disruption, healthcare, and e-commerce—and in infrastructure, growth areas such as renewable power.

Some common private equity strategies

Primaries—These strategies make up the core of most private equity strategies. They include 'buy-outs' where companies are acquired to create an uplift in value, often using significant leverage. Primaries also include venture strategies, where start-up or early-stage companies are acquired to access their significant operating leverage. This more speculative equity is usually acquired at attractive prices and rarely with debt. Core primary strategies include credit strategies that facilitate a change in control, as well as more vanilla investments in real assets, including real estate, infrastructure and natural resources.

Secondaries—These strategies involve a manager investing in existing portfolios of primary investments, which are often offered at a discount due to either a shorter remaining fund life or poorer quality of assets. Managers often allocate part of their capital to secondaries as they can be an effective diversification tool. They can also be used to reduce some of the risk associated with manager selection uncertainty, which is also known as blind pool risk. Secondary investments with shorter maturity profiles can be an important source of liquidity for a manager.

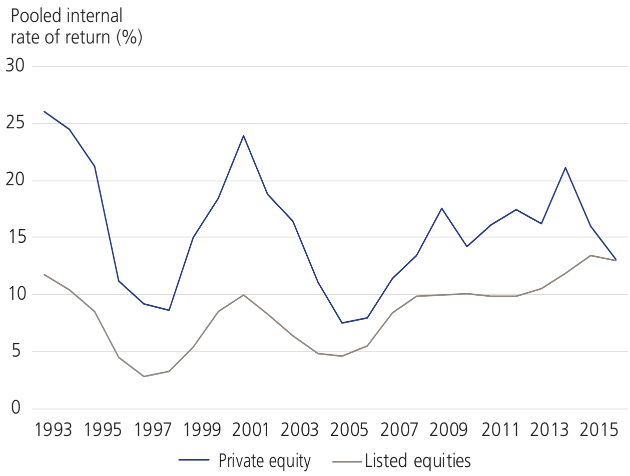
Co-investments—These strategies involve investing alongside another core manager who has a specific area of expertise, and often involve taking direct minority ownership of the investment. As these strategies often have lower fees, they can be used to target a specific industry in a cost-effective manner.

What are the key benefits of investing in private equity?

The much higher number of private companies versus publicly-listed companies brings about a greater opportunity set and is widely seen as an advantage of investing in the asset class. This is particularly relevant as the number of publicly-listed companies has generally been in decline for the past two decades.

In addition to providing greater diversity, private equity investments have consistently outperformed listed equities over time and with lower volatility, as shown in the chart below. This can be because valuations tend to be less impacted by sentiment-driven swings in public markets. It can also reflect a greater degree of operational control that a private equity manager can enforce relative to a holder of listed equity.

Private equity investments have consistently outperformed listed equities



Source: Cambridge Associates LLC, Frank Russell Company, MSCI Inc., and Thomson Reuters Datastream. Data as at 30 September 2018. Private equity is the Cambridge Associated Benchmark index. Listed equities are the MSCI All Country World index (gross) modified public market equivalent internal rate of return. Based on data compiled from 1,990 buyout and growth equity funds, including fully liquidated partnerships, formed between 1993 and 2016. Internal rates of returns are net of fees, expenses and carried interest. Cambridge Associates research shows that most funds take at least six years to settle into their final quartile ranking, and previous to this settling they typically rank in two to three other quartiles. Therefore, fund or benchmark performance metrics from more recent vintage years may be less meaningful.

Private equity—Harvesting the illiquidity premia

Where does private equity source its return?

Private equity investments derive their return in much the same way as listed equities. However, private equity managers have an expanded toolkit to drive outperformance. This can include better access to information, improved governance (through control and alignment of interests), an operational, long-term focus, and favourable exit timing. Such tools are often not available in listed equity markets and contribute towards the illiquidity premia. As is the case with hedge funds, manager return dispersion can also be quite wide. This means manager selection is often a key source of return within fund-of-fund vehicles. Although private equity has a high correlation to listed equities (it can be as high as 0.8), volatility is typically much lower.

How liquid is it?

Private equity is usually a highly illiquid investment. Once invested, capital often cannot be redeemed for the full term of the investment (often six to 10 years), and returns are often irregular as the fund's investments are realised. Investments can sometimes be sold on secondary markets, but this can be at a discounted value. However, according to BlackRock, "the cashflows from a successful fund should be positive after a few years, as the fund begins to exit portfolio companies".

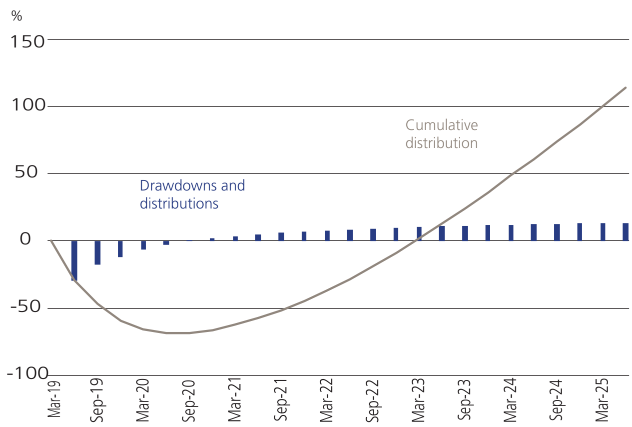
What are the key risks?

There is a range of risks specific to private equity, though utilising fund-of-fund vehicles rather than a single alternative investment partnership can lower these risks. Like hedge funds, private equity strategies are less regulated than publicly-offered investments and may exhibit higher operational risk. Acquired companies can also be more exposed to specific sector themes and events, and failure risk in venture capital is high.

Investments can also be vulnerable to 'vintage year' risk, where private equity managers face acquisitions in an expensive public market environment—a risk that can be increased given the recent significant build-up in funds being directed to private equity. As investor capital commitments remain with the investor until drawn, this can create issues, such as where that capital should be invested and how exposed the investor is to unexpected drawdowns. Manager dispersion is also typically higher in private equity relative to listed markets.

Due to the drawdown nature of private equity investments, the J-curve is a term often used to describe the life of the fund and illustrates the early commitment phase and likely payback of the fund. As the chart below shows, distributions from the fund start during the drawdown phase and, in many cases, the full commitment, are never drawn.

The likely payback of a private equity fund



Source: Hamilton Lane.

Real assets—Sustainable income and inflation protection

What are real assets?

Investments in real assets typically refer to investments in unlisted property assets (including real estate), as well as 'productive' assets, such as timberland, energy-related investments, and infrastructure. The investment characteristics of private real estate investments are often quite distinct from productive assets, where an asset's productive capacity is often key to its life span and value. Reflecting this, in this section we discuss real estate and other real assets separately.

Real estate

Alternative real estate exposure is accessed through equity or debt exposure to unlisted property assets. Investments can be direct or through a manager that facilitates a portfolio of investments, ranging from open-ended liquid funds to closed-ended illiquid structures.

Total return from the asset class is comprised of income and capital appreciation. Due to the stability and predictability of the income component of returns, real estate is generally regarded as a defensive asset class.

Real estate equity—This is where an investor either partially or wholly acquires a property asset or a pool of property assets. With real estate equity, investors are typically seeking stable income from rent as well as capital return. As real estate equity is exposed to non-traditional risk premia and can invest across regions and types of real estate assets, these investments can also bring diversification benefits. As rents tend to rise with inflation, they also provide a hedge against periods of rapidly rising inflation.

Real estate debt—Often, this involves lending to segments where more traditional lenders, such as banks, have chosen not to lend or have significantly reduced their loan-to-value ratios. As such, investors in real estate debt typically seek a higher investment return, given the risky or speculative nature of such developments.

The main real estate sub-sectors

Institutional real estate investment tends to be diversified across three main traditional sub-sectors—commercial (which includes office buildings); retail (which includes shopping centres); and industrial (which includes warehouses, factories, logistics and bulky goods). In addition, there are various non-traditional sub-sectors that are available to invest in, which include residential, retirement villages and storage, among others.

What are the key benefits of investing in real estate?

Real estate is expected to bring stable returns, income yield, a hedge against inflation, and a low correlation to listed markets. This is why unlisted real estate is often referred to as a mid-risk asset.

Where does real estate source its return?

Real estate equity—Return typically comes from rent and capital return from income growth. In addition, changes in capitalisation rates can contribute to return, where falling interest rates can improve the underlying net present value of returns. Real estate equity benefits from exposure to non-traditional market correlations and an illiquidity premium.

Real estate debt—Return reflects the risk and default-adjusted returns associated with the lending that has been made against the assets. Correlation to traditional markets is generally expected to be less than half.

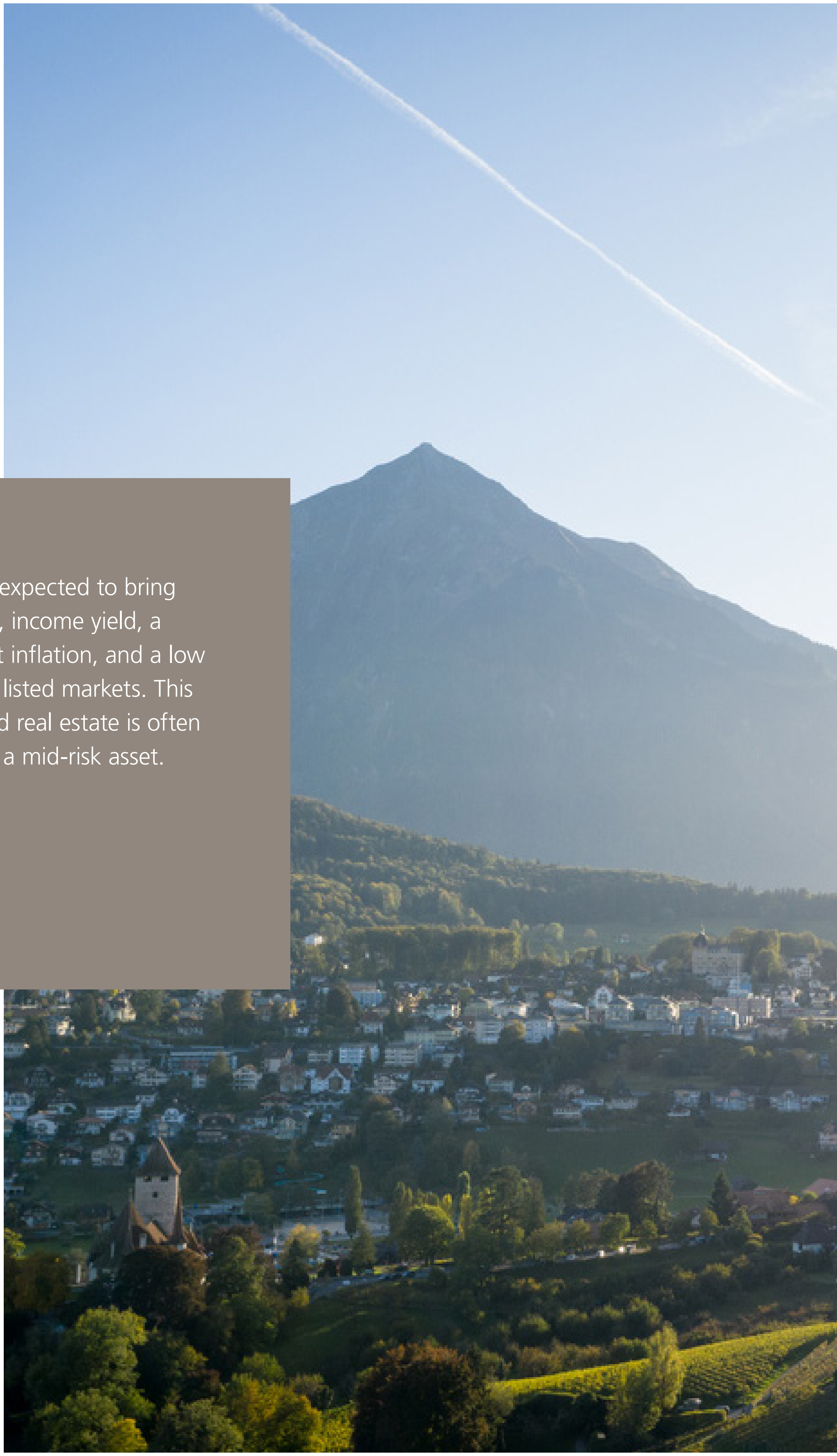
How liquid is it?

Liquidity varies from relatively high in open-ended strategies, which offer quarterly redemptions, to low in closed-ended vehicles.

What are the key risks?

Risk typically reflects changes in market interest rates (capitalisation rates). According to BlackRock, valuations can also be subject to bias, where a lagged appraisal process means values are slow to reflect the current market environment. Other risks include lease structures, tenant quality, and geographic concentration.

For real estate debt, a recent narrowing of spreads or covenant-lite arrangements can increase the potential for loan terms to not adequately reflect the investment's true underlying risk.



Real estate is expected to bring stable returns, income yield, a hedge against inflation, and a low correlation to listed markets. This is why unlisted real estate is often referred to as a mid-risk asset.

The risks for these assets centre around issues of valuation, vulnerability to events in the prices of underlying outputs, as well as investment-specific risks.

Other alternative investments

Other real assets

Other real assets include a diverse range of tangible and productive assets that deliver income and can usually hedge against rising inflation. Examples include timberland, farmland, energy-related investments, and infrastructure investments. The asset's productive capacity is typically key to its life span and value. Investments are usually closed-ended structures, similar to private equity.

Investing in a range of assets can bring about diversification benefits. In addition, by investing in assets that are at different stages of their life cycle, this can provide diversification benefits. For example, development assets tend to have higher risk and return characteristics compared with assets that are in full operation.

Like other alternatives, other real assets exhibit a low correlation to traditional markets (generally less than half that of traditional assets), and illiquidity premia form an important part of the return profile.

The risks for these assets centre around issues of valuation, vulnerability to events in the prices of underlying outputs (such as commodities), as well as investment- specific risks, such as natural disasters, pest infestation, government seizure, and regulatory risk.

Commodities

Examples of commodity investments include energy, industrial metals, precious metals, agriculture and livestock. These assets are less commonly accessed by investors, largely due to their historically higher risk and lower average return profiles. While it is possible to gain exposure by physically owning these assets, this typically incurs storage and holding costs. As such, many investors seek exposure via non-deliverable futures.

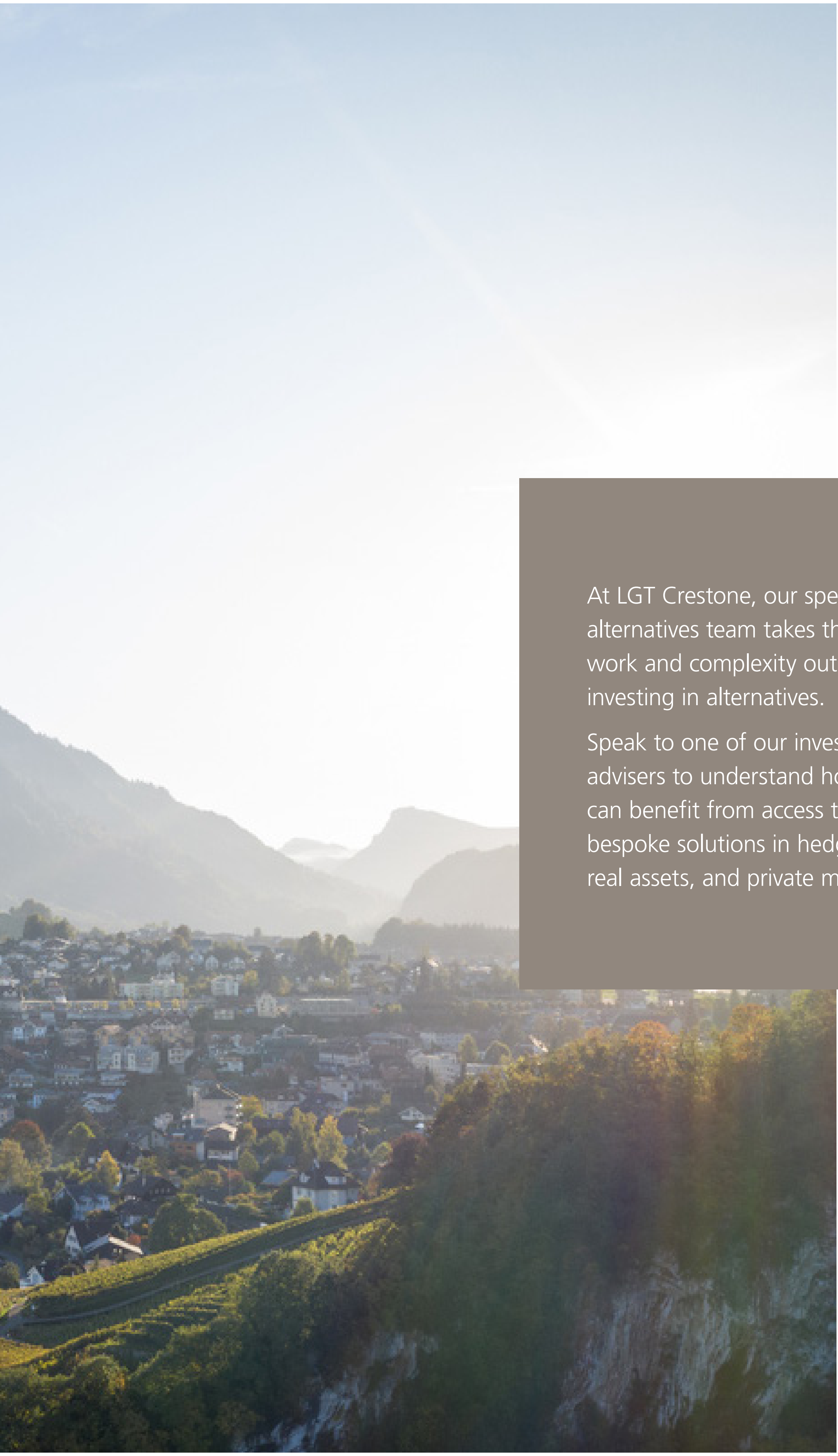
Commodities can be subject to high volatility, given their exposure to changing costs of extraction, weather, demand cycles, as well as political risk. These assets typically have very low correlation to listed equities and fixed income assets but, unlike most other alternatives, are highly liquid.

According to BlackRock, "the rationale for incorporating commodities into a portfolio should be based on their diversification benefits as well as their ability to protect portfolios in periods of rising inflation."

Structured products

Structured products include a very broad spectrum of products that are designed to achieve or exhibit a particular risk, return, taxation or other attribute. Credit derivatives are a common type of structured product. In essence, structured products can utilise any asset class to create desirable attributes for an investor with specific requirements.

Following a period of strong gains for risk assets, a common trend recently has been for managers to craft products that are designed to limit negative returns in a market sell-off but still participate in any market upside.



At LGT Crestone, our specialist alternatives team takes the hard work and complexity out of investing in alternatives.

Speak to one of our investment advisers to understand how you can benefit from access to bespoke solutions in hedge funds, real assets, and private markets.

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