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What are Alternative Assets?

The world of finance and investment is full of unfortunate terms and phrases. Unfortunate in that they are unclear, unfortunate in that they may actually be used in different senses in different situations, or unfortunate in that they evoke emotional responses which may not in fact be justified in the cold light of day. "Alternative assets" is one such term.

Dictionary definitions of "alternative" as a noun range among the following:

- "something different from";
- "able to serve as a substitute for something else";
- "either one of two, or one of several, things or courses of action between which to choose".

Yet the conjunction of "alternative" with "assets" suggests that it is here doing duty as an adjective (qualifying a noun, for the grammatical purists out there), in which cases dictionary entries would include:

- "different from and serving, or able to serve, as a substitute for something else";
- "of which only one can be true, or only one can be used or chosen, or take place at any one time";
- "outside the establishment or mainstream, and often presented as being less institutionalised or conventional";
- "ecologically sound and/or more natural or economical with resources".

In other words, as a noun "alternative" seems to be capable of at least three meanings, and as an adjective of at least four, which might be summarised as: "serving as a back-up", "mutually exclusive", "unconventional or non-traditional", and "green" (in its socio-political meaning). Of these, at least three are unhelpful, the first two in particular. There is no suggestion that we should invest in alternative assets *instead* of something else, or that they represent a mutually exclusive choice so that we may invest *only* in alternative assets. In any event, in neither case would we be able to make any sense of the situation unless we knew instead of *what*; what might the other alternative or alternatives be?

It is the third meaning that we are going to have to adopt, and yet even here we must be careful, for this usage would include overtones of being marginal, or even downright cranky such as when used to describe alternative medicine. Roget's *Thesaurus*, for example, offers "conventional" as an antonym, and "unorthodox" and "unusual" as synonyms. It is perhaps these overtones which can give weight to the pejorative resonance with which the phrase "alternative assets" is often uttered.

It is not even particularly helpful to look at the way in which the phrase is used in practice by investors, since there seems to be no common agreement on this. People can agree on examples (private equity, hedge funds and real estate (property), for example) but not on a universal definition. There seem to be at least three different ways in which the phrase is used to distinguish certain types of assets.

Illiquid

Many say airily "oh, alternative assets are illiquid. You know, not like bonds or equities – illiquid." However, this possible definition runs into trouble straight away.

For a start, not all bonds and equities are liquid, or at least not all the time. Anyone who may have tried to sell even good quality US corporate bonds in September 2008 will appreciate the force of this comment all too well. However, let that go. The definition still does not work.

Active currency rates are an alternative asset, and what could be more liquid than currency? Similarly gold, which many rightly regard as the ultimate defensive asset. Why? Precisely because one can take it anywhere in the world and turn it instantly into cash. In an Armageddon-type scenario one could even use it as a unit of purchasing power in its own right. So here are two "alternative" assets which we can identify straight away as being arguably even more liquid than bonds and equities.

Unquoted

This definition too runs onto the sandbanks as soon as we set sail in it. It is true certainly that private equity funds, or at least the limited partnership variety, are unquoted. However, all the commodities are "quoted" in the sense of having a price which is available for trading on public markets from one moment to another, as are energy assets, such as oil and gas, and of course currencies. We should also note, without necessarily having to pursue the point further at this stage, that adopting this definition would create some serious ambiguities which it might prove very difficult to resolve. How would you classify 3i, for example? As a private equity fund, or as a public company and major constituent of the FTSE 100 index?

Not Bonds or Equities

I have never heard this definition suggested, save in my own investment modules and workshops, but it seems to me to do the least violence to the situation, since it is both more difficult to attack linguistically and a closer fit for the instinctive attitude of most investors towards such assets. Certainly, one often sees a portfolio divided between "fixed income" (bonds), "equities", "cash" and "alternatives".

However, even here there are problems. For example, many investors include "real estate" (property) as an asset class in its own right and then have an allocation to "alternatives" alongside it. Some others include private equity within their allocation to "equities". There are even some who argue for a still more restrictive definition, which would only cover what one might term "exotics" or "collectibles" such as musical instruments, paintings, etc.

This is one of those situations where no sizeable group of people are ever going to agree on a common solution. It is, however, submitted that "not bonds or equities" is less open to debate than any of the other candidates, and will therefore be adopted for the purposes of this book.

ARE ALTERNATIVE ASSETS REALLY "ALTERNATIVE"?

This may seem like a really pointless question to be asking, the posing perhaps of some arcane academic distinction, but it is not. On the contrary, it exposes a very serious and controversial issue.

The fact that these assets are commonly referred to as "alternative" reinforces the view that they are somehow peripheral to the whole business of investing or, even worse, that there is "proper" investing and "other" investing. "Proper" investing being of course bonds and equities, which should occupy the bulk of your time, and "other" being what you might take a quick look at if you have the time once the main business of the day is done. In other words, that alternative assets are somehow inferior to bonds and equities, which might be thought of as "mainstream". It would be unthinkable, under this view, for anyone to invest *only* in alternative assets, since they become by definition something extra which one goes in for only if one has the time and inclination after first setting one's allocations to bonds and equities.

With very few exceptions indeed, this worldview flows over into actual asset allocation in practice; it is for precisely this reason that we should take this issue so seriously. An automatic or unconscious assumption is being made which is capable of skewing decision making very badly indeed.

It became briefly fashionable during the dot com bubble to talk about "a whole new paradigm", or "a paradigm shift". By this was meant that as a result of the information and communications revolution brought about by the advent of the internet, a completely different belief system had come into being, and that it was necessary for finance and investment thinking and practices to be brought into line with it. Should you, for example, be so square and un-hip to ask how a business with no prospect of earnings for many years could be worth several hundred million dollars, you would be met with a pitying smile and the news that "you just don't get it, do you?"

In fact, at the risk of being thoroughly un-hip, the use of the word "paradigm" was probably itself misguided. As used initially by Thomas Kuhn in his book *The Structure of Scientific Revolutions*,[1] it was confined to the scientific community. It was a system of scientific beliefs, and scientific only. What the internet pundits were talking about was actually not a paradigm at all, but an episteme.

An episteme, a concept coined by the flamboyant French thinker Foucault,[2] is a system of thought which embraces all aspects of culture and society, not just science. It also embraces the concept of "zeitgeist", the spirit of the times. In the sudden readiness of consumers to make purchases online, for example, we see not a new paradigm but a new episteme.

One of the features of an episteme which Foucault identifies is this very issue of unconscious assumptions. In the field of literary criticism, for example, Foucault's work had a huge impact, as people realised that it was impossible properly to analyse or comment upon a book without understanding the episteme within which the author lived and worked.

There is for example a very early Hitchcock film called *Murder*, made in 1930 starring Herbert Marshall and based upon a novel by Clemence Dane and Helen Simpson. It does indeed feature a murder, the title being a bit of a give-away here, the motive for which, it tran-

[1]Thomas Kuhn, Chicago University Press, Chicago, 1962.
[2]Michel Foucault, *The Order of Things*, Routledge, London, 1974.

spires, was blackmail. The information in respect of which the individual concerned is being blackmailed is that he is of mixed blood or, as he is dismissively described in the film, "a half-caste". A modern audience of course finds this incomprehensible. Many people today are of mixed race, and the fact that somebody is would not excite even comment, let alone prejudice or disdain. Yet we are not living in the 1920s and 1930s as the authors of the novel and the original audiences of the film were respectively. Clearly things must have been viewed differently in those days or there would be no point to the film, and Alfred Hitchcock was not the sort of man to make a film which had no point to it. So, it must have been the case that the prevailing episteme of those times included the unconscious assumption, no matter how incredible and objectionable it may seem to us today, that to be of mixed blood was somehow to be inferior, undesirable or untrustworthy, and certainly not the sort of cad to whom one might wish one's daughter to get married.

So, let us be aware of unconscious assumptions, and of the very important part which they can play.

For, just as with films and literature, we cannot properly understand investment practice unless we understand the episteme within which it takes place, since this will colour instincts, reactions, thoughts, discussions and decisions alike. It is here that we encounter the real problem with the word "alternative". While this is difficult precisely to articulate, it is part of a system of unconscious assumptions which includes elements of being "more difficult", "more risky", "dangerous", "cranky", "optional" and "unnecessary". No better evidence is required of all this than the very low allocations made to alternative assets relative to bonds and equities, at least outside the US.

The view is very much that bonds and equities are essential, while everything else is an optional extra, and quite possibly an unnecessary luxury. This has led in turn to some dramatically undiversified portfolios, particularly among pension funds who, ironically, are often the only class of investor actually to be under a legal duty to diversify their assets.[3]

The reader should therefore be aware that alternative assets in general are subject to a great deal of unconscious prejudice, and that their supporters are required to justify them both constantly and in great detail in a way which is never demanded, for example, of quoted equities.

At the other end of the scale, there are very few institutional investors who have eagerly embraced alternative investments as a source of

[3] In the UK, for example, see Pensions Act 1995 s.36(2)(a).

diversification across asset classes which hopefully offer lowly correlated returns. The Yale Endowment probably enjoys the highest profile of these, and in recent years alternative assets have generally totalled about 65% of their total asset allocation.[4] If only for this reason, the question which serves as the section heading is clearly relevant and valid. If alternative assets can make up about two thirds of the portfolio of one of the best investors in the world, how can they really be said to be "alternative" at all?

THOUGHTS ON CLASSIFICATION

Having established that we are going to assume that any assets other than bonds and equities can be "alternative", let us see if we can identify some different asset types, and consider how we might further discuss, and possibly classify them.

First and most obviously, if we are going to say that bonds and equities are not "alternative", then what about things which are not bonds or equities and which yet represent them, such as futures, options and swaps positions over individual bonds or stocks (shares), or groups or markets which include them? There is a yet further complication here, of course, since hedge funds routinely deal in such instruments, and yet by most people's reckoning are firmly in the "alternatives" camp.

It is probably best to treat these not so much as an asset type as a way of investing, a means rather than an end. They are thus an investment technique, or a means of replicating or synthesising a particular investment, rather than the investment itself. As we will see, it is in fact often the case with the asset types which we will be considering in this book that synthetic coverage of this nature is the only practical path to take.

Private Assets

On one view, alternative assets fall for the most part rather neatly into two separate categories, but with Hedge Funds hovering uneasily with more of their weight on one side of the line than the other.

Many alternative assets are publicly quoted and highly liquid, thus making it rather difficult to see what is really so "alternative" about them at all. Commodities, energy, gold and currency assets all definitely fall into this category. On the other side of the dividing line stand three which are very different: private equity, real estate (property) and infrastructure – we might term "private" asset types for two important reasons.

[4] See for example the Yale Endowment Annual Report 2009.

The first and most obvious reason is that the things in which they invest cannot by any stretch of the imagination be described as quoted assets or instruments. Private equity funds may invest in shares, but the shares in a private company have few of the characteristics (as investments, not as legal instruments) of their quoted counterparts. They can neither be openly traded nor can they be offered to the public. There may even be important legal differences; in the UK, for example, the Takeover Code applies to public companies but not to private ones.

Real estate funds invest in buildings, which may well from time to time have an advertised price when they happen to be on the market for sale, but these periods are infrequent, and in any event there is no guarantee at all that even then the advertised price has any connection with the building's real value, however we might measure that. Property assets are illiquid, whereas bond and quoted equities are not. Property assets require care and maintenance, which bonds and equities do not, and their value can be enhanced by improvement or development, actual or potential.

As for infrastructure funds, these are perhaps the furthest removed from bonds and equities of all, since they invest in projects, albeit these might be legally structured for funding purposes into companies. On one analysis, an infrastructure fund is paying agreed capital sums in return for the right to share in a stream of future cash flows. What could be more illiquid than the contractual right to share in a project's income stream for perhaps the next 30 years or so? What could be further removed from the concept of legal instruments which can be traded instantly on the world's financial markets?

So, they are "private" asset types in the sense that their underlying investment entities are not publicly quoted. But there is something else as well: this is that the overwhelmingly popular ways in which such assets are accessed are themselves private. Yes, there are quoted private equity vehicles, such as 3i, and doubtless there will sooner or later be an infrastructure equivalent of this FTSE 100 monster, but the vehicle of choice for sophisticated investors has always been the limited partnership.

Real estate is more problematic in this regard, for there are of course hundreds of quoted property investment vehicles around the world ranging from mutual funds to REITs; this is, for example, how most European pension funds have chosen to structure their property exposure. However, private real estate (often wrongly and confusingly called private equity real estate or PERE[5] for short, simply because it employs a private equity type fund structure) has always been a significant part of American investment portfolios and recently

[5]Or even, still more confusingly, sometimes PERA.

crossed the Atlantic and seems set to be a growing part of the European scene.

There are of course those who question why anyone would want to access assets through a private vehicle when they could have the lower fees and comforting liquidity of a public vehicle. As we discuss elsewhere, however, this should increasingly be recognised as a double edged sword. First, that liquidity may be more imagined than real. Second, in turbulent equity market conditions such vehicles can easily give rise to both man-made volatility and man-made correlation as their unit or share prices ride up and down with stock market beta rather than necessarily with the value of the underlying assets.

So, we might classify as “private”, those asset types which satisfy both these criteria. There will always be investors who seek out quoted private equity exposure, and for such people then there are certainly proxies such as 3i investing at the company level, or fund of funds equivalents readily available. The bulk of private equity capital is, however, deployed through private vehicles.

With infrastructure the problem is more complex since when investors talk of investing in “quoted infrastructure”, they frequently have in mind buying shares in companies which undertake infrastructure activity, the drawbacks of which approach will be fully explored in later chapters.[6] “Quoted infrastructure”, in the sense of listed funds which invest in projects, do exist, but given that the underlying assets (projects) are themselves illiquid, then something like a limited partnership will often be the vehicle of choice for any sophisticated investor looking to access this asset class too, not least because of various tax advantages. Stand-alone partnerships are also used by investors to access individual projects.

With real estate the situation is more problematic and “private real estate” is simply a sub-set of “real estate”. However, something which is often overlooked is that many of the world’s biggest investors choose to build their own direct portfolios of property assets, and this activity too would form part of private real estate. After all, what could be more “private” than simply buying something yourself and keeping it as your own personal property?

So, it does seem to be the case that there is indeed a category of alternative investments which we can classify as private assets, and these would comprise almost all private equity and infrastructure, and all that real estate investing which is conducted either directly or

[6] For what it’s worth, some research carried out a few years ago in Australia, admittedly on very limited data sets, suggested that private infrastructure funds had strongly out-performed “quoted infrastructure” even after deduction of all fees. See the chapter on infrastructure for more details.

through unquoted vehicles. Perhaps the test should be that it is only here, with private assets, that true illiquidity (at least in the legal sense of the word) is to be found.

While it is always dangerous to make predictions, and this one may seem more perverse and controversial than most, it is entirely possible that in future a number of investors will begin actively to seek out private assets as a significant part of their portfolios precisely for the very illiquidity which they offer, no matter how counter-intuitive this may feel to most investors reading this book. This point will be examined and developed in the next chapter.

Commodity Type Assets

Another discernible category of assets would be those which are, or represent, some quantity of a physical object, such as an ounce of gold, a barrel of oil or 20 tons of pork bellies. This would embrace everything which we will be treating as "commodities" and "energy", as well as gold, which we will consider as a separate asset class for both historical and practical reasons.

These all share some obvious common characteristics. They can all be publicly traded from one second to another on financial markets. They all represent substances which can be used either as raw materials or as means of production by industrial companies around the world. They are all financial investments, but each in its purest form can be transmuted into physical ownership; those with long memories might, for example, remember the larger-than-life Texan businessman Bunker Hunt calling for physical delivery during his bid to corner the world silver market in the late 1970s.

For some investors they represent "defensive" investments. They offer the comfort of being able to hold physical assets rather than financial instruments. They offer the reassurance that a commodity must always have some intrinsic value, being unable to fall to zero as could the shares (stocks) of a bankrupt company, or even the bonds of a failed state. Perhaps they might even be believed to offer that most elusive holy grail of all, a source of excess return which is largely uncorrelated to global equity markets.

Of course, this is all a bit of an illusion. As we will see, it is usually precisely financial instruments that such investors end up holding, rather than the physical asset itself, since they cannot handle, and thus do not want, physical delivery. Even in the case of physical gold, it is usually a piece of paper rather than a gold bar which sits in the safe, or with your custodian. In the case of just about every one of these commodity type assets, what you get left with is not a quantity of the stuff itself, but exposure to the underlying futures contract, the price of which may or may not represent the future strike price at expiry and which, many argue, does not even have a particularly close relationship with the prevailing spot price.

It remains the case, however, that these asset types do seem to be recognisably different to private assets. Most obviously, they are liquid. Any futures contract, or an option in respect of it, can be bought and sold, and where these are exchange traded rather than dealt Over the Counter, then they carry only symbolic counterparty risk. So, liquidity is one thing which sets them apart.

Volatility and Valuation Issues

Volatility is another. Even measured on a year to year basis, which masks the true extent to which their prices may go up and down over shorter periods, this is high; both oil and gas, for example have a single standard deviation of about 40%, which means that if you were looking for a 95% degree of confidence you would have to allow in your modelling for them to go either up or down 80% in the course of any single year. Private assets, on the other hand, because they are held in private vehicles, tend to have relatively stable values which go up and down only either as assets are bought, sold or revalued, or cash flows are received and distributed.

It is only fair to point out that there is a strong counter-argument here, and one which gained in both topicality and urgency during the gathering whirlwind of 2008. It transpired that the framers of the relatively recent International Accounting Standards (IAS) governing the valuation of assets had never envisaged the sort of extreme market conditions which in fact occurred, and the situation was complicated still further by American accounting bodies attempting to impose some of their own domestic FASB[7] requirements on any businesses in the rest of the world having any links with the US (the reverse of the usual situation, where agreed IAS provisions are given effect by domestic accounting regulations).

The FASB provisions, however, seemed even less appropriate to extreme market circumstances than their IAS counterparts, as was dramatically demonstrated during September 2008 when, at one time, there was simply no effective market anywhere in the world for corporate bonds, for example. Some of these provisions seemed to be saying that an investor could only value an asset at the price at which they could actually sell it in the marketplace at that moment. Logically, then, if there was no buyer available at any price, the asset should be written

[7]Financial Accounting Standards Board.

down to zero. Given that this would have had a major impact on the balance sheets of banks around the world who were struggling, successfully or otherwise, to stay in business and out of liquidation, such views did not meet with universal approval.

In the event, some classic political fudges ensued, some of which even allowed accountants to treat certain types of assets as if they were something else entirely. Two principles of general application might usefully be noted here.

A People will usually try to change the data to fit the rules, rather than vice versa.

B If a rule leads to a ridiculous result, then it is usually because it was a ridiculous rule to start with.

Accountants at the time argued that there was a concept known as "fair value" which always existed and could always be measured. It is only fair to note (1) that they were always at pains to stress that this was not the same thing as calculating something which was "real", "true" or "correct" (surely another example of B above), and (2) that since the financial crisis many accountants have now changed their views and there is currently an active debate raging within accountancy circles as to whether there really is such a thing as universal "fair value" after all.

Even post-crisis, it is necessary to touch upon this point because it is both a sensitive and an important one. Many critics of private assets point to the issue of valuation as showing that the "value" of, for example, an interest in a private equity fund, cannot be accurately assessed or relied upon for audit purposes. One is tempted to respond as Brahms habitually did when people used to point out that a particular passage in one of his symphonies was remarkably similar to a few bars in one of Beethoven's: "any donkey can see that", he would say.

Nobody pretends, least of all anybody in the real estate or private equity industries, that an interest in a private vehicle which invests in private assets, can be accurately measured in the sense of arriving at some philosophical touchstone of finite, absolute value. Indeed, it is probably more correct to say that the real value of any such underlying asset can only be established for certain once it has been sold, and every last piece of the consideration realised in cash and distributed back to investors. Attempts, inspired by auditors and regulators alike, to "mark to market" such assets simply reveal a deep and disturbing ignorance of their true nature.

As Markowitz noted[8] more than fifty years ago, investors treat uncertainty as a bad thing and certainty as a good thing. This is true. Indeed,

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[8] *Portfolio Selection: Efficient Diversity of Investments*, John Wiley & Sons, New York, 1959.

it is so self-evidently true that one wonders why anyone felt a need to say it in the first place. However, it does not go far enough. It is not just that investors prefer certainty (even apparent or illusory "certainty") to uncertainty. It is that most of them are completely unable to handle uncertainty in any shape or form, certainly in their decision processes. There has for example been much research into cognitive biases such as Ambiguity Bias (a heavily skewed bias towards an apparently more certain outcome) and Illusory Correlation (a bias towards seeking confirmation of an apparently more certain outcome from historic financial data, even to the extent of seeing patterns in the data which do not in fact exist).

This tendency is most marked in those who have what the Americans now call a "Type A" personality, people who believe strongly in one right answer and the ability of mathematics to calculate it. Such individuals tend to make very good actuaries and bond analysts, but very poor investors. The fortunes of any investment portfolio will always be prey to considerable uncertainty. Even if one constructs a portfolio composed entirely of long UK gilts one can only limit the type and extent of the uncertainty, not eliminate it altogether (you cannot accurately predict what is going to happen to inflation and interest rates over a 20 year period, for example). It is their belief that this uncertainty is somehow something which can be calculated or measured, as opposed to evaluated or assessed; an attitude which lies at the core of so-called Modern Portfolio Theory, and bedevils the world of finance.

There is a simple response to such an attitude, no matter how well rooted it may appear to be in mathematical theory. Uncertainty is a part of human existence and, since investment cannot occur except as a result of human interaction and decision making, thus also of investment. Either you are comfortable with that uncertainty, and can envisage outcomes occurring within certain parameters rather than as single, predictable events, or you are not. If you are not, then you have two choices: either to stay out of those areas of investment which seem to give rise to the most uncertainty, or to try to impose inappropriate mathematical methods upon them in an effort to make yourself feel better about the whole business. In fairness, most investors would greatly prefer the first option, but find themselves increasingly being pushed into the second.

Time Horizons

So, whether by reason of market mechanics or accounting and valuation, commodity type assets will tend to display much more volatility, on a year to year basis but also when measured over shorter periods.

This strongly suggests that they are likely to be more suitable for long term investors, who can within reason choose the moment at which they sell, rather than short term investors, who may be forced to sell when they would really rather not, in order to meet some pressing liability.

In practice, these days many investors divide their portfolios in two. The sorts of phrases you will come across are "risk reducing" or "liability matching" assets, on the one hand, and "return seeking" assets on the other. The former will be chosen on the basis of displaying as little volatility of historic returns as possible. With regard to the latter, higher levels of volatility will be tolerated, this being balanced by the expectation of compensating higher returns. While the actual labels "short term" and "long term" may not be used, this is equivalent to an investor having mentally divided their portfolio by investment time horizon, though we are here talking about a more complex decision process, where trade-offs of volatility, liability profile, correlation and internal resources and processes should all have been given due consideration too.

Whatever the case, commodity type assets would seem properly to belong not in the first of these categories, where volatility is definitely your enemy, but firmly in the second, where in many cases volatility could quite possibly be your friend.

There is one exception to this, and it is a very important one since it encompasses a whole separate approach to investment, and one which has many dedicated managers offering products and services bearing its name.

Global Tactical Asset Allocation (GTAA)

This is not a book on investment strategy, but we are considering alternative assets as a background to the whole business of asset allocation and so it is important to understand the difference between strategic and tactical asset allocation. Briefly, and perhaps over-simply, the former is long term while the latter is short term.

A strategic asset allocator will attempt to model the liabilities, both long term and short term, of an investor and then construct a portfolio which seems to offer the best compromise between matching the near term ones and having enough money when the time comes to be able to pay the long term ones. Generally speaking, the asset mix once having been chosen will not be interfered with except for periodic rebalancing to bring it back within its target parameters.

Incidentally, rebalancing is itself generally a benign process, since not only does it restore diversification but also forces the investor to buy something when it goes down and sell it when it goes up; surprisingly, in practice many investors do exactly the opposite. Please note that we are here talking about types of assets, what are generally called asset classes, rather than individual assets. Should you be holding a portfolio of individual shares (stocks) then this section is not advice to buy more of one automatically should it go down in price (a process known as "averaging down"). On the contrary, there may be very good reasons why it has gone done, and equally good reasons to sell your remaining holding before it goes down any further. We are here talking about a situation where you might be holding, say, an S&P500 tracker fund as a way of having exposure to US equities, and where the value of that tracker fund may have declined relative to your holdings in, say, real estate simply because US equities *as a whole* have dropped in price relative to real estate *as a whole*. Like it or not, it does seem to be the case that over long periods most asset classes move within broad (sometimes very broad, as with gold, for example) bands and that rebalancing will tend to force you to buy towards the bottom of the band and sell towards the top.

Tactical asset allocation is seen as much more exciting, which is why many investors around the world seek to practice it. Here, you might get together as a team on a Monday morning, or on the happening of some specific event which seems significant, and think about what asset classes seem over-valued or under-valued, or likely to be so in the near future. You will then seek to buy (or, more likely since this is essentially a hedge fund type approach, go long) the ones you like and seek to sell, or go short those you do not.

This is a deceptively simple description of what is a very complex approach, which blends into Global Macro, and can also make use of active currency strategies, as well as exposure to commodities by way of Managed Futures. It can be performed at a very simple level by means of ETFs, or executed in much more complex fashion with leverage, derivative positions and currency overlays. Whatever the case, it essentially involves taking short term bets at the level of asset classes or types (not individual assets).

Given its exciting nature and sexy acronym, it is small wonder that many investors around the world feel drawn to GTAA and try to adopt it as a strategy for at least part of their portfolio. Alas, reality soon reasserts itself. Tactical asset allocation requires a very quick decision process (sometimes a matter of minutes) and a strong nerve, both things which are in short supply among the world's institutional investors. If it takes you a year to decide that this may be a good time to short the dollar, then, even if you were right when you started writing your first paper to Investment Committee you certainly are not any longer, since the opportunity will have long passed. If you can take the emotional stress of running a losing position for several months, then fine, but is there any guarantee that your committee will not pressure you (or even direct you) to close it out?

So, most investors who want to move in this direction take the decision sooner or later to appoint an external GTAA manager, though most do so, in common with all their alternative asset allocation decisions, in respect of such a small percentage of their portfolio that the time and effort required in appointing and monitoring the manager is out of all proportion to any positive impact which the GTAA exposure might have on their overall returns.

There is another point to be considered here. Some investors try to classify strictly every type of risk to which they are subject, and in what proportion of their portfolio each one is present; indeed, some are required to do so by their legal or regulatory environment. GTAA raises an insuperable problem here, since the GTAA manager cannot specify in advance what asset types they will consider, nor will the investor necessarily know from one week to the next in what they have invested. So, if you do have just such a rigidly demanding risk management system then you should consider very strongly whether GTAA is really an area you wish to get into.

The reason it is useful to mention GTAA here is that, as pointed out above, this might be seen as something of an exception to the principle that commodity type assets may not be suitable for short term investors. Within a GTAA portfolio, it may be precisely short term volatility upon which the manager is relying for their return, believing that it is about to move in their favour.

Subject only to this one exception, however, it seems reasonable to state as a principle that commodity type assets are not suitable for short term portfolios, since if one cannot choose the time of one's selling then one is always going to be at unacceptably high risk of short term downside in the market price.

An Alternative Way of Accessing Conventional Assets?

Before we leave this chapter on attempting to delineate exactly what we are talking about when we mention alternative assets, it is necessary to deal with an argument which was advanced in an earlier book[9] to the effect that alternative assets are simply an alternative way of accessing conventional investments, or "just different investment strategies within an existing asset class". Such a statement seems very difficult to accept.

[9] *The Handbook of Alternative Assets*, Mark Anson, John Wiley & Sons, New York, 2002.

If you buy a bar of gold, then surely you are doing so because you want a bar of gold? You might, for example, be buying it as the ultimate defensive investment, and intending to bury it in a biscuit tin in your back garden, intending to recover it on emerging from your personal bunker after a nuclear holocaust, as one Swiss banker of the writer's acquaintance was indeed known to do. To say that you are somehow trying to put yourself in the position of having bought something else entirely seems impossible to conceive.

Even if one were to take a less obvious example, could it really be said that by committing money to a limited partnership which intends to make seed stage venture capital investments in start-up companies in the US, one is somehow buying a proxy for the NASDAQ or the S&P? What about oil, or pork bellies, or infrastructure projects? What about silver, coffee or an office block in Mayfair? What other, conventional investments are these supposed to represent?

On the contrary, the reason people invest in alternative assets is precisely because they are "different", because they offer different return profiles (in some cases, even different types of return) and because they offer at least the possibility of uncorrelated returns.

So, as is clearly stated at the beginning of this chapter, there is indeed no universally accepted definition of "alternative assets", but they clearly must be different to something else, something "other", or the phrase would be a meaningless one altogether. To suggest, as the writer of the earlier book does, that the assets themselves are not alternatives, but sub-sets of mainstream, conventional asset classes, and that only the means of investors' access is "alternative", seems impossible to accept. Of what "existing asset class" is real estate "just a different investment strategy"? Or infrastructure projects? Or natural gas? Not to mention Stradivarius violins …?

What We Will be Considering

Having made some sort of attempt at defining what we are talking about when we refer to alternative assets, it may be helpful to set out exactly what we are going to be talking about. It is acknowledged that the following may not be a perfect intellectual exercise in asset classification, but it does at least have the merit of being broadly in line with current investor thinking.

- Real estate
- Energy
- Private equity
- Hedge funds (but discussing active currency separately)

- Infrastructure
- Commodities
- Gold
- Active currency
- Other (including forestry)

SUMMARY

There is no universally agreed definition of "alternative assets", nor even any consensus as to which individual asset types may be so described.

For the purposes of this book, we will adopt the view that investment in anything other than either bonds or (quoted) equities will be seen by investors as "alternative". It is submitted that this fits reasonably well with prevailing investor beliefs, particularly outside North America.

An alternative view, that alternative assets simply represents an alternative way of accessing conventional assets, must be rejected.

Some alternative assets can be classified as "private assets". These are private equity, real estate and infrastructure when accessed through private vehicles such as limited partnerships.

Some alternative assets can be classified as commodity type assets. These share three common characteristics: (1) they are liquid, (2) their prices are quoted on public exchanges and (3) they take the form of or, as traded, represent physical assets which are used either as raw materials, means of production or a measure of intrinsic value.

Commodity type assets tend to be highly volatile, and the key concept of volatility will be examined further in the next chapter. Briefly, there are situations where volatility can be your friend rather than your enemy, but it is important to be able to differentiate between these!

For the purposes of this book, the alternative assets to be considered are: real estate, energy, private equity, hedge funds, infrastructure, commodities, gold, active currency and "other".