

# **INVESTING IN ALTERNATIVES**

**Gold, Bitcoin and Beanie Babies!**

# ALTERNATIVES TO WHAT?

- It is true that most of the investment philosophies that we have talked about in this book are **directed at those who invest in stocks and bonds with long-only strategies.**
- It is also true that in the process, we are **ignoring vast swaths of the investment universe**, from other asset classes (real estate, collectibles, cryptos) to investing and building private businesses to selling short and derivatives trading.
- These ignored investment classes are what fall under the **rubric of alternative investments**, and while many of these choices have been with us for as long as we have had financial markets, they were accessible to only a small subset of investors for much of that period.
- In terms of investment philosophies, there are **significant numbers of investors who have made their money by owning and building their own businesses, trading gold or crypto, or even collecting artwork.**

# THE ALTERNATIVE INVESTMENT UNIVERSE

## The Missing Pieces (Alternative Investments)

### Investment/ Asset classes

- Non-traded real estate
- Collectibles (gold, art, NFT)
- Cryptos

### Public/Private Divide

- Venture capital
- Private Equity
- Private Credit

### The Long/Short Axis

- Hedge Funds
- Derivative investing
- Structured products

## Standard Portfolio Allocation

Long only, with mix of equities and bonds determined by risk preferences and market views

Publicly traded equities

Publicly traded bonds

Cash holdings reflect liquidity needs (more liquidity needs -> more cash), views on stock and bond markets (bullish -> more cash)

Cash (invested in close to riskless and liquid investments)

## The Alternative Investing Sales Pitches

### Low Correlation with traded stocks/bonds

Adding alternative investments to a stock/bond portfolio will yield better risk/return tradeoffs

### Investment Alphas (excess returns)

Superior managers (VCs, PES) find mistakes that are more likely to persist in alternative investment space.

# 1. LONG / SHORT

- **In principle, there is little difference between being long on an investment and holding a short position**, with the only real divergence being in the sequencing of cash flows. In practice, though, **regulators and a subset of investors seem to view short selling more negatively.**
- **Many institutional investors, including most mutual, pension, and endowment funds, are restricted from taking short positions** on investments, with exceptions sometimes carved out for hedging. For close to a century, at least in the United States, hedge funds have been given the freedom to short assets, and while they do not always use that power to benefit, it is undeniable that having that power allows them to create return distributions that are different from those faced by long-only investors.
- Finally, it is worth noting that the **opening of derivatives markets** in the last few decades has created new avenues for shorting assets.

## 2. PUBLIC/PRIVATE

- For **young private businesses**, and especially those that aspire to become bigger and eventually go public, it is **venture capital** that fills the void, covering the spectrum from angel financing for idea businesses to growth capital for firms further along in their evolution.
- For **more established private businesses**, some of which need capital to grow and some of which have owners who want to cash out, the capital has come from **private equity investors**.
- On the debt front, the public debt and bank debt market is **supplemented by private credit, where investors pool funds to lend to private businesses**, with negotiated rates and terms, a process that has been around a while, but one that has also become formalized and a much larger source of funds.

## 3. ASSET CLASSES

- **Real estate:** For much of the twentieth century, real estate remained outside the purview of public markets, with a segmented investor base and illiquid investments, requiring localized knowledge. That is **starting to change**.
- **Collectibles:** The collectible asset class spans an array of investment, most of which generate little or no cash flows, but derive their pricing from scarcity and enduring demand.
  - The first and perhaps the longest standing collectible is **gold**, a draw for investors during inflationary period or when they lose faith in fiat currencies and governments.
  - The second is **artwork**, ranging from paintings from the masters to digital art (non-fungible tokens or NFTs), that presumably offers owners not just financial returns but emotional dividends.
  - At the risk of raising the ire of **crypto** enthusiasts, we would argue that much of the crypto space (and especially bitcoin) also fall into this grouping, with a combination of scarcity and trading demand determining pricing.

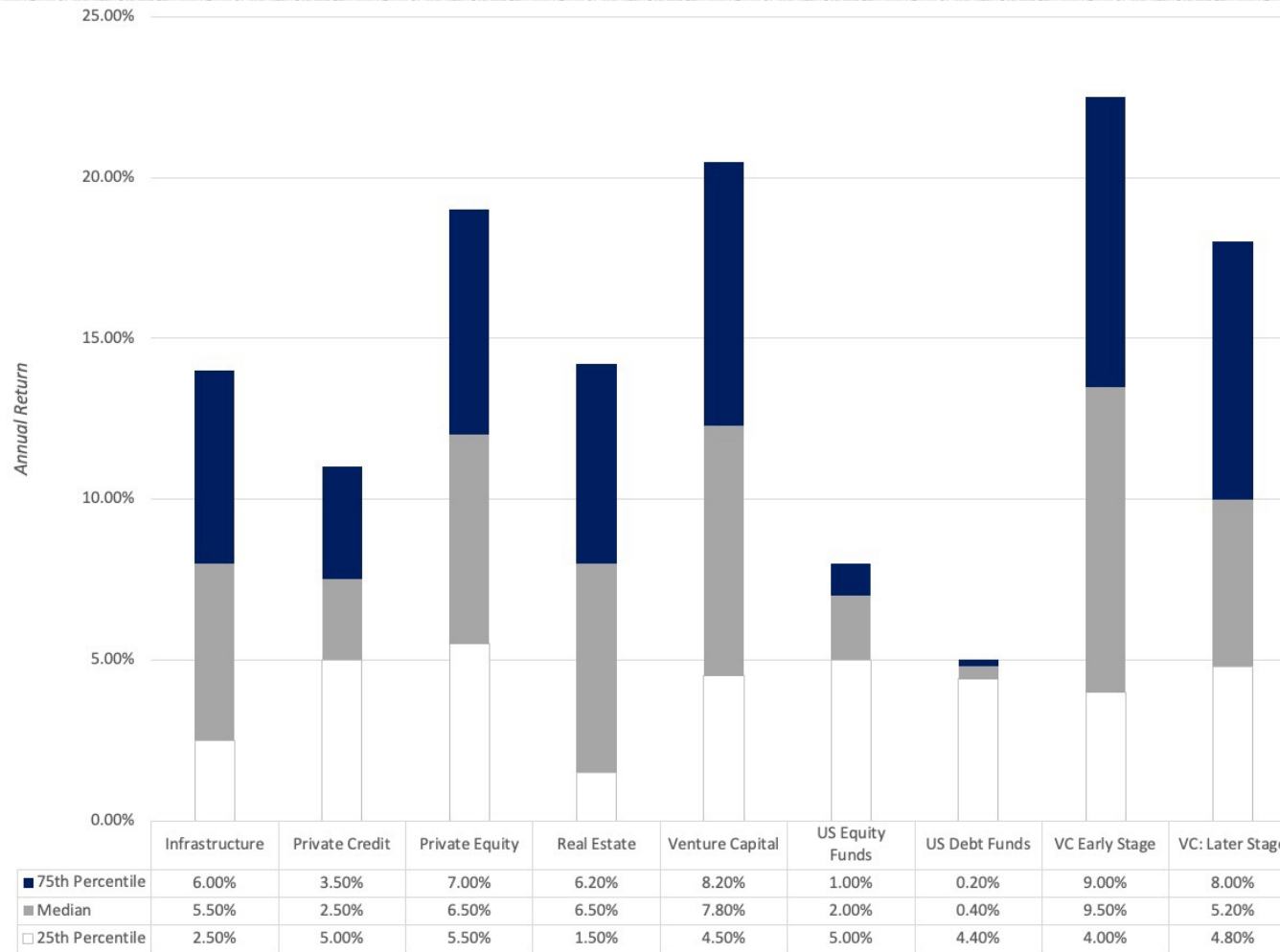
# THE SALES PITCH FOR ALTERNATIVES!

- The strongest pitch for adding alternative investments to a portfolio dominated by publicly traded stocks and bonds comes from a basic building block for portfolio theory, which is that adding investments that **have low correlation to the existing holdings in a portfolio** can create better risk/return trade-offs for investors.
- That pitch has been supplemented in the last two decades with arguments that alternative investments also offer a **greater chance of finding market mistakes and inefficiencies**, partly because they are more likely to persist in these markets, and partly because of superior management skills on the part of alternative investment managers, particularly hedge funds and private equity.

# 1. THE CORRELATION ARGUMENT

	Investment Grade Bonds	Cash	Commodities	Currencies	Hedge Funds	International Equity	Long/Short Equity	Managed Futures	REITs	S&P 500
Investment Grade Bonds	1.00									
Cash	0.12	1.00								
Commodities	-0.18	-0.12	1.00							
Currencies	-0.47	-0.06	-0.21	1.00						
Hedge Funds	0.14	-0.02	0.6	-0.25	1.00					
International Equity	0.41	0.00	0.45	-0.57	0.73	1.00				
Long/Short Equity	0.3	0.06	0.46	-0.4	0.86	0.84	1.00			
Managed Futures	-0.16	-0.04	0.04	0.25	0.34	-0.12	0.05	1.00		
REITs	0.58	-0.05	0.25	-0.31	0.61	0.71	0.66	0.03	1.00	
S&P 500	0.37	0	0.4	-0.39	0.72	0.86	0.84	-0.05	0.78	1.00

# THE ALTERNATIVE ALPHAS



# PRICE VERSUS VALUE: A REVISIT!

Type	To value	To price
<b>Assets</b>	Can be valued based upon expected cash flows, with higher cash flows and lower risk = higher value.	Can be priced against similar assets, after controlling for cash flows and risk
<b>Commodity</b>	Can be valued based upon utilitarian demand and supply, but with long lags in both.	Can be priced against its own history (normalized price over time)
<b>Currency</b>	Cannot be valued	Can be priced against other currencies, with greater acceptance and more stable purchasing power = higher price.
<b>Collectible</b>	Cannot be valued	Can be priced based upon scarcity and desirability

# ALTERNATIVES: PRICE OR VALUE?

- Real estate: Commercial real estate **can be valued**, since it generates cash flows (rental and least income) and even residential real estate has a value, if you impute cash flows based upon what you would pay as a rental to stay at the property. In practice, it is **mostly priced**.
- Collectibles: Collectibles cover a wide swath of investments, and they can **only be priced**.
- Trophy assets: We will complete the discussion by looking at **trophy assets**, investments that have cash flows (and thus can be valued), but where that **cash flow effect has been drowned out** by a demand for these assets that reflects almost a collectible status.

# REAL ESTATE: TRADED PORTION

	United States	Global
<b>REITs</b>	\$1,120,897	\$1,515,764
<b>Real Estate (Development)</b>	\$6,734	\$512,953
<b>Real Estate (General/Diversified)</b>	\$4,950	\$349,936
<b>Real Estate (Operations and Services)</b>	\$107,958	\$605,711
<b>Rest of the Market</b>	\$28,628,250	\$107,882,319
<b>Real Estate as Percentage of Market</b>	4.15%	2.69%

**The non-traded:** In 2023, for instance, it is estimated that the total value of real estate globally is about \$400 trillion, with a third in residential and two thirds in commercial real estate.

# HISTORICAL RETURNS

<b>Asset Class</b>	<b>Data Source</b>	<b>Period</b>	<b>Return Measure</b>	<b>Arithmetic Average (%)</b>	<b>Standard Deviation (%)</b>	<b>Geometric Average (%)</b>
<b>Stocks</b>	S&P 500	1928–2023	Dividend + Price Appreciation	11.66	19.55	9.80
<b>Treasury Bonds</b>	FRED	1928–2023	Total return on 10-year bond	4.86	7.95	4.57
<b>Treasury Bills</b>	FRED	1928–2023	3-month T-bill rate	3.34	3.01	3.30
<b>Corporate Bonds (Baa)</b>	FRED	1928–2023	Total return on	6.95	7.71	6.68
<b>Equity</b>	FTSE	1972–2023	Dividend + Price Appreciation	12.74	18.41	10.89
<b>Mortgage REITs</b>	FTSE	1972–2023	Dividend + Price Appreciation	8.40	27.64	4.68
<b>All REITs</b>	FTSE	1971–2023	Dividend + Price Appreciation	11.27	20.42	9.00
<b>Commercial Real Estate</b>	NCREIF	1978–2023	Total return, appraised values	9.20	7.40	NA
<b>Residential Real Estate</b>	Case Shiller &	1928–2023	Transaction prices	4.42	6.24	4.23

# NOTES ABOUT REAL ESTATE RETURNS

- **The first is that the price appreciation in real estate over time has been modest**, with residential real estate delivering a compounded average return of 4.23 percent a year from 1928 to 2003, lower than the 4.57 percent that investors could have earned on a 10-year treasury bond. The returns are better on a total return basis, with income cash flows supplementing the price appreciation, with the NCREIF index of commercial real estate indicating annual returns of 9.20 percent between 1978 and 2023, with less than half of those returns coming from price appreciation.
- **The standard deviation in the appraised real estate indices (NCREIF and Case-Shiller) is low**, but that is because these indices are based on either appraised values or infrequent transactions. Investors who use this as an indication that real estate is less risky than other asset classes will be making a serious mistake.

# CO-MOVEMENT WITH OTHER INVESTMENT CLASSES

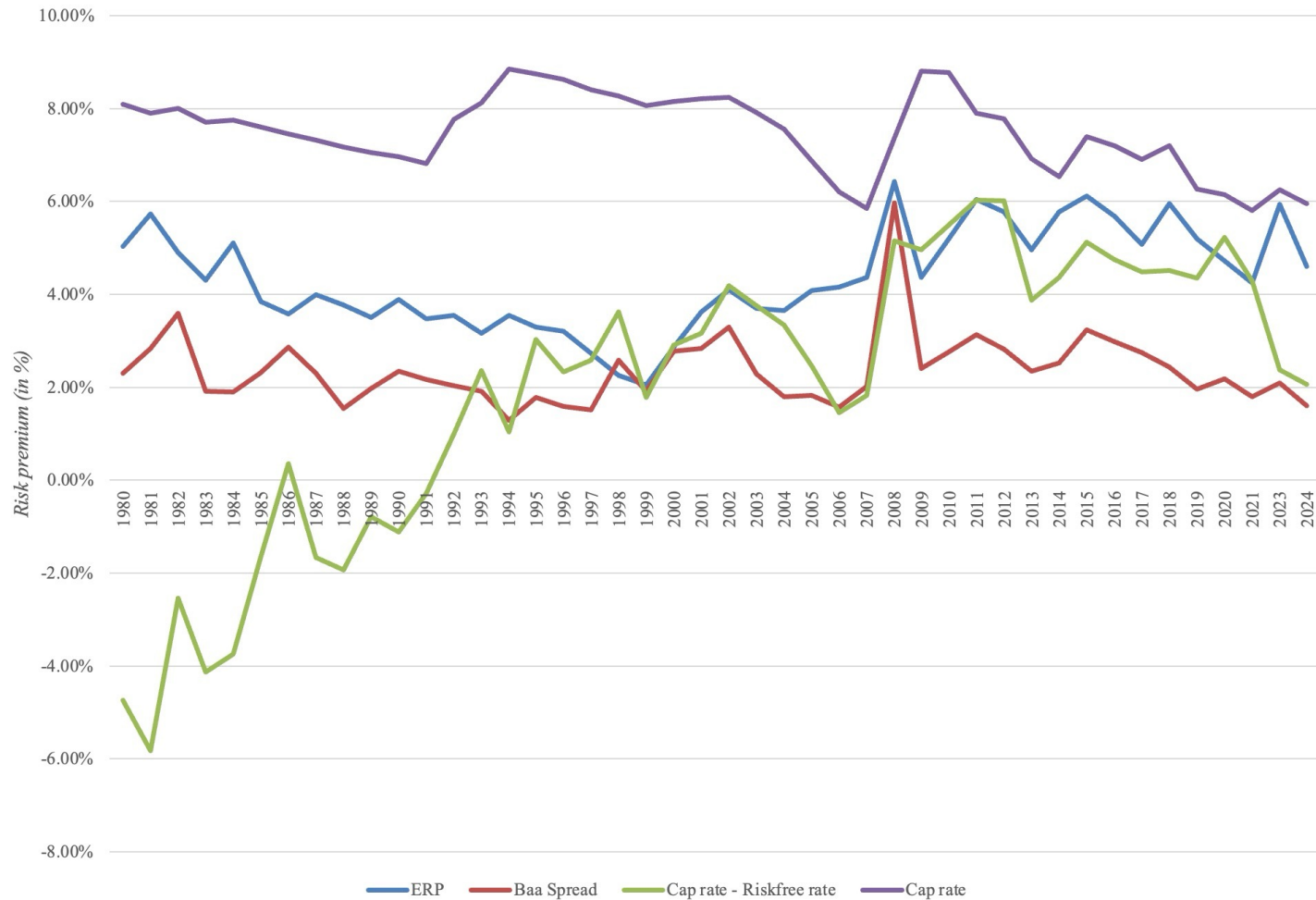
	<b>I&amp;S</b>	<b>CREF</b>	<b>Home</b>	<b>C&amp;S</b>	<b>Farm</b>	<b>S&amp;P</b>	<b>T-bonds</b>	<b>T-bills</b>	<b>Inflation</b>
<b>I&amp;S</b>	1.00								
<b>CREF</b>	0.79	1.00							
<b>Home</b>	0.52	0.12	1.00						
<b>C&amp;S</b>	0.26	0.16	0.62	1.00					
<b>Farm</b>	0.06	-0.06	0.51	0.49	1.00				
<b>S&amp;P</b>	0.16	0.25	-0.13	-0.20	-0.10	1.00			
<b>T-bonds</b>	-0.04	0.01	-0.22	-0.54	-0.44	0.11	1.00		
<b>T-bills</b>	0.53	0.42	0.13	-0.56	-0.32	-0.07	0.48	1.00	
<b>Inflation</b>	0.7	0.35	0.77	0.56	0.49	-0.02	-0.17	0.25	1.00

**I&S = Ibbotson & Siegal; CREF: CREF index; Home: Index of home prices; C&S: Case & Shiller; Farm: Index of farmland prices.  
Source: Ibbotson and Brinson (1996).**

# RETURNS BY DECADE: INVESTMENT CLASS

			Real Return (Annual) (%)					
Decade	Actual Inflation (%)	Unexpected Inflation (%)	Stocks	T-bills	T- bonds	Baa Corp Bonds	Gold	Real Estate
1930–1939	-1.92	0.07	6.19	2.91	5.93	9.69	NA	0.87
1940–1949	5.51	3.08	4.14	-5.03	-2.99	-0.32	NA	3.05
1950–1959	2.24	-1.89	18.69	-0.24	-1.41	0.08	NA	0.85
1960–1969	2.53	0.84	6.07	1.45	-0.02	0.70	NA	-0.35
1970–1979	7.41	2.80	0.11	-1.12	-1.83	-0.12	30.05	1.39
1980–1989	5.14	-2.33	12.81	3.68	7.45	9.31	-6.10	0.76
1990–1999	2.94	-0.90	15.88	1.92	4.89	6.75	-5.65	-0.24
2000–2009	2.53	-0.02	-1.37	0.16	4.09	6.08	12.42	1.77
2010–2019	1.76	-0.38	12.27	-1.24	2.59	5.48	2.68	2.11

# CHANGE COMING TO REAL ESTATE?



# REAL ESTATE: CHANGE IS IN THE WIND!

## The 20<sup>th</sup> Century

- Largely untraded & illiquid
- Held by individual investors & specialized real estate investors
- With high leverage
- Low to Moderate Returns
- Low Risk
- Negatively correlated with financial assets
- Inflation protection

## The 21<sup>st</sup> Century

- More liquid & traded
- Institutional investors enter the fray
- With continued high leverage
- Higher Risk
- Positively correlated with financial assets
- Return & Inflation Protection  
-> ?

# REAL ESTATE IN YOUR PORTFOLIO?

- 1. As an add-on:** Add real estate to a portfolio dominated by financial assets, hoping that it **hedges against inflation risk** and produces better risk/return tradeoff.
- 2. As center of portfolio:** Make real estate the center of your portfolio, hoping to take advantage of localized knowledge (of location and regulations) to earn excess returns, relative to other investors.
- 3. As a trade:** Take advantage of the swings in real estate prices over time, hoping that you have the capacity to detect shifts in mood and momentum, and using leverage to increase your payoff.

# THE BOTTOM LINE

- It is undeniable that financial assets get most of the attention, when we look at investments as investors, and we generally **pay short shrift to investments that fall outside the standard paradigm.**
- That is starting to change as investors look at alternatives, drawn by two factors:
  - Their “low” correlation with financial assets
  - The potential for “alpha” in alternative investments
- The largest alternative asset class is real estate, and while through much of history it has not been traded, things are starting to change.