OPALESQUE

A SQUARE

OPALESQUE RESEARCH

IS THERE AN ALTERNATIVE TO ALTERNATIVE ASSET CLASSES?

A WHITE PAPER DOCUMENT

By: Sona Blessing

September 1st, 2008

A SQUARE
OPALESQUE RESEARCH

Introduction

Is there an alternative to alternative asset classes?

Is it possible to identify sources of returns that are truly uncorrelated to the broader financial markets? In theory the source of market risk can be isolated. By default, a risk originating outside of financial markets will not be affected by it. Or, if the source of risk rests outside the domain of mainstream financial markets, then this risk should be insulated from the vagaries of the financial market - as it has nothing to do with this market.

It is important to appreciate that even though the source of risk lies outside the market, the risk is 'real' and, if borne, so are the prospects of being compensated for it. Even so, an exposure to such risk is not immune from a performance pull-back, as its triggers are idiosyncratic.

For instance, the occurrence or not of a natural catastrophe such as an earthquake determines the positive/negative performance of insurance-related securities. With regard to weather derivatives, for example, a one degree rise or fall in temperature is the 'return' driver. Clearly neither the occurrence of an earthquake nor a shift in daily temperature is remotely influenced by events playing out in financial markets – as they originate in nature.

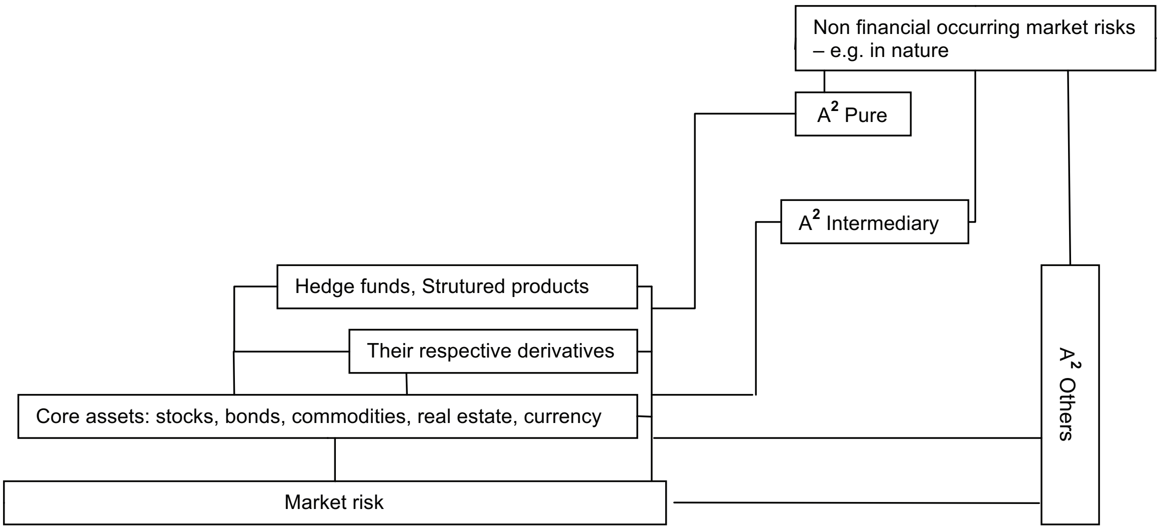
However it is virtually impossible to invest in the theoretically isolatable risk itself - as in, investing in 'just' the occurrence of an earthquake. The process of extracting performance from that source of risk or the wrapper/instrument that make it an investable proposition (ie an investment vehicle – for example, in the case of earthquakes, Cat 'bonds', which have a component of interest rate-related risk), unfortunately means by default that market (risk) contamination starts creeping in. In the case of insurance event led securities, for example, their performance is sensitive to shifts in LIBOR.

What are 'alternative alternatives'?

Financial literature tends to define alternative investments as a negation to traditional assets or, in other words, if core asset classes include equities, bonds, real estate, commodities, currency, and if these are compounded by their respective derivatives, then alternative investment strategies are the resulting permutations and combinations thereof - such as hedge funds, structured products, etc. If we were to take this thinking a step further, then 'alternative alternatives' would be a negation of alternative investments.

For research I undertake at A SQUARE, I base my classification of investable alternative alternatives on the degree of their exposure to (theoretically isolatable) non-market risk. These then fall into three categories of 'alternative alternatives':

A SQUARE Alternative Alternatives



Source: A SQUARE, Sona Blessing

Pure alternative alternatives

Pure alternative alternatives are those that have a pre-dominant exposure to 'exploitable risk premia' that lie 'outside' the realm of financial markets. These include:

- Insurance risks – life (mortality, longevity risk); non-life (natural catastrophe, etc); and
- Biological growth of trees (the rate at which a tree grows has nothing to do with financial markets).

Intermediary alternative alternatives

The source of exploitable risk premia may not exclusively lie outside financial markets. The process of exploiting the risk premia means that these wrappers are vulnerable to macro economic and idiosyncratic risks.

- Timberland (where the risks relating to the wrapper/investment vehicle are relatively high, for example, in the case of exposure via equities and hedge funds)
- Pure-play asset-based loan strategies, such as bridge financing, trade finance, entertainment finance, litigation-led investing, leasing (ie aviation/rail), and direct investment in infrastructure assets.
- Scarcity-led investments/investing in 'physicals' such as collectibles (although it is debatable as to whether their performance is influenced by, or mimics, that of market cycles), including wine, art, vintage cars, stamps, rare coins, autographs, memorabilia and stringed musical instruments such as violins.
- Hybrids – this includes blended alternatives, such as public and private equity, crossovers, PIPEs (private investments in public equity), SPACs (special purpose acquisition companies, and PPP (public private partnerships).

Other alternative alternatives

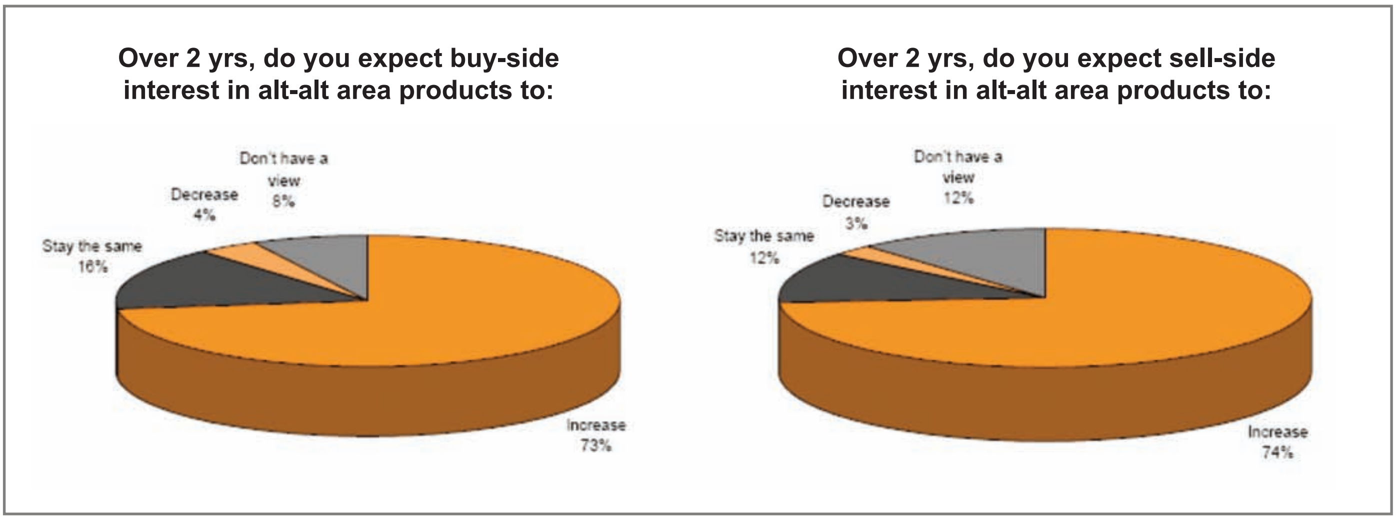
Chosen for their alternative motive, this includes strategies where the source of exploitable risk premia is sourced in financial markets and may be conditioned by or extracted from market movements; hence there may be a higher correlation to financial market movements.

- 'Invest-for-the-future' type theme investing (such as water, natural resources, equity investments in infrastructure, shipping, recycling resources and renewable fuels)
- Behavioural finance – extraction process
- Volatility – extraction process
- Carbon trading – extraction process
- Currency investing for absolute returns

Access to alternative alternatives: constraints and challenges

In comparison to traditional equities or even hedge funds, the number of investment opportunities within the pure and intermediary alternative alternatives is relatively confined. This is partly because many of these pure and intermediary alternative alternatives are less than a decade old, with most still in their infancy. However, these new strategies have witnessed steady growth both in terms of assets under management as well as in terms of capital attracted.

Based on an 'alternative alternatives' survey[1] carried out by The CAIA Association in May this year (in which 400 of its 2,000 members took part), 84% responded to whether they or their organisation were currently considering investments in alternative alternatives, or 'alt-alt' as The CAIA Association terms it; 38% indicated that they or their organisations are currently considering investments in this area.
Another conclusion the survey drew was that the market's interest in alternative alternatives is growing. Over the next two years, 74% of members of The CAIA Association believe that sell-side interest is growing, while 73% believe the same holds true for the buy-side.

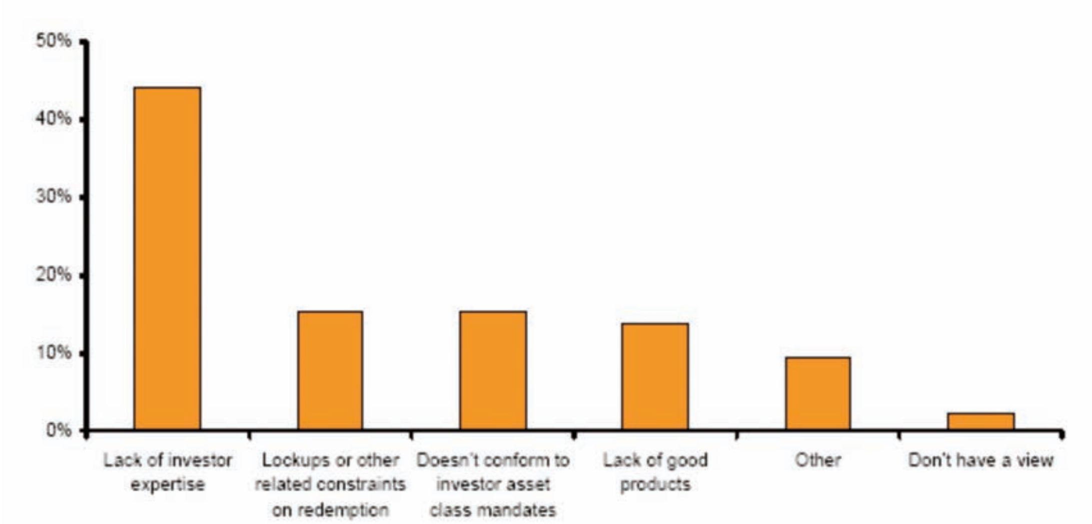


Source: The CAIA Association Survey May 2008

Based on my own experience at A SQUARE, investor interest in insurance-related securities, asset-based lending (in particular media/entertainment/film), trade and litigation-led investing, bridge financing, infrastructure, transportation leasing and timber has magnified.

On the supply side, I am seeing a lot of activity in asset-based lending, including the emergence of niches within this strategy, and also the growth of specialist fund-of-funds. In the collectibles space, wine funds (more so than art) have also witnessed a flurry of new entrants.
Hybrids that have a split allocation to private and public equity, especially in the climate change, renewable and natural resource, alternative energy and infrastructure space have also witnessed an expansion, not just in terms of new players, but in the context of assets under management.
In spite of this growing popularity, capacity constraints, illiquidity, complexity and the 'headline risk' associated with some of these strategies can and has been dissuasive. The CAIA survey also cited lack of good products (14% of respondents) and restrictions on investor redemption via lockups (15%) as some of the hurdles encountered by prospective investors. Furthermore, 44% cited lack of investor expertise!

What do you think is the biggest hurdle to investment in this area?



Source: The CAIA Association Survey May 2008

Opportunities and application

At A SQUARE, I review each of these investable alternative opportunities on a clinical basis. I attempt to strip them down to where the sources of exploitable risk premia lie, and so assess the likely extent to which the wrapper, and/or the exploitation process, are susceptible to pull backs that can be attributed to market risk. Other questions I try to find answers for are:

- Can the exploitable risk premia associated with the strategy be easily multiplied/replicated?
- Is the risk commensurately compensated?
- How consistent is performance likely to be?
- Is there a risk of return dilution and if so, the likely rate at which it is to occur?
- Is the vehicle well managed in terms of assets/liabilities?

The effects of integrating such a 'stand-alone' investment on a portfolio's volatility and risk profile is something I also closely follow - especially in times of market turmoil. Across the board, industry professionals (whether academics, institutional investors, pension or hedge fund managers) are in consensus when it comes to how the introduction of alternative alternatives would impact a portfolio – ie improve its efficiency frontier and risk-return profile. Further insights on this topic are shared by The CAIA Association survey, which asked, "What do you think the biggest selling point is for such products relative to traditional hedge funds?"
The answer "diversification" received a response level of 70% (and multiple responses were allowed).

An all alternative alternatives portfolio could potentially deliver over 12% net return to investors while keeping the annual portfolio volatility below 3%. Adding 10% of such a portfolio to a conservative portfolio (30% equity and 70% bond) enhances portfolio returns by over 6% and lowers the overall portfolio risk by 2%. Adding 10% of such a portfolio to a more aggressive portfolio (30% equity, 20% bonds, and 50% alternative investments) enhances portfolio returns only marginally but still lowers the overall portfolio risk.

In practice, for pension funds or endowments, the size of the fund being managed seems to have some bearing on the percentage of the portfolio that is allocated to alternative alternatives, and to which specific strategies. For example, pension fund managers managing over USD100bn have a noticeably higher tendency to allocate and invest in alternative alternatives. In some cases, they have over the past few years (two to four) stepped up their presence from zero to as much as 20%+ (although this includes allocations to private equity).

I believe this behaviour is partially driven by their foregone "need" to perform - and to that end, achieving "diversification" has been a much prophesied mantra. It is important to remember that this has in fact been successfully implemented for over a decade now, by the likes of Yale and Harvard, in what has come to be known as "The Endowment Model."

The medium to smaller players have either begun investing, with allocations ranging from anywhere between 5% and 20%+, or are seriously considering doing so. Furthermore, I know of others that have either outsourced this function or have deliberately decided against it, because they are not prepared to invest in "something" they do not fully understand. Restrictions, regulations, pre-determined conformity criteria and commitment size can narrow the choice of alternative alternatives that they can allocate to.

Collectibles, it seems, have yet to be widely taken up by pension funds looking for alternative alternatives. There are exceptions, but in most cases "headline risk" excludes their ability to allocate to the collectibles such as wine and art. One pension fund manager I spoke to on this topic cited a lack of comfort with valuations and pricing as one reason for not allocating.

Indeed, in the context of collectibles, transaction costs tend be high (and so can negatively impact returns), particularly if such investments are not held over the long term. A close look at the financial implications of including art as an asset class were examined in an article that appeared in The Journal of Alternative Investments in the spring of this year [2]. It reveals that,

"Art's low correlation with other asset classes offers diversification benefits from holding art in an investment portfolio. Optimal portfolio allocations using empirical returns over the past 25 years provide support for investors to consider art as attractive, albeit small, addition to their investment strategy."

Whilst some pension fund managers are yet to be convinced, institutional investors, fund of funds, hedge funds, and high net worth individuals seem to be more comfortable investing in risks associated with collectibles. The response I received from one wine fund manager – who recently offered an institutional share class – went along the lines of 'if investing in orange juice gets checked off as commodity investing; why shouldn't grape juice qualify?'

Timberland investing traditionally bore the connotation of being boring, very illiquid and delivering relatively low returns – with investors essentially being restricted to investing via the timber investment management organisations (TIMOs) route. This view is archaic. Timberland has evolved into one of the most dynamic asset class that is currently much sought after. It is a triple play on real estate, the biological growth of trees and carbon credit compensation.

Pressed by the need to deliver higher returns, or maintain targets, has backed the quest for diversification. It has also supported a trend that has consistently raised allocations to alternative alternatives, with levels opportunistically rising to 40%. Representing an institutional behemoth, I asked one manager where, within a "core-satellite" portfolio allocation approach, he would place alternative alternatives? Strategically I assumed around the periphery of both. The response, however, was that in times of a severe liquidity crisis, such as now, alternative alternatives form the core and the rest is tactically allocated as satellite.

Conclusion

Although alternative alternatives might remain out of bounds and off the radar screen for some, and as an asset class is still considered to be in its infancy by others, the search for uncorrelated market returns continues to broaden. I truly believe it is only a matter of time until they are more widely embraced and implemented within portfolio allocation. It is important to remember that it is not just traditional assets or mainstream hedge fund strategies to which alternative alternatives show low – or no – correlation; they also maintain low correlation characteristics among themselves. On the supply side there are signs of evolution, as the broader base decomposes into isolatable, investable niches – eg the possibility of investing in just Champagne – within the broader category of wine; or just teak within timber.

1 The CAIA Association Alternative-Alternative Survey, May 2008

2 The Journal of Alternative Investments, Spring 2008, Volume 10, Number 4; "Art as a Financial Investment", by R.A.J. Campbell