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CAPITAL & ECONOMICS

Alternative Capital: Why Are Alternative Investments Becoming More Popular?

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OVERVIEW

Traditionally, investors have looked to equities, bonds and cash instruments as places to put their money on the expectation that doing this will generate a return on their investment.

But in recent years, extended periods of very low interest rates around the world have left many investors with inadequate returns on their bonds and virtually no return on their cash investments. Rising volatility on equity markets has also left many of the more adventurous institutional investors bruised and disillusioned.

The malaise affecting these main asset classes has increasingly driven investors, especially long-term investors like pension funds, to seek higher rates of return by deploying more of their capital in so-called alternative assets. Many of these alternatives offer not only the possibility of generating reasonable returns for investors, but by performing in ways that are low-correlated with traditional instruments like the stock market. When markets tumble, as was seen in the first weeks of 2016, alternative investments tend to remain unaffected – adding a much-needed additional layer of diversification to a portfolio.

But investing in alternative assets is not for everyone. With the current market uncertainty and low interest rates, what do businesses need to know?

IN DEPTH

At the most basic, alternative investments are investments in asset classes other than equities, bonds or cash. They can play a part in strategies used to improve returns to investors when equity returns are low or negative, as well as to diversify investment risk profiles – reducing the potential negative impact of market shocks.

Among the most popular alternative investments are:

- **Commodities** – materials such as grains, metals, or basic materials
- **Hedge funds –** pooled funds that speculate using credit or borrowed capital
- **Derivatives –** futures or options contracts, including carbon credits and foreign exchange
- **Collectables** – fine art, wine, stamps, classic cars, coins, antiques, jewelry, or other tangible assets with strong fan-bases willing to pay a premium
- **Real Estate** – directly or through tax efficient pooled investments such as Real Estate Investment Trusts (REITS)
- **Insurance risk** – bonds linked to events that lead to insurance losses, such as natural disasters

As markets for these assets and strategies expand and participation grows, more of these alternative investments are becoming suited to the needs of institutional investors. Interest in alternative capital is growing as a result – it now makes up around 12 percent of reinsurance market capital, according to Aon's January 2016 Reinsurance Market Outlook report, with nearly $69 billion in alternatives as of September 30, 2015. At current growth rates this is set to reach $120-150 billion by 2018.

The Attraction of Alternative Investment Strategies

Most alternative investments are made directly or indirectly by institutional investors – including pension funds, but also by endowments, high net worth individuals, and family offices. As their returns tend to have a lower correlation to the standard asset classes, they are increasingly being used to both help offset market volatility and generate higher returns during periods of low yields.

Catastrophe bonds are one such asset. They emerged beginning in the 1990s to meet the need of insurance companies to mitigate the risks they would face if a major catastrophe incurred damages they would be unable to cover using existing funds. They are a form of security that allows issuers to reduce their own exposure to natural disasters and other significant catastrophe events by bringing in more risk-bearing capacity to the catastrophe reinsurance market.

While insurers gain the benefit of increased coverage for losses, investors can also benefit. Because changes in the market valuations of catastrophe bonds and other insurance-linked securities (ILS) are linked to events that lead to insurance claims rather than fluctuations on the financial markets, they can help to diversify the performance of an investment portfolio. This can add stability in periods of market volatility, and growth in periods of market stagnation.

In this way, they provide reassurance that there may be some protection against a sudden plunge in the value of traditional assets.

The Risks of Alternative Capital

As with most investments, there are risks associated with alternatives.

While collecting art, wine or classic cars may be a more glamorous way of deploying capital than stocks and shares, there is always a risk that prices will be adversely affected by changes in fashion. Works of art by Vincent Van Gough may be worth millions today, but in his lifetime he famously struggled to sell his paintings – investors in collectables are similarly reliant on the whims and fancies of collectors. There may also be fixed costs associated with tangible assets, which often have to be stored and insured.

The sub-prime mortgage crisis of 2007-2009 also demonstrated that alternative investments can sometimes be very risky. When the U.S. housing bubble burst beginning in 2007, very few markets around the world remained unaffected, as investors liquidated nearly every non-cash asset – including real estate, art, and even classic cars – to generate the cash they needed protect themselves from collapsing credit markets.

Some critics have expressed concern that due to the way the insurance risk market is structured, some catastrophe bonds have similarities with the way banks carved up subprime mortgages before the 2008 financial crisis, and that as a result the industry could be put at risk of collapse.

Why Insurance-Linked Securities Are Not Sub-Prime Mortgages

There may be superficial similarities between insurance-linked securities and the way sub-prime mortgages can be pooled and structured to create investable securities, says Paul Schultz, CEO of Aon Securities. But, he says, there are fundamental differences in the structure of the market for insurance risk that make the kind of meltdown that occurred in sub-prime mortgages unlikely in catastrophe bonds.

“At the time of the sub-prime mortgage crisis the market lost discipline in the way it was underwriting, and so it began to ignore the standard metrics about how you lend money,” says Schultz. The ILS alternative capital market, however, is more transparent than the market for mortgage backed securities – both in the way transactions are structured and with regards to the underlying risk.

Property and catastrophe bond prices can fluctuate in value based on supply, demand, and seasonal factors like any other tangible asset, notes Schultz. But there are also solid third party models available to estimate and forecast catastrophe risk based on, amongst other factors, historical weather patterns and losses. These provide investors with an independent assessment of risk that is specific to catastrophe bonds.

“The insurance industry has highlighted this benefit since the inception of the market back in the mid 1990s, but really until the global financial crisis didn’t have hard data to support it,” says Schultz. The industry can now point to hard evidence that these securities deliver non-correlated performance when other financial assets struggle to deliver, he says. Aon’s ILS indices for property catastrophe bonds, for example, has demonstrated low correlation to the broader markets during and since the 2008 financial crisis, posting positive returns for the period.

Another big difference is the level of sophistication in this market. "We spend a great amount of time as a firm and as an industry educating investors on the asset class. Furthermore, we don't sell securities to small investors – you need to have $100 million of assets to invest in this class," says Schultz, "so investors tend to have a greater level of financial acumen."

The Benefits of the Rise of Alternative Investment

Investors should be under no illusion – by investing in insurance risk they will be exposed to the financial consequences of insurance losses. But while these risks can't necessarily be fully quantified in advance, they can be modelled and managed. The *quid pro quo* for investors is they are paid a premium for holding the underlying risk – and an investment return on the assets invested. From a portfolio perspective, the big bonus is true diversification.

There is also a wider benefit for the economy and society. The more that pension funds and other large investors invest in insurance risk, the more the cost of insurance declines and capacity to insure is increased. This in turn will decrease the volatility of property insurance pricing, increasing stability in the insurance market, which will in turn increase access to insurance to those typically unable to afford it.

The end result will be to reduce the negative economic impact of natural disasters on the wider economy, as those affected will be able to recover faster, without the need for government support. While alternative investments may make up a small percentage of most investors' overall portfolios, with the right investment strategies they can have a significant impact.

TALKING POINTS

"Stock and bond returns will be strained for the next three to five years, so it makes sense to [consider] other sources of returns. But be aware of what kind of risk you are adding to your portfolio." – Mark Wilson, Chief Investment Officer, The Tarbox Group

"The threshold question that has to be answered is what are you trying to accomplish with the investment. Unless a person really understands it and what it will accomplish, they are probably introducing more risk to their portfolio." – Grant Rawdin, CEO, Wescott Financial Advisory Group

"There are many questions investors should be asking their advisors. What is the underlying liquidity of the investments? What is the liquidity of the fund? What is the fee structure? In what types of environment does the alternatives manager expect to perform?" – John Gane, CEO, Fort Rock Asset Management

FURTHER READING

- Stock Market Got You Down? Take A Look At The Alternatives – CNBC, February 8, 2016
- Betting Against Disaster – Nikkei Asian Review, February 8, 2016
- Alternative Investments: How Do They Stack Up? – Investors Chronicle, December 18, 2015
- Alternative Investments Become Part Of Mainstream – Business Standard, December 26, 2015
- The Top Alternative Investments For 2016 – Investopedia, January 19, 2016
- How Are Your Alternative Investments Wired? – Institutional Investor, January 11, 2016
- How Cities Can Avert Financial Ruin After A Natural Disaster – CityLab, December 7, 2015
- Reinsurance Market Outlook, January 2016 – Aon report
- Alternative Assets: The Next Frontier For Defined Contribution Plans – Aon paper

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