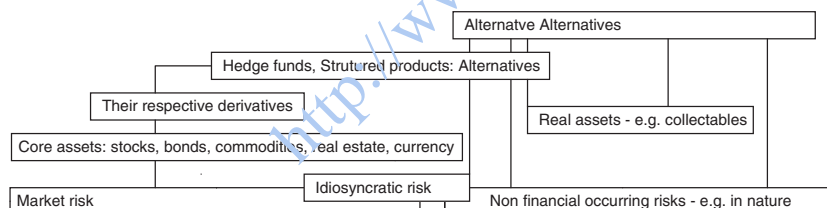


## Introduction

### What are Alternative Alternatives?

My working definition for this book has been based on unconventional, non-traditional, nonmainstream hedge fund investments and strategies whose risk profiles and return drivers are atypical, unique and/or idiosyncratic in nature.

Given that financial literature tends to define alternative investments as a negation to traditional assets or, in other words, if core asset classes include equities, bonds, real estate, commodities and currency, and if these are compounded by their respective derivatives, then alternative investments are the resulting permutations and combinations thereof – such as hedge funds, structured products, etc. If we were to take this thinking a step further, then ‘alternative alternatives’ could be considered a ‘negation’ of alternative investments.



Source: Sona Blessing

### Why Alternative Alternatives?

The *raison d'être* for alternative alternatives and my hypothesis has been:

- In theory, market risk (also referred to as systematic risk or beta) can be isolated and measured.
- By default, a risk originating outside financial and capital markets (as in nature) should not be affected by it.

- Clearly, neither the biological growth of trees nor the occurrence of natural/weather phenomenon are influenced by events playing out in financial and capital markets. Quite simply, trees will continue to grow provided they have adequate sunshine, water, air and the appropriate soil conditions.
- Natural catastrophes such as earthquakes will continue to strike without our ability to accurately time and/or predict their occurrence.
- Potentially, each of the above, if made investable can provide exposure to a specific, nonreplicable, unique risk premia that could deliver returns.

Put differently, if the source of risk (inefficiency/inefficiencies – risk premia) rests outside the domain of mainstream financial markets, then it should be insulated from the vagaries of the financial market – as it has nothing to do with this market. It is important to recognise that even though the source of risk resides outside the market, the risk is real and, if borne, so are the prospects of being compensated for it. Even so, an exposure to such risk is not immune to a performance pull-back, as its risk profile is different and its return drivers or triggers are idiosyncratic.

In practice and in the real world it is virtually impossible to get ‘exclusive’ exposure to naturally occurring sources of risk. However, exposure to such risk can be calibrated – and, if taken on, offers access to a source of partially inhomogeneous return. Similarly, research I have undertaken reveals (affirmed by the occurrence of the credit and sovereign debt crisis) that select sources of idiosyncratic risk, although not originating in nature, are equally capable of offering unique risk–return profiles, provided the risk transfer process has been structured ‘correctly’.

## **RISK ORIGINATION**

### **Naturally Occurring Sources of Risk**

#### ***The Biological Growth of Trees***

The biological growth of trees is a naturally occurring phenomenon, i.e. trees grow (they increase in size and they gain in volume) independent of and irrespective of financial markets. However, for this to function as an investment, the underlying assumption being made is that the implied price of a tree and the land it stands on are not zero. At any given point in time, the actual price being paid for a ‘tree’ (and/or the land it stands on) is still determined by the laws of demand and supply.

#### ***Natural Catastrophes***

The occurrence, or not, of a natural catastrophe such as an earthquake could determine the positive/negative payout of investing in insurance linked securities

or, in the context of weather derivatives, a one degree rise or fall in temperature could be the ‘return’ driver. Clearly neither the occurrence of an earthquake nor a shift in daily temperature is remotely influenced by events playing out in financial markets, as both originate in nature. However, investing in ‘just’ the occurrence of an earthquake or a shift in temperature is at best impossible without a financial vehicle.

For the process of extracting a return/performance from such naturally occurring sources of risk, or the wrapper/ instrument that make it an investable proposition, is unfortunately where financial, market contagion starts creeping in. An investment vehicle such as a cat bond that has exposure to, for instance, an earthquake, has, among others, a component of model risk, interest rate-related risk (LIBOR) and counterparty risk.

### **Nonnaturally Occurring but Idiosyncratic Sources of Risk**

#### ***Asset-Based Lending (ABL): ‘Secured’ Credit Risk Transfer, or Lending Money Against Collateral***

In the case of such strategies, the source of risk is not entirely isolated from and alien to financial markets as has been historically evidenced during the Great Depression. Often referred to as ‘merchant banking in a hedge fund garb’, ABL is when money is lent against a tangible asset – or cash flow generating collateral. The reference here is to private loans with no securitised secondary market.

Such ‘coupon-clipping’ (cash flow based) return streams are generated by taking on idiosyncratic risk (primarily credit). These strategies tend to hinge around the creditworthiness of a borrower (and the ‘quality’ of collateral), but clearly they are also exposed to other risks, which include, but are not confined to, pricing and valuation, duration, liquidity, legal, structure and regulatory. Such investment opportunities have included trade and commerce finance, shipbuilding and leasing, aviation and rail leasing, claims (insurance, legal, medical, hospital, etc.), infrastructure – public and private finance, entertainment finance across the entire chain (pre-budget, post-film distribution – movies, music, libraries, artists, royalties, etc.) and others such as bridge loans and syndicated loans.

#### ***Collectables***

Idiosyncratic risk, scarcity-related premia, the persistence of inefficient markets and the ability to identify, verify, evaluate, source and secure ‘sought-after’ objects are the main drivers of return. Whether or not such ‘scarcity led’, ‘emotional’ investments in real, ‘tangible’ assets, as in art, wine, stringed music instruments, vintage cars, rare coins, stamps and other collectables, are influenced by the cyclicity of financial markets continues to be debated.

For instance, ‘While auction prices for contemporary art dropped as much as 50 percent in the crisis, values of the most desirable classic modern works were little changed or rose, dealers said.’<sup>1</sup> Select art works of historical relevance have found favour because they are perceived as a ‘store’ of value, particularly when there is considerable uncertainty shrouding an economic recovery, when cratered interest rates are likely to persist and there is no opportunity cost. They can also serve as a hedge in anticipation of a hyperinflation-like scenario.

## Extraction Strategies

### *Volatility and Behaviour Finance*

Then there are strategies, e.g. volatility driven, that find their origin in the market (across asset classes such as equity, bonds, currency, real estate, commodity), but their capturable source of risk premia or performance lie in the extraction process. Irrespective of the direction in which markets move, it is the frequency and scale of those moves that strategically determine when and whether gains will be made.

Likewise, the ability to formulate strategic and tactical investment moves to generate returns that are based on interpreting and analysing scientific observations (sociological–economic–political–psychological), on why and how human beings tend to behave under various market conditions, as well as actively exploiting informational inefficiencies e.g. by trading market pricing inefficiencies to render performance.

## PECULIARITIES

The above-listed investment opportunities and strategies seem to share certain ‘alternative alternative’ characteristics:

- Nonreplicable risk or risk that cannot be replicated easily. It is difficult to replicate the actual occurrence of a natural catastrophe or the biological growth of a specific 25-year-old tree.
- Idiosyncratic. As illustrated by the following excerpt in the concept of Marine Insurance<sup>2</sup>:

In any event, disregarding shifts in income, importance in terms of premium production and market shares, ships will continue to sink, be stranded, collide and catch fire sometimes, and cargo will never cease to break, disappear, rust and get stolen. This fills our hearts with happiness, since it assures our future right to exist. There will always be marine insurance!

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<sup>1</sup> Scott Reyburn, ‘Giacometti sculpture fetches record \$103.4 million’, *Bloomberg*, 3, February 2010.

<sup>2</sup> Walter M. Mellert, *Marine Insurance – Technical Publishing Marine*, Swiss Re.

Whereas there are probably 13,765,311 brick houses owned by middle class blue-collar working families with a fire hydrant within 100 m, likelihood has it that there will only be one 35-year-old thoroughly rusted steamship, managed by a Liechtenstein managing company for Japanese interest, flying a Panamanian flag and employing an illiterate captain and an equally uneducated crew in turn entrusted with a sensitive cargo of milk chocolates to be transported from Rotterdam across the equator to Rio de Janeiro in mid-December insured against all risks of course. No doubt you will agree that this scenario represents an absolutely unique combination of individual risk factors making the risk as a whole not repeatable, at least not within a reasonable time period. The logical conclusion to be drawn from this would no doubt be that a book of marine insurance business is a collection of non-homogeneous risks, just very loosely related by the fact that somewhere along the line, there is some form of transport involved.

Statistically, this implies that correlation of data will be low, whereas fluctuations of the unpredictable kind will be high – not exactly the mathematician’s dream.

On a more down-to-earth note, it further illustrates that marine insurance is a risky business, difficult to assess and therefore requiring a high degree of experience, know-how, imagination and, last but not least, ‘gut feeling’ from its underwriters.

- Inefficiencies. Their markets tend to be inefficient and are driven by factors such as, in the context of investing in collectables, who is looking for which painting, rare wine bottle? How much are they willing to pay? Who is a distressed seller? Is it a verified ‘original’? How scarce is it?
- Heterogeneity. In the context of micro life settlements – longevity/mortality risk – each policy is unique or in the case of asset-based lending strategies, each loan needs to be evaluated and structured individually.
- Low-to-no correlation, as in the case of naturally occurring catastrophes, such as winds in Europe, and an earthquake occurrence in the US, Japan, etc.
- Such risk premia are not always apparent – they can be disguised, concealed and so need to be well understood, carefully researched and analysed differently.

## CONCLUSION

I have always held, and continue to believe, alternative alternatives will play a meaningful role in the context of an investment landscape that has and will continue to be in flux. As the quest for ‘all-weather’ performance delivering strategies intensifies, not only have alternative alternatives drawn renewed investor and manager interest but more importantly they have witnessed innovation and growth in assets under management.

Although alternative alternatives still continue to remain out of bounds and off the radar screen for some, and as an asset class is considered to be in

its infancy by others, it is only a matter of time before they are more widely embraced and implemented within portfolio and asset allocation. On the supply side there are signs of evolution, as the broader base further decomposes into isolatable, investable niches – e.g. the possibility of investing in a species such as teak in the context of timberlands, loan-based lending against fine food and wine as collateral, as also the emergence of exchange listed investment opportunities with alternative alternative strategies as underlyings (litigation led investing, in coins, etc.).

A word of caution is not entirely out of place. Some of these strategies might never assume ‘mainstream’ status; it is possible that some may remain supply constrained and, on a relative basis, may continue to be more ‘illiquid’ than their traditional asset counterparts. In addition, the underlying risk in some instances could prove to be deceptive and more complex than bargained for. To go full circle, however, I believe it is these very characteristics and inefficiencies that will enable alternative alternatives to afford diversification and offer a different risk return profile to that obtained from mainstream investments.

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