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Investing in alternative investments

Most of us have heard of the main asset classes: shares, property, fixed interest and cash, but alternative assets are less well known. These types of assets can provide further diversification and enhanced returns for your clients' investment portfolios.

Alternative investments are those found outside of these traditional asset classes. Typical investments include unlisted real assets (such as real estate, infrastructure and natural resources), private equity and venture capital, hedge funds, private debt, and structured credit.

Generally, these assets aren't correlated to the performance of the share market - they can often perform when share market returns are down or flat. The net result is that alternative investments add an extra layer of diversification - you're not 'putting all of your eggs in one basket'.

However, as these investments are typically less liquid and less regulated than traditional assets, and can involve leverage, they are generally restricted to institutional or high net worth investors.

There are two key types of alternative investments:

1. **Growth alternatives** offer the opportunity for enhanced absolute returns, with a focus on capital growth.
2. **Defensive alternatives** generally offer a more stable, income driven return profile, with a focus on capital preservation.

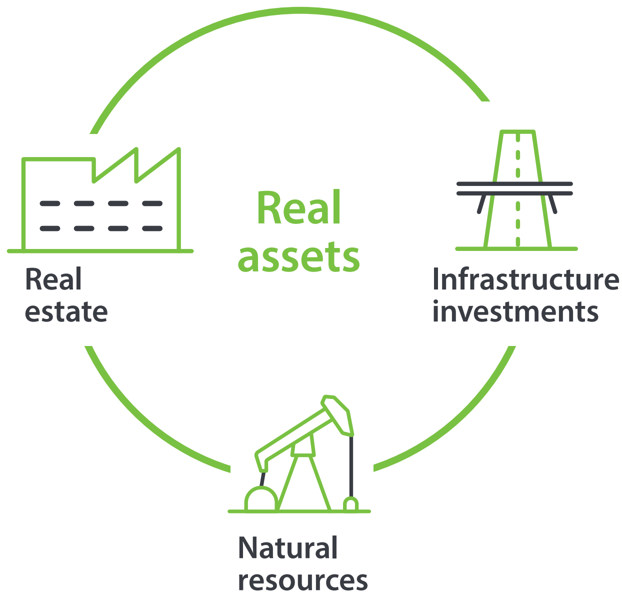
What are the main alternative asset classes?

The main alternative asset classes are listed below. With the exception of private equity (which is always considered growth), each can form part of either a growth or defensive allocation, with the key determinant being the level of risk and return expected of the strategy being undertaken by the investment manager within a given asset class.

1. Real assets

Real assets offer enhanced portfolio diversification and can help protect against the impact of inflation. They are generally tangible or 'hard' assets such as:

- **Real estate** – acquisition, financing, or development of residential, commercial, or industrial properties.
- **Infrastructure** – services and facilities essential to the economic development of society such as energy, transportation, communications, logistics, utilities, and waste management.
- **Natural resources** – exploration, production, or development of various types of naturally occurring materials or substances such as timberland, agriculture, water, energy, and metals.

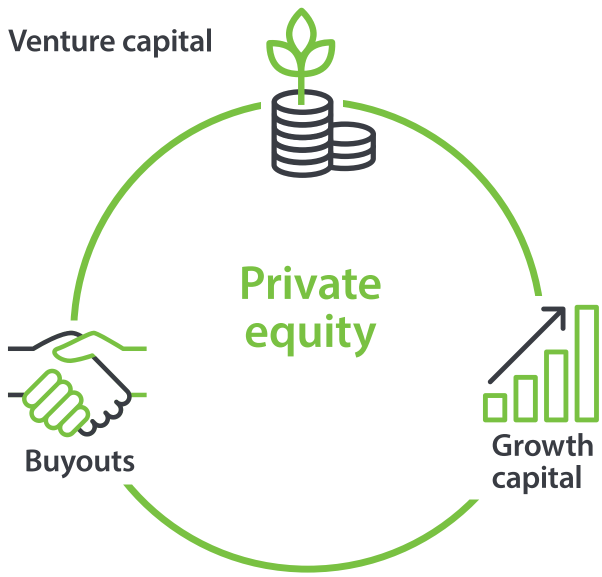


2. Private equity

Private equity is essentially an ownership stake in a company that is not publicly listed or traded. This asset class is typically made up of three core segments which are defined by the relative life stage of the underlying companies:

1. **Venture capital** – which focuses on start-up and early-stage ventures.
2. **Growth capital** – which helps companies expand or restructure.
3. **Buyouts** – where a more mature company or one of its divisions is purchased outright.

Private equity managers seek to generate high returns for investors by enhancing the business model and improving the operations of target companies prior to a future sale.



3. Hedge funds

Hedge funds are actively managed investment funds which employ various strategies with the goal of generating higher returns (alpha) with low correlation to and less volatility than listed share markets. They may also provide 'tail-risk' protection for portfolios in the event of falling prices in traditional share or bond markets. While the hedge fund universe is broad, some of the key strategies include:

- **Equity hedge** – seeks to identify securities which are overvalued or undervalued, buying (going long) those which are undervalued (expected to rise in price), and selling (shorting) those which are overvalued (expected to fall in price).
- **Relative value** – seeks to exploit valuation discrepancies or mispricing of securities which share similar characteristics.
- **Global macro** – seeks to take a fundamental, top-down view across different asset classes and regions in the context of economic and geopolitical perspectives.
- **Event driven** – seeks to profit from security pricing inefficiencies that can occur when companies are involved in a range of corporate events such as takeovers, restructures, mergers, and bankruptcies.
- **Trend-following** – seeks to follow the general market direction, buying (going long) when markets are expected to continue to rise, and selling (shorting) when markets are expected to continue to fall.

4. Private debt

Private debt refers to lending offered directly to commercial borrowers by asset managers as opposed to banks, with the loans not being traded or issued in an open market. Borrowers, whether private or public, borrow funds directly from a private debt fund issued and managed by an asset manager. The income returns generated by these private debt funds for their investors are primarily derived from the interest payment cashflows due on the loans. The level of returns will vary depending on the degree of risk the respective private debt fund targets such as the relative credit quality of the corporate borrower, the collateral supporting the loan (eg hard assets such as real estate or corporate cashflows), and the relative seniority of the loan within the capital structure of the borrowing company (eg a 'senior' loan secured by assets is deemed to be lower risk than an unsecured 'mezzanine' loan which sits between 'senior secured' loans and 'common equity').

5. Structured credit

Structured credit typically involves the process of securitisation whereby debt obligations, such as loans and mortgages, are pooled and packaged into interest bearing securities marketed to institutional fixed income investors such as insurance companies and pension funds. The underlying collateral for the loans determines the type of debt, ranging from mortgage-backed securities (MBS) which are collateralised by commercial or residential real estate, through to collateralised loan obligations (CLOs) which are backed by a pool of corporate loans.

These securitised MBS and CLO structures are typically segmented into what are known as 'tranches', with each tranche offering investors a level of return – typically a regular coupon payment like a bond. The relative seniority of each tranche will ultimately determine the level of risk and expected return for an investor in each tranche. That is, a more senior tranche will have less risk and thus a lower expected return, while a more junior, equity like tranche will heighten the risk, with investors in these tranches therefore expecting a higher return to compensate for the potential exposure to losses.

How to access alternative investments with IOOF

Each of our multi-manager investment solutions offer varying levels of exposure to alternative investments for your clients. Our current alternative manager line up for Multimix and MultiSeries is available here.

To find out more about our alternatives program and our investment solutions, please speak with your business development manager.

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