Chapter 12: Alternative Investments

Introduction

1. Alternative investments often include:
    a. Private Equity: investments in private companies, specifically emphasizing the fact that they are not public
    b. Real Estate: direct or indirect investment in land and buildings
    c. Commodities: investments in physical products, such as precious and base metals, energy products, and agricultural products.
2. These are considered alternative investments because they are alternatives to traditional asset classes, such as debt and equity securities. They provide the potential for enhanced returns as well as diversification (the practice of combining different types of assets in a portfolio in order to reduce risk.)

Why Invest in Alternatives?

1. Introduction
    a. Features of alternative investments include being less regulated, transparent, liquid, and easy to value than debt and equity investments.
2. Advantages of Alternative Investments
    a. The two main advantages of alternative investments are that they provide:
        i. The potential for enhanced returns
        ii. Reduced risk by achieving diversification
            1. Investors rarely allocate all of their money to one class of asset or security. Instead, they diversify their portfolio by investing in assets that behave differently than each other. If two assets have a correlation of anything less than +1.0, then combining these two assets in a portfolio provides diversification and reduces risk.
            2. This is because the risk to the portfolio of including these two assets or securities is lower than the weighted sum of the risks of the two assets.
3. Limitations of Alternative Investments
    a. Compared to traditional asset classes, alternative investments are:
        i. Less regulated and less transparent, which leads to investors being less likely to invest in them (which may provide an opportunity for investors to capitalize on market inefficiencies.)
        ii. Less liquid, which may be less important for institutional investors who are willing to hold assets for longer periods of time.
        iii. More difficult to value, due to the fact that the availability of data that can be used to assess value is limited. Appraisal is often used in these circumstances.

Private Equity

1. Introduction
    a. Private Equity firms invest in private companies that are not publicly traded on stock exchanges. Although people typically refer to PE, investments can also include debt, although this is less common.

2. Private Equity Strategies
    a. Venture Capital
        i. Venture Capital is a form of PE that involves financing the early stages of companies. VC often invests in start-ups that may be in the stage of an idea, business plan, or small company with few employees, low revenue, and still under development. VCs offer both capital and expertise for growing the business. VC is considered to be the most risky of PE strategies due to the fact that most companies fail. Even if they do not, they will often have multiple years of non-profitability. But, those that do succeed rewards their investors well.
    b. Growth Equity
        i. Growth Equity is a form of PE that involves financing companies with already proven business models, good customer bases, and positive cash flows/profits. These companies often have the potential to grow in some manner that their current/projected cash flows can not support, and so the company turns to growth equity for funding. This type of investment is done at later stages in the business life cycle than venture capital.
        ii. Some growth equity firms specialize in preparing companies for an initial public offering. This is often done in return for equity, which dilutes the ownership of the company, but can bring value that outweighs this cost.
    c. Buyouts
        i. Buyouts are a PE strategy that involves financing already established companies that require funding to restructure and facilitate change of ownership. This is sometimes applied to public companies that are then taken private.
        ii. Leveraged Buyouts (LBOs) are a specific kind of buyout that use financial leverage to fund the buyout of the target company. The term leveraged is used to describe the fact that the strategy employs financial leverage, referring to the ratio of equity to debt used by the investor (in this case, the PE firm.)
            1. Because using financial leverage will require that the PE firm pay back its debt and interest payments, target companies are often required to provide sufficient cash flow over the time horizon of the debt repayment.
    d. Distressed
        i. Distressed investing involves paying the debt of distressed companies, meaning those who have defaulted or are at risk of defaulting on their debt. Investors will often pay this debt at a small percentage of its par value, meaning (for instance) 20-30% of the total debt. If the company recovers, the debt paid realizes some difference (partial vs complete?) between what was paid the total debt. Distressed debt does not typically include cash flows.

e. Secondaries
    i. Secondary investing involves the buying or selling of existing private equity investments. Private equity investments are typically organized in funds that have an average lifespan of somewhere around 10 years. The first three to four years are spent creating the investments, followed by five to seven years of developing the investments and returning capital to those who invested in the private equity fund. Some private equity partnerships may not be able or willing to hold all of their investments (whether in the form of venture capital, growth equity, buyouts, or distressed) and can then sell these investments to other private equity investors in secondary markets. These are known as secondary transactions.

3. Structure and Mechanics of Private Equity Partnerships
    a. Private equity typically takes the form of partnerships, which are comprised of two types of partners:
        i. General Partner: typically the firm that sets up the partnership. It is responsible for raising capital, finding suitable investments, and making decisions. General partners have unlimited personal liability for all of the debts of the partnership.
        ii. Limited Partner: investors who contribute capital to the partnership. They are not involved in the selection and management of investments. They have limited personal liability.
    b. Private equity firms may create different funds for different types of investments. The investments are not individually managed by the general partner, but are instead managed by fund managers who are hired by the general manager.
    c. Private equity firms make money through two mechanisms:
        i. Management Fees: fees that are paid to the general partner by limited partners, and are typically a percentage of assets under management (specifically that amount invested by the limited partner.)
        ii. Carried Interest: a percentage of the profit from a private equity investment. This is made so that the incentives of the general partner are aligned with those of the limited partners.
    d. Investments in private equity partnerships tend to be illiquid. Once committed, it is difficult, if not impossible, for limited partners to withdraw their investment.
    e. Investments made by limited partners are not made at once. Instead, limited partners promise a total investment amount, which is drawn on over the life of the fund by the general partner through what are called capital calls. As the investments made by the private equity firm are completed, returns are paid to the limited partners after the carried interest is deducted. During this entire time, management fees must be paid by the limited partners. So, in order for the limited partners' return on investment to be positive, they must receive returns that exceed their management fees and called capital. If a private equity investment is sold in a secondary transaction, limited partners receive their proportional percentage of the cash generated by the sale.
        i. The J Curve is a line drawn to represent the cash flows that a limited partner receives from a private equity investment. This is because it is shaped like the letter J. It is negative with a negative slope at first due to capital calls and

management fees, and then later develops a positive slope as investments are completed, followed by positive overall cash flows as their returns increase. (This is over the life of an ideal private equity fund.)

Real Estate

1. Introduction
    a. Commercial Real Estate refers to real estate that generates income. The major segments of commercial real estate, which each have their own characteristics, advantages, and limitations, are land, offices, multifamily residential dwellings, retail properties, industrial properties, hotels, and other segments.
2. Commercial Real Estate Segments
    a. Land
        i. Raw, or underdeveloped land, is a kind of real estate investment that can be risky due to the fact that there are no sources of cash inflows and tha there are only outflows such as real estate taxes. As buildings, roads, utilities, etc… are built, the value of raw land increases due to expected increases in cash flows. However, the value of raw land can fluctuate quickly in large magnitude as demand changes.
    b. Offices
        i. Offices are one of the largest commercial real estate segments and are typically owned by real estate investment firms. These companies lease space to tenants with a variety of time horizons, and demand payment regardless of whether or not the tenant occupies the space. For this reason, the cash flows are fairly predictable. Additionally, payments are adjusted for inflation.
    c. Multifamily Residential Dwellings
        i. Multifamily residential dwellings are another large segment of commercial real estate, and are defined as properties that contain multiple residences within a single property or development. Leases are typically within the range of a year, and so this segment is sensitive to supply and demand of the local real estate market.
    d. Retail Properties
        i. Retail properties include shopping malls, commercial shopping centers, and buildings for other retail purposes. The terms on these leases can last from weeks to years.
    e. Industrial Properties
        i. Industrial properties include manufacturing facilities, research and development space, and warehouse/distribution space. Terms vary in length.
    f. Hotels
    g. Other Segments
        i. Other segments may exist within commercial real estate depending upon the economy. One factor that influences this is degree of economic development.

3. How to Invest in Real Estate
    a. Private Market Investments
        i. Real Estate Limited Partnerships
            1. Real estate limited partnerships take forms similar to those of the private equity partnerships described above. Real estate investment firms typically take the role of general partners and raise capital through limited partners. The real estate investment firms are responsible for the development, and sometimes management, of the relevant properties. Limited partners may face years of negative cash flows due to capital calls and management fees being required before the general partner can complete their investments and pay dividends.
        ii. Real Estate Equity Funds
            1. Real estate equity funds hold investments in hundreds of commercial real estate properties that are diversified by geography, property type, and vintage year. Real estate equity funds are often open-ended funds, meaning that they issue or redeem shares when investors want to buy or sell. Redemptions can take place at intervals, such as quarterly or annually, or on demand. These redemptions are often paid from the cash flows generated by the properties, but there are no guarantees that the properties will provide sufficient cash flows for investors' demands.
    b. Public Market Investments
        i. Real Estate Investment Trusts (REITs)
            1. REITs are real estate investments traded in public markets. Similar to other securities, they are traded on exchanges, making them more liquid than other forms of real estate investment. REITs are owned by companies that develop and manage properties, and are used at all stages of real estate investment.

Commodities

1. Introduction
    a. Commodities, such as precious and base metals, energy products, and agricultural products, tend to rise in price with inflation. So, they can provide protection against inflation in a portfolio.
    b. Methods of investing in commodities include:
2. Purchase of the Physical Commodity
3. Purchase of Shares of Natural Resources or Commodity-Related Companies
    a. Investors can purchase shares of companies that have a major portion of their operations in the exploration, recovery, production, and processing of commodities.
4. Purchase of Commodities Derivatives
    a. Investors can purchase securities that have underlyings in commodities or commodities indexes. Typically, commodities derivatives are forwards, futures, options, and swaps.