Alternative Investments

With the stock market volatility starting to rattle investors and the bond markets poised for declines should interest rates rise, investors are looking increasingly towards non-correlated alternative asset classes. Alternative investments made up the biggest part and were the best-performing asset class for a typical family office portfolio in 2018, according to a new survey from research firm Peltz International. The objective of creating a diversified portfolio of alternative investments would be to have returns remain positive during a future market downturn, a possibility given the current level of the stock market, the Feds' interventions, a possible recession, never ending deficit spending, an inverted yield curve and the global macro-economic environment more generally.

Traditionally investors have allocated to hedge funds for their alternative's exposure yet these did poorly in 2008 and lackluster since. Amadeus Wealth Advisors has conducted due diligence on a number of alternative asset classes and managers and recommend investors consider the following:

Private Debt, Private Equity, Private Equity Secondaries, Equipment and Aircraft Leasing, Real Estate on a Primary and Secondary basis, Energy, Intellectual Property, Direct and Co-Investments, Venture, GP Interests, Multi-Alternatives and other Special Situations. * Let's review these categories.

Private Debt can begin with BDCs. Recognizing the important contribution that small and middle market businesses make to the American economy, Congress passed the Small Business Investment Act in 1980 to allow for an increased flow of capital to privately owned U.S. companies. The result was the formation of Business Development Companies or BDCs. BDCs are investment vehicles that allow investors to pool capital in a tax advantaged manner in order to invest in the debt and equity of privately held American businesses. BDCs are exempt from all entity level taxation as long as certain regulatory and IRS guidelines are met. They must distribute 90% of their income and capital gains. They can be publically traded in the form of mutual funds but we recommend the registered but non-traded form. The latter typically pay between an 8% and 9% coupon and at some point in the life cycle, they frequently undergo a liquidity event, at which time you can liquidate or continue to receive the coupon.

Another form of private debt is available via SBIC (Small Business Investment Company) funds that have a license with the Small Business Association (SBA). These are privately-owned investment companies that are licensed by the SBA. SBICs supply small businesses with financing in both the equity and debt arenas. They provide a viable alternative to venture capital firms for many small enterprises seeking startup capital. Typically these funds raise between $50 and $100 million from private investors and they are then allowed to borrow a multiple of this amount from the SBA. The interest charged on these loans are relatively low compared to what the funds subsequently charge borrowers and this turn of leverage has allowed these funds to pay investors between 8% and 12%. These funds often have a “hurdle” or “preferred return” which is the return the sponsor must pay to the limited partners before they can take any of their profits. The preferred return is often 8%.

Other private debt funds, frequently referred to as mezzanine or ‘mezz’ funds represent a hybrid form of debt which is subordinated to another debt issue from the same issuer. Mezzanine debt often has embedded equity instruments, usually warrants, attached, which increase the value of the subordinated debt and allows for greater flexibility when dealing with bondholders. Mezzanine debt is frequently associated with acquisitions and buyouts, where it may be used to prioritize new owners ahead of existing owners in case of bankruptcy. Some examples of embedded options include stock call options, rights and warrants. These funds have been able to generate returns between 10% and 20%, the latter occurring when warrants have played a role.

Real Estate Investment Trusts (REITs) are an excellent diversifier. Equity REITs invest in and own properties. Their revenues come principally from the properties' rents. Mortgage REITs deal in investment and ownership of property mortgages. These REITs loan money for mortgages to owners of real estate, or purchase existing mortgages or mortgage-backed securities. Their revenues are generated primarily by the interest that they earn on the mortgage loans. Hybrid REITs combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages. We prefer registered but non-traded Equity REITs. Why non-traded? If you study the price behavior of the REIT ETFs (exchange traded funds), you'll discover they are highly correlated with the S&P 500. Since our objective is to find non-correlated return streams, the non-traded structure is preferable. These REITs can be well diversified or concentrated in certain sectors. So in addition to well-diversified national portfolios, you can find portfolios concentrating in health care properties, shopping malls, residential, global, and even New York City real estate! The non-traded REITs also frequently have liquidity events after the fund becomes fully subscribed and closes, allowing for an exit if you so desire. Because they typically pay between a 7% and 8% coupon, when they go public, there can be price appreciation so as to allow the price to come into line with the publically traded REITs which typically pay a lower dividend. They often have a 6%-7% preferred return.

There is also the availability of real estate secondary funds. These will acquire a diversified portfolio of mature, high quality real estate limited partnerships with a 10-20% discount to NAV in the secondary market. Today they might be focused on funds with 2005 to 2008 vintages (the years the funds were established and bought properties) since these will have previously gone through the real estate risks such as leasing, financing and development associated with primary funds. These funds can invest globally, often have a hurdle of 8% and a target net IRR of 15%.

Private Equity is a popular alternative. In the private equity market you can purchase an interest in a privately held company. As you'd suspect, these investments have much less liquidity than more traditional investments. The cash flows associated with these investments are typically described by the so called "J-Curve", where a portfolio is constructed in years 1-5, improvements to the companies are made and debt paid down in years 3-7, and companies are sold in years 5-10. In addition, as a consequence of the 2008 declines, many institutional investors ended the year with too high an allocation to private equity given their target allocation. Many of these institutions are selling their private equity interests into a secondary market created for these illiquid securities. Secondary Funds may have outsized returns because they're buying further into the J-Curve, reducing the holding period and missing the early years' negative returns. These funds typically have an 8% preferred return.

Equipment leasing funds will invest in revenue producing equipment that is essential for businesses to conduct their operations. The equipment will have substantial economic lives. They may also finance infrastructure and energy projects. The investments will include equipment leases, participation agreements, residual sharing agreements, project financings and vendor and rental programs. In many cases, they hold title to or have a controlling position in the equipment. These funds focus on equipment needed in a number of fields including: agricultural, medical, manufacturing, technological, transportation, energy, environmental, infrastructure and others. These funds typically pay a 7% coupon and often have a preferred return, frequently 8%. The Funds can operate globally. Typically they raise funds over the first two years, operate the program in years 1-4 and then liquidate the portfolio over years 4-7, aiming to have a majority of investor money returned by year five.

Aircraft leasing funds build a portfolio of approximately 30 to 50 mid-life aircraft. They typically build the Fund's portfolio through acquiring multi-aircraft portfolios with less than 5 years in lease term remaining and execute sale-leaseback transactions with the airlines. The investment strategy is built on the premise of leasing aircraft to their break-up metal values, where an aircraft's airframe and engines are monetized separately. These Funds invest in commercial aircraft, engines and related assets that produce attractive yield and strong leveraged returns.

In addition to mutual funds, ETFs and individual equities, there are a number of alternatives available that provide more direct exposure to the energy markets. Limited partnerships, working interests, master limited partnerships (MLPs) and unit investment trusts (UITs) all provide pass-through treatment of both income and deductions derived from oil and gas investments at the wellhead. You can participate in the industry up, mid or downstream. Upstream operations deal primarily with the exploration stages of the oil and gas industry. Midstream activities include the processing, storing, transporting and marketing of oil, natural gas and natural gas liquids. Midstream is represented by the oil and gas operations that take place after the production phase, through to the point of sale. Downstream operations can include refining crude oil and distributing the by-products down to the retail level.

We prefer funds that diversity across many of these categories, combining riskier aspects with more conservative. For example a fund could develop a diversified portfolio of mezzanine capital investments (thereby combining features of the private debt space), along with investments in independent producers, acquiring high quality long-lived oil and natural gas assets, financing and/or investing in midstream assets. These managers can also participate in oil and gas exploitation and development projects. Funds typically offer an 8% preferred return and a target IRR in the high teens.

You may also be interested in the tax benefits available through oil and gas drilling partnerships. These deductions typically include both Intangible and Tangible drilling costs (75%-85%) and a depletion allowance (15%) on a portion of the income received from the partnership wells. Limited Partner interests are typically used by investors seeking to offset a portion of their Passive Income. If you invest through an entity that limits your liability, then your investment is considered passive. The character of losses for Limited Partner investors are such that the losses passed through from the K-1 can only offset Passive Income from another source or be carried forward indefinitely to offset income from the program in future years. However, you can also elect to invest in a Partnership as an investor General Partner for the tax benefits instead of as a Limited Partner. If you do, you will have unlimited liability for the Partnership's activities until you are converted to Limited Partner status, however the character of losses for General Partner investors are such that the losses described above (intangible/tangible/depletion) can offset Active Income reported on a tax return (wages, interest dividends, capital gain, other income, etc.) and as such act as if they were a tax credit. The oil and gas exploration and transmission industries are speculative, heavily regulated and involve a significant degree of risk so a thorough due diligence process is recommended.

The "preferred return" or "hurdle rate" is a term used in the private equity world. It refers to the threshold return that the Limited Partners of a private equity fund must receive, prior to the General Partner receiving its share of profits, sometimes called carried interest or "carry." This amount is often 20%. The so-called "2 & 20" fee structure consists of an annual 2% management as well as the 20% carried interest.

There exist today funds that purchase a 20% interest in the General Partner, so that the limited partners in these funds now participate in the 2% & 20% the general partner earns. These exist in the and private equity and real estate asset classes.

Intellectual Property (IP) funds will acquire the IP of retail and consumer brands, license out the brand to licensees and collect royalty payments in return. These funds target investments with equity-like return potential with a high current yield, hoping to increase the intellectual property's valuation as well as provide downside protection through guaranteed minimum royalty payments. The intellectual property acquired include trademarks, patents and copyrights in targeted sectors including apparel, accessories, health & beauty, electronics, housewares, food & beverage and entertainment. Such a fund would enter into licensing agreements with retailers and wholesale licensees who pay royalties and related income and fees for the right to use the IP owned by the fund. Fees run 1.5% - 1.75% with a 20% incentive.

While we are not disenamored of hedge funds, many have underperformed since the market declines in 2008. Generally we recommend you considered smaller funds that specialize in a sector, a long/short health care fund for example, or funds that are more broadly diversified in less trafficked asset classes. Global macro funds offer an ability to capture this diversity. Funds we consider invests in equities, currencies, commodities and debt in developed, emerging and frontier markets. They can invest long/short, in event driven trades, in IPOs as well as other strategies. Fund of funds can also be considered.

Finally, there are a number of very unique funds that acquire a minority interest in private equity funds, enabling the limited partners to participate in the general partner’s 2% & 20% fee structure.   While historically made available only to institutional investors, Amadeus Wealth Advisors has access to these funds at lower minimums for individual investors. Please do not hesitate to contact us at 212-697-330 should you wish to discuss investing in any of these alternatives. Our opinions are subject to change without notice and are not intended as investment advice or a solicitation for the purchase or sale of any investment or security. Please consult your financial professional before making any investment decision.

**Potential investors should be aware that an investment in Limited Partnerships involves a significant degree of risk and, therefore, should be undertaken only by investors capable of evaluating the risks of a Fund and bearing the risks they represent. In addition, there may be occasions when the Principals, General Partner, Advisor, Sub-Advisor and their respective affiliates may encounter actual and potential conflicts of interest with respect to a Fund. Prospective investors in a Fund should carefully read the Risks Section*

of the Private Placement Memorandum for each fund and consider the information discussed therein which enumerates certain material risk factors and conflicts with respect to the Fund. If any of the events discussed in these sections occur, the Fund's business, financial condition, results of operations and prospects could be materially adversely affected. In such case, performance could decline, the Fund's ability to achieve its investment objective could be negatively impacted and investors may lose all or part of their investment.

Amadeus Wealth Advisors, LLC