

Alternative Investments for Portfolio Management

Alternative investments comprise groups of investments with risk and return characteristics that differ from those of traditional stock and bond investments. Alternative investments are typically, although not always, characterized by:

- relative illiquidity, which tends to be associated with a return premium as compensation;
- potential to diversify relative to a portfolio;
- high due diligence costs; and
- performance appraisal that is unusually difficult, due in part to the complexity of establishing valid benchmarks.

Allocations to alternative investments are often made with the expectation that they offer the potential for risk diversification and/or greater opportunities to apply active management skills and capture alpha.

READING ASSIGNMENTS

Reading 24

Alternative Investments Portfolio Management
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LEARNING OUTCOMES**READING 24. ALTERNATIVE INVESTMENTS PORTFOLIO MANAGEMENT**

The candidate should be able to:

- a** describe common features of alternative investments and their markets and how alternative investments may be grouped by the role they typically play in a portfolio;
- b** explain and justify the major due diligence checkpoints involved in selecting active managers of alternative investments;
- c** explain distinctive issues that alternative investments raise for investment advisers of private wealth clients;
- d** distinguish among the principal classes of alternative investments, including real estate, private equity, commodity investments, hedge funds, managed futures, buyout funds, infrastructure funds, and distressed securities;
- e** discuss the construction and interpretation of benchmarks and the problem of benchmark bias in alternative investment groups;
- f** evaluate the return enhancement and/or risk diversification effects of adding an alternative investment to a reference portfolio (for example, a portfolio invested solely in common equity and bonds);
- g** describe advantages and disadvantages of direct equity investments in real estate;
- h** discuss the major issuers and suppliers of venture capital, the stages through which private companies pass (seed stage through exit), the characteristic sources of financing at each stage, and the purpose of such financing;
- i** compare venture capital funds and buyout funds;
- j** discuss the use of convertible preferred stock in direct venture capital investment;
- k** explain the typical structure of a private equity fund, including the compensation to the fund's sponsor (general partner) and typical timelines;
- l** discuss issues that must be addressed in formulating a private equity investment strategy;
- m** compare indirect and direct commodity investment;
- n** explain the three components of return for a commodity futures contract and the effect that an upward- or downward-sloping term structure of futures prices will have on roll yield;
- o** describe the principal roles suggested for commodities in a portfolio and explain why some commodity classes may provide a better hedge against inflation than others;
- p** identify and explain the style classification of a hedge fund, given a description of its investment strategy;
- q** discuss the typical structure of a hedge fund, including the fee structure, and explain the rationale for high-water mark provisions;
- r** describe the purpose and characteristics of fund-of-funds hedge funds;
- s** discuss concerns involved in hedge fund performance evaluation;
- t** describe trading strategies of managed futures programs and the role of managed futures in a portfolio;

- u describe strategies and risks associated with investing in distressed securities;
- v explain event risk, market liquidity risk, market risk, and “J-factor risk” in relation to investing in distressed securities.