UBS

Alternative Investment Education Series

# *Alternative Investments:* A Primer

UBS Financial Services Inc. (UBS FS) is pleased to provide you with information about alternative investments. There are a few points we would like to raise with you at the outset.

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**The Alternative Investment (AI) universe consists of investments outside of publicly traded debt, equity, and real estate. It includes investments ranging from hedge funds (HF) and managed futures (MF) to venture capital and private equity (PE) funds, natural resource partnerships and private commercial real estate (CRE). Alternative investments are not new; HF have been around since 1949, the venture capital model had its roots in the 1940s, while investing in commercial real estate (CRE) has been around for hundreds of years.**

## Characteristics

Alternative Investment funds are generally not required to register under the Investment Company Act of 1940 and restrictions are placed on investors eligible to access them. They are not listed on an exchange and are offered as private investment funds available only to high net worth and institutional investors.

Alternative Investments have an absolute performance objective. As such, they do not merely seek to outperform a benchmark but rather aspire to produce positive returns under varying market conditions. They tend to use leverage to increase returns and their performance is largely dependent on investing skill rather than just market exposure. They have historically exhibited moderate correlation with traditional financial market indices over long periods of time. They typically also exhibit reduced liquidity relative to traditional investments, with monthly to multi-year lock-ups. Their managers typically charge higher fees, which may include performance fees. Historically, adding AI to traditional portfolios has often resulted in enhanced risk-adjusted returns.

A feature that is common across most AI categories is the large dispersion of performance across managers and a degree of performance persistence. Therefore, even more so than for traditional investments, manager selection is of critical importance.

## Four Broad Categories

Alternative Investments tend to fall into four broad subtypes which differ from traditional assets in a variety of ways.

**Private Equity Funds:** These are negotiated investments in privately held companies at different stages of maturity undertaken with the objective of improving their profitability and growth prospects and reselling them at a higher price in the future. PE fund managers often have increased access to information regarding private investments, while traditional money managers must rely on publicly-available information, because they only invest in the public markets. Also, they often invest based on a negotiated lower price, while traditional money managers typically pay market prices. They often create value and are able to exit acquisitions at higher multiples thus creating a profit for their investors.

**Hedge Funds:** These funds invest in the global equity and fixed income markets and typically employ sophisticated trading strategies, use leverage and derivative instruments and go both long and short the markets. HF managers have the flexibility to invest opportunistically in strategies where they see value, unlike traditional money managers and mutual funds that are often constrained to invest in pre-defined markets. HF managers can short-sell the securities they believe will fall in value and thereby may profit from declining markets if they are correct in their judgment. In contrast, traditional money managers face limits on short-selling and may be required to be invested even if they believe markets are in a declining trend. HF managers can also use derivatives and leverage to hedge or magnify returns and risks, while traditional money managers are limited in their use of derivatives and leverage.

**Commercial Real Estate Funds:** These are negotiated private debt and equity investments in real estate assets with the objective of generating current income and/or reselling at a higher value in the future. RE historically has experienced significant fluctuations. Cycles in value and local market conditions often influence investing outcomes. Most CRE investments employ leverage which has the effect of magnifying both gains and losses. It is important to remember that these investments are illiquid, are not listed on any exchange and are generally regarded as fixed and long-term. Generally, there are no liquidity provisions, no mechanisms in place to sell partial interests in non-realized funds, along with significant restrictions on transfer.

**Managed Futures Funds:** These funds are similar to HFs in some ways. They take exposure by using futures, options and forwards on traditional commodities, financial instruments and currencies. MF managers offer access to global futures markets through the use of professional money managers called Commodity Trading Advisors (CTAs). They use trading strategies and money management techniques to attempt to achieve profits and control risk. CTAs generally fall into one of two categories: Systematic or Discretionary. Systematic traders perform quantitative analysis on historical prices and follow either systematic or discretionary approaches to trading. Discretionary managers base investment decisions on the analysis of supply and demand, valuations and cyclical conditions.

## Risks in Alternative Investing

Alternative Investments can pose risks beyond those that exist in traditional investments. For instance, the use of leverage can result in substantial losses if an investment does not behave the way the investment manager predicted, as leverage magnifies potential for both positive and negative returns. Alternative Investment managers are often compensated in part through incentive fees which may create the incentive to increase risk. Another source of risk is that reduced liquidity in certain markets may make it difficult to exit an investment during times of stress. Also, most private investment funds are subject to less regulation than their public counterparts, thereby reducing the level of supervision over an investment manager's activities.

It is therefore important to measure these risks correctly so that they can be managed appropriately. The key is to recognize that the nature of risk in AI differs from traditional asset risk. Over time, returns in AI tend to be distributed in non-normal ways. Within traditional asset classes, it is often enough to understand expected mean (or average) returns and the volatility around the mean. In contrast, with AI it is important to acknowledge that there exists a higher probability of extreme events. In statistical terms, this is equivalent to saying that return distributions within AI are skewed and have fat tails. When return distributions are negatively skewed, this suggests a greater possibility of infrequent but substantial losses. Similarly, fat-tailed distributions (i.e. distributions with excess kurtosis in statistical jargon) imply a greater

frequency of large deviations from the mean, either positive or negative.

When constructing portfolios that include AI, it is important, therefore, to understand how the characteristics of the portfolio will be affected beyond expected returns and volatility, and to include skewness and excess kurtosis considerations.

## Benefits & Considerations in Alternative Investing

The addition of alternatives to a portfolio can potentially reduce volatility for a given level of expected return. In addition, investors for whom portfolio liquidity is not a concern may also be able to realize above-average returns arising from the illiquidity of the underlying assets. AI, in effect, allow investors to unlock what is known as illiquidity premiums. These are not available to the same extent within traditional assets.

As market events are reflected differently in each strategy and in each broad AI category, combining a portfolio of such investments with different but complementary investment styles and risk/return attributes is desirable. However, a naive diversification across a large number of strategies may be suboptimal too. In AI, the process of due diligence is typically more time-consuming and more costly than in traditional investments. The reasons include the complexity of holdings and exposures, their diversity, and their lack of transparency. It is therefore important to choose carefully among selected strategies and amongst the managers that practice those strategies. One must also take care to skillfully combining them into robust portfolios. The construction of a portfolio of different AI strategies is a complex task requiring a deep understanding of the statistics commonly used in the financial industry as well as sound investing judgment.

## Private Equity

PE funds pursue an investment approach based on acquiring control of companies to increase the market value of their pooled capital through active engagement and then exiting at a later stage at a profit. This engagement may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition/disposal plans. PE funds sometimes also take a public company private for a period of restructuring before either returning it to public ownership or by selling it to another company or fund. Globally around $2,500 billion of capital has been raised and cumulatively deployed through fund investments. In addition, around $400 billion of committed, but uncalled, capital remains to be invested.

### Private Equity Strategies

PE is an extremely heterogeneous asset class with many sub-sectors. These sub-sectors, which we discuss below, have very different asset characteristics. This means that each subsector has different performance drivers, which investors need to understand to make informed decisions.

- **Leveraged buyouts:** Leveraged buyout firms specialize in helping entrepreneurs to finance the purchase of established companies.

- **Venture capital:** These firms provide risk capital for starting, expanding and acquiring companies. Most are quite specialized, often investing in a single field, such as telecommunications or health care. Venture capital firms also tend to specialize by investment stage.

- **Mezzanine capital:** These funds provide an intermediate level of financing in leveraged buyouts below the senior debt layer and above the equity layer. A typical mezzanine investment includes a loan to the borrower, in addition to the borrower's issuance of equity in the form of warrants, common stock, preferred stock, or some other equity investment.

- **Distressed Investing:** This includes i) the purchase of companies that are distressed or out-of-favor, for low multiples of cash flow and/or low percentages of asset value; or, ii) the acquisition of quality companies with excessive leverage or those that are going through bankruptcy that require restructuring.

- **Special situations investing:** Special situations investing is a broad category which encompasses variations of opportunistic distressed investing, equity-linked debt conversion plays, project finance, as well as one-time opportunities resulting from changing industry trends or government regulations.

### Benefits & Considerations for Investing

PE can be a source of attractive returns over the long term. Moreover, PE returns do not correlate closely with returns from traditional asset classes. They also provide access to selected growth opportunities even in low macroeconomic growth environments. This is because successful private equity managers are focused on picking companies with growth potential and actively creating conditions for growth, which investors can monetize. Properly implemented, the introduction of PE can improve portfolio diversification.

They are however long-term oriented illiquid investments. Interests in PE funds are generally not readily marketable, transferable or redeemable. They have uncertain cash flows with respect to both capital calls and distributions. Also, they are a form of blind pool investing, since investors do not know beforehand what their funds will be invested in and must rely on the skills and judgment of the PE manager.

### Conclusion

PE is an illiquid long-term oriented asset class, which, when approached with the necessary expertise, has the potential to improve the risk / return properties of an investment portfolio. PE is heterogeneous and includes several sub-sectors, all of which have their own unique characteristics. Given large dispersion of returns across managers and a degree of performance persistence, manager selection is of critical importance.

## Hedge Funds

A HF, in essence, is an investment structure for managing a private, loosely regulated, investment pool that can invest in both physical securities and derivative markets on a leveraged basis. It may take the form of a limited partnership, corporation or trust. Hedge Fund Research Inc. estimates that, as of Q1 2011, there are around 9,418 HFs managing $2 trillion in capital. Despite the proliferation of funds over the years, assets in the industry remain very concentrated.

HFs can be distinguished by their investment techniques i.e., short selling, use of leverage, dynamic trading strategies and derivatives. In general, HFs allow the fund manager to be active on both the long and short sides of the markets, compensate the fund manager with performance related-fees in addition to asset-based fees and allow the fund manager flexibility in investment style and approach.

### Hedge Fund Strategies

HF strategies arise from taking speculative positions in a combination of market and credit risk instruments for which the manager believes that the risk-reward relationship is attractive. Such positions are often referred to as arbitrage, or risk arbitrage. Through such positions, hedge funds are able to implement a variety of "non directional", "semi-directional" and "directional" strategies, whereby direction here refers to exposure to market direction.

HFs are a heterogeneous group with over twenty distinct strategies within four broad strategy groups:

- **Equity Hedge Strategies:** Their main objective is to seek long-term capital appreciation while maintaining very low net exposure to the overall stock market, individual industry groups, and other proxies of systematic risk, such as measures of value, growth, book leverage, or size.

- **Event Driven Strategies:** Event Driven strategies concentrate on the profit potential created by major corporate events, such as mergers, acquisitions, restructurings, bankruptcies or liquidations.

- **Macro Strategies:** Macro Strategies primarily trade in the most liquid markets in the world, such as currencies and government bonds, typically betting on macroeconomic events such as changes in interest rate policies or currency devaluations. They rely mostly on an assessment of economic fundamentals.

- **Relative Value Strategies:** Relative value strategies seek to profit from the relative mispricing of related assets, e.g. convertible bonds and the common stock underlying the conversion option; options and futures and their underlying reference assets; debt instruments of the same issuer or of different issuers with different maturities or yields.

### Benefits & Considerations for Investing

One can think of HF returns as a combination of exposure to macro factors (economic exposure or 'beta'), fund-level elements (fees structure, trade implementation capabilities) as well as manager skill (or 'alpha') in processing security or market specific information. The excess returns that some HF managers exhibit is a result of cheaper trading costs (due to large volumes and turnover), better market access and superior information processing abilities. HFs do, however, as alluded to earlier, pose unique risks that must be understood and managed.

### Conclusion

Well-managed HFs have the potential to offer risk-adjusted returns that are superior to those of traditional investments by taking advantage of market inefficiencies. Given the historically low correlation of certain strategies with traditional asset classes, HFs have often enhanced returns in economic environments in which traditional stock and bond investments have offered limited opportunities. HFs, given their flexible mandates, also allow investors to participate in a wide variety of new financial products and markets not available within traditional asset classes.

## Commercial Real Estate

CRE investing includes making equity or debt investments in multi-family residential, land, office, industrial, retail, hotel properties and other more specialized assets. A significant advantage of CRE is that investors can gain access to this segment through a number of different vehicles and structures that provide different types of opportunity at different points in the business cycle. It is important to remember that the CRE market does not necessarily move in tandem with the residential housing market. It is driven more by economic factors such as economic growth, job creation, consumption and inflation.

### An Alternative Asset

Investing in CRE is regarded as an Alternative Investment as it uses absolute return as its performance yardstick, while traditional investments use relative return. These investments utilize anywhere from 30 to 75% leverage, while traditional investments typically do not rely on leverage. Historically, CRE has had a relatively low correlation with financial market indices. Over the long term CRE has also been less volatile when compared to traditional investments such as equities and fixed income. Also, CRE is a physical asset and is relatively illiquid, as opposed to traditional investments which are financial assets and are highly liquid. Lastly, real estate is typically considered a better inflation hedge than traditional investments. This is because as inflation rises, the value of real estate usually increases, whereas traditional investments such as stocks are usually hurt by adverse inflation surprises.

### CRE Strategies

- **Private Debt:** This includes whole loans, mezzanine loans and B notes. A whole loan is a term used to distinguish between an original mortgage loan and a pass through security. A mezzanine loan is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. A B-Note refers to the tranche that is subordinate to the investment grade portion of mortgage debt. In addition, investing in CRE through private debt typically produces steadier returns than CRE equity investments as they are less sensitive to economic conditions. The disadvantages involved in private debt include limited upside potential and lower liquidity due to the mid-level structure, as well as difficulty in creating diversified portfolios due to the concentrated nature of debt positions.

- **Public Equity:** Investors can gain exposure to CRE through public equity markets in two ways: Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs). Both are types of companies that invest in real estate and whose shares are traded on exchanges. REITs invest in real estate directly, either through equity stakes in properties or through mortgages. They must distribute 90% of their earnings to shareholders and thereby qualify for lower corporate tax treatment. REOCs are similar, except that they reinvest earnings into the business and do not enjoy preferential tax treatment. They engage in the development, management or financing of real estate. Both REITs and REOCs are often traded on a long-short basis by HFs.

- **Private Equity:** This includes: core, core plus, value-added and opportunistic strategies. Core

refers to a low risk/low potential return and unleveraged strategy. Core plus refers to a low risk/low potential return and leveraged strategy. Value-added refers to moderate risk/moderate return and higher leverage strategy, while opportunistic refers to the highest risk/highest potential return and highest leverage strategy. Core has been the bulk of most investments, and usually involves investments in stable, fully-leased, multi-tenant properties within strong, diversified metropolitan areas, owned with little or no mortgage debt. Core funds also have highly predictable cash flows. Value-Added funds usually involve substantial redevelopment or re-leasing of a property to increase its potential value at a rate in excess of general market trends. Opportunistic funds include new property development and heavily leveraged property ownership. They are usually focused on "off-market" deals that have significantly higher risk profiles.

### Conclusion

Properly selected CRE strategies have the potential to create current income along with capital appreciation. Moreover, CRE is usually also considered a hedge against inflation. It offers direct ownership and can expand the efficient frontier in a portfolio. The flip side to this is that investors may have to accept illiquidity and be ready to invest for the long term.

## Managed Futures

MF offer access to global futures markets through the use of professional money managers called Commodity Trading Advisors (CTAs) who implement strategies using futures contracts. A futures contract is an exchange traded, liquid, standardized contract which specifies that the parties involved agree to buy or sell a certain underlying instrument at a specified price at a certain date in the future. Futures markets provide exposure across all major asset classes, including those based on interest rates, equity indexes, foreign exchange, energy, agricultural commodities and metals. These markets tend to be very active, liquid and deep.

CTAs attempt to achieve capital appreciation primarily through trading of commodity, exchange traded futures and options, exchange cleared over-the-counter instruments, and swaps. They typically follow either Systematic or Discretionary approaches to trading.

### MF Strategies

- **Systematic** CTAs utilize quantitative research techniques to arrive at trading algorithms and proprietary trading models to exploit inefficiencies or capture trends in markets. Often, decisions are made based on computing rules arrived through statistical data analysis. For instance, they may evaluate momentum in prices by assessing for serial correlation to arrive at views on future prices. They may study volatility to determine if sudden price movements exceed caps or thresholds and accordingly scale their trading positions. Their trading models tend to fall into two broad camps. (i) Trend Following; and (ii) Relative Value.

    - **Trend Following:** These strategies are profitable if they are able to identify a trend that subsequently emerges during a period of increased volatility. However, they can experience losses when trends reverse.

    - **Relative value:** These, as the term suggests, are focused on identifying temporary mispricing between related financial instruments. Some examples of these mispricings may be in foreign exchange carry strategies, where one may borrow at cheaper rates in one currency and lend at a higher rate in another, yield-curve rich/cheap strategies, and spread trading. If prices do not move in the anticipated direction, or take a very long time to do so, these strategies result in losses.

- **Discretionary** CTAs make trading decisions on the basis of their own expert judgment and "trading instinct," not necessarily on the basis of trading signals generated by any program, model or algorithm. Many Discretionary CTAs are also called Fundamental. CTAs using this Fundamental approach attempt to predict future price levels by studying external fundamental factors, namely supply and demand for a particular group or type of underlying. They may, based on their qualitative judgments, buy undervalued commodities and sell overvalued commodities simultaneously.

## Gaining exposure

Investors may gain exposure to MF in a variety of ways. For example, they may invest through pooled investment vehicles. These pooled investment vehicles or funds are typically structured as a limited partnership, L.P. or a limited liability corporation, L.L.C. Investors may also gain exposure to MF through managed accounts directed by CTAs, which have discretion to trade on the investors' behalf for a fee. Another way is through a mutual fund type structure. In addition to this there are a variety of actively and passively managed MF indices.

## Conclusion

MF allow investors to participate in the global futures and forwards markets of commodities, foreign exchange, equity indices, and interest rates sectors. They offer access to global markets, bring professional management, provide relatively better liquidity than other alternative investments, a fair degree of transparency as well as the potential for long term capital appreciation. More importantly they have low correlation with other AI and traditional assets.

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