

It is time to start looking at alternative assets

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It is time to start looking at alternative assets. Not because there is any pressing need to invest in them today, but because doing a thorough analysis takes time and rushed mistakes can be expensive.

During the past five years, equity markets have more often than not been cheap and have performed strongly. Today, we are moving into an environment where traditional assets are still generally around fair value. However, if the strong markets we've seen over the past few years persist, we may soon be moving into an environment where traditional assets are fully priced or, better still, expensive. (A really good bull market would be wonderful.)

If that comes to pass, attractive alternatives will become a particular focus – and the key will be to sort the wheat from the chaff and there will be a lot of the latter.

This is not a trivial task. It requires a deep understanding of what drives returns in a particular asset class; under what circumstances will it shine? When will it disappoint? What could cause a disaster? What might a disaster look like? Typically, these are the factors that are not well described by promoters of products that access alternative asset classes. So now is the time to start looking closely at alternatives from the point of view of understanding exactly what makes them tick so that when the time comes, we will be well placed to make sound decisions.

Let's start with a simple model of investment returns that can be usefully applied to most (if not all) asset classes, be they alternative or traditional:

Returns = Market returns + Alpha - Fees

- **Market returns** are simply the returns provided by the underlying sector, on average, often reflected by an index. To assess likely future market returns, we need to understand what factors drive the returns of the sector in good and bad scenarios.
- **In thinking about alpha**, we need to consider not only how much added value to expect, but also how much more or, more importantly, how much less than the sector average a manager could produce. Under what circumstances can underperformance be substantial? Is underperformance predictable? Is it avoidable?
- **Finally, fees are obviously important.** And, in some cases – such as with hedge funds – fees are actually one of the most important drivers of returns. (As an aside, timber has been a very successful institutional investment in the US and, as we know, a very popular and spectacularly unsuccessful investment in Australia. The difference, in a large part, has been due to fees. A quick glance at the P&L of the various offerors of

the tax-driven tree schemes will have alerted potential investors to the scale of fees being charged. farrelly's quick analysis around 2005 found upfront fees at something in the order of 50% of funds invested. Even if our analysis was way off the mark, those tree schemes were never going to work.)

In terms of examples of how this analysis can be done in practice, we'll look at four common alternative assets: hedge funds, direct property, gold and commodities.

HEDGE FUNDS

Every year or two, farrelly's reviews its long-term outlook for hedge funds as one of the regular quarterly white papers. A quick summary of the findings from the latest review (March 2014):

- So-called market neutral hedge funds have, in fact, historically carried approximately 20% exposure to equities and 15% exposure to junk bonds. That is, in the event of substantial downturns in these markets, they are likely to perform poorly.
- Despite these modest exposures, the key drivers of long-term returns are alpha and fees.
- Alpha has diminished sharply over time as the quantity of funds managed by the hedge fund industry has grown exponentially.
- The fees of most of these funds are so high that a large part of the alpha achieved by managers has disappeared in fees.
- Disasters in this asset class – if suitably diversified across different hedge fund types – will probably be measured by returns in the order of –10% to –20%, rather than total loss of capital. One wildcard to watch out for would be a total freezing of derivatives markets due to counterparty failures or even concerns about counterparties. And, as Bernie Madoff and others have reminded us, fraud remains a real risk in this asset class.

The end result is that the key to successful hedge fund investing is to be able to identify good managers with fee structures that give investors a reasonable chance. Just identifying good managers (hard in itself) is not nearly enough to confidently invest in this asset class. Fees really matter.

A comment on CTAs

One popular form of hedge funds is futures trading funds, commonly known as CTAs (named after the managers of these funds who are known as Commodity Trading Advisers). CTAs buy and sell futures generally based on signals generated by computer programs – normally, some form of trend following signal. They became very popular because they

performed very well during the GFC – which prompted a large inflow of funds at a time when hedge funds more generally struggled with outflows. As the money poured into CTAs, returns went flat. Who would have guessed? Lots more funds under management does not mean there will be a similar, automatic increase in alpha to share around. As we shall see, this is something of a recurring theme with alternatives.

DIRECT PROPERTY

Once a core holding for most portfolios, direct property investment, with all of its issues – illiquidity, lumpiness and high entry and exit costs – has drifted away from the mainstream and is now considered an alternative asset.

Drivers of underlying property returns are straightforward. What's the yield? How fast can rents grow? What might happen to capitalisation rates (the valuation multiple applied to property)? Across the broad market, estimating these factors in good and bad times are quite straight forward. The end results generally paint quite an attractive picture for this asset class in a portfolio.

Alpha is again an important issue. The skill or lack thereof of the manager clearly makes a difference. However, even the most skilled manager can come unstuck due to factors that arise from the generally low level of diversification associated with most direct property products via which investors access this asset class. This means that factors specific to the particular properties in a fund – such as tenants, the local economy and so on – can result in returns that are well away from the broad market average.

And, of course, there is the issue of gearing. Anyone contemplating an investment in a property syndicate should seriously consider the implications of gearing. A good rule of thumb is to think about what a 20% fall in the value of the property would do to gearing levels, where covenants are set, what the response of the lenders might be when covenants are breached, and what economic environment might cause all this. We strongly encourage subscribers to run the numbers for themselves – refer to the Forecasts in Focus section of the December 2013 edition of this Handbook. It's very sobering. For what it's worth, we wouldn't be keen on a syndicate with gearing of greater than 35%.

Finally, fees. There are normally lots of them, and they should be taken into account when assessing likely risks and returns of direct property products.

GOLD

Buying a passive gold holding such an ETF where there is no alpha and fees are low reduces the issue of analysing a gold investment down to developing an understanding of what drives the price of gold. Unfortunately, unlike the two previous examples, the drivers of the

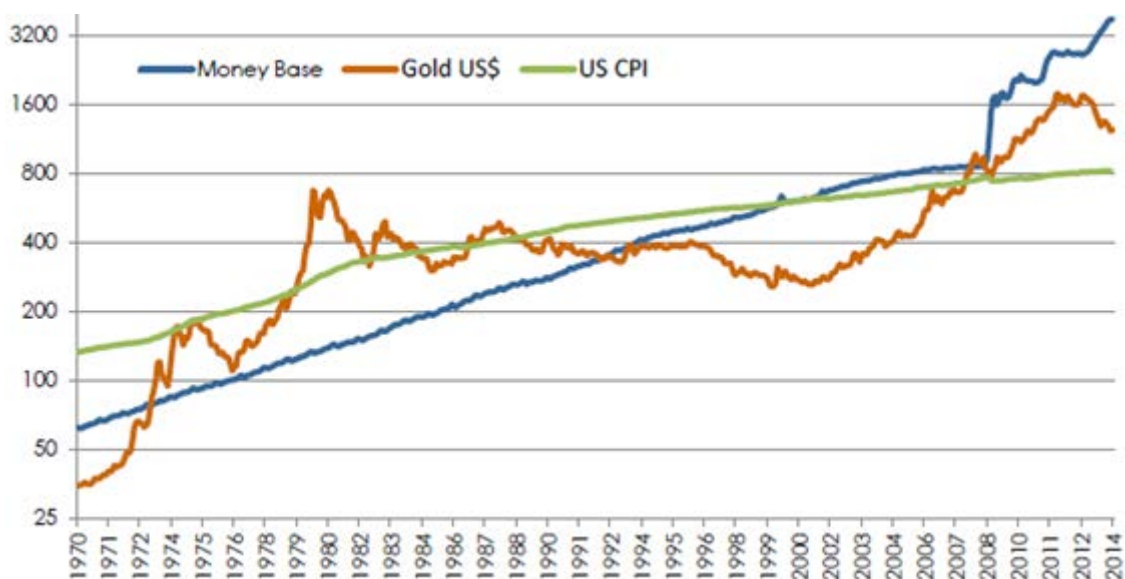
underlying gold price are far from clear – to farrelly's, at least.

We can start out by identifying what does not drive the price of gold. It's not money printing and, in the medium term, it's not inflation or even inflation expectations as is clearly confirmed by even a cursory look at Figure 1.

So what does drive the price of gold? In farrelly's view, in the very, very long term (40 to 60 years), the intrinsic value of gold reflects changes in purchasing power. In other words, gold should give a return about equal to inflation plus or minus a bit, if held for 40 to 60 years. This is pretty much what it has done for the past 200 years or more.

Unfortunately, that knowledge is really not helpful when thinking about shorter timeframes. In the medium term, the price of gold is subject to a range of forces that can drive it much higher or lower than its intrinsic value (which, unhelpfully, is difficult or impossible to be measured.)

Figure 1: Gold, money creation and inflation



Source: US Federal Reserve

These forces range from the buying and selling of gold by central banks, the amount of gold produced by miners, the amount of gold consumed by industry and jewellery, demand for gold from passive long-term investors and, finally, the trading activities of a horde of speculators reacting to any bit of news that may send the gold price a few dollars higher or lower. In the end, it comes down to demand and supply. Working out what that may look like a year, five years or 10 years hence is beyond the scope of farrelly's abilities.

For someone considering including gold in a portfolio, here is the best advice farrelly's can offer:

- Expect returns in line with inflation – or less, if bought at prices that are historically high in inflation-adjusted terms (at time of writing in March 2014) that means anything above around US\$750 per ounce);
- Develop and test an excellent model for predicting demand and supply. In doing, so be very skeptical about commonly accepted wisdom on what drives prices.

This is another alternative asset that farrelly's can't get too excited about right now.

COMMODITIES

Investing in passive commodity funds has been a favourite strategy of institutional investors, particularly in the US, since around 2005. Because such funds are passive, we can again pretty much ignore the impact of alpha (none) and fees (modest). Which leaves market returns.

The key driver of medium- to long-term commodity prices is the cost of production. Ongoing improvements in methods for agriculture, mining and refining has meant that real costs of production have fallen relentlessly since the 1850s and, with them, real commodity prices. Not a good start. Even worse, buying, say, 1 million barrels of oil requires storage and insurance which further reduce returns.

This all makes commodities seem like a really bad investment – negative real returns less storage and insurance costs. As it turns out, returns from investing in commodities aren't quite as bad as you may expect. Firstly, one hundred and fifty years of falling prices abruptly came to a halt in 1999 with the reawakening of the Chinese and Indian economies. The massive demand for commodities coming out of these economies caught producers by surprise and sent prices soaring, leading to the resources boom with which we are all too familiar. The net result was that average commodity price growth has started to match or exceed inflation when looked at over the past 50 years.

Even more important to the development of commodities as an investible asset class was mainstream researchers discovering that buying cash-backed futures is a far more efficient way to get exposure to commodities. Instead of buying a million barrels of physical oil, it is much easier to buy some West Texas Crude futures, put down a margin deposit and reinvest the remaining cash – no storage, no insurance, no messy issues with merchants and delivery, just a clean simple transaction. And, best of all, incredibly, for much of the past 50 years, these futures could be bought at a price representing a discount to the physical price. Getting exposure via the futures market gave returns equal to the physical returns plus an additional amount from the discount, generally referred to as the risk premium. The risk

premium has been extremely significant. A 2004 study found that buying cash-based futures added a whopping 4.5% per annum to returns over those that would have been achieved by buying physical commodities at the spot price. The net result was that commodities delivered equity like returns when bought via cash-backed (or collateralised) futures, as is shown in Figure 2.

Figure 2: Average returns of spot commodities & cash-backed commodity futures

Asset	Return (%pa)	Volatility (%pa)
	July 1957 – Dec 2004	(July 1957 – Dec 2004)
Cash-backed Futures	11.2	12.1
Spot commodities	6.7	na
Stocks	11.6	14.9
Inflation	4.1	–

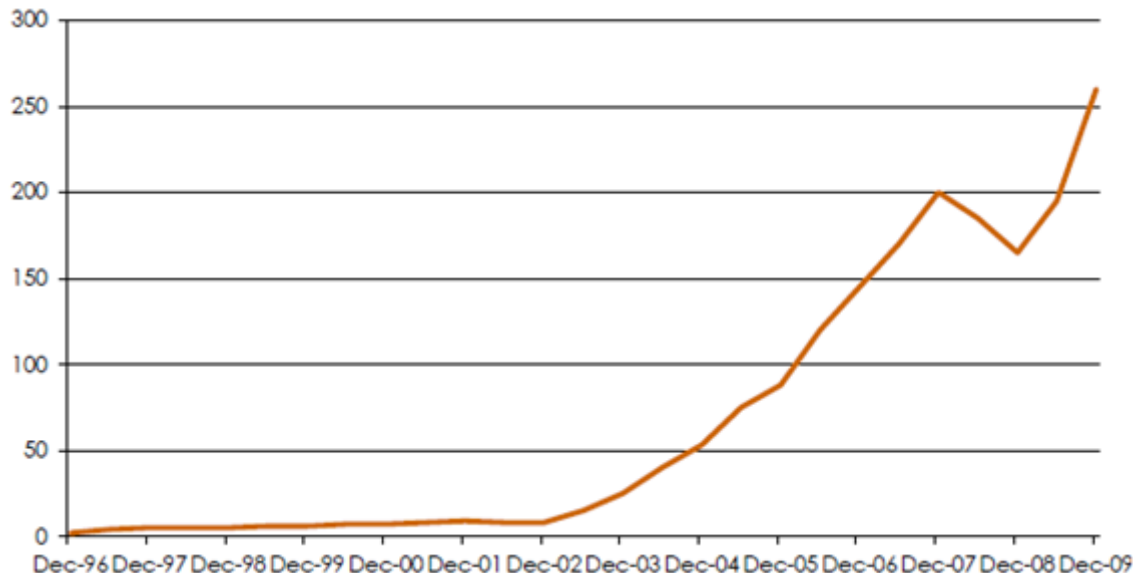
Sources: Gorton, G and Rouwenhorst, KG, "Facts and Fantasies about Commodity Futures"

Better still, returns showed a correlation to equities of around zero. At last, here was a genuine diversifier that produced good returns and dramatically lowered risk in portfolios.

And then the story got even better.

Further research by a major investment bank showed that the tendency for commodities to trade at a discount varied from commodity to commodity and that the commodities that most often traded at a discount were energy commodities. Unsurprisingly, the commodities that traded at the biggest discounts tended to produce the best long-term returns. In 2004 and 2005, a variety of explanations emerged for why the discount existed. One popular theory was that oil producers were willing to pay a risk premium to remove the pricing risk of their coming years' production and that, similarly, speculators demanded that risk premium to take on that pricing risk. In fact, that probably wasn't far from the truth. Further work by the said investment bank developed a commodities index that was weighted by the value of each commodities' annual production – and, surprise, surprise, it resulted in a 70% weight to the energy commodities. Of course, it back tested beautifully. New products were developed and the money poured into the sector, as shown in Figure 3.

Figure 3: Commodity Futures Funds – Funds Under Management (US\$bn)



Sources: Barclays

To no one's surprise, the investment bank made a lot of money. On the other hand, investors have been disappointed. Who would have guessed that the discount on the futures would disappear and be replaced with a premium. Returns on these types of funds have been lower than returns from spot commodity prices. The so-called risk premium turned negative.

Regrettably, the investors did not consider the impact that a horde of passive buyers would have on the need for producers to pay a risk premium to hedge their price risk. The risk premium was assumed to be permanent – efficient markets and all that. In reality, the size of the futures discount or premium was always going to simply be a function of demand and supply of futures buyers and sellers. If the supply of oil producers seeking to hedge didn't dramatically increase, the huge increase in supply of new players happy to provide the producers with that hedge was always going to drive down the size of the premium.

As the great Yogi Berra once remarked; "In theory there is no difference between theory and practice. In practice there is."

What does this long winded but interesting journey into the recent past tell us about investing in commodities in particular, and alternatives in general? It says that the key issues that potential investors in commodities need to understand before making a commitment to this area are:

- Will continued growth in emerging markets keep commodity prices at current historically high levels or will production of physical commodities increase sufficiently to push prices back towards old levels? Sophisticated analysis of the

changes in costs of production should probably be used to assist in this assessment.

- Will the discounts on futures contracts reappear on a sustained basis? What needs to happen to the volume of funds invested in commodity futures for this to happen?

More generally, it illustrates the importance of having an understanding of what drives returns, and what those drivers may look like in the future.

SHOULD WE INVEST IN ALTERNATIVES FOR DIVERSIFICATION BENEFITS?

Diversification benefits come about where the addition of an asset to a portfolio gives higher expected returns for the same level of risk, or the same returns with less risk. To assess whether an asset really DOES provide useful diversification requires an understanding of expected returns, risks and correlations between the existing portfolio and the new asset – hence, the emphasis here on understanding returns and risks, and the conditions in which an alternative asset is likely to perform well or poorly.

If the aim is simply to reduce portfolio risk without consideration of likely returns, there is a much better option than alternative assets – secure debt in the form of government bonds or term deposits. Secure debt will reduce risk and do so with a known return profile.

This paper illustrates the need to have a clear understanding of the return drivers of any asset prior to making a commitment to it. Past returns are usually an extremely poor guide to the future. On the other hand, understanding just where past returns have come from can be an exceptionally useful way of formulating an expectation about future returns and future risks. In particular, be wary of asset classes that have been subject to a substantial increase in inflows.

None of this is trivial. It takes time and effort. Now is a good time to start.



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