

An Introduction to Alternative Investments

With every alternative asset category growing in the recent past, global assets under management of alternatives grew at an annualized 10.7% between 2005 and 2013, twice the rate of traditional investments. Just as impressive as the absolute growth of alternative assets is the degree to which they are now entrenched as a standard component of almost every investment portfolio. Institutional investors have not only increased their allocations to alternatives over the past few years, but the vast majority intend to either maintain or increase them for the foreseeable future. Retail investors, meanwhile, are moving rapidly into the market, as new product vehicles provide unprecedented access to a broad range of alternatives managers and strategies. Gone are the days when the sole attraction of alternatives was the prospect of higher returns. The market meltdown caused by the global financial crisis, coupled with the extended period of volatility and macroeconomic uncertainty that followed, have left their marks, and investors are now turning to alternatives for consistent, risk-adjusted returns that are uncorrelated to the market. They are also increasingly looking to alternatives to deliver on other crucial outcomes like inflation protection and importantly, income generation. Over the next five years, net flows in the global alternatives market are expected to grow at an average annual pace of 5 percent, dwarfing the 1 to 2 percent expected annual pace for the industry as a whole. By 2020, alternatives could comprise about 15 percent of global industry assets and produce up to 40 percent of industry revenues. [1]

With the Fed induced surge in equity markets and the latter's proximity to all-time highs along with the similar bubble like levels in the bond market, many investors perceive there's nowhere to hide in traditional markets. The willingness to accept greater illiquidity to achieve higher returns, the so-called "illiquidity premium" has become increasingly acceptable. The objective of creating a diversified portfolio of alternative investments would be to have returns remain positive during the next market downturn. Historically, sources of capital flowing into alternatives have included pension plans, endowments and foundations, sovereign wealth funds and family offices however this past decade has seen a significant increase among individual investors.

Traditionally investors have allocated to hedge funds, a term which can encompass a multitude of investment styles, for their alternatives exposure, yet these did poorly in 2008 and lackluster since. Other categories of alternatives asset classes can also include: Private debt, equity and real estate on a primary and secondary basis, equipment leasing, non-traded REITs, intellectual property, venture capital, distressed investments, co-investments, and various special situations.

Let's begin our discussion with private debt. Private debt can be classified into a number of different subcategories. The three most common methods used to distinguish the asset class are by seniority in the capital structure (senior, subordinated, unitranche), the type of lending transaction (corporate, infrastructure, or real estate), and geography (North America, Europe, Asia/emerging markets). Private debt funds lend money to businesses which cannot access bank loans or don't want to wait months for the latter to complete their due diligence review. Loans are typically diversified across geography and industry except in the case of sector specific funds. Transactions can involve secured asset backed loans, senior secured and senior subordinated cash flow loans, subordinated loans, and convertible debt. Many funds will seek to enhance the fixed income base return with paid-in-kind interest coupons, original issue discounts, prepayment premiums, equity co-investments, preferred stock, warrants and prepayment premiums. Some funds are sector specific. Health care debt funds will investment in specialty and generic pharmaceuticals, biological agents, biotechnology, medical devices and products, laboratory and medical diagnostic products as well as companies in other areas of health care. Energy related funds will invest in midstream, including gathering, processing, marketing, transporting and storage of hydrocarbons, downstream, including refining, processing, and storage, conventional electric power generation, renewable energy as well as upstream investments. Venture debt funds will make loans to emerging technology, venture backed, privately held companies. These funds tend to believe the best start-ups are backed by a small group of top-tier early stage venture capital firms so they work complementarily with the venture firms in identifying, investing in and providing value to these start-ups.

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 however many are also structured in non-traded form. The latter typically pay between a 6% and 8% coupon and at some point in their life cycle, they undergo a liquidity event via a listing on a public market.

Another form of private debt is available via Small Business Investment Company (SBIC) funds, which have a license with the Small Business Administration. 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 for many small enterprises seeking startup capital. Typically these funds raise between $50 and $100 million from private investors and then borrow a multiple of this amount from the SBA. The interest the SBA charges on these loans is relatively low compared to what the funds subsequently charge borrowers and this turn of leverage provided by the SBA enables these funds to pay investors income between 8% and 12%.

As you may be aware, 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 frequently 8%.

Other private debt funds, frequently referred to as mezzanine or ‘mezz’ funds represent a hybrid form of debt which is subordinated to other debt issued by the same company. Mezzanine debt often has embedded equity instruments attached, usually warrants, which increase the value of the subordinated debt and allow 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. These funds have been able to generate returns between 10% and 15%, the latter occurring where warrants or other forms of equity play a role.

Real estate investing is a very popular alternative. The sub-asset classes available make for very robust and dynamic investment opportunities for properties in the US and abroad including retail, office, multifamily, mixed-use, parking garages and industrial properties. Funds with superior returns will have experience with transaction structuring, acquisition, finance, asset management and eventual disposition of the properties. Structuring can consist of acquisitions, sale/leasebacks, net leases, synthetic leases, ground leases and other transactions. Numerous opportunities exist for future revenue growth, including mark-to-market of rents, interior and exterior renovations programs among others.

Considerable due diligence is required inclusive of a review off the fee structure since real estate transactions can involve commitment, acquisition, asset/property management, leasing, construction, financing and disposition fees. Funds generally will provide excellent cash yields, often making growing quarterly distributions ranging from 6% to 12% with target IRRs ranging from 10% to 20%. For multi-family housing projects, minimum investments are typically $100,000 and for funds purchasing commercial real estate, $250,000 is a more typical minimum. Most funds have the 2% & 20% fee structure discussed in prior sections of this alternatives summary.

Real estate can also be acquired in much smaller increments via Real Estate Investment Trusts, or REITs. 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 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. REITs can come in publically traded and non-traded from. If you study the price behavior of the exchange traded fund REITs, you'll find they are highly correlated with the S&P 500. If your objective is to find non-correlated return streams, the non-traded structure would be considered preferable. These REITs can be well diversified or concentrated in certain sectors. 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, typically in 3 to 5 years.

Private Equity is a popular alternative investment. Private equity is capital that is not traded on a public exchange. It's composed of individual investors and funds that invest directly in private companies for a number of purposes including buyout, growth equity, venture capital, distressed investing, to enable liquidity events such as an initial public offering or a sale to a public company. Institutional and retail investors provide the capital for private equity, and the capital can be utilized to fund new technology, make acquisitions, expand working capital, and to bolster and solidify a balance sheet. In the private equity market you can purchase an interest in a privately held company either directly or as is more common, through a limited partnership. As you'd expect, these investments have much less liquidity than more traditional investments. Investors typically make a capital commitment and the capital is called over a period of time ranging from one to four years depending on the fund. The cash flows associated with these investments are typically described by something 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. These investments will often be accompanied by negative returns in the early years but if acquisitions are made in a good vintage year, the better private equity funds have achieved returns in excess of 20%. The fee structure for private equity firms typically varies, but most commonly includes a 2% management fee and a 20% performance fee. The 20% performance fee is often subject to a hurdle or preferred return of 8%, meaning the investor must earn 8% annualized before the fund's management can take their 20% share of the profits. Private equity funds typically have minimums of $1mm however feeder funds, or funds that aggregate smaller commitments often permit investments of $250,000. In addition, there have recently been funds investing in private equity that are registered with the SEC and traded on an exchange which permit investments as little as $25,000.

In addition to traditional private equity, many institutions are selling their private equity interests into a secondary market. Sellers of private equity investments sell not only the investments in the fund but also their remaining unfunded commitments. For the vast majority of private equity investments, there is no listed public market, however, there is a robust and maturing secondary market available for sellers of private equity assets. Buyers seek to acquire private equity interests in the secondary market for multiple reasons. For example, the duration of the investment may be much shorter than an investment in the original private equity fund, thereby avoiding the J-Curve. Likewise, the buyer may be able to acquire these interests at an attractive price while they simultaneously avoid the early year's negative returns. Conversely, sellers may seek to sell interest for various reasons, including the need to raise capital, the desire to avoid future capital calls, the need to reduce an over-allocation to the asset class or for regulatory reasons. Secondary funds usually have the same terms as primary, namely the2% and 20% management and performance fees discussed earlier.

Investing in the energy asset class can be approached in a variety of ways. Despite the abrupt industry setback of the past few years, global energy demand has grown consistently since 1980. According to the EIA, the annual growth rate of global energy demand averaged nearly 2.0% over the past 30 years. Interestingly, while there have been drops in individual years, there were no decreases over any five-year period. In 2016, global demand for oil rose by 1.6 million barrels per day, reaching 96.4 million barrels in total. Energy investing can be via downstream, midstream or upstream investments. 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, which can be thought of as infrastructure investments, involve numerous components, including those needed to produce, store, transport and distribute oil and gas and related products. Downstream operations can include refining crude oil and distributing the by-products down to the retail level. Most individual investors approach the sector through upstream and midstream activities, either through a diversified fund or a direct investment. Most funds will focus on acquiring companies engaged in oil service and equipment, exploration and production and the midstream sector and will utilize its expertise in management, operations and finance to assist its portfolio company's management in improving operating results and profitability. Often funds will 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 financing and/or investing in midstream assets as well as investments in independent producers, acquiring high quality long-lived oil and natural gas 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. The recent decline in the price of oil has enabled funds with cash available to acquire deep value assets as many producers face difficulties servicing their debt.

Tax benefits are available through oil and gas drilling limited partnerships. These deductions typically include both intangible and tangible drilling costs, equal to 85% to 100% of your investment and a depletion allowance of 15% on a portion of the income received from the partnership wells. Another way to participate in the energy sector is via royalty interests. Royalty is a percentage of revenue paid to a land or mineral owner from the production of oil and gas on his or her property. Operators sign a lease with a fund and extract oil and gas on their property. The funds collect royalty payments based on the monthly gross revenue from production then distribute quarterly payments to the limited partners. As mineral owners, investors are allowed a 15% tax depletion allowance. Many of these funds have the illiquid characteristics associated with private equity, however liquid forms of energy exposure exist as well. Master limited partnerships or MLPs, and unit investment trusts or UITs, all provide pass-through treatment of both income and deductions derived from oil and gas investments at the wellhead. The oil and gas exploration and transmission industries are speculative, heavily regulated and involve a significant degree of risk so as with the consideration of all alternative investments, proper due diligence is required before making an investment.

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 can 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, technology, transportation, energy, environmental, infrastructure and others. They typically pay a 6% coupon and often have a preferred return, frequently 8%. The Funds can operate globally. They typically 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.

Many of these partnerships are structured with a so-called “2 & 20” fee structure where there is an annual 2% management as well as a 20% “incentive” or “carried interest”, the percent of gains the general partner takes after the limited partners have earned their preferred return. There also 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.

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.

Venture capital is financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential. For startups without access to capital markets, venture capital is an essential source of money. Risk is typically high for investors, but the downside for the startup is that these venture capitalists usually get a say in company decisions. For small businesses, or for up-and-coming businesses in emerging industries, venture capital is generally provided by high net worth individuals, also known as 'angel investors' as well as venture capital firms. Angel investors are typically a diverse group of individuals who gained their wealth through a variety of sources. However, the majority are usually entrepreneurs themselves, or are executives who retired early from previous ventures that developed into successful empires. There are thousands of venture capital firms in the United States. Most of them are smaller and not well known like the big names with which you may be familiar. The problem with these funds is they often have a diverse portfolio of investments with only one or two quality early stage firms in the fund. When these firms seek subsequent rounds of financing, the venture fund often does not have the cash to invest, having fully deployed all of their capital, consequently getting diluted by later stage investors. Some funds will step in and invest in these later rounds, paying the venture funds a small fee to participate. These later stage funds are thus able to cherry pick the best investments of the venture funds. They sometimes also offer direct co-investment opportunities outside of the fund directly into the early stage company as well. Though providing venture capital can be risky for the investors who put up the funds, the potential for above-average returns is an attractive payoff.

A co-investment is a minority investment made by investors in a company alongside a private equity fund manager or venture capital firm. Co-investments enable investors to get in on potentially very profitable investments without paying the usual fees charged by the private equity fund. Co-investment opportunities are generally restricted to large institutional investors who already have existing relationships with the private equity fund manager, and are typically not available to retail investors however feeder funds which aggregate smaller investors, can provide access to these investments. Why would a private equity fund manager give away a lucrative opportunity? Private equity is usually invested through a limited partnership (LP) vehicle in a portfolio of companies. In certain situations, the LP's funds may already be fully committed to a number of companies, which means that if another prime opportunity turns up, the private equity fund manager may either have to pass up the opportunity or offer it to some investors as a co-investment.

Distressed securities are financial instruments issued by a company that is near to or currently going through bankruptcy. As a result of the issuing company's inability to meet its financial obligations, these financial instruments have suffered a substantial reduction in value, but because of their implicit riskiness, they offer investors the potential for high returns. Distressed securities can include common and preferred shares, bank debt, trade claims and corporate bonds. Investors looking for a bargain and willing to accept the risk often become interested in distressed securities. In some cases, these investors believe the company's situation is not as bad as it looks, and as a result, they anticipate their investment to increase in value. In other cases, investors may foresee the company going into bankruptcy, but they feel confident that there might be enough money upon liquidation to cover the securities they've purchased. Unfortunately, in many cases, the companies that issue distressed securities end up filing for 7 or 11 bankruptcy, and as a result, individuals interested in investing in these securities need to consider what happens in the case of bankruptcy. In most bankruptcies, equity, such as common shares, is rendered worthless, making investing in distressed stocks extremely risky. However, senior debt instruments, such as bank debt, trade claims and bonds, may yield some payout. In particular, if a business files chapter 7 bankruptcy, it stops operations and goes into liquidation, at which point its funds are dispensed to its creditors, including bondholders. Conversely, under a chapter 11 bankruptcy, a business restructures and continues operations. If reorganization is successful, its distressed securities, including both stocks and bonds, may yield surprising amounts of profits.   Funds investing in distressed securities will make control-oriented investments in middle-market businesses and operating assets in the

United States and Europe experiencing some form of financial, operational or cyclical distress. In certain cases, these funds will seek to target direct acquisitions of controlling stakes in companies through a plan of reorganization, bankruptcy auction or other form of structured transaction. By entering via senior debt obligations, these funds can have the ability to provide attractive private equity-like returns with meaningful downside protection.

Another category of fund will have an intermediate term liquidity profile and as such, often falls through the gaps associated with other alternative funds – generally too illiquid for hedge funds and lacking the operating qualities and longer term hold periods associated with private equity. Frequently termed ”multi-alternative”, these funds often invest across asset classes, sectors, geographies and capital structure and access investments via the many specialist investment teams with a global reach across a large management firm. Teams have access to off-market transactions and selectively marketed opportunities. One fund might invest in a number of sectors including infrastructure debt and equity investments, real estate debt and equity investments, private debt and equity investment, securitized asset investments, insurance-related and other opportunistic investments.

For the ultra-high net worth, real assets can be an excellent diversifier. Investments made in 2008 in art, antique cars, Chinese porcelain and rare violins have performed well.

For the moderate net worth, many today are wondering whether they'll have sufficient income to maintain a comfortable retirement yet are reluctant to chase the stock market higher. The bond market similarly offers little in the way of comfort. For those investors who cannot afford the typical $250,000 minimum required by the funds discussed above, many of the listed but non-traded products; BDC's, REITs equipment leasing funds and the more recent Interval Funds in particular, have lower minimums and can generate monthly income annualized in the 6-8% range. Since they are non-traded, an upward move in interest rates will likely have much less of a negative impact on principal compared to liquid fixed income investments. Please contact Amadeus Wealth Advisors should you wish to conduct further due diligence on the investments discussed in this introduction.

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1 McKinsey & Company: The Trillion Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments