Alternative Assets

—— An Australian Perspective

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In an ever changing financial services landscape following the Royal Commission into misconduct in the banking, superannuation and financial services industry, and given the volatility and uncertainty in global financial markets during the coronavirus COVID-19 pandemic, sophisticated and professional investors are more than ever actively seeking opportunities to invest in alternative asset classes as a means of diversification and asset protection.

Alternative assets are a talking point in the world of finance at the moment, as investors scurry to protect their portfolios from extreme volatility and the unknown impact that COVID-19 will have on global economies. Undoubtedly the new economic world we live in will challenge the status quo from an investment and risk management perspective.

So what are alternative assets? And how can they be used to potentially both protect and enhance an investors' portfolio needs, and help in maintaining target returns or investment objectives through these challenging economic times and beyond?

In simple terms, alternative assets describes a broad asset class that includes any investment that does not fall into the traditional asset classes of stocks, bonds, property or cash. The list of alternative assets is endless with new investment products and structures frequently becoming available. As outlined below, some of the more popular and familiar alternatives include hedge funds, private equity, venture capital, commodities, private debt, unlisted property, infrastructure and more recently cryptocurrencies.

Pictured below is a brief overview of some of the more common alternative investment asset classes.

Private Equity

Consists of capital invested into unlisted companies either directly or through a unit trust

Commodities

Includes investments in basic natural resources, agriculture, energy, hard and soft commodities

Venture Capital

Investing in a new or growing business either directly or through a fund

Unlisted Property

Investing into property or realestate via off-market funds or syndicates

Managed Futures

Investing into a porfolio containing a number of futures contracts in a range of sectors

Hedge Funds

Investment trusts that use strategies different to traditional funds such as by using derivatives or leverage

Private Debt

Investing in senior or subordinated debt loans to borrowers

Infrastructure

Investing into social and economic structures and facilities

Cryptocurrencies

Digital tokens designed to work as a medium of exchange to facilitate the transfer of assets

The reason why more investors are looking towards alternative assets is that historically their returns have had a relatively low correlation with the returns of traditional assets.

In the midst of an unprecedented global pandemic, trade-wars and geopolitical tension, we now face the potentially devastating impact that these events will have on our wealth and the global economy. Many economists believe that the magnitude of the adverse effects caused by COVID-19 on the global economy cannot yet be determined. As the RBA Governor Philip Lowe conceded in a relatively recent economic update: "*The coronavirus has clouded the near-term outlook for the global economy*".

Despite this recent plunge in global equity markets being triggered by the global pandemic, some investors believe that this may be signaling that challenging times are ahead for the global economy for some time. In his latest report, Craig Ferguson from Antipodean Capital Management suggests that the Australian economy may have peaked within the economic cycle and a period of downturn may be on the horizon, with the Australian economy experiencing its largest contraction since the 1930's and an unprecedented 800,000 jobs lost (RBA July figures). Despite the worst of the pandemic now seemingly over domestically, the RBA warns that the road to economic recovery will be long and arduous. In their July 2020 release regarding the current state of the economy the RBA announced, *"the outlook remains uncertain and the recovery is expected to be bumpy"*.

Craig Ferguson from Antipodean Capital Management explains that *"the Australian economy has experienced one of the sharpest and fastest recessions and equity bear markets in history, but that recovery has been underway since April due to excessive monetary and fiscal liquidity and a base in the Australian data cycle in mid-May. These factors have offset falling earnings, with analysts expecting corporate earnings to have fallen by between 40-60% over H1 2020. However, Q3-4 should mark the first quarters of earnings recovery, which may well underpin equity prices. That said, headwinds remain. COVID-19 second wave risks in Australia and continued first wave risks in the USA and EM economies may dampen data cycle recovery. High unemployment may be sustained for a number of years. Residential and commercial property prices may fall as a result of COVID-19 related issues. Additionally, the potential cessation of stimulus – termed the monetary and fiscal cliff – may produce a decline in economic activity in late 2020 or 2021, if the underlying economy has not sufficiently recovered before stimulus is withdrawn. These factors outline why the RBA is correct to argue that considerable uncertainty remains.*

In addition, portfolio construction is challenging for asset allocators when cash rates and bond yields are near the zero bound, as they currently are. Significant holdings of bonds won't diversify a heavily weighted equity portfolio if stock markets fall, as the zero bound effectively limits the degree to which yields could fall and bond profits rise." Therefore, to continue to meet target returns throughout these periods of uncertainty, many investors are being forced to think outside the square in terms of where they are allocating their capital. With alternative assets boasting less volatility and lower equity correlation than many traditional assets, they are fast becoming the solution for many investors wanting to safeguard their portfolios from the ambiguity of the future.

Adam Morse, Managing Director of BlueRock Private Wealth, believes now is an important time to be looking towards alternatives investments, when structuring a portfolio. *"The current environment has resulted in minimal risk/reward fundamentals for fixed income and traditional growth assets are suffering from stimulus induced overvaluation or are failing to rebound based on a dire economic outlook. Alternatives offer our portfolios uncorrelated returns, downside protection and 'real asset' style returns. We look for best of breed alternatives, across the style spectrum, with either a defensive or growth characteristics, as a genuine replacement for traditional asset classes. Private equity, gold, currencies, long-short and market neutral all currently feature in our portfolios."*

Ominous economic forecasts are not the only reason why investors are increasing their allocation of alternative assets, as in recent times, returns in many alternative investments have outperformed the returns of traditional assets.

The Future Fund is Australia's sovereign wealth fund and was established with the goal of strengthening the Government's long-term financial position. The role of the fund is to generate high, risk adjusted returns over the long-term. The fund posted an impressive annual return of 11.5 percent on the 30 of June 2019. This dwarfed the measly returns of the All Ordinaries index (XAO) over the same period, which were approximately 6.11 percent. The Future Fund's impressive performance last financial year was not an anomaly, as the fund has developed a proven track record of risk-adjusted, high performance since its inception. The 10-year annualised return of 10.4% was greater than that of the median super fund, which was 9.6% over the same period.

The success of the Future Fund can be attributed to its unique portfolio of holdings, of which approximately 47 percent is invested collectively in alternative assets. Compare this to the average portfolio which typically has < 10% of assets invested in alternatives and you begin to see how important alternative assets are within a portfolio.

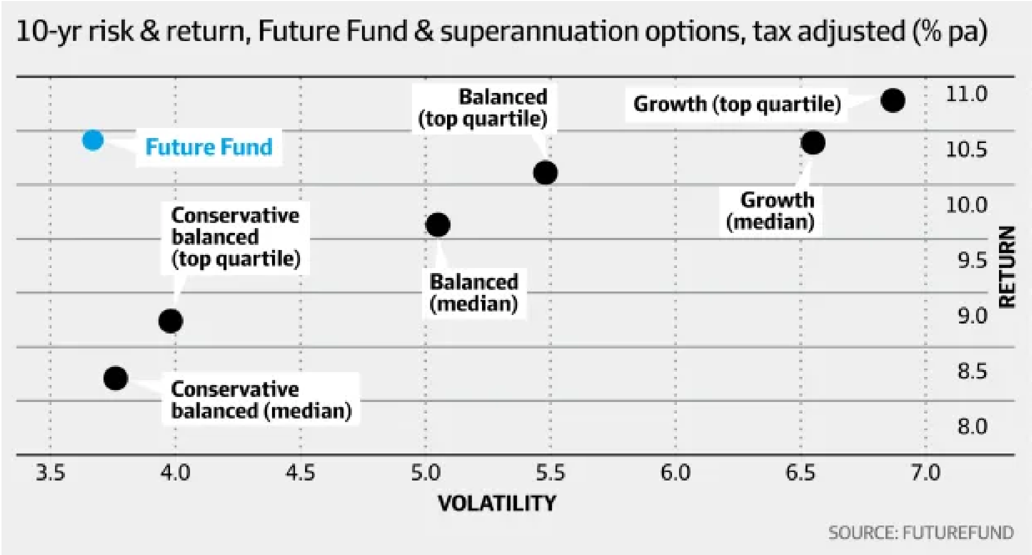
Below is the asset of allocation of The Future Fund as of 31/03/20, the assets classified as alternative holdings are circled.

Asset allocation

Table 2: Future Fund asset allocation		
Asset class	**$m**	**% of Fund**
Australian equities	9,874	6.1
Global equities		
Developed markets	30,823	19.0
Emerging markets	13,919	8.6
Private equity	29,514	18.2
Property	10,726	6.6
Infrastructure & Timberland	12,260	7.6
Debt securities	15,729	9.7
Alternatives	23,837	14.7
Cash	15,596	9.6
TOTAL	162,278	100.0

Not only can the Future Fund credit part of its success to using alternative asset investments, but it has also achieved great diversification, with holdings in private equity, property, debt securities as well as infrastructure and timberland in both developed and emerging markets.

Funds such as the Future Fund can select a diverse range of alternative assets in order to strengthen their portfolios, as well as to mitigate risk and volatility exposure. The Chairman of the Future Fund, Peter Costello believes that minimizing exposure to these factors is key to maintaining target returns. "The Future Fund is positioned to have less risk and less volatility than a balanced fund so that it can outperform in periods of downturn." This pledge was proven in Quarter 1 of 2020, when the Future Fund recorded a negative return of 3.4%. Over the same Quarter the ASX 200 fell 23.1%, which means the Future Fund outperformed the Index by a colossal 19.7%!



Pictured above is the 10 – year Volatility vs Return performance of the Future Fund in comparison to other superannuation fund options.

The Future Fund is not the only fund using alternative assets to achieve greater returns. Rueben Collins - Australasia head of data provider Preqin noted, *"77% of all sovereign wealth funds (SWFs) invest in alternatives, in one form or the other, with varying degrees of exposure. Kuwait Investment Authority, the world's first such fund, invests 10% of its AUM in private equity alone. China Investment Corporation, the world's second largest SWF, which already has a significant allocation to alternatives, plans to grow this to 50% by 2022. Singapore's GIC began investing in alternatives in the 1980s with a passive strategy. In recent years, this has matured into a proactive investment approach involving deal sourcing and origination and co-investing with a wide spectrum of partners."*

Aside from SWFs, many other private and public fund managers are utilising alternative assets to fulfil their investment objectives. Stephen Romic who is responsible for asset allocation at DFS Portfolio Solutions, provided us with an insight into how he devises alternative asset allocations based on different investment strategies:

Defensive Asset Diversifiers

- Liquid Alternative Investment Strategies: which include managed futures, market neutral, global macro, tail-risk strategies etc; and constructed to assume negligible levels of equity and bond risk to complement traditional portfolio exposures.
- Private Debt: diversified, non co-mingled exposure to first mortgage loans with significant levels of subordination levels. We continue to be meaningfully exposed to this sector.
- Distressed Private Debt: has appeal given the anticipated increase in opportunities, albeit at the very end of the defensive risk spectrum.

Growth Asset Diversifiers

- Private equity: selective allocation given prevailing valuation risk, generally across private and public markets.
- Infrastructure: selective allocation to renewable energy assets.
- Unlisted property: has appeal given the anticipated increase in distressed opportunities, albeit with elevated risks. Currently under review.

Despite the market seemingly waking-up to the virtues of alternative assets, they are still largely underweighted in many investors' portfolios.

Many investors are still compelled by the familiarity of traditional assets, thus continue to hold a portfolio that is largely exposed to the performance of domestic and global equities markets. The investors that fail to adapt to the dynamic alternatives landscape risk being left behind in comparison to those who are willing to innovate and evolve to become market leaders.

The table below is from a well-known Australian financial advisory firm and illustrates their recommended portfolio weightings based on the investors preferred level of risk. Scarily, these recommended holdings do not include any alternative assets, regardless of the investor and their investment goals. By following these recommendations, investors leave themselves completely exposed to changes in the global economy and equities markets in particular.

	Secure	Defensive	Conservative	Balanced	Growth	High Growth
Cash	100%	25%	10%	5%	3%	1%
Bonds		55%	50%	35%	17%	
Property		6%	10%	10%	10%	10%
Aust Shares		8%	17%	27%	42%	55%
Int Shares		6%	13%	23%	28%	34%
Total	100%	100%	100%	100%	100%	100%
Income	100%	80%	60%	40%	20%	1%
Growth	0%	20%	40%	60%	80%	99%

In contrast, Ben Meikle the Executive Director of Melbourne based boutique wealth and investment group Carnbrea & Co., explains how his fund has been able to use alternative investments to its advantage. *"At Carnbrea, we believe it is through diverse asset allocation and maintaining a sufficiently diversified portfolio that investors will be able to outperform over the long term. We encourage clients to understand and hold alternative assets. Given the level of uncertainty in the current market environment, alternatives play an increasingly important role in portfolios to help protect against volatility and downside price movement."*

Asset Class	Balanced	Growth
Australian Equity	14%	19%
Int'l Equity - Developed	17%	24%
Int'l Equity - Emerging	3%	4%
A REITs	3%	4%
Int'l REITs	3%	4%
Alternatives	**10%**	**15%**
Australian Fixed Interest	25%	15%
Int'l Fixed Interest	25%	15%
Cash	0%	0%

Source: Carnbrea &Co.'s Strategic Asset Allocation weightings

"In Carnbrea's long-term Strategic Asset Allocation framework, we allocate 10% to alternatives in the client balanced profile and 15% in the growth profile. The current recipients of this allocation are infrastructure, global macro strategies and gold. Sharp spikes in volatility in recent periods have tested many alternative strategies. Given the broad universe in the alternatives class, it is important to review the alternatives holdings in clients' portfolios on a regular basis to ensure the chosen strategies/assets are behaving appropriately and as expected."

Typical alternative asset classes that investors which are trending

Private Equity (PE) & Venture Capital (VC) investments have reached record highs in recent times with the Australian Investment Council reporting that funds had $30 Billion as of June 2018 in private equity and venture capital assets under management (AUM). Steve Gledden is a Managing Partner at Straight Bat Private Equity, he expects private equity investments to continue to grow in the next few years; *"The outlook for global growth, inflation and interest rates remains at all-time lows. Investors remain uncertain about public market assets as prices appear to decouple from fundamentals. Money continues to move towards private equity and venture capital as investors seek alpha in preference to beta related risk."* This trend is not unique to Australia, as private equity investment is experiencing strong growth worldwide. The American Investment Council research shows that private equity investment in the US has doubled in the past decade and now totals approximately $331 billion USD. A Mckinsey report recorded that the total private capital assets under management hit a milestone in 2017 when they surpassed a total of $5 trillion USD. Despite private capital investment already reaching all-time highs, investors are still eager for more, as a 2019 UBS survey reported that 39% of family office investors are wanting to increase their private equity investments.

Early stage and VC investments in Australia also experienced rapid growth during 2019, with data from PitchBook analysed by KPMG showing a record $1.7 Billion was invested into local startups. It's certainly indicative of many Australian investors now looking towards start-ups to find potential 'market disruptors' that can provide astronomical returns to those willing to assume the risky nature of such an investment.

An emerging segment in private equity is in secondary capital, which is investment capital that is used to buy shares in a private company from existing shareholders where they realise the proceeds, not the company. SecondQuarter is Australia's first venture secondaries fund and its Managing Partner Ian Beatty believes the success of similar liquidity products in the UK and the US can be replicated in Australia. *"Since Australia's pension funds started to allocate into the country's top VCs, venture capital as an asset class has started to find its scale. Investors in Australia's best technology companies who need liquidity along the private market path to exit have had no dedicated provider to date. We believe that by filling this void we will increase the velocity of capital in the technology ecosystem which will help Australia to continue to build great tech businesses - and we will also generate a good return for our investors at the same time"*

Property has provided many investors with bumper returns in recent years due to soaring house and land prices. Traditionally, if an investor wanted to add property to their portfolio however, they were forced to directly purchase the deeds themselves, or via shares in listed property companies or via listed real estate investment trusts. Many wholesale funds now offer investors the opportunity to invest in property through private unit trusts which can pool investors capital to invest into property that typically would not be feasible for an investor to purchase the property directly. The unit trusts can invest in property developments including residential, commercial, mixed use or industrial, as well as investing in existing property assets that can generate yield.

An example of a highly innovative residential fund is the Brickfloor Trust, which provides investors with diversified exposure to Australian residential property (established dwellings) with enhanced returns through offering put options – and charging put option premiums – to home sellers. "*Residential property is Australia's largest asset class, is typically well understood by investors and can provide strong returns with lower volatility than many other asset classes. This is particularly the case where capital growth and rental yield can be complemented by other sources of income, in our case, put option premiums."* said Dean Fraser, Founder & CEO of Brickfloor.

Probuild Constructions is one of Australia's leading building contractors, and has taken an novel approach to engaging more deeply with their developer clients, whilst also participating in the developments together with their investor base through the establishment of both a master property equity fund and a master property credit fund for the projects or assets they are contracted. As noted by Nathan Theos, Executive Director of Probuild Constructions: *"One of the challenges in funds management in property are that opportunities are tightly guarded, further impacting this challenge is the consolidation of funds management firms, with just a few controlling most of the market. Therefore, finding fund management partners that can provide a vehicle into these tightly guarded opportunities is critical, along with the requisite fund management expertise. Given our history in the property market in Australia with some of the largest developers, we can provide a competitive entry point for any investor wanting exposure to high quality property assets."*

MAI Capital is another property fund manager that launched the ICD Credit Fund in 2019 with positive market acceptance. The Fund offers investors exposure, in the form of loans, to the group's high-quality project portfolio which has a core focus to invest in large scale residential, commercial and government development projects in core CBD locations across Australia and New Zealand. Steve Yang explained *"MAI Capital's private property funds provide investors with access to institutional grade and highly exclusive property projects that are not otherwise available to private and family office investors, and the investment strategy and product are tailored to their needs and preferences. These qualities have been well received by investors in a time when traditional asset classes are more vulnerable to volatility particularly in equity markets."*

Private Debt investments have become more commonplace in Australia as credit becomes more difficult to access through the traditional banking channels for many borrowers. New regulations and economic uncertainty has led to the major trading banks tightening their lending criteria and lowering of their loan to value ratios. This has increased demand for private credit and has provided investors with the opportunity to invest in this alternative asset class to achieve their target returns whilst borrowers compete for capital. The latest data from Preqin showing that Private Debt fundraising globally in quarter 2 of 2020 was up 54% from Q1. The high-risk adjusted returns that private debt has been able to provide investors, combined with the allurement of diversification, has many investors adding these assets to their portfolio.

The SILC Group currently manages a Credit Fund which seeks to provide investors with the opportunity to invest in risk assessed, secured commercial loans. By offering different loan classes via discrete and pooled loan units, investors have the flexibility of choice when choosing which asset is right for them.

Koby Jones the Managing Director of The SILC Group noted that *"Although alternative investments such as private debt can be illiquid and historically difficult to access, investors are more than compensated through commensurate returns while diversifying risk and can complement traditional assets in an investors' portfolio. In many instances, investors into private debt have the flexibility to select the type of loan they choose to invest in which have varying loan to value rations, security interests, loan terms and loan repayment options. The capital that is provided from the investor to a borrower in the form of a loan has a contractual agreement with that borrower which has clearly defined obligations and outcomes which in turn provides greater certainty to the investor."*

Infrastructure investments were once an elusive asset for many investors, however in recent times the opportunities available have grown exponentially, as governments worldwide seek to construct, replace and privatise many infrastructure assets. Due to the nature and immense costs of many of these assets, high barriers to entry are formed which leads to many of these assets to achieve monopolies or duopolies in their markets. Investors are drawn to some of the unique benefits that arise from these market structures such as, strong long-term cashflows and growth. Globally, Australia is considered as an ideal place for infrastructure investment as it is a nation that boasts an impressive track record of infrastructure business and political stability. In the 2019 Australian Infrastructure Investment Report a surveyed investor and infrastructure developer revealed, "Every major investor in the world would like to be in Australia. We've got lots of domestic capital and certainly most of the big overseas players… we're forever having people knock on the door, whether they are from Canada, Asia, or the Middle East."

Historically alternative assets were only accessible to institutional investors

In years gone by, many investors have been restricted to mainly investing in traditional assets and it was usually only large institutions and superfunds that had access to many alternative investment opportunities. The few alternative asset funds that were previously available came with high minimum investment requirements and costly fee structures compared with ETF's and mutual funds, making them unattractive to investors.

However, the alternative investment landscape is changing drastically, as many funds are catering to investor demands by facilitating the investment of alternative assets for wholesale, professional and sophisticated investors. Funds and investment managers that have recognized this shifting trend in asset allocation, by innovating and adapting their services and product offerings, have been most successful throughout this period as they have reduced the barriers entry for both investors as well as alternative investment managers.

Koby Jones, Managing Director of The SILC Group states that *"As the global economic, financial and political environments became more unpredictable and volatile, diversification of investors portfolio's into alternative asset classes provided for greater protection and access to enhanced returns relative to the preserved associated risks of investing in alternatives. The SILC Group has been at the forefront of developing solutions for investors to gain exposure to quality managers in alternative assets and in particular private markets throughout the region, which we see continuing for some time to come.*

In closing, I ask: with a global economy clouded by uncertainty combined with the significant opportunities that alternative assets can offer, is there really any ***alternative*** *anyway?"*

For more information regarding alternative investment opportunities please feel free to visit The SILC Group website at http://www.silcgroup.com.au/ or phone (03) 9600 2828 to speak to one of our investment managers.

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The SILC Group

The SILC Group (AFSL No 407100) is a multi-faceted financial solutions provider focussed on the unique needs of discerning wholesale and sophisticated clients. Our experienced team of specialists can provide you with greater access to traditional and alternative investment opportunities.

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