

What exactly are Alternative Investments?

What is an alternative investment? With growing popularity among investors, the question of what exactly constitutes an alternative investment is becoming more important. In investment circles the definition of what exactly constitutes an alternative investment is pretty wide and vague. Since we use the name alternative investment, the logical question is, alternative to what? What are traditional investments? It depends a lot on the sophistication of the investor. To a sophisticated investor, many investments might be considered traditional. One definition of traditional investment is by asset class. Bonds and equities are considered traditional investments. Anything besides, is an alternative investment. An extension of this definition is to add that any other way besides buying (holding a long position in) a bond or equity, is an alternative investment. It isn't too much of a stretch to look instead at the properties of traditional assets and how they are traditionally invested in.

Traditional investments:

- Equities
- Bonds
- Long only
- No leverage
- Liquid markets only

Where do we put these?

- FX
- Commodities
- Real estate
- Infrastructure

Alternative investments:

- Hedge funds
- Private equity
- Private debt
- Structured credit – sophisticated investors would classify these as fixed income
- Asset backed securities – sophisticated investors would classify these as fixed income
- Insurance linked investments
- Litigation claims
- Freight derivatives
- Asset leasing
- Anything an investor can dream up that provides a return that is potentially uncorrelated to equities and bonds.

To be useful an alternative investment should address a weakness or a gap in traditional investing.

- A positive expected return over the cost of capital or financing.

Its not much use investing in something with a negative expected return, after cost of capital or funding. Even in a portfolio context, such an investment would not be a diversifier or a hedge, it would be an offset.

- A low or negative correlation to traditional investments.

In the quest for diversification, its not much use investing in something which was highly correlated to other investments in the portfolio. If a set of investments were highly correlated, you could replace one of those investments with a combination of the others. It would reduce the complexity of managing the portfolio since there would be fewer items to monitor.

Investor concerns regarding alternatives:

- Illiquidity. Some alternative investments are illiquid. Some are by nature illiquid and some just happen to be illiquid when you want the liquidity. Investors should demand higher returns for poorer liquidity. Liquidity is a complex subject related to mark-to-market valuation. Sometimes, liquidity limitations can be a good thing if they prevent the investor from crystallizing losses at the wrong time. This is especially the case when mark-to-market pricing is not representative of true value and underprices the an investment.
- Leverage. Leverage is neither good nor bad but amplifies positive and negative returns. However, in most cases, the application of leverage transfers the control of the investment over to the provider of said financing. This can be a risk if the provider of leverage withdraws funding at an inopportune time.
- Complexity. Some alternative investments are complex and difficult to understand. Investors should always understand what they invest in if nothing else so that they can make the right decisions in response to profits and losses.

Beware. The investment industry is full of plain vanilla investments labelled alternative investments when their purveyors seek to justify their higher fees. Investing in these can be a waste of time and money and provide a false sense of comfort. The investment industry is also full of alternative investments dressed as simple, traditional investments when their purveyors seek to satisfy investor demand for simplicity and transparency. Investing in these can hold unpleasant surprises. Try to approach all investments with the same innocent curiosity of a 'tourist' and question everything and anything you wish until you are satisfied.