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ALTERNATIVE INVESTMENTS ARE GOOD DIVERSIFIERS

Dr Nafees Hossain, Fund Manager at Prescient Investment Management, considers the place of alternative investments in the active versus passive debate

With the general role of any investment strategy being to deliver real returns over the long-term, wealth creation can be achieved by active or passive means.

Active fund managers generally have come under pressure in recent times due to under-performance, but can be expected to do well again as they evolve with the changing investment landscape.

Alternative assets are an example of product innovation on the part of active managers. Alts, as they are referred to, are uncorrelated with traditional assets: stocks, bonds and cash; domestic and offshore.

Alternatives include hedge funds, private equity and venture capital.

What differentiates hedge funds from traditional long-only investments is their ability to go short and to profit when prices fall. Hedge funds have a lot more flexibility in terms of their mandates and what they're able to do from a liquidity and credit perspective.

They can also be differentiated by being generally less liquid. However, illiquidity commands a premium that is built into the asset class. Put differently, the less liquid an investment, the greater the return that is expected.

Venture capital is often associated with tech companies like Uber and airbnb, which both started with venture capital funding. However, the venture capital model is risky with only about 3% of companies that are backed paying off in the end.

There are different types of alternative funds, including real estate and debt funds. Another type of private equity fund looks to buy cash generative businesses at big discounts. These companies contrast with the likes of Tesla, which have negative free cash flows and whose prices discount enormous future growth.

Infrastructure funds are another realm of alternative investments. In this field, renewable energy funds have become a popular asset class and a source of real returns.

Due diligence

For astute investors, proper research and due diligence are needed to understand alternative assets, particularly in terms of the risk that they represent.

With infrastructure funds this would involve assets like solar or wind farms. With hedge funds, it's important to understand the style and philosophy of the manager who may adopt a fundamental or quantitative approach to investing.

Where the downside is concerned, investigate the scenarios under which the investment would not deliver the required returns.

A growing number of active managers offer access to specialist funds. A pioneer in this field, Prescient offers a range of alternative funds, including renewable energy and hedge funds. When developing new products, we remain true to our DNA, which incorporates an emphasis on capital preservation.

Prescient's renewable energy fund undertakes due diligence for each project and offers a return of CPI plus 7% in a time when real returns have been hard to come by. The fund's qualities make it an attractive, uncorrelated portfolio diversifier.

The Prescient Wealth Market Neutral QI Hedge fund is uncorrelated to traditional assets like bonds, cash and equities, and whether the market is up or down, the fund looks to add absolute returns.

With hedge funds, it's important to use leverage appropriately, with portfolio construction playing a big role in achieving high risk adjusted returns. As of April this year, the Prescient Wealth Market Neutral QI Hedge fund's performance is ahead of cash and equities, with the fund having beaten the passive index in the year to date, delivering close to 8% in alpha.

Costs and technology

Alts can be good diversifiers, adding real returns over the long-term that are uncorrelated with traditional assets.

However, alts also command higher fees than traditional products. And with many active managers having delivered substandard alpha over recent years, the debate about fees often takes place in the context of active versus passive funds.

Our view is that the neutral ground is best found by establishing a direct correlation between performance and fees. The aim is to out-perform benchmarks like cash and, amongst active managers, there are funds delivering alpha.

Indicative of the changing investment landscape is the role of technology in fund development, especially quant funds which have an ever-greater ability to process, manage and meaningfully analyse large amounts of data to detect trends and patterns.

This exciting trend has helped quant funds take their place in the investment industry.

However, the broader tech revolution is also impacting asset management. Social media, for example, are being used to read market sentiment.

While high frequency trading has been another beneficiary of the technology boom, it has the potential to impact markets in terms of volatility and what are termed "flash crashes". Because of this, automated trading systems have also resulted in more regulation.

Volatility

Market volatility has been very low, indicative of a period of caution for markets due to geo-political risks, and the fact that markets and the macro economy in the US are driving sentiment. In addition, quantitative easing is still in place, particularly on the part of the European Central Bank (ECB) and Bank of Japan. This is distorting asset prices.

Given that it's likely volatility will increase from here, investors should consider incorporating a long-volatility tilt in their portfolios. Market neutral-type strategies are suited to a higher volatility environment.

In terms of asset allocation, current conditions lend themselves to being bullish on Europe and therefore long on the euro and short on the dollar. PMIs are up across Europe, which seems to be where the US was five years ago in terms of its pro-growth scenario.

ECB tapering, when it happens, will be a strong catalyst for the euro. Bonds, however, seem not to have already priced in this eventuality, making a case for being long on European equities, but short of European bonds. There is also a bullish case to be made for the pound, which trades at decade lows with implications for UK trade and growth.

In the US, the S&P is at high multiples while the macro cycle is looking toppish. Political risks are prevalent.

Despite big "whoopsies" in SA and Brazil, money flows to emerging markets are picking up. With a lot of the bad news, for example South Africa's junk status, priced in, downside risks are more muted. On a relative basis, emerging markets are looking good compared with the US.

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