



## Alternative investments in portfolios



June 2010

### Introduction

Insinger de Beaufort applies five (5) risk profiles:

- Defensive
- Cautious
- Balanced
- Growth
- High Growth

Each of the five profiles has two versions, one with Alternatives and one without Alternatives, bringing the total number of risk profiles to ten.

### The added value of Alternatives

Many investors are unfamiliar with Alternatives. This is unfortunate, as Alternatives can add real value to investment portfolios. The greater diversification achieved when investing in Alternatives generally improves the risk/return profile thanks to the lower correlation between Alternatives and traditional investments. In other words, while retaining the same level of risk, you can increase the expected return on your portfolio.

The disadvantages of investment in Alternatives are the often illiquid nature of these investments (which varies according to the type) and the fact that some do not pay interest or dividends.

### Different types of Alternatives

Although we have so far described Alternatives as a single asset class, this does not really do them justice. Alternatives vary widely, ranging from highly transparent and tangible to highly complex. Their common characteristic is their generally low correlation with 'traditional investments' such as equities and bonds.

The following are five Alternatives in which we invest:

- Real Estate (Direct)
- Hedge Funds
- Private Equity
- Commodities, including gold
- Convertible Bonds

Insinger de Beaufort conducts thorough research into these different types of alternative investments. This research and our macro-economic forecasts are used to determine the allocation to these investments. The ultimate objective is to reduce portfolio volatility and generate more stable returns compared to portfolios containing only traditional investments.

Please find below a brief description of the different types of alternative investments.

### Direct real estate

Direct Real Estate is interesting to investors for several reasons. In contrast to listed real estate, it has a low correlation with the equity and credit markets. Its long-term returns and risks are normally somewhere between those of equities and bonds. Moreover, real estate generally has an annual income, often linked to inflation. There are several ways of investing in Direct Real Estate. Perhaps one of the most well-known is investment via limited partnerships, in which you and a (limited) number of other investors become joint owners of one or more investment properties.



### **Hedge Funds**

Hedge Funds received high levels of negative publicity during the recent financial crisis. This was probably due to the (incorrect) perception among investors that they always generate positive returns. Although prices were squeezed in 2008 and some hedge funds were (temporarily) closed or wound up, on average this asset class performed better during that year than other risky investments, such as equities, commodities and high yield bonds.

However, hedge funds are generally complex products, and investment in these type of funds can be very risky.

Hedge funds often work with derivatives (options and futures) and combine long and short positions. It is difficult to classify hedge funds in a single category as the varieties are almost endless. The investment risk therefore ranges from very low to very high. Many hedge funds focus on investing in equities, others specialise in bonds, currencies, commodities, or special situations, such as mergers and acquisitions.

By applying a combination of long and short positions, hedge funds typically focus on avoiding investment losses. The name hedge fund derives largely from this characteristic. Long positions are standard investments whereby the funds profit from price rises. Short positions are investments which hedge funds sell on the market without actually owning them at that point, by borrowing them temporarily from another party. By repurchasing these investments only after a drop in price and returning them to the party from which they were borrowed, the hedge fund profits from the fall in price. The correct combination of long and short positions enables a successful manager to restrict losses in a downward market or even earn a positive return.

Hedge funds have existed since the nineteen-forties. In particular over the past few decades, new varieties have emerged which have a very high rather than very low investment risk. The high risk almost always derives from investment in less liquid instruments and a high level of leverage (large amounts of loan capital). These funds should really be called leveraged funds, but are often referred to rather inappropriately as hedge funds.

An additional risk of investment in hedge funds is that they are often legally registered in countries which conduct very limited supervision and have minimum reporting requirements. The risk of fraud is consequently higher than for regulated on-shore funds. Furthermore, liquidity risk plays a major role in hedge funds. There is often a penalty clause or waiting period on withdrawal from the fund, while under extreme circumstances funds may suspend the option to exit the fund entirely until further notice.

One final, important characteristic of hedge funds is the higher fee structure, especially when a high return is earned. The cost of investing in hedge funds is generally higher than for traditional investment funds. In addition to a management fee, a performance fee is often also charged which is calculated across the earned return above a specific threshold.

In spite of the risks inherent to investing in hedge funds, they do form an important asset class. The best hedge fund managers have proved themselves capable of earning relatively high returns combined with relatively low investment risks over a long period. With a view to restricting the risks involved in investing in individual hedge funds, use is made of funds of funds, i.e. funds which invest in a basket of hedge funds.

### **Fund of Hedge Funds**

These are investment funds which in turn invest in other investment funds. Fund of funds are mostly, but not exclusively, used to invest in hedge funds. This considerably restricts the risks involved in investing in individual hedge funds. This method can also be used to construct a balanced portfolio of hedge funds with relatively sound risk/return ratios, as the performances and risks of one type of fund are compensated for by the other types of funds. The main disadvantage of investing in fund of funds is the dual fee structure. Investors pay not just the management fees for the fund of funds, but also those of the underlying funds.



# INSINGER DE BEAUFORT

## BNP PARIBAS WEALTH MANAGEMENT

### **Private Equity**

Private Equity generally entails investment in companies which are not listed, or in (parts of) companies which are to be delisted. This often involves financing existing companies undergoing Management Buy-Outs or MBOs. Or it may be financing start-ups, or (relatively) new business activities. The latter type is also known as venture capital and carries additional risks. As most Private Equity investments entail large amounts of leverage (high levels of interest-bearing debt), it implies a higher risk than equity investment via the stock market. Private equity investments are generally conducted via participations in funds for joint account and for a period of seven to twelve years. These participations often cannot be traded, or only to a limited degree. This illiquidity makes investment in Private Equity unsuitable for clients with shorter time horizons.

### **Commodities**

Commodities can be classified into soft and hard commodities. Soft commodities are crops such as grain, tobacco, coffee and peanuts. Hard commodities include gold, silver, oil and oil products.

Although the correlation between commodities and traditional asset classes is low, as commodities are often used early on in manufacturing processes, there is a link between commodities and other financial markets. For instance – in normal market conditions – a rise in the oil price may affect inflation, which will in turn influence the capital market interest rate and therefore the credit markets. Although the price of commodities is largely driven by fundamental trends which govern supply and demand, there are times at which speculative investors influence these markets. This explains the frequently volatile nature of these markets. Commodities such as gold (and silver) are often seen as safe havens in times of uncertainty. Aside from physical delivery of the commodity, not generally the preferred option for investors, there are many opportunities for investing in commodities.

### **Convertible Bonds**

Convertible bonds are bonds which can be exchanged for equities under specific terms and conditions and during a specific period. This may be equities of the same company, but there are also convertible bonds which can be exchanged for equities of another company, known as exchangeables. An (additional) cash payment may be required when the exchange takes place. Convertible bonds usually have a much lower coupon value than standard corporate credits.

The terms and conditions for exchange, such as the conversion price (the equity price), the conversion ratio (how many equities in return for conversion of a bond) and the conversion period, are established when the bonds are issued. The generally low coupon value means that the risks involved in convertible bonds are often greater than for standard corporate credits. Depending on the price growth of the equity with which the exchange may be made, there are higher risks involved in convertible bonds than for corporate credits. The risks involved in convertible bonds will increasingly imitate those for equities the closer the market price of the underlying equity moves to the conversion price or if it exceeds it, which results in the convertible price rising (far) above par.