

# ALTERNATIVE INVESTMENTS

## A WEALTH OF OPPORTUNITIES

This past year's underperformance by both the stock market and the bond markets has brought quite a bit of attention to a lesser-known asset class: **alternative investments**. Also called "alternative assets" or simply "alternatives," these are investments in anything other than traditional investments, i.e., stocks, bonds, mutual funds, exchange-traded funds (ETFs), and cash. The alternative assets class includes myriad strategies, some well-known, and others extremely niche.



There are two goals for alternative investments in the context of portfolio allocation/design: **enhancing returns and improving diversification**. Generally, alternative investments are given a 10% to 30% allocation, depending on the risk profile and investment goals of the individual investor. It's important to note that most, if not all, of these alternative investments are restricted by law only to investors who are accredited or qualified. We'll review the main categories of alternative investments, discuss the risks, touch on their use in building an investment portfolio, and consider ways in which investors can access these investments.

## The 8 Main Types of Alternative Investments:



- 1 Private equity
- 2 Private debt
- 3 Structured products
- 4 Hedge funds
- 5 Real estate
- 6 Commodities
- 7 Collectibles
- 8 Cryptocurrency

### 1 Private Equity

**Private equity** describes any investment in which an investor supplies capital to a private company in exchange for equity, or ownership, in that company. "Private" denotes the fact that this is a private transaction between the company and the investor. The process of finding good private companies in which to invest is complex and difficult. Many investors enlist the services of private equity firms that act as intermediaries between investors and private companies. The private equity firm creates an investment vehicle called a limited partnership. A limited partnership pools investor capital and gives a representative of the private equity firm, called a general partner or investment manager, the authority to invest that capital on behalf of the investors. Once an investment is made in a private company, that company is referred to as a "portfolio company."

Private equity is a broad category with many smaller subcategories. The main differentiator among subcategories is the funding stage the portfolio companies are in. If the portfolio companies are not yet operating, investments in these businesses are considered **seed capital**. If the portfolio companies have ongoing operations but are



still in the early stages, investments in them are considered **venture capital**. Both of these early-stage subcategories of private equity come with a high risk of total loss of principal value, but offer the potential for outsized returns if the portfolio companies grow and improve rapidly.

Once a company has undergone one to three rounds of funding, it is generally no longer considered for venture capital. At this point, **growth equity** investors come in. Many private equity firms focus on this stage of the business life cycle, often referred to as “middle-market.” Middle-market companies have established track records of growth and appreciation but need an influx of fresh capital to maintain growth rates. In a confusing use of terms, this area of private equity investing is often referred to by the main category name, private equity investing, instead of by its subcategory name, growth equity investing.

A subcategory of private equity that is not based on the funding stage of the portfolio companies is

**buyouts**. Buyouts are a strategy in which an investor purchases the entire company, as opposed to only a portion of the company’s equity. One strategy in the buyout subcategory is the leveraged buyout, or LBO. In this strategy, a private equity investor takes out a large loan that it uses to purchase a company. After the purchase, the investor uses that business’s cash flows to pay off the loan, usually in installments. If an **LBO** is done successfully, the investor can pay off a substantial portion of the loan and sell the company for an outsized return on investment, even if the business has not grown in value.

Private equity is used in a portfolio for both diversification and enhanced returns. Diversification comes from the historically low correlation between public equity valuations and private equity valuations. In other words, the movement of public stock prices has very little connection or impact on the price movement of private companies. An aggressive investor might allocate up to 20% of their portfolio to private equity to seek outsized returns and take advantage of the diversification benefits. A risk-averse investor would likely avoid private equity, seeking diversification through a less volatile alternative investment.

## 2 Private Debt

**Private debt**, like private equity, involves investors supplying capital to a private business. Instead of getting equity in exchange for its capital, the borrowing company agrees to pay the investors back the original principal with an agreed-upon rate of interest. There are also covenants, or additional terms and conditions, that private debt investors can demand on top of the agreed-upon interest rate. As with private equity, most investors choose to pay a private debt firm to find and make investments on their behalf through a limited partnership structure. Why would a company seek



a loan from the private capital markets rather than from a bank? Banks reject business loan applications for a variety of reasons: high risk, unproven business, lack of understanding of the business or business model, lack of available loan capital, etc. The private markets have more flexibility in researching, understanding, and taking risks on private debt transactions.

Private debt can fill the role mentioned earlier of an alternative investment that is less risky than private equity. It is important to note, however, that this is

a broad generality. Individually, private debt investments can have far greater risks than private equity investments. Historically, though, private debt has a higher probability of profit and lower probability of loss, hence the generalization that private debt is less risky than private equity. Private debt has similar diversification benefits, due to a lack of correlation to public debt price movements. Those seeking to better diversify a portfolio without taking high risks can attempt to find a private debt limited partnership with a low-risk strategy and a track record of successfully executing that strategy.

### 3 Structured Products

A **structured product** is created by grouping together debt obligations, with the goal of attaining a higher yield than most publicly traded debt securities, yet the structured product is theoretically just as “safe” because of the diversification across myriad individual private debt deals. These investments are usually sold as securities by brokerage firms rather than being accessed through a limited partnership.

One structured product is the **mortgage-backed security (MBS)**. MBSs are created by taking standard mortgages and bundling them together, then selling off different groupings, called tranches. The tranches are made up of a small percentage of many, many mortgages. The idea is that grouping these mortgages together diversifies the risk. Leading up to the Global Financial Crisis of 2008, ratings agencies gave the tranches of MBSs very high ratings, informing investors that these were low-risk investments. But these ratings were wrong. As mortgage defaults skyrocketed, many tranches of structured products became worthless. As the GFC showed, these products can have a high degree of risk, including the potential for a full loss of the principal.



Structured products play a role in building investment portfolios, primarily for institutional investors. Institutions seeking certain cash flows or slightly enhanced fixed-income returns, for numerous reasons, use structured products to attain those cash flows or fixed-income return goals.

## 4 Hedge Funds

Hedge funds make various types of investments on behalf of investors using a limited partnership structure. Historically, these were traditional investments in stocks, bonds, and cash. Unlike a mutual fund or ETF, however, hedge funds can perform short selling, or betting against a stock. Short selling, in other words, lets the hedge fund make money when the market goes down. Hedge funds also have more



flexibility than mutual funds and ETFs when using leverage or borrowed money. Today, hedge funds have expanded far beyond traditional investments and strategies. There are hedge funds specializing in areas such as global investments, arbitrage, commodities, cryptocurrencies, and many others ranging from traditional and common to cutting-edge and extremely niche.

One common hedge fund strategy is the **“long/short.”** In this

strategy, the hedge fund goes long, or buys, one stock, while going short, or selling, another stock that is very similar. The hedge fund is betting that the stock that it bought (long) will outperform the stock that it sold (short). If the investment that is bought (long) outperforms the investment that is sold (short), the hedge fund will profit regardless of the direction that prices go. This means that even if both stocks drop in price, if the stock that was sold (short) declines by more than the stock that was bought (long), the trade will be profitable.

Hedge funds, like private equity, are primarily used to improve

the diversification of a portfolio while also seeking enhanced returns. The diversification rationale is that the hedge fund’s trading strategies, especially the use of short selling, causes hedge fund returns to have a very low historical correlation to the performance of the broader capital markets. At the same time, those strategies aim to outperform the broader market.

Hedge funds can have a very high degree of risk, including the risk of the full loss of the principal capital. This risk is often bolstered by the use of leverage, or borrowed money. Risk-averse investors should look for other alternative investments to attain the same diversification benefits that hedge funds offer.

## 5 Real Estate

**Real estate**, or the purchase of land and buildings, is the most common alternative investment. For thousands of years, purchasing land and property has been a primary method of wealth preservation and investment for people around the globe. In contemporary capital markets, investors can access real estate in many ways, including direct investment, co-investment, limited partnerships, and real estate investment trusts (REITs).

**Direct investment** is what most people think of when they hear “investing in real estate.” It is a direct purchase of land/property, using cash or a loan, by a person, either as an individual or through an entity (an LLC, a trust, etc.). The investment can be purchased to be used as a residence or with the intent of leasing the space to a tenant in exchange for rent payments. Purchasing a good property at a good price,

finding tenants to lease to, and maintaining that property is arduous work that discourages many potential real estate investors. To address these challenges, there are limited partnerships, co-investment, and REITS.



**Limited partnership** structures can be used for real estate in the same way that it is used for private equity, private debt, and hedge funds. Investors who want access to real estate but do not want to do the work to find and maintain good investments can pay a fee to an expert who makes and manages investments on behalf of investors. Real estate limited partnerships have different specializations, such as office space, hospitality, healthcare, residential, and industrial real estate, among others.

Limited partnerships investing in real estate can be a very effective addition to a portfolio for both enhanced returns and improved diversification, especially because of the optionality around the risks associated with real estate limited partnerships. Each partnership has its own investment strategy with its own associated risks. Strategies range from conservative (net lease) to aggressive (development), which makes real estate an applicable alternative for most investor risk profiles.

**Co-investments** go hand-in-hand with the limited partnership structure and are applicable to any alternative investment that uses limited partnerships. Co-investing occurs when the investors in a limited partnership invest directly in the portfolio companies or portfolio properties of the partnership. One common use for co-investments is to allow the partnership to access an investment that it would otherwise not have enough capital to invest in. For instance, if a property requires an equity investment of \$10 million, and the

partnership has only \$20 million, it is unlikely that the investment manager would be comfortable investing 50% of the partnership's capital in a single property. If, however, several investors are willing to co-invest with the partnership, then the partnership may need to put up only \$4 million (20% of its capital). The other \$6 million comes from limited partners investing directly in the property alongside the partnership. This is a far more acceptable investment size for the partnership, and it gives the investors an opportunity to double down on one of the partnership's investments, but with lower fees.

Co-investment should be considered only by aggressive investors, since they are generally very large investments in a single property or portfolio company. As a result, co-investments are mostly executed by ultra-high-net-worth investors following the guidance of a wealth advisor.

**Real estate investment trusts (REITs)** are an increasingly common real estate investment vehicle, but since they are publicly traded securities, they aren't generally considered an alternative investment. REITs are public investment companies that take investor capital and perform direct real estate investing or some other form of real estate investing. The regulatory requirements and restrictions for REITs differ from those for traditional mutual funds and ETFs, but we won't dive into those nuances here. It should simply be noted that REITs are a publicly traded security that gives investors exposure to real estate. REITs can be used in almost any portfolio to add diversification and income, though REITs have a higher correlation to public equities and public debt securities than private real estate (direct, partnerships, co-investments) does. As with partnerships, the risks of each REIT should be considered individually.

## 6 Commodities

Commodities are raw materials such as **oil** and refined natural resources such as **timber, gold, wheat, soybeans**, etc. To invest in commodities, an investor can either purchase the commodity outright or use a futures contract. With an outright purchase, investors buy and store the commodity until they decide to sell, hoping to do so at a higher price to earn a profit. This practice is extremely rare, because it necessitates the costly transportation and storage of the commodity. Many investors gain exposure to a commodity using an ETF that tracks the commodity price.

Unlike the other alternative investments we've reviewed, commodities neither produce nor have the potential to produce streams of income. Since



there are no income streams, the profitability of an investment in commodities depends fully on a change in the commodity's market price.

With a **futures contract**, the investor puts up a certain amount of margin (cash) to enter the contract. If the investor enters a futures contract in which they agree to buy the commodity, then the investor is liable to pay the institution holding the contract for any decrease in price and is compensated by the institution for any increase in price. The process works in reverse if the investor enters

a futures contract in which they agree to sell the commodity. Due to the cost and the difficulty of exchanging commodities outright, as explained above, these futures contracts almost never get executed. They are used by the producers of commodities or large consumers of commodities (businesses) either to speculate on, or to hedge against, changes in the price of the commodity that they deal in. The contracts are “closed” by settling in cash instead of exchanging the commodity.

In terms of portfolio construction, commodities are a source of diversification and capital preservation. The most common is precious metals, specifically gold. Gold is used to preserve wealth, primarily in anticipation of or in response to inflation. A small allocation to gold can be an appropriate addition to most portfolios, especially for long-term, risk-averse investors.

## 7 Collectibles

**Collectibles** include all manner of price-appreciating goods, such as fine art, trading cards, historical artifacts, rare cars, and more. The most common way in which investors gain exposure to these alternative assets is by purchasing them outright in private transactions. Like commodities, collectibles do not provide



a stream of income. Any profits from an investment in collectibles will more likely than not come from price appreciation and an eventual sale of the collectible. The ultra-high-net-worth community has been the primary beneficiary of the appreciation in the prices of fine art and other extremely expensive collectibles, since their prices make these investments inaccessible to most investors. There are, however, many investors in the average-net-worth range who profit from investing in other, less expensive items such as trading cards, antique coins, comics, and more.

Some attempts have been made to increase retail access to the fine art market by securitizing and selling shares in highly valued pieces of art. These attempts have not yet been fully market-tested, so for the mo-

ment we must simply acknowledge that they are ongoing and continue to watch their performance.

## 8 Cryptocurrency

We would be remiss if we didn't mention **cryptocurrency** in a review of alternative investments. Some people put crypto squarely in the traditional investment category of “currency” or “cash.” Although its name may include the word “currency,” crypto is far from a traditional cash investment. It is rarely noted that there is a distinct difference between investments in the technology behind these cryptocurrencies and investments in the cryptocurrencies themselves. The decentralized ledger technology and its application in terms of digital transactions has immense potential, and large and reputable financial institutions are already using them. That said, most peo-



ple have witnessed the immense uncertainty resulting from the recent collapse of the crypto exchange FTX. The uncovering of fraudulent or extremely risky activities by a growing number of crypto entities (exchanges, issuers, and hedge funds) has shown that the unregulated cryptocurrency market is still extremely volatile and unproven. Until sufficient regulation exists to protect

investors, as well as a proven track record of use and price appreciation, LCR Wealth will not, and does not, include cryptocurrency in any of its asset allocations.

## Conclusion

Diversification can be attained using alternative investments regardless of the risk-return profile of the specific alternative investment strategy. This means that a conservative strategy can diversify a portfolio to the same degree as an aggressive strategy. For that reason, alternative investments continue to gain popularity as an essential asset class when designing portfolios for investors, whether those investors are risk-seeking or risk-averse. For risk-seeking investors, allocations can be tailored to add tremendous potential for enhanced returns, especially in the long run.

Alternative investments contain far more nuances, options, and distinctions than can be discussed comfortably in this brief paper. However, the above review of the seven main categories should **serve as a guide** to the extraordinarily wide-ranging term that is “alternative investments.”

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