Alternatives: Picking the diamonds from the rhinestones

Percival Stanion argues that true 'alternative' investments are hard to find, but diversification is still possible

Alternative assets are as prized as blue diamonds. Unfortunately, they're just as rare – most of what glitters in the investment universe is actually rhinestone.

That's because for all their perceived distinctiveness, most alternative investments ultimately act like either equities or bonds – or, more rarely, a combination of the two. More often than not, their only distinctive features are higher management fees and low 'illiquidity premia'.

A close look at property, widely considered a classic alternative, highlights the challenge. If you buy a building site, you are effectively investing in the stock of a high-growth company where performance hinges on capital gain. If you buy a finished building, meanwhile, your investment will act like a debt instrument, with rents playing the role of coupons.

Yet while true alternatives are hard to find, that doesn't mean they're not worth the effort.

And even if pure alternatives aren't available, finding ones that have the right mix of bond- and equity-like characteristics can also help – as long as they come at an attractive price.

Property, for example, can offer protection against inflation and has contractual cashflows that aren't necessarily fully synchronised with traditional asset classes.

Where we can, we also invest in private equity (through listed structures). It's an investment best suited to long-term institutional investors, who can take advantage of the illiquidity premium.

The caveat is that there is a big disparity of performance across the asset class and careful due diligence is essential. Similar fund selection issues also hold for hedge funds.

We also like absolute return fixed income with scope for negative duration. Such a strategy aims to generate positive returns at all points of the financial cycle – whether interest rates are rising or falling.

Other alternatives come into their own at specific points in the cycle. For example, in the aftermath of the great financial crisis 2008, when large parts of the market were blocked from traditional sources of financing, we saw an attractive opportunity in aircraft leasing. This was both bond-like in the contractual income it generated but also had characteristics of equities as the value of the aircraft could appreciate. So we invested and the position did well.

Beware of infrastructure – and catastrophes

Infrastructure assets – such as toll roads, airports or hydro-electric projects – are less appealing. Because they're typically contracts with the public sector, they end up mimicking the public bond market, albeit with less liquidity and higher fees. Nor do they offer the prospect of equity-like capital gains.

Catastrophe bonds, meanwhile, tick the diversification box, but valuing the risks of hurricanes, earthquakes or plane crashes demands the sort of expertise that's the preserve of the very same insurance companies who sell such bonds.

After investigation, we have also rejected artworks, wine, stamps, diamonds and rare cars. On the face of it, the returns can be reasonably attractive. But these are speculative and highly illiquid assets with little intrinsic economic value.

As for commodities, not only do we not see them as alternatives, we don't even think of them as assets. They're liabilities. Take timber. It generates no income, you have to pay to store and insure it and, over time, it rots. Forests, on the other hand, are assets. Investors can vary input prices relative to revenue by choosing the pace at which trees are harvested and planted as well as the species mix.

One commodity that we do like is gold – not because of its commodity characteristics, but because it acts as a proto-currency. Like timber, gold doesn't generate an income and does incur ownership costs. But it isn't a wasting asset and has historically worked as a store of value. Today's concerns about North Korea and the erratic Trump presidency also play to its advantage. And, in an era of low or negative yields across assets, gold's lack of income is less of a concern.

Overall, we're sceptical about most of what is labelled 'alternative'. The majority behave just like conventional assets. But there are some viable options available. The big question investors need to ask is whether the returns are sufficient to compensate for that lack of liquidity.

However these investments are labelled, our aim is to adapt to the changing relationships between the assets in our portfolio. And we never forget that, conventional or 'alternative', the price you pay for an asset will have a meaningful impact on your ultimate return.

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