

Alternative alternatives

Why alternative alternatives?

What are alternative alternatives?

Classification of alternative alternatives

Alternative alternative characteristics

Researching alternative alternatives

Performance & Integrating alternative alternatives in a portfolio

Constraints, challenges and outlook

Why alternative alternatives?

Irrespective of when the next financial crisis occurs there is a need to be cognisant of the changing investment landscape and the repercussions associated with being market participants in a complex, highly inter-connected world:

- where information exchanged on the robustness of economies, its markets and its players is virtually instantaneous
- where technology plays a pivotal role in not just running markets - but can and has been disruptive
- where the impact of human error (lapse of concentration, “fat-finger”, etc.) should not be underestimated
- where institutions will likely continue to be “too big to fail” and “too inter-connected to collapse”
- where the existing mismatch between investable risk premia and capital inflows is expected to widen further - resulting in efficient markets - packed with over crowded trades, making it harder to generate returns - encouraging the use of leverage
- where the frequency and intensity with which financial crisis occur, is predicted to rise
- where market volatility is slated to rise
- where speculators have the ability to, do, can and will move markets
- where the velocity at which money moves has a bearing on leverage levels in the financial system
- where public debt ratios in the advanced economies at present are on an unsustainable path

Why alternative alternatives?

“Risk is inherent in every investment”

The raison d'être for alternative alternatives and my hypothesis has been:

In theory, market risk (also referred to as systematic risk = or beta) can be isolated and measured.

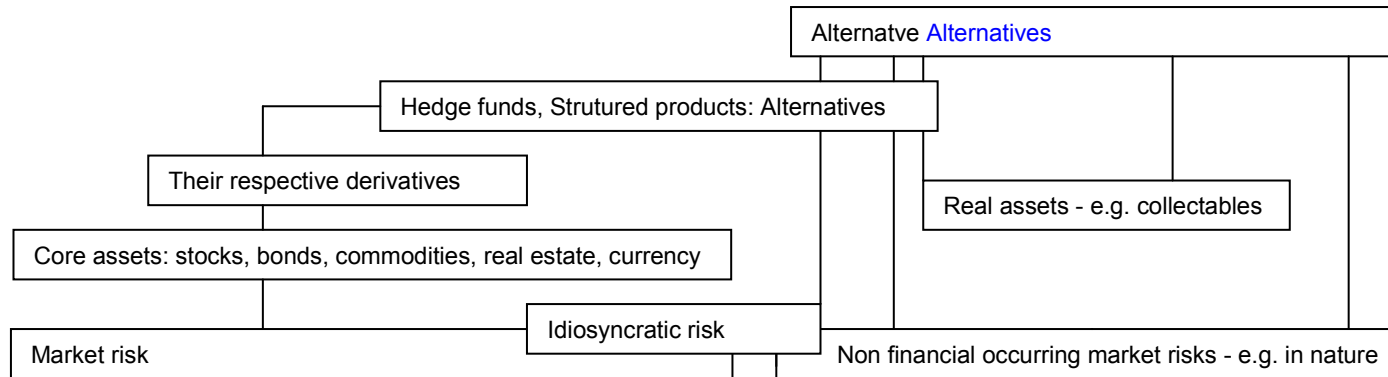
By default, a risk originating outside financial and capital markets (as in nature) should not be affected by it.

Potentially if made investable, such risk can provide exposure to a specific, non-replicable, unique risk premia that could deliver returns.

Put differently, if the source of risk (inefficiency/ies - risk premia) rest(s) outside the domain of mainstream financial markets, then it should be insulated from the vagaries of the financial market - as it has nothing to do with this market.

It is important to recognise that even though the source of risk resides outside the market, **the risk is real, and if borne, so are the prospects of being compensated for it.**

What are alternative alternatives?



Source: Sona Blessing

My working definition for the book has been based on:

unconventional, non-traditional, non-main stream hedge fund investments and strategies whose risk profiles and return drivers are atypical, unique and or idiosyncratic in nature.

Alternative alternative assets and strategies:

Timberland investing, Insurance risk transfer,

Asset/loan based lending (aviation, shipping, trade, entertainment, litigation financing, etc.),

Collectables

Extraction strategies such as volatility and behavioural finance.

Classification of alternative alternatives

Risk Origination

I. Naturally occurring sources of risk:

The biological growth of trees

Trees grows (they increase in size and they gain in volume) independent of and irrespective of financial markets

Natural catastrophes

Natural catastrophes such as earthquakes will continue to strike without our ability to accurately time and or predict their occurrence

In practise and in the real world it is virtually impossible to get "exclusive" exposure to naturally occurring sources of risk. But exposure to such risk can be calibrated - and if taken on, offers access to a source of partially inhomogeneous return.

The process of extracting a return/ performance from such naturally occurring sources of risk, or, the wrapper/ instrument that make it an investable proposition - is unfortunately where financial, market contagion starts creeping in.

Classification of alternative alternatives

II. Non-naturally occurring but idiosyncratic sources of risk

Asset based lending (ABL): “secured” credit risk transfer - or lending money against collateral

Often referred to as “merchant banking in a hedge fund garb” - is when money is lent against a tangible asset - or cash flow generating collateral.

The reference here is to private loans with no securitised secondary market.

In the case of such strategies, the source of risk is not entirely isolated from and alien to financial markets as has been historically evidenced during the Great Depression

Collectables

Idiosyncratic risk, scarcity related premia, the persistence of inefficient markets and the ability to identify, verify, evaluate, source and secure “sought after” objects are the main drivers of return.

Whether or not such “scarcity-led,” “emotional” investments in real, “tangible” assets as in art, wine, stringed music instruments, vintage cars, rare coins, stamps and other collectables are influenced by the cyclical nature of financial markets continues to be debated.

Classification of alternative alternatives

III. Extraction strategies

Volatility

Volatility driven strategies that find their origin in the market (across asset classes such as equity, bonds, currency, real estate, commodity) – but their capturable source of risk premia or performance lie in the extraction process.

Irrespective of the direction in which markets move, it is the frequency and scale of those moves that strategically determine when and whether gains will be made.

Behaviour Finance

The ability to formulate strategic and tactical investment moves to generate returns that are based on interpreting and analysing scientific observations (socio-economic-political-psychological), on why and how human beings tend to behave under various market conditions.

As well as actively exploiting informational inefficiencies - for example by trading market pricing inefficiencies to render performance.

Alternative alternative characteristics

- **Non replicable risk or risk that can't be replicated easily**
(It is difficult to replicate the actual occurrence of a natural catastrophe or the biological growth of a specific 25 year old tree)
- **Idiosyncratic**
(Marine insurance)
- **Inefficiencies**
(Collectables)
- **Heterogeneity**
(In the context of micro life settlements - longevity/mortality risk - each policy is unique ...
or in the case of asset based lending strategies - each loan needs to be evaluated and structured individually)
- **Low-to-no “correlation”**
(As in the case of naturally occurring catastrophes such as winds in Europe, and an earthquake occurrence in the US, Japan etc.)
- **Such risk premia are not always apparent - they can be disguised,**
concealed and so need to be well understood, carefully researched and analysed differently

Researching alternative alternatives

In researching alternative alternatives

I have followed a **pragmatic approach** that relies on a combination of:

- **data collection**
 - **monitoring**
 - **SWOT analysis** (i.e. identifying and understanding the strengths, weaknesses, opportunities and threats)
 - **case studies**
 - drawing on the **experiences and expertise of those that walk the talk**
- Not only has, and does, this real world approach help in **“de-mystifying”** the widely held perception alternative alternatives have of being **“esoteric”** assets and strategies –
more importantly it adds a **“practical log”** dimension that makes comprehending the associated risk-reward profiles, drawbacks, strategic scope, integration potential as an investment (including within a portfolio) - why and how they have fared through the most recent credit crisis, and how they are expected to fare going forward feasible.

Performance on a stand alone basis

A majority of the alternative alternative assets and strategies have continued to deliver “characteristic”, in-line, positive performance irrespective of the credit crunch, sovereign debt and the ensuing recessionary environment.

- **Timberland has continued to “grow” increase in volume and value terms**
- **Insurance linked strategies (life and non life) have delivered a positive performance. Including those that partially suffered owing to the collapse of Lehman in 2008 (counter party risk exposure as Lehman was one of the custodians of the special purpose vehicle accounts)**
- **Loan based lending strategies have even benefited from the enhanced rigidity in regulation applicable to banks and other formal money lending institutions**
- **Collectables of historical significance have maintained or appreciated in value**
- **Volatility trading strategies have depending on the underlying traded, and selectively, delivered in-line performance**
- **Behavioural finance conditioned funds - selectively, have also delivered in-line performance**

Performance on a stand alone basis

- On occasions where there has been a performance set-back - it has been largely owing to structural issues.
- **Robustness**
Paradoxically, even though most of these strategies are “stereotypically” perceived as being “illiquid”; if needed to be exited - they have proved to be remarkably stable and “liquid.”
- Understanding fully an asset’s or the strategy’s source of risk (its origin), characteristics-peculiarities (including valuation methodology, illiquidity, uniqueness), return drivers, persistence, scalability, short comings, terms and conditions - systematically isolating them from the risk posed by the investable wrapper/ investment vehicle (structural), operational, legal, regulatory, tax, currency, manager, market risk, liquidity etc. is imperative.
- Alternative alternatives underlying investible source of “pure/core” risk has, and is capable of performing (positively), given its fairly high “certainty of returns dimension”
- These assets and strategies can offer “real” diversification and provide a differentiated risk-reward profile

Performance vs. traditional investments and indices?

- **Thoughts on “correlation” :**
It means different things to different people, can be manipulated ... it is based on data from the past ... accuracy of data - “craft” and caution needs to be exercised in interpreting data
- **Isolate the source of risk, the return driver, calibrating exposure to market contagion (hedging it out)**
- **Example of market contagion risk in the context of timberland, ILS, loan based lending, collectables, volatility, behaviour finance**
- **Respect the underlying risk and return dynamics/characteristics of these assets/strategies**

Integrating alternative alternatives in a portfolio

- **No one size fits all**
- **Active vs. strategic /tactical management vs. core-satellite approach**
- **Rebalancing**
- **Asset liability management**
- **Structuring a steady cash flow**

Constraints and challenges

- **Limited manager universe, limited track record, limited opportunities**
- **Capacity constrained strategies (scalability)**
- **Inefficient - time and cost involved, relative to the size of allocation**
- **Liquidity constraints**
- **Transparency, Operational, Regulatory issues**
- **Discomfort with valuations of the underlying assets**
- **Structure - finding managers who can invest through managed accounts and provide liquidity**
- **Positioning: Identifying a legitimate place within the portfolio**
- **Headline risk**

Constraints, challenges

Alternative alternatives as strategies are still in their nascency which means statistically significant data is often incomplete, lacking and scarce.

Assuming it were available, caution needs to be exercised in its interpretation - as by definition a lot of these asset classes and strategies are characterised by idiosyncratic risk - i.e. measuring and pricing those occurring in nature, regulatory, legal, valuation, illiquidity related risk amongst others.

Outlook

On the supply side there are signs of evolution

As the broader base further decomposes into isolatable, investable niches

- For example, the possibility of investing in a species, such as teak, in the context of timberlands
- Loan based lending against art, fine food and wine as collateral
- The emergence of exchange listed investment opportunities with alternative alternative strategies as underlyings (litigation led investing, in coins, etc.)

Conclusion

- **Some of these strategies might never assume “mainstream” status**
- **It is possible that some may remain supply constrained**
- **On a relative basis, may continue to be more “illiquid” than their traditional asset counterparts**
- **The underlying risk in some instances could prove to be deceptive and more complex than bargained for**
- **But it is these very characteristics and inefficiencies that will enable alternative alternatives to afford diversification and a distinct risk return profile to that obtained from mainstream investments.**

Contact

Research Specialist , Consultant and Author of *Alternative Alternatives*

<http://eu.wiley.com/WileyCDA/WileyTitle/productCd-0470683961.html>

Book Chapter:

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100 Women in Hedge Funds *Connect*: www.100whf.org

Tel: + 41-22-5481889

Email: blessing@opalesque.com



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