



## *Alternative Investments Checklist*

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# Alternative Investments

Hedge Funds

Private Equity

Real Assets

Venture Capital

Multi-Strategy Funds

Buyouts

Private Real Estate

Arbitrage

Special Situations

Timber

Event Driven

Distressed Debt

Commodities

Long-Short Equity

Mezzanine

Energy

Managed Futures

# Asset Allocation Strategy – Big Picture

- We are living in a low return world. Real interest rates are currently about 2% and risk premiums are low.
- Low bond yields indicate a high likelihood that most institutions' return targets will not be achieved. Credit spreads are very tight, so additional risk in bonds provides very little incremental reward.
- U.S. stocks are priced to provide a 4% real return in the future at current P/E ratios. A contraction in P/E's would produce lower real returns. Unlike several years ago, today there are no obvious, compelling opportunities to add value within the U.S. stock market.
- International equities remain relatively attractive, but currently offer less potential for outperforming U.S. equities than a few years ago.

# Asset Allocation Strategy – Big Picture

- The flood of money into alternatives has crowded-out some return opportunities. However, since traditional asset classes are priced to provide very low returns, we believe that alternatives offer significant diversification advantages.
  - Hedge funds control approximately \$1 trillion in capital (and much more when leverage is considered). The reward for investing in common arbitrage opportunities has largely been priced away. Future returns from hedge funds are likely to be far below most investors' expectations.
  - Declining capitalization rates in real estate has dampened expected returns.
  - Private equity continues to experience a large amount of capital chasing a limited investment opportunity set.
- Conclusion: **Diversify**
  - There's little reason to make large bets on any particular asset class or strategy (including alternatives). Current valuations in most asset classes indicate modest expected return premiums for taking more risk, which increases the potential for downside scenarios.
  - Remain vigilant and flexible. Watch for new opportunities and capitalize on them.

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# Why Invest in Real Assets?

- **Portfolio Objective:**

- Protect the portfolio from unexpected inflation.
- Diversification benefits from low correlations to most traditional asset classes.
- Equity-like long-term expected returns (significantly above equities over the 10-year horizon).

- **Recommended Approach:**

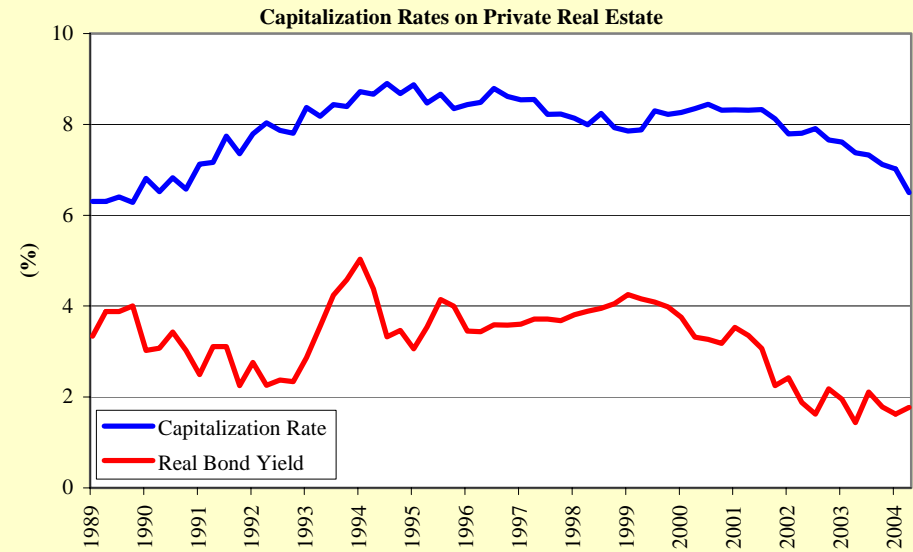
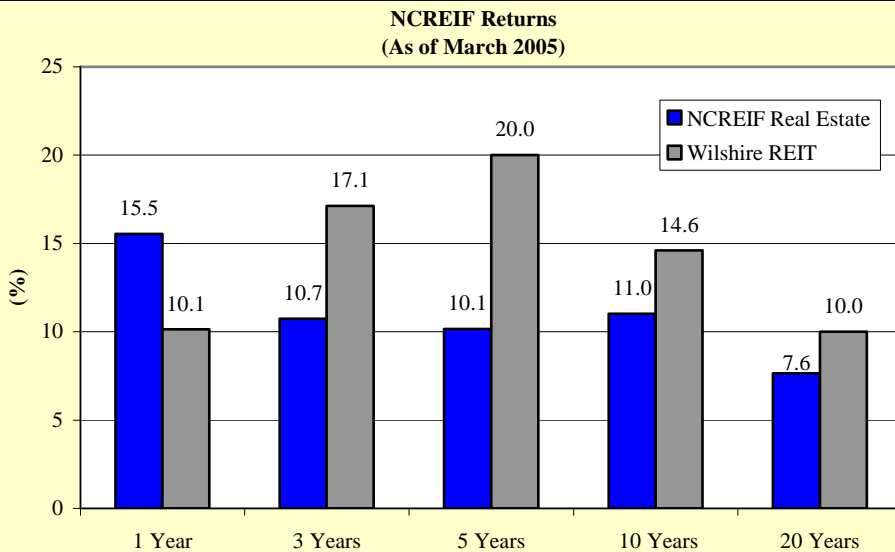
- Spread assets across a broad spectrum of investments including real estate, oil & gas and timberland.

- **Return Expectations:**

- We expect that a broadly diversified real asset portfolio will return about 8.3% net of fees over the 10-year horizon, and about 8.5% over the very long term (about 4% from income).
- Over the past 10-years, real estate has returned about 15% and commodity indexes have returned about 8%.

# Real Estate – Current Outlook

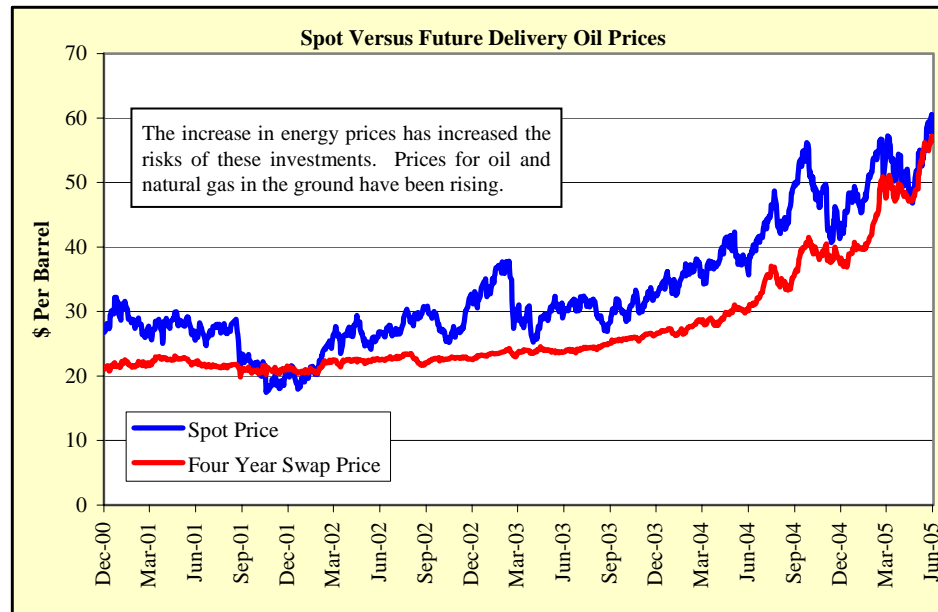
- Recent trends in real estate ...
  - Over the last five years, the public REIT market has significantly outperformed the private real estate sector (21% annualized vs. 11%). This trend is likely to reverse in the years ahead, and we expect the near-term returns for public REITs to trail private real estate investments.
  - Prime core properties are currently valued at very low capitalization rates, increasing the entry price risk for that segment of the market.
  - The U.S. office sector seems to be rebounding.
- Therefore, we recommend ...
  - Overweighting private real assets vs. REIT's
  - Investing in open-end funds to accelerate implementation (also offer liquidity)
  - Focusing on value-added strategies: moderate leverage and operating improvements



# Real Assets - Oil and Gas

## General Characteristics:

- Investments in natural resources
- Long-term investment partnerships
- Can invest in just production, or both exploration and production
- Part of return is tied to commodity prices, and part is tied to operating efficiency
- Under a stable pricing environment, targeted returns from 10% to 12% annually (net of fees)



# Private Equity

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# Private Equity

- **Portfolio Objective:**
  - Increase long-term expected returns (S&P 500 + 5% annually).
- **Recommended Approach:**
  - Spread assets across a broad spectrum of buyout strategies and take several years to build the portfolio to achieve vintage year diversification.
  - Avoid sector concentration (mistake in 1990's was concentration in venture capital)
  - Manager Risk: Wide spread between returns for median and best funds.
  - Strategy Risk: Macro events, competition for opportunities, exit opportunities.
  - Liquidity Risk: Duration varies by strategy and market conditions.
- **Return Expectations:**
  - A mature private equity program is expected to return 11.5% net of fees over the 10-year horizon, and about 12.5% over the very long term.
  - Over the past 10-years, the median annual return for buyout funds was 13.5% annually, and 25.9% per year for venture capital funds.

# Current Private Equity Environment

- **Buyouts**

- Capital is plentiful
- Valuations are rising
- Returns over last decade below expectations
- Improving exits
- Getting deals and adding value important

We Like

- Proven opportunistic investors
- Smaller funds
- Industry specific funds
- Secondary funds

- **Venture Capital**

- Capital is still plentiful
- Investment pace and valuations on the rise
- General Partners are optimistic
- IPO market improved
- Access to “top-tier” groups very difficult

We Like

- Top-tier funds of funds
- Lesser known firms with solid track records
- Secondary funds

# Current Private Equity Environment *(cont.)*

- **Mezzanine**

- Capital needed to complete buyout deals at current valuations
- Competition for deals squeezing returns
- New entrants emerging in form of publicly traded BDCs, though trend may be in decline
- Avoid for now

- **Special Situations**

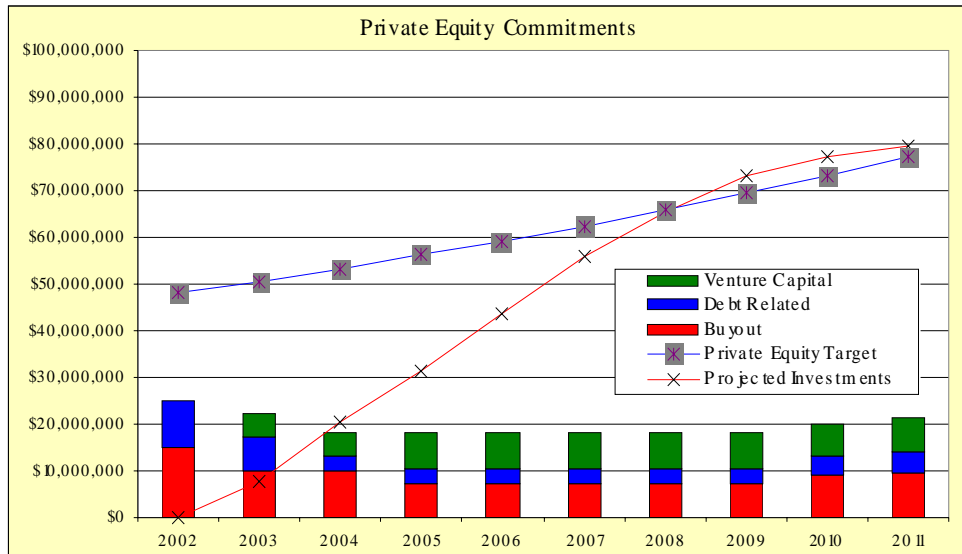
- Large cap non-control distressed over for now (in US)

We Like

- Smaller, control distressed strategies
- New niche deals like levered debt funds
- Eclectic and opportunistic strategies

# Private Equity Implementation Timeline

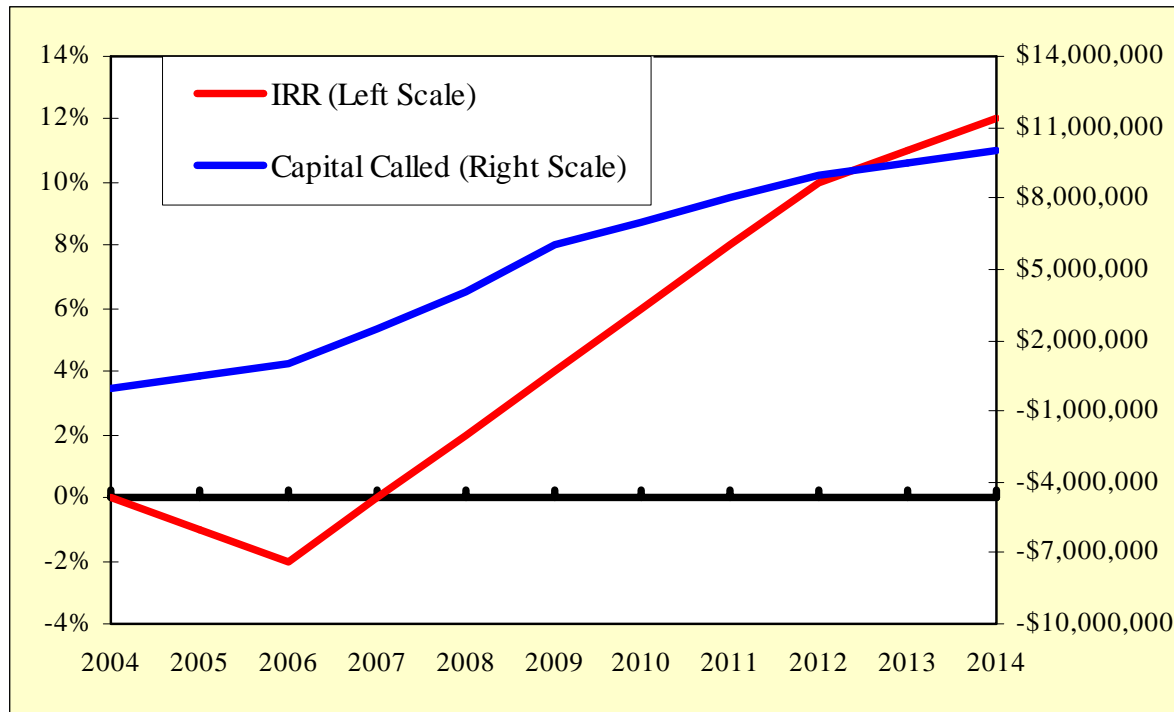
- Diversify
  - Industries
  - Strategies
  - Time
- Commitment Schedule
  - Over-commit versus \$ target
  - Forecast cash flows
  - Continually updated and adjusted



Year	Buyouts	Debt-Related	Venture Capital	Total Commitments	New Partnerships	Private Equity Target	Projected Investments
2002	\$15,000,000	\$10,000,000	\$0	\$25,000,000	2-3	\$48,000,000	\$0
2003	\$10,000,000	\$7,500,000	\$5,000,000	\$22,500,000	4-6	\$50,592,000	\$7,750,000
2004	\$10,000,000	\$3,000,000	\$5,000,000	\$18,000,000	4-6	\$53,323,968	\$20,460,000
2005	\$7,500,000	\$3,000,000	\$7,500,000	\$18,000,000	4-6	\$56,203,462	\$31,253,725
2006	\$7,500,000	\$3,000,000	\$7,500,000	\$18,000,000	4-6	\$59,238,449	\$43,835,913
2007	\$7,500,000	\$3,000,000	\$7,500,000	\$18,000,000	4-6	\$62,437,325	\$56,131,902
2008	\$7,500,000	\$3,000,000	\$7,500,000	\$18,000,000	4-6	\$65,808,941	\$65,662,577
2009	\$7,500,000	\$3,000,000	\$7,500,000	\$18,000,000	4-6	\$69,362,624	\$73,050,530
2010	\$9,000,000	\$4,000,000	\$7,000,000	\$20,000,000	4-6	\$73,108,206	\$77,282,243
2011	\$9,500,000	\$4,500,000	\$7,500,000	\$21,500,000	4-6	\$77,056,049	\$79,730,422

# Implementation “J-curve” Effect

- Diversify
  - Industries
  - Strategies
  - Time
- Commitment Schedule
  - Over-commit versus \$ target
  - Forecast cash flows
  - Continually updated and adjusted



# Current Investment Climate

- Valuation multiples rising
- Loose credit markets, cheap debt
- Fairly good public market liquidity
- Financial buyers being aggressive
- Good environment for investors who can buy right and add value
- High entry prices appear to be a significant risk to future returns

# Growth and Multiple Enhancement

## Typical Value Added Initiatives

- Organic growth and acquisitions.
- Align interests of management and investors.
- Coach and augment management teams.
- Financial controls / reporting.
- Develop / refine branding strategies.
- Optimize capital structure / prudent use of leverage.
- Manage for exit.

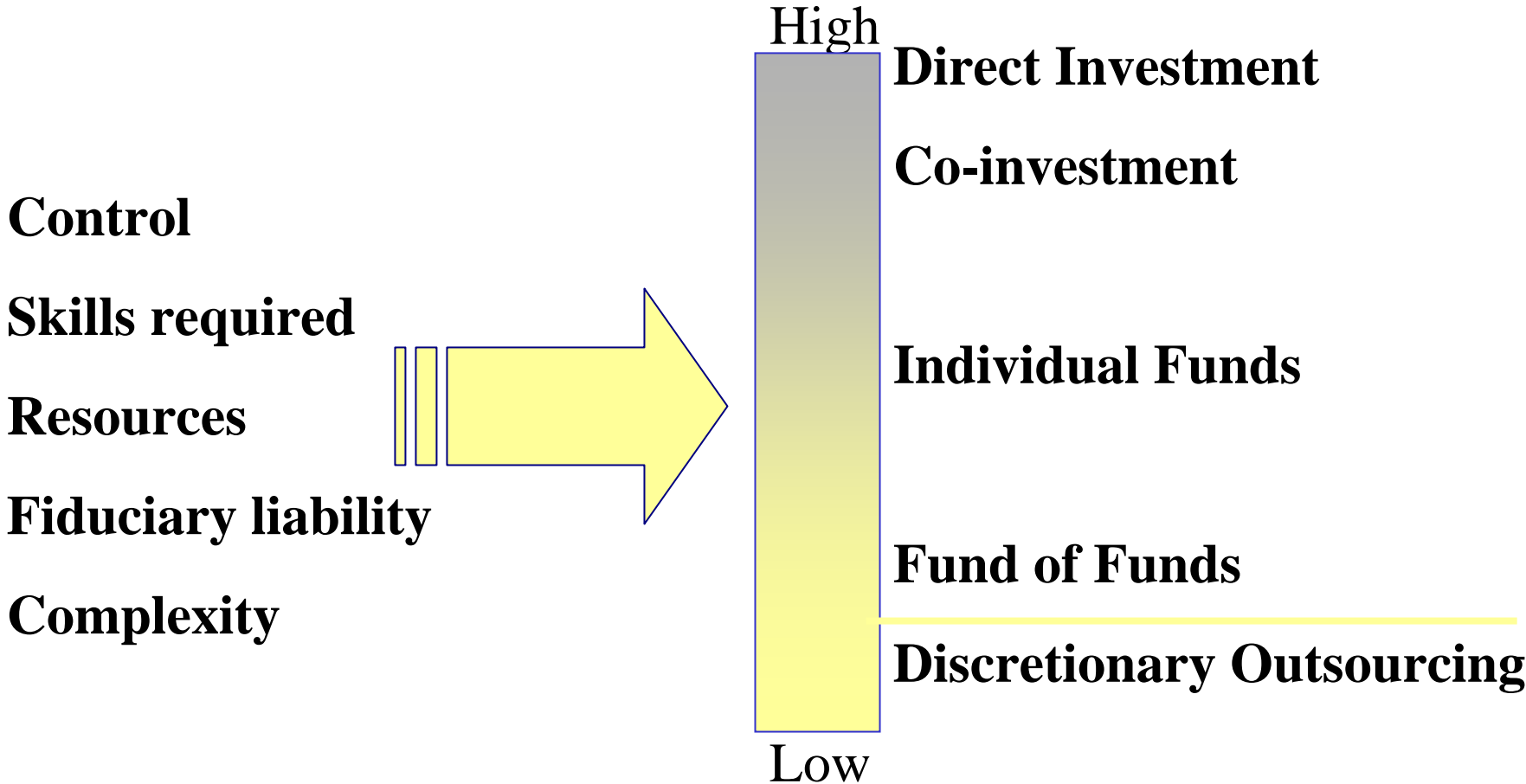
# Venture Capital

- Investment Stages
  - Seed - Concept
  - Early – Pre Revenue
  - Mid – Customers, but using cash
  - Later – Growth phase through profitability
  - Mezz – Pre IPO
- Outlook
  - Valuations mixed
  - Duration is longer since exit hurdle is higher
  - Exits via IPO difficult
  - Strategic buyers flush with cash but selective
  - Top funds very hard to access

# Secondary Investing

- Secondary – Buying an interest in an older fund from an original investor
  - Funds usually >50% invested
  - Existing portfolio can be valued
  - Many interests sell at a discount to NAV
  - Avoids some fee drag and early losses
  - Excellent entry investment for new investors
- But – you can only buy what is for sale
- Outlook
  - Wave of capital has been raised for buying secondary interests
  - Few large transactions are left
  - Discounts have been shrinking
  - Falloff in fund formation during recession may reduce opportunities
  - Seller's market for mature deals has made near-term returns very attractive
  - It is getting late in the game, but is it over?

# Implementation



# Take-Aways

- No compelling trends to pursue, so diversification is important
- Value added investment processes can drive good returns
- Long term strategy that will take 4-6 years to reach full allocation
- Manager selection is critical to a successful outcome

# Hedge Funds

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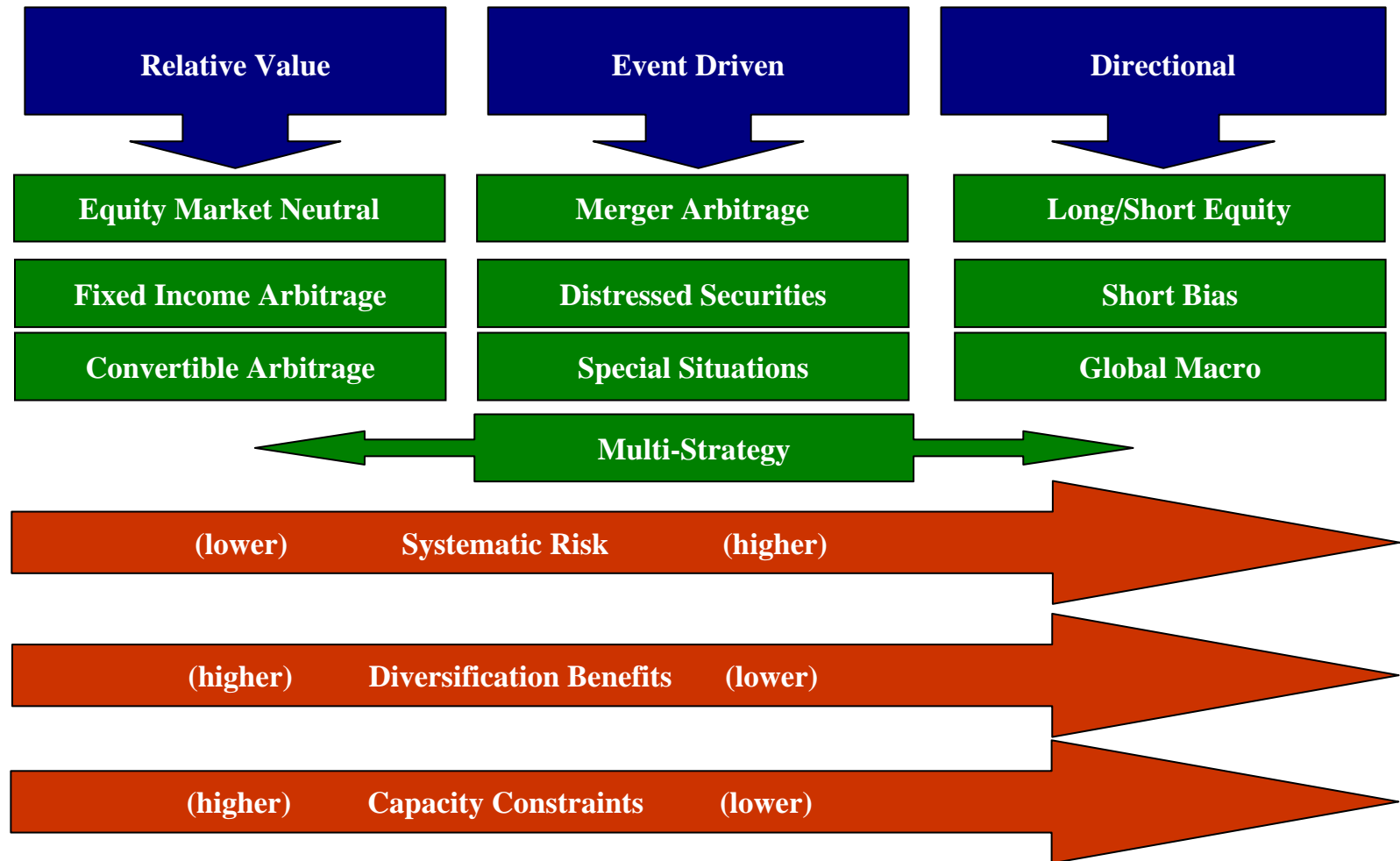
Long-Short Equity

Managed Futures

# Hedge Funds - Objective

- **Objective:**
  - Diversify opportunities for generating returns by incorporating weakly correlated, low volatility, investment strategies.
- **Recommended Approach:**
  - Assemble a portfolio of managers whose skills, strategies, and risk exposures complement each other and the traditional asset class portfolio.
  - Focus on managers whose returns are not dependent on the equity markets.
- **Expectations:**
  - Over the past ten years, the average annual return for funds of hedge funds was 8.2%.
  - Net of fees, our long-term return expectation for a *successful* fund of hedge funds program is 5.5% real or 8.0% nominal with an expected standard deviation of  $\pm 7.0\%$ .
  - We believe the *average* fund of hedge funds will generate cash-like returns for the foreseeable future. If an institution is not confident in its (or its consultant's) ability to select superior managers, hedge funds should be avoided.
  - Direct hedge fund programs are expected to exceed fund of fund returns by at least 1% annually due to substantial fee savings.

# Hedge Fund Strategy Matrix



# Strategy Classifications

The following are general characteristics of each type of hedge fund strategy, but no two managers are exactly alike and not all managers are skillful.

## **Directional Strategies**

- Relatively high exposure to systematic risk factors, such as equity market risk
- Relatively low diversification benefits
- Relatively high performance, provided that directional bet is correct, and relatively high volatility
- Less capacity constrained than other strategies

## **Event Driven Strategies**

- Investing in the events of the corporate life cycle
- In theory, these events should not be correlated with the market
- In practice, moderate exposure to equity market risk
- Area where specialized expertise and active involvement can add value
- Moderate diversification benefits

## **Relative Value Strategies**

- Investing long and short in “related” securities
- No (low) market exposure
- Direction of market is meaningless, difference in prices between securities is driver of return
- Relatively high diversification benefits and consistent performance
- Greatest capacity constraints

# Current Hedge Fund Environment

- Past performance will not be indicative of future results.
  - Systematic risk will pay less in the future.
  - New, unseasoned managers will contribute to investor disappointments.
- The single-strategy “best in class” model is outdated.
  - Increased competition for alpha will result in opportunities being priced away more quickly.
  - Ability to move capital quickly across strategies will reward investors.
- Substantial capital flows into hedge funds, unproven manager talent, and unsophisticated investors suggest caution.

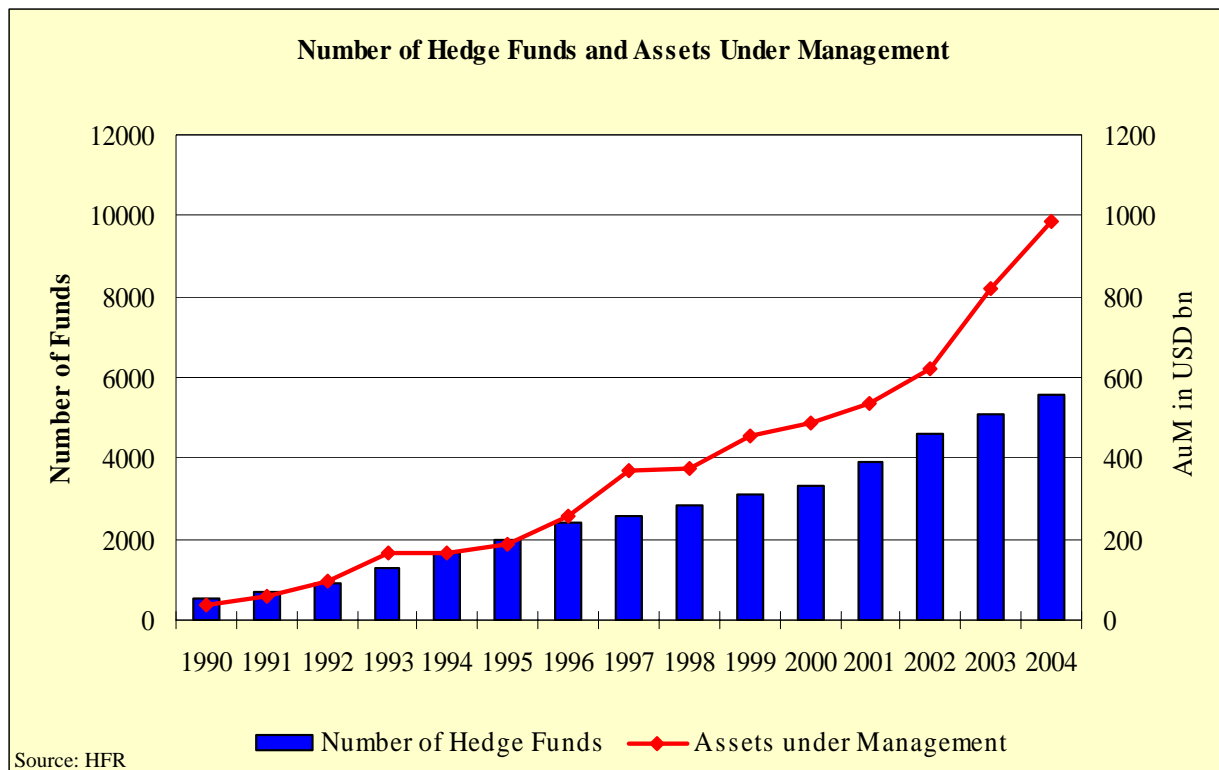
## **We Like**

- Multi-strategy managers
- Bottom-up, long/short equity managers
- Long/short credit managers
- Managers who experienced 1998
- Short credit as an opportunistic play and to hedge crisis risk

## **We Don't Like**

- Single-strategy managers in event driven or relative value categories
- New long/short managers with long-only pedigree
- Paying incentive fees for market returns
- Strategies that rely on excessive leverage for returns

# Hedge Fund Asset Flows



- Capital flows into hedge funds are a concern.
- Substantial capital chasing a finite set of opportunities and new managers wielding much of the capital suggest the average hedge fund investment experience will be disappointing.
- The challenges facing hedge funds are daunting; however, relative to the headwinds facing traditional stocks and bonds, hedge funds still have a place in a diversified institutional portfolio, in our opinion.
- We believe that superior active managers (both direct hedge fund managers and fund of hedge funds managers) will continue to add value to institutional portfolios. We also believe that we can continue to identify such managers.