Alternative assets for superior diversification and returns

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Contents

Executive summary

> "You can't predict. You can prepare."
>
> **Howard Marks** Oaktree Capital

When managing money in a world full of uncertainty, diversification is more important than ever. Alternative assets provide investors access to superior portfolio diversification and lower levels of volatility, which typically increases the likelihood of achieving an investor's objectives over the long-term.

Since the COVID-19 pandemic started, portfolios managed by Koda have remained resilient and generated strong consistent returns mainly attributed to genuine diversification from exposure to alternative and non-traditional investments.

Alternatives offer investors the opportunity to minimise portfolio volatility and correlations with traditional asset classes such as shares and bonds. This helps investors protect long-term capital and lower the downside risk during unforeseen market crises such as the GFC and COVID-19.

However, alternatives come with their own risks and are generally more illiquid and complex compared to traditional assets. It is essential that investors understand the different type of alternatives and their risk-reward profiles before incorporating them into investment portfolios.

In this paper, we discuss the role alternatives play in portfolios and explore the different types of alternatives available to investors. We also provide an overview of how alternatives are used in portfolio construction with respect to risk management and what an effective investment criteria looks like when selecting the right alternative managers.

When used appropriately, alternatives can enhance the overall risk-return profile of portfolios and help investors stay the course during turbulent market conditions. In a world full of uncertainty, it is important to remember the words of renowned investor Howard Marks "You can't predict. You can prepare."

Introduction

Alternative investments (also known as alternatives) are financial assets that do not fall into the category of traditional asset classes such as shares and bonds. Alternatives include a broad range of investments including hedge funds, private equity, venture capital and other non-traditional assets. Real assets, such as infrastructure and commercial property, are also classified as alternatives because they fall outside the category of traditional assets.

Alternatives are generally uncorrelated with traditional assets, meaning that the price movements of alternatives do not follow the same direction as those of traditional assets like shares and bonds. According to modern portfolio theory (MPT), a diversified portfolio with exposures to different uncorrelated asset classes tends to have lower volatility and can generate more consistent returns over the long term.

The lower volatility may seem illusory. However, reducing the fluctuation in a portfolio's value can provide comfort to investors who may have otherwise reacted irrationally to frequent portfolio movements such as those occasionally experienced in listed markets. The lower volatility smoothens the returns of a portfolio, and the compounded rate of return becomes uninterrupted by significant prices movements.

> “The first rule of compounding is to never interrupt it unnecessarily.”
>
> **Charlie Munger** Berkshire Hathaway

The Role of Alternatives in Portfolios

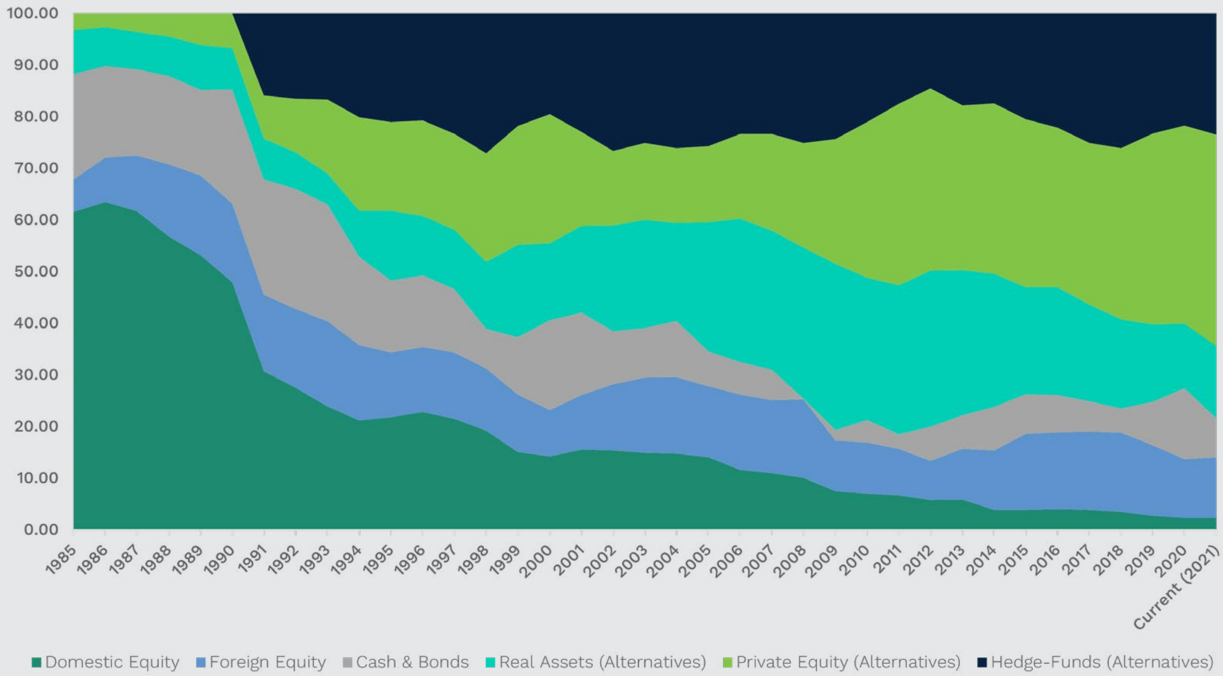
Empirical research has shown that asset allocation accounts for more than 90% of portfolio outcomes. In their influential paper, “Determinants of Portfolio Performance” (1986) Gary Brinson, Randolph Hood and Gilbert Beebower have shown that superior diversification improved long-term returns by analysing portfolio performance data from 91 large US pension funds from 1974 to 1983.

These findings complemented Harry Markowitz’s earlier paper “Portfolio Selection” which set the groundwork for MPT. Markowitz showed that risk-adjusted returns can be maximised by diversifying across various asset classes. Therefore, alternatives that are uncorrelated to traditional assets can reduce the overall volatility of portfolios and provide genuine diversification for investors.

Diversified portfolios with exposure to alternatives can better withstand market corrections and minimise the risk of portfolio drawdowns, which are the peak-to-trough declines during specific periods for a portfolio. This helps preserve the invested capital invested over the long term.

The MPT investment philosophy was widely adopted by university endowment funds, including at Yale. The late David Swensen managed Yale’s endowment fund from 1985 to 2021, and during this time diversified the fund away from public markets to alternatives. Yale has managed one of the most successful endowment funds with net returns over 12% p.a. since the mid-1980s. The chart below shows the Yale endowment’s gradual increase in alternative assets. For further information about endowment-style investing, please refer Koda’s publication on the Principles of Endowment- Style Investing using this link.

Exhibit 1. Asset Allocation of Yale Endowment, 1985-2021



Source: Yale Investments Office (March 2021)

“Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred.”

Seth Klarman Baupost Group

Types of Alternative Investments

With such a broad range of alternative investments available, it is important for investors to know the key differences among alternative strategies and the respective risk-reward profiles associated with each strategy. In this section of the paper, we explain the different types of alternatives such as hedge funds, private equity and venture capital and real assets.

1. Hedge Funds

A hedge fund is a pool of investments that is actively managed using non-traditional strategies, such as leverage, derivatives and long and short positions. Hedge funds are typically uncorrelated to traditional asset classes because they can take both long and short positions in different types of assets. In other words, hedge funds can benefit from both rising market prices (through long positions) as well as during market downturns (through short positions). Having a market-neutral strategy using long and short positions can reduce a portfolio's overall volatility and market price sensitivities from indices like the ASX200 or S&P500.

Careful research and due diligence must be done before investing in hedge funds because some funds have been known to lockup capital due to illiquidity events and some large hedge funds have even collapsed. When evaluating a hedge fund, investors should assess the fund's long-term track-record (net of fees), its investment selection process and ability to generate consistent returns above relevant benchmarks.

Investors should also consider a hedge fund's fee structure, given that fees can be expensive especially when comparing with traditional managed funds. Higher fees can be justified when performance objectives are met or exceeded, but it is still important to know how fee structures impact net returns.

2. Private Equity and Venture Capital

As the name suggests, private equity funds generally invest in private companies that are not listed on public exchanges. Private equity has become a sought-after asset class as investors seek higher returns than that provided by cash and bonds, with lower volatility than listed shares. According to McKinsey, in 2019 the total assets under management (AUM) of private equity funds grew by +12.2% to USD $3.9 trillion.

Private equity (PE) funds raise capital from investors which is then invested into private companies to accelerate their growth, improve operational efficiencies and achieve higher company valuations. Private equity funds then exit these companies by either floating them on public exchanges or selling them to other companies in order to generate returns for their investors.

The competition of private equity funds has intensified in recent years, and the number of private equity firms has more than doubled over the last decade. Private equity firms are fiercely competing to access the best sources of deal-flow and research to generate attractive returns for their investors. Due to the vast number of private equity funds and limited supply of high-quality deal-flow, the net returns of private equity funds have become widely dispersed, which is why private equity manager selection plays such a critical role in achieving superior portfolio returns.

Venture capital (VC) is a subset of private equity and involves investing in early-stage companies. These early-stage companies are expected to grow exponentially and are typically from industries such as information technology and life sciences. VC investing usually occurs after a company's initial seed funding round, when founders raise capital from family, friends and angel investors.

Specialist skills are required when assessing whether or not to back a particular early-stage company, as well as the ability to negotiate favourable terms such as liquidation preferences. Investing with an experienced VC fund gives investors access to such skills and offers exposure to a diversified portfolio of carefully selected companies.

When selecting VC funds, investors should assess the long-term track record of successful exits, experience of the VC fund's team, access to talented founders and ability to add value to early-stage companies such as offering strategic advice and valuable contacts from the fund manager's network.

3. Real Assets

Real assets refer to physical assets that have their intrinsic worth based on the substance and utility of the underlying asset. For example, real assets include infrastructure, property and agriculture.

Real assets such as direct commercial property and infrastructure have previously provided investors with steady, predictable income streams as well as capital appreciation from growing populations. However, with COVID-19, commercial property currently faces structural challenges because employees are opting for a hybrid model that involves working from home and the office. In the short-term, this has led to higher office vacancies and reduced rental income. It is uncertain at this stage as to how this will play out in the future.

For diversification benefits, investors can consider investing in unlisted property trusts rather than purchasing physical commercial property directly. This eliminates the concentration risk of being overly exposed to a single illiquid asset and an unlisted fund can offer exposure to several properties in different regions.

Direct infrastructure such as road networks, airports, rail and ports can offer investors attractive yields and capital appreciation. When considering direct infrastructure, investors should consider investments that offer predictable cash-flows through economic cycles. For instance, some infrastructure funds invest in broadcast towers, cable and wireless networks and data centres which benefit from the increase in demand for online services.

In increasing numbers, investors are also seeking impact investments that are designed to deliver financial returns as well as social and environmental benefits. These impact investments are in (but not limited to) social infrastructure, sustainable agriculture and clean energy storage.

Outside of infrastructure and property, natural resources such as renewables and water entitlements provide investors with diversification and economic benefits. For example, water entitlements are perpetual rights to share water from a river or basin. These water entitlements are uncorrelated to traditional assets and can generate substantial returns, both in income and capital appreciation.

We have not covered other alternative assets in this paper such as physical commodities, cryptocurrencies, or art and collectables. These other alternatives have the potential to provide attractive returns and diversification benefits. However, they each bring their own set of risks and should be clearly understood before investing in them. For these reasons investors should consider engaging specialist advisers to help research, understand and explain different alternative strategies and their risks and benefits.

> "Diversifying well is the most important thing you need to do in order to invest well."
>
> **Ray Dalio** Bridgewater Associates

Constructing Portfolios with Alternatives

One of the main challenges investors face when evaluating alternative investments is determining which alternatives to include in portfolios and in what proportions. In this section, we discuss how alternatives can be used in portfolio construction with respect to risk management and what an effective investment criteria looks like for selecting the right alternative managers.

> "At the end of the day, the most important thing is how good are you at risk control."
>
> **Paul Tudor Jones**
> Tudor Investment Corporation

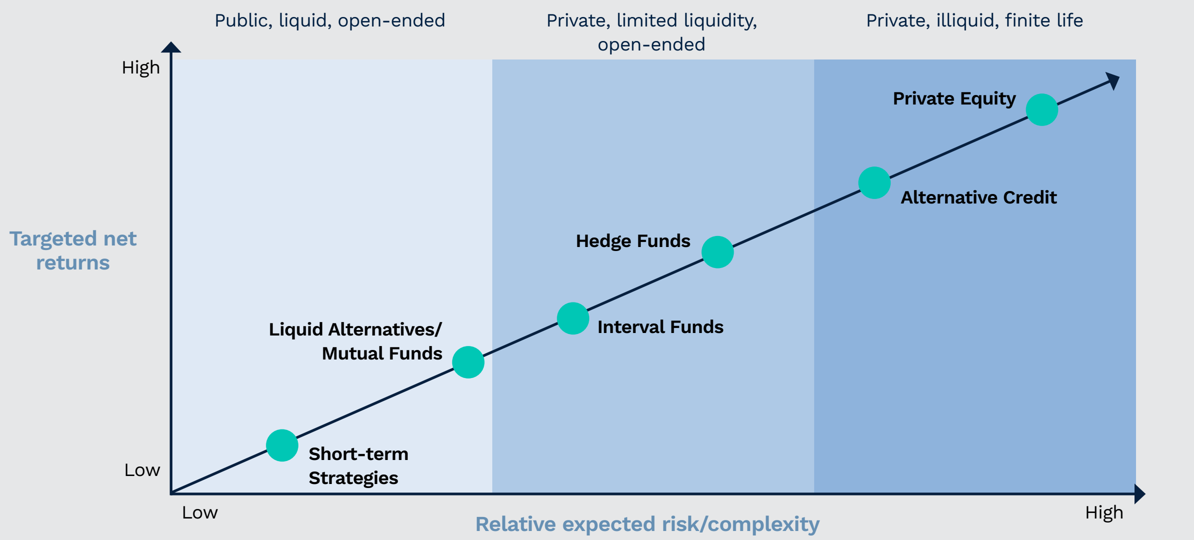
1. Managing Key Risks

Investors with different risk tolerances, investment timeframes and liquidity requirements should hold different allocations of alternative investments according to these preferences. Considering key risks such as market risk, sequencing risk and concentration risk will help investors determine which alternative investments are suitable for them and in what proportions.

Markowitz's MPT framework includes mean-variance analysis, which is a quantitative framework for constructing a portfolio, such that the expected return is maximised for a given level of risk, measured by the portfolio's standard deviation. The standard deviation is used to quantify risk and measures the variance or volatility of a portfolio's value movement.

Through a process known as risk budgeting, investors can manage market risk by determining a suitable range of standard deviation that portfolios can tolerate. Investors can also identify the risk vs return profiles of different types of alternatives and select which types match their risk profile. For example, the chart below shows the return vs risk profiles of different types of alternatives investors can consider for portfolios.

Exhibit 2. Risk vs. Return Profiles of Alternative Assets



Source: PIMCO Market Intelligence "What are alternative investments" (2019)

Sequencing risk is the danger that the timing of withdrawals from a portfolio will damage the investor's overall return. For example, withdrawing capital during a market correction will be detrimental to investors if they are forced to sell-down assets at significantly lower prices.

If investors require immediate access to capital, they should have lower allocations to illiquid alternatives or maintain sufficient liquidity in other parts of their portfolio. Investors should select alternatives that match their liquidity requirements by examining the redemption windows (i.e. how frequently can they take out money from the fund) and the specific terms in relation to lockup and suspension policies of alternatives before adding them to portfolios.

Concentration risk refers to the possibility of being overly exposed in a single investment or asset class. If a concentrated investment or asset class drops significantly in value, it will cause meaningful damage to a portfolio's overall value. To manage concentration risk, investors should determine the investment parameters of being exposed to a single holding or asset class and also be aware of the correlations between different investments and asset classes.

Correlation refers to the degree of dependency between two variables (such as two investment strategies) and is measured by the correlation coefficient, which has a range of -1.00 to +1.00. A correlation coefficient greater than zero indicates a positive relationship between two variables, a value of less than zero indicates a negative relationship and a value of zero indicates no relationship.

Having negative or low correlations between different investments and asset classes is the key to achieving good portfolio diversification. The correlation matrix below shows the correlations between 11 different asset classes. It indicates that the correlations between alternatives and the other asset classes are relatively low and therefore having exposure to alternatives provides less volatility across a given portfolio.

Exhibit 3. Correlation matrix

	Australian Cash	Australian Bonds	Global Bonds	Australian Credit	High Yield	Australian Equities	Australian Small	Global Equities	Global Equities Hedged	Emerging Markets	Alter-natives
Australian Cash	1.00										
Australian Bonds	0.32	1.00									
Global Bonds	0.27	0.74	1.00								
Australian Credit	0.35	0.29	0.48	1.00							
High Yield	-0.04	0.04	0.35	0.75	1.00						
Australian Equities	-0.09	0.00	0.22	0.62	0.79	1.00					
Australian Small	-0.09	-0.03	0.20	0.62	0.79	0.91	1.00				
Global Equities	-0.02	0.22	0.23	0.41	0.58	0.67	0.69	1.00			
Global Equities Hedged	-0.11	-0.16	0.10	0.49	0.78	0.77	0.83	0.79	1.00		
Emerging Markets	0.05	0.19	0.28	0.56	0.65	0.46	0.46	0.57	0.53	1.00	
Alternatives	0.07	0.46	0.24	0.13	0.04	0.20	0.09	0.44	-0.09	0.20	1.00

Source: Koda Investment Strategy Group Research (2022)

2. Alternative Manager Selection

The decision to diversify into alternative assets will not in itself necessarily improve results, but it can increase the probability of achieving an investor's return objective. The underlying alternative investment manager still has to have the skill required to find mispricings and other attractive investment opportunities, and the investors and their advisers should have the ability required to pick superior managers.

The Koda Capital Investment Strategy Group conducts a deep dive research and due diligence process to find top-performing specialist managers. Some of the factors Koda considers for selecting alternative managers are discussed below.

Investment process

Assessing the alternative manager's quality of research, idea generation, portfolio management and implementation are essential. Koda requires managers to demonstrate conviction that their ideas can be applied with consistent discipline throughout the investment cycle.

Risk management

Managing risk is at the core of Koda's investment process and we expect the same of the managers we invest with. Koda assesses a manager's risk management systems and controls in relation to operational, governance and market risks using quantitative and qualitative methods.

Performance

Koda differentiates luck from skill and selects managers that consistently outperform their benchmarks net of fees. Performance attribution is reviewed regularly to determine if past success was based on skill or simply being in the right place at the right time.

Fee structure

Fees charged by alternative managers can sometimes be high relative to other investments due to a manager's specialist skills. Active fund managers should be incentivised to perform above their benchmarks, however investors should not have to pay excessive fees for average or underperformance.

Capacity constraint

Koda prefers to invest with managers with limited capacity in their funds. This helps ensure that the managers remain focused and disciplined when managing invested capital, in order to capture mispricings and market inefficiencies and ultimately to generate alpha.

Alignment of interests

Portfolio managers should have a meaningful portion of their personal wealth invested in their own funds which demonstrates conviction in their own ideas and process. Having 'skin in the game' helps align the interests of managers with those of our clients.

There are other important factors Koda considers in its due diligence process that are not covered in this paper. For example, impact investing and ESG factors can be applied portfolio construction, according to different client preferences. Please contact us if you would like to learn more about Koda's investment process.

Koda's approach to alternatives

Koda's investment approach involves building highly diversified portfolios with exposures to investments that have minimal correlation with one another. Koda's approach allows our clients to remain substantially invested throughout market cycles whilst generating strong risk-adjusted returns that support their objectives.

Access to superior investment opportunities is essential to achieving superior risk-adjusted returns. This access is often restricted to institutions with large investable amounts and investors that have a long history and relationship with fund managers. At Koda, we have built long-term relationships with specialist alternative managers that have consistently delivered superior returns relative to their peers and benchmarks.

Given Koda's scale, we can offer clients access to institutional-grade research and alternative investments that are not readily accessible to most investors. Koda provides clients access to specialist alternative investments that are designed to protect and grow capital over multiple generations.

"Koda provides clients access to specialist alternative investments that are designed to protect and grow capital over multiple generations."

"The true depth of understanding and maturity as a practitioner is how we apply what we've learned to our lives."

David Swensen

Conclusion

Alternatives offer investors the opportunity to minimise portfolio volatility and correlations with traditional asset classes. This helps protect the invested capital and lower downside risk during unforeseen market events.

When used appropriately, alternatives enhance the overall risk-return profile of portfolios and help investors stay the course during turbulent market conditions. As a result, diversified portfolios with exposure to alternatives can better withstand market corrections and minimise the risk of significant drawdowns.

Managing key risks, such as those mentioned in the sections of this paper, is essential for protecting long-term capital. Diversifying into alternative assets will not in itself improve results, which is why it is important for investors and their advisers to have research capability and access to select alternative managers that have demonstrated strong track-records over the long-term.

There are unique benefits and risks associated with investing in alternatives, and as such, it is critical for investors to understand the key differences between alternative strategies. Engaging specialist advisers, such as those at Koda, can help determine the suitability of incorporating alternatives into existing portfolios, as each investor's objectives and risk profiles are unique.

We hope that you found this white paper valuable. Please email us if you would like to discuss an appropriate strategy for investing in alternatives.

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Sabil is a Partner and Investment Adviser at Koda Capital and has worked in financial services since the mid-2000s. Sabil specialises in supporting non-profit organisations, family offices and executives with their investment management.

His specialisations include providing advice on customised investment mandates, strategic/tactical asset allocation, alternative investments, financial modelling, risk management, governance and compliance for non-profit organisations.

Before joining Koda, Sabil was a Private Wealth Adviser at Macquarie Private Bank, providing holistic wealth management and investment advice to executives, family offices, and non-profit organisations. Prior to that he had advisory roles at Perpetual Private Wealth and KPMG Risk Advisory.

Sabil holds a Bachelor of Mathematics from the University of New South Wales, Master of Management (Graduated with Distinction) from the University of Sydney Business School and Diploma of Financial Planning (RG146) from Kaplan including accreditations in SMSF, Gearing/Lending and ASX Derivatives Levels I and II.

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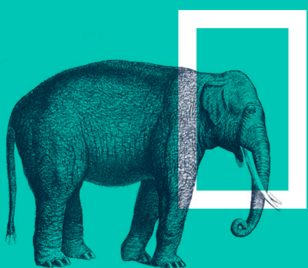

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