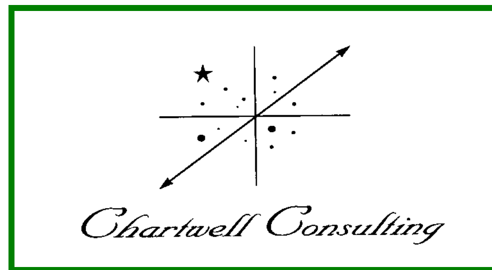

An Introduction to Alternative Investment Strategies

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Alternative Investment Strategies is the all-encompassing term used to describe nontraditional investment approaches. That is, investments in assets other than publicly traded equity and fixed income securities. AIS portfolios typically consist of either non-marketed illiquid assets (e.g. shares in non-public companies), or liquid securities managed in a nontraditional format (e.g. convertible risk arbitrage, long/short equity portfolios, etc.), or different combinations of both approaches.

The overwhelming majority of AIS (at least 80%) are devoted to the private equity marketplace. The remaining 20% of AIS are often referred to collectively as "Hedge Funds." Within that very broad latter categorization are a myriad of investment styles and disciplines, each of which require special attention to understand. This briefing paper will focus its attention on ***Private Equity (PE)***.

Private Equity is an important component of corporate finance (in addition to the public stock and bond markets). PE can refer to **what it is** (all ownership securities that a non-publicly listed company might issue), but most often the term is used to describe the types of investment situations being financed. Thus, a venture capitalist, and the opportunities he finds to invest in, are both part of the PE market. It is a source of money for: venture capitalists, private middle market companies, financially distressed companies, and public firms seeking buyout financing- all which have difficulty raising money in the public markets. PE is "private" because funds are raised in this market through transactions that do not involve a public offering. Thus, a private equity transaction is not registered with the Securities and Exchange Commission.

PE investments are professionally organized and managed equity investments. A PE manager (the "General Partner") organizes a limited partnership (the "Fund"), and acquires significant ownership stakes and takes an active role in managing the companies in which they invest (the "Portfolio Companies"). These private equity Funds raise money through the sale of "units" (conceptually similar to shares of a closed-end mutual fund) to institutional investors which include public and corporate pension funds, endowments, foundations, banks and insurance companies as well as to wealthy individuals and family offices (the "Limited Partners").

Limited partners (LP's) are passive investors who contribute capital in return for a defined economic benefit. The General Partner (GP) makes the investment decisions and contributes their expertise in return for a traditional investment management fee **PLUS** a defined economic interest in the underlying partnership (the "carried interest").

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Since PE investments are "private," the market for them is inherently inefficient. This naturally results from the lack of information concerning their prospects. These investments are also inherently illiquid, because there is no active secondary market in which to sell them. These inefficiencies (lack of information and liquidity) make it possible for GP's to acquire Portfolio Companies at a discount. These inefficiencies also cause the LP's to expect higher returns on their investments, to compensate for the additional risks they've undertaken (at least 300 basis points over the S&P 500, depending on the type of the investment).

In order to have a successful PE investment, the GP must:

- Identify a market where there is an imbalance between the supply and demand for capital. That is, where there are companies with upside potential that can't get financing;
- Buy all or a share of the company at an attractive price;
- Ensure that steps are taken which increase revenues and profits, thereby increasing the company's value;
- Successfully exit the investment, often by selling the company to a strategic corporate buyer or through an IPO.

The potential advantages of a PE investment include:

- Higher than average returns when the investment is finally exited or unwound;
- Portfolio diversification, because returns from PE investments have a low correlation to the returns from public markets;
- The ability to invest in broader and more diverse opportunities than available in the public markets (e.g. can invest in new and emerging companies, private companies, and family-owned businesses. Can invest in all phases of a company's lifecycle.

Disadvantages of PE investments include:

- "Information-poor" and inefficient asset class, requiring a range of skills to successfully execute and manage investments;
- Very high short term liquidity risk, because there is no active secondary market for units. Further, many GP's require a "lock-up" agreement, in which LP's accept no liquidity for a defined initial period;
- Long term liquidity risk because timing successful exits of individual portfolio investments is highly uncertain;
- Much higher investment management costs, almost always including a guaranteed management fee (usually 0.50 – 2.0%) *plus* a substantial share (usually 15-25%) of the LP group's return of their investment.

The Investment Decision

A limited partner (LP) must make a judgment as to the viability of the general partner's (GP) strategy and her/his ability to execute it going forward. To make this decision, an LP or its consultant should have: (1) an understanding of business strategy, the capital markets and how to

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analyze regions and industries, and,;(2) as much information as possible regarding the GP and the proposed Partnership. Most of this information is derived from the due diligence process described below.

The Limited Partners of PE investment funds need to accomplish the following -

1. Develop an intelligent and reasonable investment approach to this asset class, including the “fit” of PE investments within the LP’s overall asset mix;
2. Identify the best Partnerships that offer exposure to the LP’s areas of interest;
3. Get into those Partnerships on the most favorable terms possible.

The Future of Private Equity

- PE should continue to flourish as a business into the foreseeable future. Historical returns have been very high, which tends to attract prospective investors;
- The supply of companies for sale has historically outstripped the supply of PE capital available to buy those companies, thus allowing investors to be selective in their purchases; (but, this may be changing dramatically);
- Returns on PE investments are not necessarily correlated to those of the broader markets. When stock markets experience periodic declines, PE investments may provide higher returns than stocks. Thus, an otherwise “risky” PE investment may help protect against short term equity market declines;
- Nonetheless, Private Equity is one of the most complicated investment areas for an institutional investor, and generally requires special expertise and extra work. As interest in PE soars, some of this extra work and expertise can increasingly be accessed via an intermediary, often a party that has created its own partnership vehicle holding a “portfolio” of unit investments in a series of underlying PE funds. This is referred to as a “***fund of funds,***” and is a popular construction for smaller investors that want to invest in a diverse list of Partnerships, but don’t have the capital, time, or expertise to do so;
- Unfortunately, funds of funds involve at least one added layer of fees, on top of the already high fees of the underlying Partnerships. This underscores one of the fundamental realities of all Alternative Investment Strategies - as demand for this type of investment rises, increased supply at increased cost is coming on stream. With future returns not guaranteed whatsoever, it is definitely a time for “buyer beware”.

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