

# ◆ Roles in Multi-Asset Portfolios - Alternatives

## ➤ Private equity.

- For a portfolio of public equity securities, an allocation to private equity has limited diversification potential because public and private companies face essentially the same risk factors.
- Thus, the main function of private equity in the portfolio is to increase expected returns.

## ➤ Hedge funds.

- Some hedge fund strategies, such as equity long/short or short bias, may somewhat reduce a portfolio's overall equity beta but are mainly expected to increase returns through their managers' security selection skill.
- Other hedge fund strategies, such as merger arbitrage or global macro, may be less correlated with traditional asset classes.

# ◆ Investment Opportunity Set

- **Traditional approaches** to defining the investment opportunity set include **classifying asset groups by liquidity** or by **how they perform** over economic cycles.
  - A portfolio manager using **a liquidity-based approach** would
    - ✓ Distinguish between alternative investments that are publicly traded and those that are not publicly traded.
    - ✓ Among alternative investments that are not publicly traded, the manager would further classify them by the length of the time commitment required.

	Fixed Income	Equity	Other Assets
More Liquid	Cash Bonds	Public Equity	Commodity Futures REITs
		Equity Hedge Funds	Private Real Estate
Less Liquid	Private Credit	Private Equity	Private Real Assets

## ◆ Investment Considerations

- In addition to the risk, return, and correlation characteristics relevant to the decision to invest in the alternative asset classes, many operational and practical complexities must be considered before finalizing a decision to invest.
  - Properly defining risk characteristics;
  - Establishing return expectations;
  - Selection of the appropriate investment vehicle;
  - Operational liquidity issues;
  - Expense and fee considerations;
  - Tax considerations (applicable for taxable entities);
  - Build vs. Buy.

# ◆ Investment Considerations

## ➤ Risk consideration

- Several characteristics of alternative investments limit the usefulness of mean-variance optimization as a tool for determining their appropriate portfolio allocations.
  - ✓ Because of **illiquidity and valuation issues, option-like return patterns**, and the fact that returns from some strategies tend to be low or negative during a drawdown period and high in later years, we **cannot assume returns are normally distributed**.
  - ✓ Additionally, for alternative investments for which committed capital is not immediately invested by the manager, **a portfolio's effective allocation to the asset class might be less than its target.**

# ◆ Investment Considerations

## ➤ Expected return

- Setting return expectations for alternative investments is made more difficult by their short history relative to other asset classes and by the **limited validity of the data** that are available.
  - ✓ A suggested approach to determining an expected return for a particular class of alternative investments is to
    - ◆ estimate each of its risk factor exposures,
    - ◆ add the expected returns from these exposures to the risk-free rate.

# ◆ Investment Considerations

## ➤ Investment Vehicles

- A typical structure for an alternative investment vehicle is a **limited partnership**.
  - ✓ With this structure, the liability of investors in the fund is limited to the amount they have committed.
  - ✓ Often these limited partnerships are registered offshore for tax or reporting reasons.
- **Investing directly in a limited partnership** is appropriate for **large investors** that have the expertise to evaluate managers and fund strategies.
- Investing through a **fund-of-funds** may be appropriate for investors that **lack the needed expertise**.
  - ✓ The **benefit** of a fund-of-funds is that it provides access to this asset class to investors who otherwise would not have it.
  - ✓ The **drawback** is that they charge an additional layer of fees above those charged by the underlying limited partnerships.

# ◆ Investment Considerations

## ➤ Investment Vehicles

- Some investors that are large enough to demand favorable investment terms may establish **separately managed accounts (SMAs, funds of one)** through which to access alternative investments.
  - ✓ A risk with SMAs is that general partners, when allocating certain investment opportunities to investors, may favor limited partners who are paying the fund's standard fees.
- Some **open-ended mutual funds** and "undertakings for collective investment in transferable securities" (**UCITS**) have developed to give smaller investors access to alternative investments.

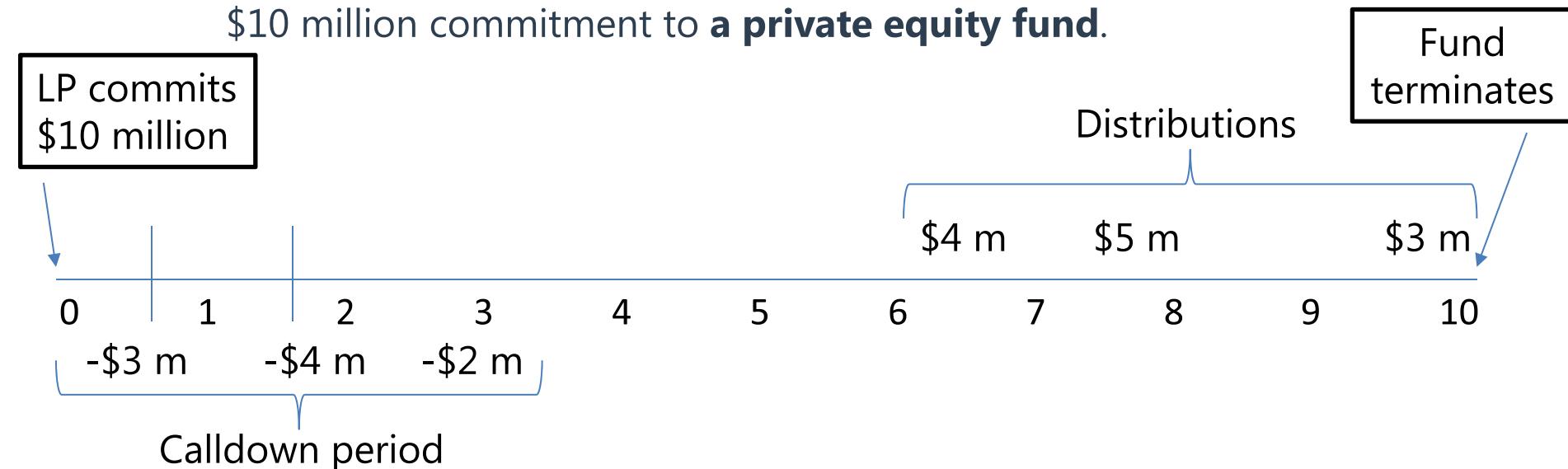
# ◆ Investment Considerations

- **Liquidity Concerns: Liquidity risks associated with investment vehicle**
  - For funds in the private equity, private credit, real estate, and real asset sectors, liquidity provisions are often **more strict** than is typical for hedge funds.
    - ✓ **Subscriptions** are structured in "closes" for new investors, usually over a one-year period.
    - ✓ **Limited partners commit a stated amount of capital**, and the general partner will "call" this capital over an investment period (such as 3 to 5 years) as they identify investment opportunities.
    - ✓ **Redemptions** are typically not available.
    - ✓ Instead, the fund will **distribute capital over its life** (often 10 to 12 years) as it exits its investments.

# ◆ Investment Considerations

## ➤ Liquidity Concerns: Drawdown Structure

- The following illustrates a time line of cash flows that might occur for a \$10 million commitment to **a private equity fund**.



- Note in the figure that only \$9 million of the limited partner's capital was called. A general partner is not required to call the full amount of committed capital.