



Alternative Investments



Alternative Investment Features, Methods and Structures



Exam Focus

- Features and categories of alternative investments
- Compare direct investment, co-investment, and fund investment methods
- Investment ownership and compensation structures

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Features of Alternative Investments

Traditional investments: ownership of public equity securities, fixed-income instruments, or cash

Alternative investments: nontraditional investments

Distinguishing features may include:

- **Specialized knowledge** to value cash flows and risks
- **Low correlations** with traditional asset classes
- **Illiquidity** and long investment horizons

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Characteristics of Alternative Investments

Alternative investment characteristics

- Different investment structures
- Incentive fees
- Performance appraisal challenges
- Longer time horizons
- Larger financial commitments

Sophisticated investors with long time horizons

Large pension funds, sovereign wealth funds, and endowments

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Characteristics: Question

An advantage of investing in alternative investments *most likely* is:

- A. high liquidity.
- B. low investment fees.
- C. higher expected returns.

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Private Capital

Private capital includes **private equity** ownership and providing **private debt**

- Private debt includes loans, bonds, venture debt, and distressed debt

Private equity

- Investments in private companies
- Investments in public companies with the intent to take them private (a leveraged buyout)

Venture capital is a specialized form of private equity

- Ownership capital, either start-up phase or early life cycle
- Ideas and business plans, with limited operations or customers

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Real Assets

Real assets includes tangible and intangible assets

- **Tangible physical assets** (e.g., land, buildings, and natural resources)
- **Intangible assets** (e.g., patents, intellectual property, and goodwill)
- Future cash flows and/or store of value

Infrastructure is a special type of real asset involving land, buildings intended for public use to provide essential services (e.g., bridges and toll roads)

- Developed by governments or **public-private partnerships (PPP)**
- A **concession agreement** is the contract in a PPP; exclusive right to operate

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Real Assets

Natural resources

- **Less developed land:** farmland, timberland, or for resource exploration
 - Expected price appreciation and cash flow yields (e.g., crop yields, lease payments, future timber harvests, and mineral drilling rights)
- **Standardized products:** a.k.a. commodities
 - Harvested, extracted, or refined; do not generate income
 - Sold by commodity producers to commodity consumers
 - Lower correlation of returns with other asset classes
 - Inflation hedge, countercyclical holding

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Real Assets

Collectible assets

- **Tangible collectible assets**
 - Fine art, rare coins, wine, and other rare assets
- **Intangible collectible assets**
 - Patents, litigation, and digital assets

Digital assets can be created, stored, and transmitted electronically

- **Cryptocurrencies:** Bitcoin, altcoins, central bank digital currencies
- **Tokens:** nonfungible tokens, security tokens, and utility tokens
- **Altcoins:** stablecoins and meme coins

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Types of Alternatives: Question

Tangible physical assets that generate current or expected future cash flows and/or are considered a store of value are *best* labeled as:

- A. real assets.
- B. private equity.
- C. venture capital.

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Types of Alternatives: Question

Identify which statement about a digital asset is *most accurate*.

A digital asset:

- A. includes digital art but not cryptocurrencies.
- B. is anything that can be stored and transmitted electronically and has associated ownership or use rights.
- C. must adhere to very specific designs or requirements in order to work within the limited types of technology that support it.

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Hedge Funds

Hedge funds are private investment vehicles that may invest in public securities, private capital, and/or real assets.

Hedge funds are distinguished by their **investment approach** rather than by their investments:

- Use of leverage and derivatives
- Long and short positions
- Different risk and return profiles
- A **fund-of-funds** is a portfolio of hedge funds

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Alternative Investment Methods

Accessing alternative investments

- **Fund investment** (e.g., a private equity fund or a real estate investment trust)
- **Co-investment** into a portfolio company of a fund
- **Direct investment** into a company or project (e.g., infrastructure project)

Gaining experience with alternatives

- Start investing in alternatives via funds
- Co-investing with other investors
- Direct investing

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Investment Methods: Question

When an investor invests in an asset without the use of an intermediary, it is called:

- A. co-investing.
- B. fund investing.
- C. direct investing.

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Fund Investment

Fund investment: generally used by investors with limited resources and/or limited experience with alternatives

- Investor contributes capital to the fund
- The fund identifies the investments on behalf of the investor
- The investor is charged a management fee, plus a performance fee
- A hurdle rate or benchmark defines the potential for a performance fee

Limitations for fund investors

- Little or no say in investment decisions
- Fund investors don't typically have the skills or experience to invest directly

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Fund Investment

Fund investment structures for alternatives

- Differ substantially from traditional investment funds
- Require a **precommitment of funds** before investment selection
- **Extended period** during which the fund may not be sold
- Higher and more **complex management and incentive fees**
- Less frequent **transparency of returns** and fund positions

Alignment of investor and management interests

- **Performance-based** as opposed to flat fee structures
- Important terms of the fund are detailed in the term sheet

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Co-Investment

Co-investing may be next step for fund investors, before investing directly themselves

- **Co-investment rights** give a fund investor the right to make a **direct investment** alongside a fund
- Investors expand their investment **knowledge and experience** beyond fund investing
- Provides investment opportunities at **lower fees** than fund investing

Managers benefit from co-investors

- Expand the scope of new investments and accelerate new cash flows
- Increase the diversification of an existing pool of fund investments

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Direct Investment

Direct investment requires sufficient skill, knowledge, and experience to select and manage individual alternative investments

- Requires specialized knowledge and **oversight capabilities**
- **Maximum flexibility** and control over investment choices, timing, and financing

Examples of direct investments

- Buying a direct stake in a private company (i.e., private equity)
- Owning real estate directly
- Investing directly in infrastructure
- Investing directly in natural resources

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Investment Methods: Example

Identify one reason an investor would elect to participate in each of the following alternative investment methods:

Fund investing
Co-investing
Direct investing

-3

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Ownership Structures

Limited partnerships maximize the flexibility to distribute responsibilities between managers and outside investors.

The **general partner** (GP) manages the fund and has unlimited liability:

- Manages the **fund operations**; may manage multiple funds at once
- **Agreed standard of care** and authority to buy/sell assets/borrow funds

The **limited partners** (LPs) are outside passive investors in the partnership:

- LPs commit to future investments and have **limited liability** of funds invested
- **Accredited investor** requirements may apply (e.g., requiring minimum net worth)

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Ownership Structures

Limited partnership agreements (LPAs) contain the **limited partner terms**:

- Distribution of profits and losses
- Manager roles and responsibilities
- Investment criteria and restrictions
- Withdrawals and dissolution of the agreement

A **side letter** is a **supplemental document** issued between a GP and LPs:

- Terms that override or modify the original LPA terms
- Examples: rights to a successor fund, *excusal right*, *most favored nations* clause

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Ownership Structures

Public-private partnerships are agreements between the public sector and private sector to **finance, build, and operate** public infrastructure:

- Examples include bridges, roads, and other public infrastructure
- A **special purpose entity** is used to raise capital for the construction phase
- Capital includes ownership capital and borrowed funds
- A **concession agreement** defines terms and duration of the concession

Other ownership structures

- Master limited partnerships (MLPs) are listed and used for **natural resources**
- Real estate investment trusts (REITs) and exchange-traded funds (ETFs)

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Ownership Structures: Question

Which statement regarding alternative investment partnership structures is *most accurate*?

- A. The fund manager has limited liability for anything that goes wrong.
- B. The fund manager is a limited partner, and investors are general partners.
- C. Investors' upfront cash outflow can be a small portion of their total commitment to the partnership.

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Compensation Structures

Asymmetry of information refers to general partners having more specialized knowledge and control over operations than the limited partners.

- **Incentive structures** are designed to align the interests of the GP and LPs.

Types of compensation

- **Management fee:** 1%–2% of assets under management
 - **Private equity funds** levy management fees on *committed capital* rather than *invested capital*
 - **Hedge funds** levy fees on assets under management
- **Performance fee:** a.k.a. *incentive fee* or *carried interest* based on hurdle rate

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Incentive Fees and Hurdle Rates

Hurdle rates a.k.a. the preferred return: used to define the incentive fees for managers

- **Hard hurdle rate:** an incentive fee is only paid to the manager on annual returns **above the hurdle rate**
 - Example: hurdle is 8%, actual return is 18%, 80/20 share
 - Incentive fee =
- **Soft hurdle rate:** an incentive fee is paid to the manager if the hurdle rate is met based on a **share of the total return**
 - Example: hurdle is 8%, actual return is 18%, 80/20 share
 - Incentive fee =

-2

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Catch-Up Clause

Catch-up clauses relate to soft hurdle rates and to the timing of when the manager receives the incentive fee.

1. The **limited partners** first receive 100% of the hurdle return.
2. The **GP catch-up** is the GP's share over the hurdle rate.
3. The **GPs receives 100% of distributions** until the total return has been shared 80/20.

Example: soft hurdle rate is 8%, actual return is 18%, 80/20 share

Identify the timing and amounts of payments to the LPs and GPs **with** and **without** a catch-up clause.

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Catch-Up: Solution (1)

With a catch-up clause

1. LPs receive 100% of the hurdle rate:
2. GP catch-up: GP's share over the hurdle rate:
3. GP receives 100% of distributions until the return has been shared 80/20

The GP's total share is: 0.2 (18%)

Already paid (GP catch-up) _____

Still to pay

The GP receives 100% of the next distributions until the extra _____ is paid.

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Catch-Up: Solution (2)

Without a catch-up clause

1. LPs receive 100% of the hurdle rate:
2. No GP catch-up: 0%
3. Remaining return is split 80/20
GP share:
LP share:

GP total share = LP total share= '

Note: This is equivalent to a hard hurdle rate, as only the excess returns are shared. This is why catch-up provisions apply to soft hurdle rates.

-4

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High-Water Mark

A high-water mark is a hedge fund's peak net asset value that is used in the calculation of performance fees:

- Subsequent performance **must be above the high-water mark** to earn performance fees.
- Falls in the fund value, followed by growth back to the previous HWM, will not earn performance fees.
- Performance above the HWM will earn performance fees.

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Other Provisions

A **clawback provision** grants limited partners the right to reclaim a portion of GP's performance fee

- Is activated when losses are incurred later in a fund's life after earlier success
- Is common in private equity, but not in hedge funds

Waterfall structures determine distribution of cash flows to GPs and LPs

- GPs receive a disproportionately larger share of the total profits relative to their initial investment
- **Deal-by-deal:** performance fees paid per deal; GP paid before LPs
- **Whole-of-fund:** performance fees paid at the aggregate fund level; LPs paid first

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Compensation: Question

Calculate the general partner's performance fee earned based on the following terms:

Single-period fund rate of return: 20%

Hard hurdle rate: 10%

GP performance fee: 18%

Catch-up clause: none

A. 1.6%

B. 1.8%

C. 2.0%

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Solutions

Characteristics: Question

An advantage of investing in alternative investments *most likely* is:

- A. high liquidity.
- B. low investment fees.
- ☒ C. higher expected returns.

Investors are often attracted to alternative investments seeking greater diversification and/or higher expected returns. A is incorrect because investors usually face longer investment periods, reduced liquidity, and less efficient markets with alternative investments than with more traditional assets. B is incorrect because alternative investments often carry higher fees, including performance and/or incentive fees.

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Types of Alternatives: Question

Tangible physical assets that generate current or expected future cash flows and/or are considered a store of value are *best* labeled as:

- ☒ A. real assets. Real assets are generally tangible physical assets that generate current or expected future cash flows and/or are considered a store of value. Major categories of real assets include real estate and natural resources, as well as intangibles, such as patents.
- ☐ B. private equity.
- ☐ C. venture capital.

B is incorrect because private equity, considered an alternative investment, is nonpublicly traded capital that is invested directly in private companies (or in public companies that are being taken private). It is typically used to invest in firms in the mature life cycle stage or in decline. C is incorrect because venture capital is ownership capital used for nonpublic companies in their early life cycle or start-up phase.

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Types of Alternatives: Question

Identify which statement about a digital asset is *most accurate*.

A digital asset:

- ☐ A. includes digital art but not cryptocurrencies.
- ☒ B. is anything that can be stored and transmitted electronically and has associated ownership or use rights.
- ☐ C. must adhere to very specific designs or requirements in order to work within the limited types of technology that support it.

Digital assets can be thought of as anything that can be stored and transmitted electronically and has associated ownership or use rights.

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Investment Methods: Question

When an investor invests in an asset without the use of an intermediary, it is called:

A. co-investing.

B. fund investing.

C. direct investing.

In direct investing, an investor makes a direct investment in an asset without the use of an intermediary.

A is incorrect because in co-investing, an investor invests in assets indirectly through a fund but also possesses rights (known as co-investment rights) to invest directly in the same assets. B is incorrect because for fund investing, an investor contributes capital to a fund—and the fund, not the investor, identifies, selects, and makes investments on the investor's behalf.

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Investment Methods: Example

Identify one reason an investor would elect to participate in each of the following alternative investment methods:

Fund investing	Fund investing gives investors with limited resources or experience an entrance into alternative investing.
Co-investing	Investors who have better specific skills and greater ability to allocate investments to individual assets may select a more active investment approach while retaining manager involvement. This results in lower fees for the investor than for a purely fund-based approach. Also, co-investors select and manage an investment jointly with a general fund manager, which potentially gives them greater control and higher returns than they could earn in a fund-only structure.
Direct investing	Direct investing offers investors flexibility and control when it comes to choosing their investments, selecting their preferred methods of financing, and planning their approach.

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Ownership Structures: Question

Which statement regarding alternative investment partnership structures is *most accurate*?

- A. The fund manager has limited liability for anything that goes wrong.
- B. The fund manager is a limited partner, and investors are general partners.
- C. Investors' upfront cash outflow can be a small portion of their total commitment to the partnership.**

Limited partners (LPs) are outside investors who own a fractional interest in the partnership based on the amount of their initial investment and the terms set out in the partnership documentation. LPs commit to future investments, and their up-front cash outflow can be a small portion of their total commitment to the fund.

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Incentive Fees and Hurdle Rates

Hurdle rates a.k.a. the preferred return: used to define the incentive fees for managers

- **Hard hurdle rate:** an incentive fee is only paid to the manager on annual returns **above the hurdle rate**
 - Example: hurdle is 8%, actual return is 18%, 80/20 share
 - Incentive fee = $0.2 (18\% - 8\%) = 2\%$
- **Soft hurdle rate:** an incentive fee is paid to the manager if the hurdle rate is met based on a **share of the total return**
 - Example: hurdle is 8%, actual return is 18%, 80/20 share
 - Incentive fee = $0.2 \times 18\% = 3.6\%$

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Catch-Up: Solution (1)

With a catch-up clause

1. LPs receive 100% of the hurdle rate: **8%**
2. GP catch-up: GP's share over the hurdle rate: $0.2 (18 - 8) = \mathbf{2\%}$
3. GP receives 100% of distributions until the return has been shared 80/20

The GP's total share is: $0.2 (18\%)$	3.6%
Already paid (GP catch-up)	-2.0%
Still to pay	<hr/> 1.6%

The GP receives 100% of the next distributions until the extra **1.6%** is paid.

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Catch-Up: Solution (2)

Without a catch-up clause

1. LPs receive 100% of the hurdle rate:
2. No GP catch-up: 0%
3. Remaining return is split 80/20
GP share: $0.2(18 - 8) = \mathbf{2\%}$
LP share: $0.8 (18 - 8) = \mathbf{8\%}$

GP total share = **2%**, LP total share = **16%**

Note: This is equivalent to a hard hurdle rate, as only the excess returns are shared. This is why catch-up provisions apply to soft hurdle rates.

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Compensation: Question

Calculate the general partner's performance fee earned based on the following terms:

Single-period fund rate of return: 20%

Hard hurdle rate: 10%

GP performance fee: 18%

Catch-up clause: none

A. 1.6%

☒ B. 1.8%

C. 2.0%

GP performance fee:

$$= 0.18 (0.2 - 0.1) = 1.8\%$$

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