# Chapter 1: What Is an Alternative Investment?

## Demonstrate knowledge of the view of alternative investments by exclusion

### Recognize characteristics of institutional quality investments

Traditional investment includes publicly traded equities, fixed-income securities and cash

Def **institutional**-**quality** **investment**: type of investment that financial institutions such as pension funds and endowments might include in their holdings; expected to deliver reasonable returns at an acceptable level of risk; not very small and very speculative projects

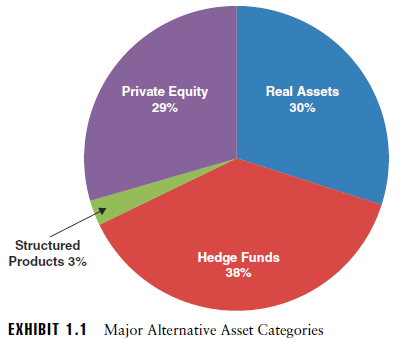
## Demonstrate knowledge of various alternative investment types.

### Describe real assets and distinguish real assets from financial assets

Natural resources, commodities, real estate, intellectual property, and infrastructure

Real estate and especially real estate investment trusts are frequently viewed as being traditional institutional-quality investment

**Real** **assets**: direct ownership of non-financial assets, rather than ownership through financial assets



Natural resources focus on direct ownership of real assets with no or little alteration by humans, such as mineral and energy rights or reserves

Commodities emphasis on having been extracted or produced; homogeneous goods available in large quantities, such as energy products, agricultural products, metals, and building materials

Def **operationally** **focused** **real** **assets**: include real estate, land, infrastructure, and intellectual property

Real estate focuses on land and improvements that are permanently affixed, like buildings

Land comprises a variety of forms: undeveloped land, timberland, and farmland

Infrastructure investments: claims on income of toll roads, regulated utilities, ports, airports, and other real assets traditionally held and controlled by public sector

Real assets include intangible assets, such as intellectual property (e.g. patents, copyrights, and trademarks, as well as music, film, and publishing royalties

### Describe hedge funds

Def **HF**: privately organized investment vehicle that uses its less regulated nature to generate investment opportunities that are substantially distinct from those offered by traditional investment vehicle, which are subject to regulations

### Describe private equity

1. **Venture** **capital**: financing to start-up companies that do not have a sufficient size, track record, or desire to attract capital from traditional sources
2. **Leveraged** **buyouts**: equity of a publicly traded company is purchased in order to take firm private
3. **Mezzanine** **debt**: name from position of capital structure of a firm
4. **Distressed** **debt**: debt of companies that have filed or are likely to file in near future for bankruptcy protection

### Describe structured products

Structured products are instruments created to exhibit particular return, risk, taxation, or other attributes

1. Collateralized debt obligations [CDOs]
2. Credit derivatives: facilitate credit transfer

## Demonstrate knowledge of the concept of structures in investments

### Describe how structures help distinguish alternative investments from traditional investments

Used **structure** to denote attribute that differentiate traditional and alternative investments

**Structure** denote a related set of important aspects that identify investments and distinguish them from other investments

### Define the five primary types of structures

There are 5 primary types of structures

1. Regulatory structures
2. Securities structures
3. Trading structures
4. Compensation structures
5. Institutional structures

Mutual funds -> traditional investments; hedge funds -> alternative investments

### Recognize how structures influence various alternative asset types

1. **Regulatory** structure: role of government, including both regulation and taxation, in influencing the nature of an investment. E.g. HF is less regulated
2. **Securities** structure: structuring of cash flows through leverage and securitization. The use of securities and security structuring transforms asset ownership into potentially distinct and diverse tradable investment opportunities
3. **Trading** structure: role of investment vehicle’s investment managers in developing an implementing trading strategy; e.g. buy-and-hold management strategy may have a minor influence on underlying investment returns, while aggressive, complex, fast-paced trading strategy can cause the ultimate cash flows from a fund to differ markedly from cash flows of underlying assets
4. **Compensation** structure: refer to ways that organizational issues, especially compensation schemes, influence particular investments
5. **Institutional** structure: refers to financial markets and financial institutions related to a particular investment, such as whether the investment is publicly traded

Here are how real assets are influenced by structures

1. **Real** **assets**: tend to have relatively fewer influenced from structures; commodities are primarily driven by securities structure, as they are traded using futures contracts. The majority of land and real estate has institutional structure of being privately held and traded
2. **HF** are primarily driven by trading structure: the use of active, complex and proprietary trading strategies. HF are also distinguished by regulatory structures (e.g. use of structured due to tax regulations) and compensation structure, including use of performance-based investment management fees
3. **PE**: institutional structure, as not publicly traded. Compensation, securities, and trading structures also play nontrivial roles in shaping the nature of PE
4. **Structured** **products**: securities structure. Also, typically moderately influenced by institutional, regulatory, and compensation structures

### Recognize the limits of using structures to categorize alternative investments

The concept of 5 structures is designed to help us understand and analyze investment products but not necessarily to define classes of securities. The context of these 5 structures can help identify an investment’s distinguishing characteristics.

## Demonstrate knowledge of how alternative and traditional investments are distinguished by return characteristics

### Recognize the role of absolute return products as diversifiers

Def **diversifier**: an investment with a primary purpose of contributing diversification benefits to its owner

Def **absolute return product**: investment products viewed as having little or no return correlation with traditional assets, and have investment performance that is often analyzed on an absolute basis rather than relative to performance of traditional assets

### Define illiquidity, and describe the advantages and risks of illiquid investments

Def **illiquidity**: returns are difficult to observe due to lack of trading

The risk of illiquidity assets may be compensated for higher return

### Define efficiency and inefficiency, and describe their relationship to competition and transaction costs

Def **efficiency**: tendency of market prices to reflect all available information

Def **inefficiency**: refers to deviation of actual prices from valuations that would be anticipated in an efficient market

## Demonstrate knowledge of how alternative and traditional investments are distinguished by methods of analysis.

### Recognize return computation methods

**Return** **computation** **methods** for alternative investments are driven by their structures and can include such concepts as IRR, the computation of which over multiple time periods, uses size and timing of intervening cash flows rather than intervening market values; may also take into considering leverage

### Recognize statistical methods

Non-normality is usually addressed through the analysis of higher moments of return distributions, such as skewness and kurtosis

### Recognize valuation methods

Alternative investment tends to focus on evaluation on fund managers, while traditional investing tends to focus more on valuation of securities

Here are some methods for valuing some types of alternative investments

1. May include analyzing active and rapid trading that focuses on shorter-term price fluctuations than are common in traditional investment management
2. Often requires addressing challenges imposed by inability to observe transaction-based prices on a frequent and regular basis.
3. Real estate, PE and structured products tend to have unique cash flow forecasting challenges
4. Some real estate and PE funds use appraisal methods that are estimates of current value of asset, which may differ from price that the asset would achieve if marketed to other investors

### Recognize portfolio management methods

Portfolio management of alternative investments often requires application of techniques designed to address such issues as non-normality of returns and barriers to continuous portfolio adjustments. The inability to trade some alternative investments like PE quickly and at low cost adds complexity to portfolio management process, such as liquidity management, and mandates understanding of specialized methods

## Demonstrate knowledge of other factors that distinguish alternative investments from traditional investments

### Recognize factors that contribute to information asymmetries

Information asymmetries: refer to the extent to which market participants possess different data and knowledge; factors: private placement

### Describe the concept of incomplete markets and the effect of incomplete markets on investors

Incomplete markets: refer to markets with insufficient distinct investment opportunities. The lack of distinct investment opportunities prevents market participants from implementing an investment strategy that satisfies their exact preferences, such as their preference regarding risk exposures.

### Recognize the prominence of innovation in alternative investments as compared to traditional investments

The new and rapidly changing nature of alternative investments raises issues regarding methods of financial analysis and portfolio management that distinguish the study of alternative investments from the study of traditional investments

## Demonstrate knowledge of the goals of alternative investing

### Define active management, and contrast active management and passive investing

Def **active** **management**: efforts of buying and selling securities in pursuit of superior combinations of risk and return.

Def **passive** **investing**: tends to focus on buying and holding securities in an effort to match risk and return of a target, such as a highly diversified index.

The focus of alternative investing is often on analyzing the ability of the fund to generate attractive returns through active management

### Recognize the role of benchmarks in managing investments

benchmark is a performance standard for a portfolio that reflects the preferences

of an investor with regard to risk and return

### Describe the concept of arbitrage, and the roles of return enhancers and return diversifiers in an investment program

**Arbitrage** is often used to represent efforts to earn superior returns even when risk is not eliminated because the long and short positions are not in identical assets or are not held over the same time intervals