An Introduction to Alternative Investments

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Introduction

The alternative investments universe generally consists of investments outside of publicly traded real estate, equity and debt. It includes investments ranging from private commercial real estate, hedge funds and managed futures, liquid alternatives to illiquid private equity funds, and real asset and natural resource partnerships. Moreover, the alternative investments industry is rapidly evolving – expanding and increasing its ability to provide durable investment strategies, and therefore is attracting interest from a growing number of individual investors. These programs are continuing to increase in popularity among the investment community because, when added to an otherwise well-balanced, fully diversified portfolio, they have the potential to provide greater risk-adjusted return, while also adding diversity and flexibility for advisors/investors seeking to construct a durable income-producing portfolio.

This paper will provide an overview of several examples of alternative investments. Advisors can use this information to determine which, if any, of these investment solutions might be appropriate for their clients' specific investment goals, given their existing portfolio of holdings and their unique tolerance for risk.

Characteristics

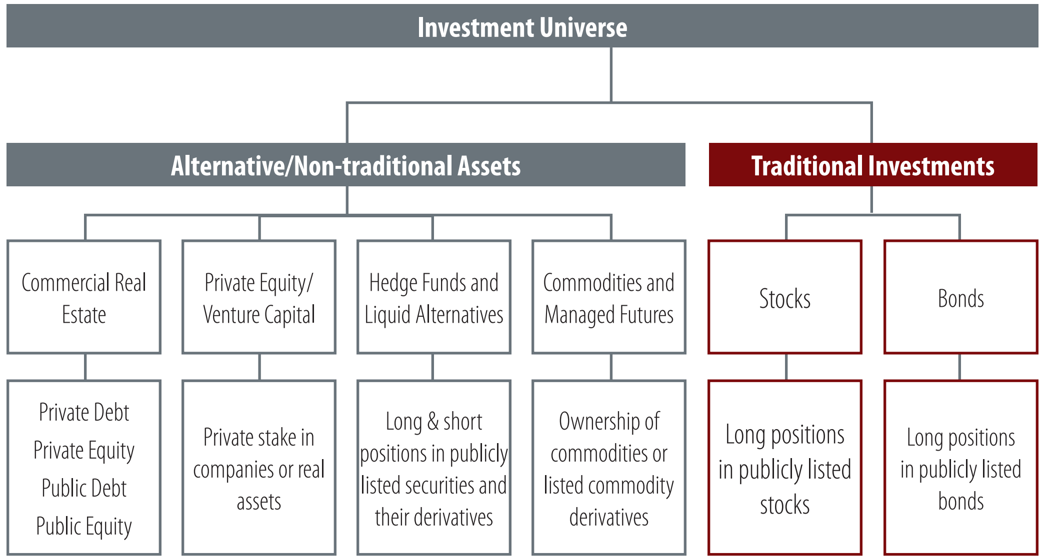
Alternative investment programs are generally not required to register under the Investment Company Act of 1940. When offered as public, non-traded investment funds, they are not listed on an exchange, placing limits on the investors eligible to access them. Until recently, these private alternative investment programs were largely available only to high net worth and institutional investors (though now they continue to make up an increasingly larger part of the average investor's portfolio).

A distinct feature of alternative investments is their absolute performance objective. In other words, they do not merely seek to outperform a benchmark but rather aspire to produce positive returns under varying market conditions. In order to achieve their absolute performance objective, alternative investment solutions tend to use leverage to increase returns as well as depend upon on investing skill rather than just market exposure to create value. Historically, alternative investments have exhibited relatively low correlation with traditional financial market indices over long periods of time. Typically they also exhibit reduced liquidity relative to traditional investments, with monthly to multi-year lock-ups. Alternative program managers typically charge higher fees, which may include performance fees.

We believe that in order to act in their client's best interest, advisors should consider taking the large dispersion of performance across program sponsors into account, in addition to evaluating the degree of each program's performance persistence. Therefore, even more so than for traditional investments, program manager selection is of critical importance.

Four Broad Categories

Exhibit 1 | Investment Universe



Alternative Investments are a heterogeneous class with the potential to provide valuable diversification benefits.

Alternative investments tend to fall into four broad subtypes – commercial real estate, private equity, hedge funds (with a variant liquid alternatives/ alternative mutual funds), and managed futures - all of which differ from traditional investments in a variety of ways.

Commercial Real Estate

Exhibit 2 | Four Quadrants of Real Estate

	Debt	Equity
Public	• Commercial Mortgage Backed Securities (CMBS)	• REIT Stocks • Publicly Traded Real Estate Property Companies • Real Estate Mutual Funds
Private	• Senior Loans • Mezzanine Debt • Whole Loans Mortgage	• Open and Closed End Funds • Separate Account/Direct Investments • Non-Traded REIT

Negotiated private debt and equity investments in real estate assets with the objective of generating current income and/or reselling at a higher value in the future.

Commercial real estate investing includes making equity or debt investments in multi-family residential, land, office, industrial, retail, hotel properties and other more specialized assets. A significant advantage of commercial real estate is that investors can gain access to this segment through a number of different vehicles and structures that provide different types of opportunity at different points in the business cycle. It is important to remember that the commercial real estate market does not necessarily move in tandem with the residential housing market. It is driven more by economic factors such as economic growth, job creation, consumption and inflation.

These investments may utilize anywhere from 30% to 75% leverage, while traditional investments typically do not rely on leverage. Historically, commercial real estate has had a relatively low correlation with financial market indices. Over the long term, commercial real estate has also been less volatile when compared to traditional investments such as equities and fixed income. Also, real estate is a physical asset and is relatively illiquid, as opposed to traditional investments which are financial assets and are highly liquid. Lastly, real estate is typically considered a better inflation hedge than traditional investments. This is because as inflation rises, the value of real estate usually increases in tandem, whereas traditional investments such as stocks are usually hurt by adverse inflation surprises.

Commercial Real Estate Strategies

- **Private Debt:** This includes whole loans, mezzanine loans and B notes. A whole loan is a term used to distinguish between an original mortgage loan and a pass-through security. A mezzanine loan is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. A B-Note refers to the tranche that is subordinate to the investment grade portion of mortgage debt. In addition, investing in commercial real estate through private debt typically produces steadier returns than equity investments as they are less sensitive to economic conditions. The disadvantages involved in private debt include limited upside potential and lower liquidity due to the mid-level structure, as well as difficulty in creating diversified portfolios due to the concentrated nature of debt positions.

- **Public Real Estate Equity:** Investors can gain exposure to commercial real estate through public equity markets in two ways; Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs). Both are types of companies that invest in real estate and whose shares are traded on exchanges. REITs invest in real estate directly, either through equity stakes in properties or through mortgages. They must distribute 90% of their taxable income to shareholders and thereby qualify for lower corporate tax treatment. REOCs are similar, except that they reinvest earnings into the business and do not enjoy preferential tax treatment. They engage in the development, management or financing of real estate. Both REITs and REOCs are often traded on a long-short basis by hedge funds.

- **Private Real Estate Equity:** This includes core, core plus, value-added and opportunistic strategies.

- Wide range of investment options to gain exposure to real estate investments.

Core usually involves investments in stable, fully-leased, multi-tenant properties within strong, diversified metropolitan areas, owned with little debt. Core funds also have highly predictable cash flows.

Core plus refers to a low-risk/slightly higher potential return and leveraged strategy.

Value-added refers to moderate risk/moderate return and higher leverage strategy. They usually involve redevelopment or re-leasing of a property to increase its potential value at a rate in excess of general market trends.

Opportunistic refers to the highest risk/highest potential return and highest leverage strategy. Opportunistic funds are usually focused on “off-market” deals that have significantly higher risk profiles.

Conclusion

- Historically low correlation with other major asset classes may provide diversification benefits when added to a multi-asset portfolio.

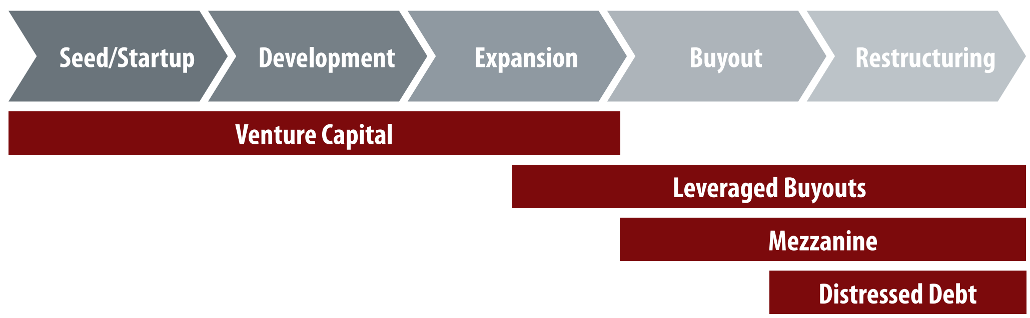
In summary, alternative investments in commercial real estate are negotiated private debt and equity investments in real estate assets with the objective of generating current income and/or reselling at a higher value in the future. Since commercial real estate historically has experienced significant fluctuations; cycles in value and local market conditions often influence investing outcomes. Most commercial real estate investments employ leverage which has the effect of magnifying both gains and losses. It is important for advisors to remember that these investments are illiquid, are not listed on any exchange and are generally regarded as fixed and long-term. Generally, there are no liquidity provisions, no standardized mechanisms in place to sell partial interests in non- realized funds, as well as significant restrictions on transfer. Properly selected commercial real estate strategies have the potential to create current income along with capital appreciation. Commercial real estate is usually also considered a hedge against inflation. It offers direct ownership and can expand the efficient frontier in a portfolio. The flip side is that investors may have to accept illiquidity risk and advisors must help them understand the long-term potential trade-off of this type of investment vehicle. These factors should be taken into consideration when evaluating commercial real estate strategies and their related suitability requirements for specific clients.

Private Equity

These are negotiated investments in privately held companies at different stages of maturity undertaken with the objective of improving their profitability and growth prospects and then reselling them at a higher price in the future. Private equity fund managers often have increased access to information regarding their investments, while traditional money managers must rely on publicly-available information, because they only invest in the public markets. Also, private equity managers often invest based on a negotiated price, while traditional money managers typically pay market prices. They often create value and are able to exit acquisitions at higher multiples thus creating a profit for their investors.

Private Equity Strategies

Exhibit 3 | Private Equity Strategies



May pursue a business model based on acquiring control of companies to increase market value through active engagement and then exiting at a later stage at a profit.

Private equity is an extremely heterogeneous asset class with many sub-sectors. These sub-sectors, some of which we discuss below, have very different asset characteristics. This means that each subsector has different performance drivers, which investors need to understand to make informed decisions.

- **Venture Capital:** These firms provide risk capital for starting, expanding and acquiring companies. Most are quite specialized, often investing in a single field, such as telecommunications or health care. Venture capital firms also tend to specialize by investment stage. These funds generally do not offer any income but have a high capital gain (but also very high risk) returns potential.

- **Leveraged Buyouts:** Leveraged buyout firms specialize in financing the purchase of established mature companies that are generating cash-flow (used to service the debt). Investing in these funds allows directionally long exposure to equity.

- **Mezzanine Capital:** These funds provide an intermediate level of financing in leveraged buyouts below the senior debt layer and above the equity layer. A typical mezzanine investment includes a loan to the borrower, in addition to the borrower's issuance of equity in the form of warrants, common stock, preferred stock, or some other equity investment. These investments provide returns through income and sometimes offer capital gain potential through equity warrants.

- **Distressed Investing:** This includes i) the purchase of companies that are distressed or out of favor, for low multiples of cash flow and/or low percentages of asset value; or, ii) the acquisition of quality companies with excessive leverage or those that are going through bankruptcy that require restructuring. Distressed security returns are a combination of the risk premium from holding low-grade securities and the illiquidity premium from holding less liquid securities. Distressed securities are usually considered risky because there is a distinct possibility that the company might not recover. If that happens, an investor may lose part or even all of invested capital. A variant of distressed investing is Special Situations investing . This is a broad category which encompasses variations of opportunistic distressed investing, equity-linked debt conversion plays, project finance, as well as one-time opportunities resulting from changing industry trends or government regulations.

Conclusion

Private equity can be a source of attractive returns over the long term. Moreover, private equity returns do not correlate closely with returns from traditional asset classes - properly implemented, the introduction of private equity can improve portfolio diversification.. They have the potential to provide access to selected growth opportunities even in low macroeconomic growth environments for successful private equity managers are focused on picking companies with growth potential and actively creating conditions for growth, which investors can monetize. They are however long-term oriented illiquid investments. Interests in private equity funds are generally not readily marketable, transferable or redeemable. They have uncertain cash flows with respect to both capital calls and distributions. Also, they are a form of blind pool investing, since investors do not know beforehand what their funds will be invested in and must rely on the skills and judgment of the private equity manager. Private equity is heterogeneous and includes several sub-sectors, all of which have their own unique characteristics. Given large dispersion of returns across managers and a degree of performance persistence, manager selection is of critical importance.

Private equity is an illiquid long-term asset class, which, when approached with the necessary expertise, has the potential to improve the risk / return characteristics of an investment portfolio.

Primary source of hedge fund returns is from manager skill and security selection in addition to directional asset class exposure.

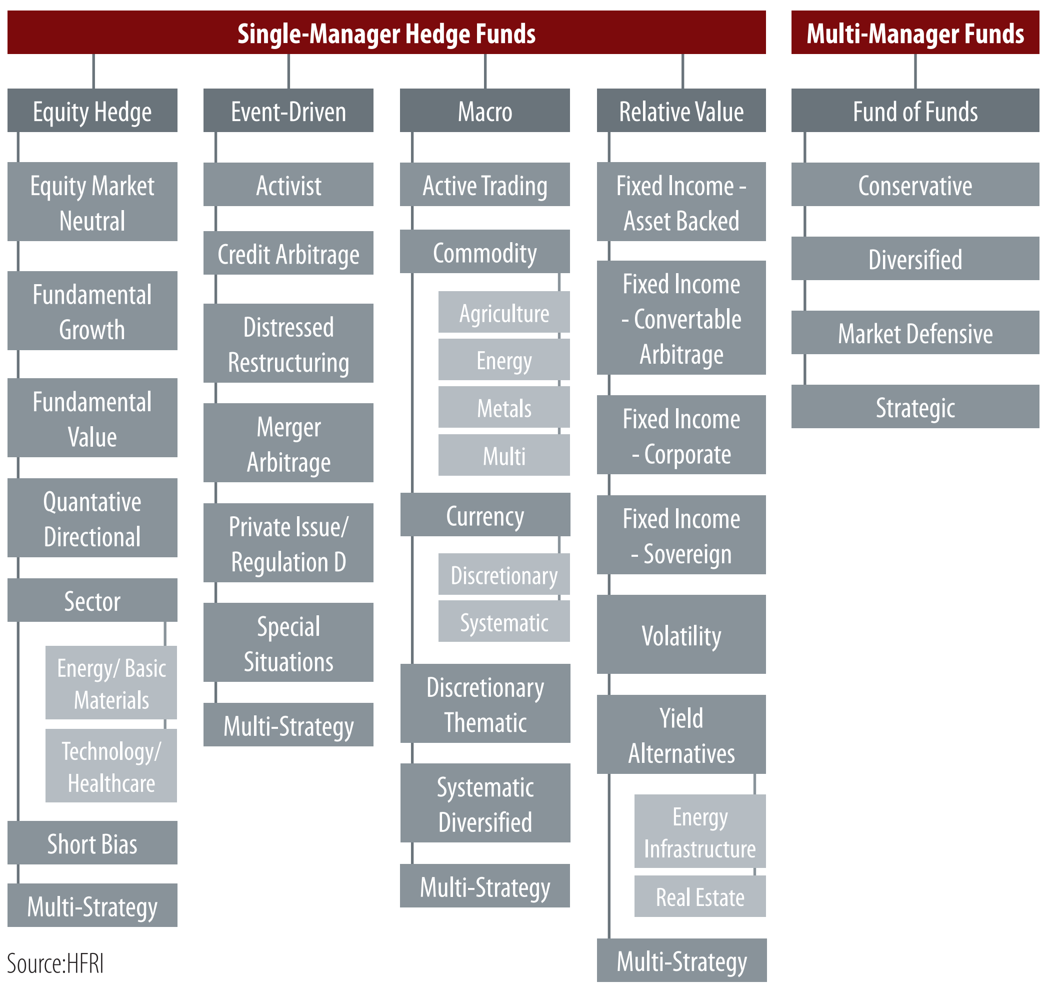
Hedge Funds

These funds invest in the global equity and fixed income markets and typically employ sophisticated trading strategies, use leverage and derivative instruments and go both long and short the markets. Hedge funds managers have the flexibility to invest opportunistically in strategies where they see value, unlike traditional money managers and mutual funds that are often constrained to invest in pre-defined markets. Hedge fund managers can sell short the securities they believe will fall in value and thereby may profit from declining markets if they are correct in their judgment. In contrast, traditional money managers face limits on short-selling and may be required to be invested even if they believe markets are in a declining trend. Hedge funds managers can also use derivatives and leverage to hedge or magnify returns and risks, while traditional money managers are limited in their use of derivatives and leverage.

Hedge Fund Strategies

Hedge funds strategies arise from taking speculative positions in a combination of market and credit risk instruments for which the manager believes that the risk-reward relationship is attractive. Such positions are often referred to as arbitrage, or risk arbitrage. Through such positions, hedge funds are able to implement a variety of "non-directional", "semi-directional" and "directional" strategies, where direction refers to exposure to market direction.

Exhibit 4 | Hedge Fund Strategies



Source:HFRI

Hedge funds are a heterogeneous group with over twenty distinct strategies within four broad strategy groups:

- **Equity Hedge Strategies:** Their main objective is to seek long-term capital appreciation while maintaining low net exposure to the overall stock market or individual industry groups.
- **Event Driven Strategies:** These concentrate on the profit potential created by major corporate events, such as mergers, acquisitions, restructurings, bankruptcies or liquidations.
- **Macro Strategies:** These primarily trade in the most liquid markets in the world, such as currencies and government bonds, typically betting on macroeconomic events such as changes in interest rate policies or currency devaluations. They rely mostly on an assessment of economic fundamentals.
- **Relative Value Strategies:** These seek to profit from the relative mispricing of related assets, e.g. convertible bonds and the common stock underlying the conversion option; options and futures and their underlying reference assets; debt instruments of the same issuer or of different issuers with different maturities or yields.

Absolute performance objective, may use leverage, may have low correlations with market indices, invest opportunistically where a manager sees value, can short-sell securities, can use derivatives to protect downside.

Conclusion

Well-managed hedge funds have the potential to offer risk adjusted returns that are superior to those of traditional investments by taking advantage of market inefficiencies. Given the historically low correlation of certain strategies with traditional asset classes, hedge funds have often enhanced returns in economic environments in which traditional stock and bond investments have offered limited opportunities. Hedge funds, given their flexible mandates, allow investors to participate in a wide variety of new financial products and markets not available within traditional asset classes.

One can think of hedge funds returns as a combination of exposure to macro factors (economic exposure or 'beta'), fund-level elements (fees structure, trade implementation capabilities) as well as manager skill (or 'alpha') in processing security or market specific information. The excess returns that some hedge funds exhibit is a result of cheaper trading costs (due to large volumes and turnover), better market access and superior information processing abilities. Hedge funds do, however, pose unique risks that must be understood and managed.

Liquid Alternatives and Alternative Mutual Funds

Regulatory changes are blurring the boundaries between "alternative" investments and what were once classified as "traditional" investments. The ability of mutual funds to offer hedge fund programs was made possible by the SEC's removal of the short-short rule, which dictated that mutual funds may not derive more than 30% of their profits from short-term trading and "short" selling. Many long-only large asset management firms that, in the past, dealt with "traditional only" type products have begun offering hedge fund strategies; employing hedge fund techniques such as short-selling and leveraging trades. In the same vein, some traditional hedge funds have begun offering their strategies in a mutual fund format, ostensibly, to attract the large audience of retail investors that were previously precluded from investing in hedge funds. Both traditional managers and hedge fund managers stand to benefit from increased fund flows, the ability to offer higher margin products and revenue diversification.

Generally based around traditional hedge fund trading strategies, managed on either a discretionary or replication basis, often offered as a mutual fund vehicle.

Certain strategies such as "long-short," that exhibit greater correlation with equity markets and in general have a long only bias, are more suitable than others (such as those with illiquid underlying holdings) to be offered in mutual fund formats. Other hedge fund strategies that have gained traction include market neutral, commodity investing and currency funds. This is because these strategies can be implemented using very liquid underlying instruments such as futures and options. Probably the greatest advantages to investors accrue from increased transparency, low minimums and greater liquidity (daily), reduced fees and stronger regulatory oversight.

Appealing as they are prima facie, hedge funds wrapped as mutual funds are intended to serve as diversification vehicles, rather than as pure skill based (or "alpha") vehicles. For some investors, the main reason to participate in hedge funds is to reap higher returns rather than to achieve portfolio diversification, believing that diversification can be cheaply arrived by using other investment vehicles. In such cases, employing hedge funds in a mutual funds structure may be less than optimal.

In certain cases, though not all, hedge funds wrapped as mutual funds may structurally inhibit the flexibility need for alpha generation for a number of reasons

- **Restricted Leverage:** Mutual funds have restrictions on leverage, where only a third of the fund can be leveraged. The average leverage in the hedge fund industry depending on the strategy is 1.8 to 3 times, considerably higher than in mutual funds. The higher leverage in hedge funds may help increase returns, but it also has the potential to magnify losses.

- **Liquidity:** Mutual funds are required by the Investment Company Act of 1940 to provide daily liquidity – less than 15% total fund AUM can be invested in relatively illiquid underlying instruments. This prohibits such vehicles from unlocking the illiquidity premium in underlying securities; some hedge fund investments are considerably less liquid than portfolios of traditional assets. They generally allow quarterly or less frequent withdrawals, generally after a one-year initial commitment. On the positive side, limited withdrawal frequency does let managers focus on longer-term performance without the distraction and demands of, in many cases, daily withdrawal rights provided by traditional managers. This can improve performance. The flip side to this is it creates a perverse incentive on the part of the hedge fund manager to hold on to underperforming securities in the hope that they may someday recover in price in the future.

- **Performance Fees:** Mutual funds have restrictions on the incentive fees that they can charge. The best investment professionals may not be attracted to such fund complexes. However, there is evidence that higher management fees and incentive compensation can significantly limit after fee returns available to investors.

- Have a place in mass affluent portfolios. Also particularly useful as a shorter-term allocation to make tactical allocation calls.

- **Curtailed Implementation:** Many hedge fund strategies cannot be successfully implemented in the open-end format; such as global macro, fixed income arbitrage, or distressed investing, which may require the use of leverage, expression through derivatives or the holding of illiquid securities. These strategies are restricted in the alternative mutual fund world.

- **Restricted Mandate:** Hedge fund strategies have flexible mandates which allow for manager strategy to evolve as market conditions change. Mutual fund structures are not allowed to have flexible investment mandates. Most have narrowly defined charters, a practice driven by industry and regulatory convention. While the investment flexibility that hedge funds enjoy has numerous benefits, it does entail the risk of style drift.

Conclusion

Investors in hedge fund strategies have generally been restricted to using private limited partnerships for implementation. However, investors can now access a limited number of actively managed or replication based hedge fund strategies through a range of more-liquid vehicles, including alternative mutual funds. These provide strategy exposure without many of the drawbacks, such as liquidity constraints and relatively high fees, associated with traditional hedge funds. Unlike hedge funds these are available to non-qualified investors with very low minimums, offer daily valuations and have 1099 tax reporting. However, these benefits are not without their own costs, including a reduced opportunity set of strategies, lack of access to many top-tier managers, and investment constraints (inability to fully leverage, etc.) imposed by the mutual fund structure of the vehicles themselves.

Managed Futures

These funds are similar to hedge funds in some ways. They take exposure by using futures, options and forwards on traditional commodities, financial instruments and currencies. Managed futures managers offer access to global futures markets through the use of professional money managers called Commodity Trading Advisors (CTAs). They use trading strategies and money management techniques to attempt to achieve profits and control risk. CTAs generally fall into one of two categories: systematic or discretionary. Systematic traders perform quantitative analysis on historical prices and follow either systematic or discretionary approaches to trading. Discretionary managers base investment decisions on the analysis of supply and demand, valuations and cyclical conditions.

CTAs implement strategies using futures contracts. A futures contract is an exchange-traded, liquid, standardized contract which specifies that the parties involved agree to buy or sell a certain underlying instrument at a specified price at a certain date in the future. Futures markets provide exposure across all major asset classes, including those based on interest rates, equity indexes, foreign exchange, energy, agricultural commodities and metals. These markets tend to be very active, liquid and deep.

Properly constructed portfolios allow access to global market opportunities using financial instruments.

Managed Futures Strategies

Systematic CTAs utilize quantitative research techniques to arrive at trading algorithms and proprietary trading models to exploit inefficiencies or capture trends in markets. Often, decisions are made based on computing rules arrived through statistical data analysis. For instance, they may evaluate momentum in prices by assessing for serial correlation to arrive at views on future prices. They may study volatility to determine if sudden price movements exceed caps or thresholds and accordingly scale their trading positions. Their trading models tend to fall into two broad camps; i) trend following; and ii) relative value.

- **Trend Following:** These strategies are profitable if they are able to identify a trend that subsequently emerges during a period of increased volatility. However, they can experience losses when trends reverse.

- **Relative Value:** These, as the term suggests, are focused on identifying temporary mispricing between related financial instruments. Some examples of mispricing may be in foreign exchange carry strategies, where one may borrow at cheaper rates in one currency and lend at a higher rate in another. If prices do not move in the anticipated direction, or take a very long time to do so, these strategies result in losses.

- **Discretionary CTAs** make trading decisions on the basis of their own expert judgment and "trading instinct," not necessarily on the basis of trading signals generated by any program, model or algorithm. Many discretionary CTAs are also loosely referred to as "fundamental." CTAs using the fundamental approach attempt to predict future price levels by studying external fundamental factors, namely supply and demand for a particular group or type of underlying commodity. They may, based on their qualitative judgment, buy undervalued commodities and sell overvalued commodities simultaneously.

Investors may gain exposure to managed futures in a variety of ways. For example, they may invest through pooled investment vehicles. These pooled investment vehicles or funds are typically structured as a limited partnership (L.P.) or a limited liability corporation (L.L.C.). Investors may also gain exposure to managed futures through managed accounts directed by CTAs, which have discretion to trade on the investors' behalf for a fee. Another way is through a mutual fund type structure. In addition to this, there are a variety of active and passive managed futures indices.

Conclusion

Managed futures allow investors to participate in the global futures and forwards markets of commodities, foreign exchange, equity indices, and interest rates sectors. They offer access to global markets, bring professional management, provide relatively better liquidity than other alternative investments as well as a degree of transparency, and the potential for long-term capital appreciation. More importantly they have low correlation with other alternative investment and traditional assets.