Essay on Alternative Investment Classes and their Role in Investment Portfolios

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Introduction

Alternative investments in the present world are analysed in varied angles but the alternative investments in a practical and academic sense is used as the diversification in the portfolio to provide better returns to the investor and also provides better risk profile to the investor (Fabozzi, 2008). In the past the investors have used the traditional asset classes to diversify their investments like domestic stocks, international stocks, emerging market stocks and bonds unlike the present time where the alternative assets classes are Real assets, Currencies, Private Equity, Hedge Funds, Venture Capital, Fund of Funds and Infrastructure (Anson, Fabozzi and Jones, 2010). The present essay is going to explore the present alternative asset classes, its risk, returns and illustrative examples in a detailed and analytical way within a portfolio construction and its management processes. The essay also looks in to reasons why an investor wants to invest in to a portfolio. In the end the essay provides consolidated conclusion and recommendations based on the analysis conducted across the essay.

Alternative Investments an Overview

In the traditional investments the institutional investors believed in high risk and high return investments which has made the alternative asset classes to be used for investments by the high net worth individuals as there was lack of access, low liquidity and lack of transparency as the barriers (Fabozzi, 2008). Yet in the modern times with better exposure and knowledge about the alternative asset classes and strategies more number of investors are investing in the alternative asset classes within their portfolios for better returns and balanced risk (Anson, 2008). In order to balance the risk and return in a portfolio an investor decides to invest in alternative asset classes in a portfolio which adopt a non traditional way of using long and short positions. These investments were favoured majorly due to the returns they provided as compared to the traditional investments (Fabozzi, 2008). The alternative investments are less regulated which leads to the less opportunity of publishing the performance of the investments or advertise any of their performance details to the potential investors. This is an overview of the alternative investments and the different types of alternative asset classes of investments are discussed below with their risk, return and the reasons for investing them along with the management processes involved in them in detail.

Types of Alternative Investments

Alternative investment asset classes available apart from the traditional investment asset classes discussed here are Hedge Funds, Real Assets, Currencies, Private Equity, Infrastructure, Venture Capital and Fund of Funds (Swensen, 2009).

Hedge Funds

The hedge funds are pooled investment asset classes which are created using varied strategies and different asset types (Robbé and Ali, 2005). The managers managing the hedge funds invest in different styles and financial instruments which are equity, long-short, distressed assets, macro-trends and arbitrage (Swensen, 2009). The hedge funds differ from other alternative asset classes namely private equity and venture capital funds where the investments are done in public equities having higher redemption frequencies with high liquidity which means investors can pull out their investment more often than others (Byrne, 2006).

The main reason for which the investors invest in hedge fund is that a hedge fund based on hedge fund strategy proves to be a diversifier taking up varied identifiable market opportunities as per the requirement and investment style of the investor (Anson, Fabozzi and Jones, 2010). The diversity in the hedge funds happens due to the flexibility in the range of choices within the available investment attributes (Swensen, 2009).

The diversity available in the hedge funds leads to reduction of risk but the goal of a hedge fund is always to enhance the returns on the investment done. The diversified portfolio with hedge funds as an asset class can exploit a wide range of price distortions (Fabozzi, 2008). The returns on a portfolio with hedge funds will be consistent as it can capitalise on declining markets through short selling. Yet the risk of losing the total investment is available in the hedge fund as it uses leverage, speculation, charges high fees and the investor of hedge fund asset class in a portfolio has very less regulatory protection (Baker and Filbeck, 2013).

For example: In a practical scenario of a fund manager speculating on models released by Ford and General Motors and on market research comes to a conclusion that GM has a better model. Thus buys $2000 worth stock of GM and short sell same amount of Ford stock. The strategy used is market neutral where if the market is favourable the hedge manager will earn profits if not the risk of loss is also high. Thus is the analysis of Hedge fund asset class within a portfolio

Real assets

The real assets are a combination of real estate, commodities, precious metals, agricultural land and oil within an asset class forming a part of a portfolio (Fabozzi, 2008). The inclusion of such an asset class provides the portfolio with utmost diversification based on the risk taking capacity of the investor and the preferences held by the investors (Anson, 2008). This is because the real assets are relatively less correlated with the traditional asset classes like bonds and stocks. The real asset is an asset class which will be suitable for high inflation in an organisation. Real assets are defined to be separate and distinct from the financial assets where the value is pulled out based on the contractual claim of the asset underlined which could be a real or intangible asset (Singh, 2011). The real asset could be property or commodity but the ETFs of futures based on the values of such real assets.

The main reason of investing in the real assets is to reduce the volatility and to enhance the returns of the portfolio on a long term basis. Though it provides stability to the portfolio yet the real assets have huge storage and carrying costs, higher transaction fees and are less liquid as compared to other alternative asset classes (Byrne, 2006).

This can be seen in an illustrative example of Brazil which has grown from a food importer to the world's largest bread baskets through the investments in the agricultural lands and in the development of agriculture of soya bean to provide 40% of the world's population the same. Thus investing such a real asset in Brazil will aid the portfolio to have a steady and long term income though far from investments done. The above analysis has clarified the risk, return, management and the reason for investing in the real asset assets class within a portfolio,

Currencies

In the present financial setup currencies across borders are treated as alternative investment strategy as holding on to currencies does not pay long term returns (Byrne, 2006). In the practical sense a portfolio having currencies as their constituent are balanced but active currency management is predicted to be inefficient in the currency markets which gives way to the currency managers to make high returns from the moves made by the currencies across the world (Robbé and Ali, 2005).

The main reason for investing the currencies as alternative investment asset class is that the currency manager determines the valuation of the currency and the trends of the currency using the fundamental and technical analysis which is a science in its own way (Robbé and Ali, 2005). Yet a currency manager depending on the forward exchange rate in currencies tends to be a poor indicator of the future spot rate in the portfolio (Swensen, 2009). A currency alternative investment is a simple long- short trade hence provides a self finance to the portfolio it is a part of. This makes currency as an alternative investment which can be added to any portfolio which consists of equities, cash or bonds (Anson, 2008). The management of currencies in a portfolio can be done through two different modalities namely absolute return strategies used above the LIBOR benchmark and currency overlay strategies used in global investments (Singh, 2011). For example when a Long USD/Yen position in the 6-month forward market is effectively borrowing 6-month money in Yen to invest in 6-month USD deposits leading to a profitable situation in the portfolio, it shows that currency is highly dependable source of risk free return in a portfolio. Thus the inclusion reason of currency as an asset class has been defined quite well in the above section with the risk and return including the management process of currencies within a portfolio.

Private equity

In the wake of globalisation Private equity has become a critical element in the investment portfolios where it provides attractive risk adjusted returns having low correlation with the bonds and equities in the portfolio (Anson, Fabozzi and Jones, 2010). This is the main reason for the investment managers to choose the private equity as an asset class to be assimilated in an investment portfolio. The major risk involved in employing the private equity in the investment portfolio is the conservative ideology of the private equity as it is the most illiquid asset classes amongst others (Singh, 2011). Thus balancing and maintaining the target return is tough due to the liquid asset classes of the portfolio fluctuate in value. The illiquid nature of the private equity makes it a choice less preferred as the portfolio will become overweight if other liquid asset classes are liquidated for immediate usage (Robbé and Ali, 2005). Thus the risk of long term investment is required to be taken up by the investor in the case of private equity as a part of a investment portfolio. Yet another risk is that it is very expensive as compared to other asset closes and is complex in nature with the high use of debt. The private equity asset classes can be exampled in Buy-outs within which investors and a management team pool their own money, usually together with borrowed money for pooling in a portfolio from its current owners Thus the inclusion reason of private equity as an asset class has been defined quite well in the above section with the risk and return including the management process of the same within a portfolio.

Infrastructure

Amongst the prevailing asset classes the infrastructure asset class is the most recent and happening asset class where it constitutes to only 5% of the total $7 trillion alternative asset classes in the industry (Anson, 2008). The infrastructure asset class is comprised of heterogeneous assets which are unrelated and diversified in the market. Each component has its own lifecycle and behaviour where the growth of the asset class is attached to the growth of the region and the country it belongs to (Baker and Filbeck, 2013). The infrastructure asset classes among the portfolio are encouraged by the Government and the private bodies for the economic development of the country. This kind of positive treatment is the main reason for the investment in the infrastructure asset class in a portfolio by the investors and portfolio managers. This quality of the asset class sets it apart from the crowd of other alternative asset classes (Byrne, 2006).

Yet another reason is that the Infrastructure asset class forms a long term investment providing stable returns though the revenues are inflation linked providing growing and defensive revenues to the portfolio (Singh, 2011). The asset class is more transparent than the rest as the assets invested in are tangible, understandable and visible to the investor having longer life cycle than the other asset classes discussed above. In such a light it provides better diversification and risk is minimal even when the market is fluctuating. Thus the inclusion reason of infrastructure as an asset class has been defined quite well in the above section with the risk and return including the management process of the same within a portfolio.

Venture Capital

The venture capital is a subset of the asset class of private equity where the investment is done in the early stage to the growth stage of the business (Fabozzi, 2008). As the private equity the venture capital is also a risky and high return providing asset class if the venture taken up is successful. The illustrated examples of a venture capital as a part of portfolio are the companies like Google, Facebook and Twitter making hay while the sun shines (Anson, Fabozzi and Jones, 2010). The major risk involved in employing the private equity in the investment portfolio is the conservative ideology of the venture capital as it is the most illiquid asset classes amongst others as like of Private equity (Fabozzi, 2008). Yet another risk is that it is very expensive as compared to other asset closes and is complex in nature with the high use of debt. Thus the inclusion reason of infrastructure as an asset class has been defined quite well in the above section with the risk and return including the management process of the same within a portfolio.

Fund of Funds

These are large vehicles that form funds to invest in other alternative investment funds. Investors inherently gain diversification by investing in multiple managers, strategies or asset classes (Robbé and Ali, 2005). Thus the inclusion reason of infrastructure as an asset class has been defined quite well in the above section with the risk and return including the management process of the same within a portfolio

Recommendation and Conclusion

On the basis of the discussion followed in the above segment on the 7 different types of asset classes that needs to be assimilated in a portfolio for better returns and low risk to the investors in the long run the consensus has been arrived at to include the hedge funds, currency asset class, infrastructure and real assets for the stability of the portfolio in the long run. The above discussion has clearly brought out the picture of all the asset classes with the aid of proper explanation of the risk, return and management process applied while using the different asset classes.

Alternative investments in the present world are analysed in varied angles but the alternative investments in a practical and academic sense is used as the diversification in the portfolio to provide better returns to the investor and also provides better risk profile to the investor. In the past the investors have used the traditional asset classes to diversify their investments like domestic stocks, international stocks, emerging market stocks and bonds unlike the present time where the alternative assets classes are Real assets, Currencies, Private Equity, Hedge Funds, Fund of Funds, Venture Capital and Infrastructure. The above discussion has clearly stated that due to risk , illiquidity and other reasons venture capital, fund of funds and private equity are not be used much.

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