CHAPMAN
CRAIG

Alternative Investments Part 1– September 2022

Over the past 10 years, one of the most significant developments in terms of investment allocations amongst the very wealthy has been the huge growth in their allocation away from traditional products into alternative assets and strategies. However, due to practical and regulatory issues, retail investors are unlikely to be involved in investment products or strategies beyond the traditional. This is first of two posts which attempts to introduce the "Alternatives" space; but we are not recommending any particular investment approach with respect to Alternatives, nor exploring issues such as historical returns and appropriateness.

"Traditional assets" refer to publicly traded equities, bonds and cash, both in segregated form or bundled into funds that trade or offer regular (usually daily) redemption opportunities.

"***Alternatives"*** can be divided into two broad categories. First are private assets – generally any investable asset that is not a traditional asset. This includes private equity, private credit, infrastructure assets and real estate. [Private meaning issued by companies that are not publicly traded and have therefore generally not made public detailed operating and financial information.]

Second, are strategies or funds that use short selling or leverage and other strategies not normally seen in traditional funds. The entities managing these strategies are often referred to as "hedge funds".

Investment vehicles offering Alternatives tend to have the following attributes:

- are less liquid, less regulated and require a larger minimum commitment that is usually the case with traditional investments;
- the underlying assets have a return profile that is not highly-correlated with traditional assets, or
- the underlying assets are traditional assets, but the strategy generates return or risk characteristics that are different from those of traditional assets, perhaps through leverage or complex trading strategies, or
- The returns from the underlying assets are structured to provide different risk return profiles to different investor groups.

We see more non-traditional assets and strategies becoming available to retail investors, perhaps because:

i. the proportion of Alternative assets within institutional client portfolios has exploded, raising their profile and public awareness, encouraging asset managers to replicate strategies or access to asset classes for a broader pool of investors;
ii. many retail investors are wealthy, and non-traditional assets could likely serve a useful purpose in their total portfolio; and
iii. the increased use of computing power has reduced the scale required to profitably manage certain strategies.

Alternatives are often considered exotic, high-risk strategies reserved for the very wealthy, who can

afford to suffer significant losses. However, many Alternatives are designed to reduce risk and could be appropriate in many portfolios.

For example, many family offices are more concerned with preserving capital and earning a reasonable return, than with maximizing returns on that capital. They are prepared to give up some of the potential upside to generate steadier returns over time.

Private Equity

Private equity (or "PE") funds originated as funds that purchased shares of public companies for the purpose of taking the company private. This was achieved sometimes via a hostile take-over or working with existing management (often referred to as a Leveraged Buy-Out, or LBO).

PE funds tend to use significantly more debt than is typical for a public company and bring more intensive or aggressive management to the business, with the intention to increase its profitability, extract capital and one day sell (to a strategic buyer, other PE firm, or take public in an IPO).

Over time, due to perceived superior returns, PE firms have built enormous capital pools and have expanded their range of investment strategies. They have funded platform-based industry roll-ups, activist approaches, minority positions in growth companies and managing the premium pools of acquired insurance companies.

The term *private equity* could also refer to Venture Capital and Growth Capital, because these investments are made prior to a company going public. Growth Capital, is invested at later stage than is VC; typically once a start-up has established its business model and is growing revenue but wishes to remain private for longer. More than 50% of the funds deployed by PE firms in 2021 could be described as Growth Capital.

PE firms are estimated to have $3.4 trillion of committed but unallocated capital, with approximately a third of that in buy-out funds. Despite much slower capital markets year-to-date 2022, the PE firms are reportedly still raising record levels of funds, with financial advisors estimating that the ultra-wealthy Family Offices continuing to increase their over-all asset allocations to PE.

Private Credit

Historically, large companies could borrow by selling bonds to institutional investors or borrowing from banks. Over time, adjacent lending markets have developed to exploit opportunities around these two main pillars.

After the 2008 financial crisis, Regulators raised the cost of risk taken on by banks through higher regulatory capital and buffers and new reporting standards. This caused banks to pull back from some credit markets tending to push costs higher in those markets.

The higher returns on offer drove capital into the private credit space. Credit funds, some sponsored by existing PE firms, raised billions to make available to companies that could not easily access the senior lending bank market or public bond markets – due primarily to size but perhaps a combination of size and credit quality.

The rationale for this enlarged private credit market is that:

i. Diversifying a total portfolio, especially those heavy to equities and investment grade debt;
ii. With bank lending cut back, there were more opportunities to lend to borrowers with adequate credit quality than was previously the case;
iii. Central bank liquidity expansion had materially reduced yields on conventional investment grade bonds to the level that return expectations at many institutions could not be achieved, whereas the private credit market offered returns above 6% without unreasonable risk;

iv. Leveraged lending (like all bank lending) is typically floating rate, which appeals to many investors; and
v. As a market perceived as local, illiquid and perhaps inefficient (e.g., lack of credit ratings and publicly-available financial information), the narrative developed that returns relative to risk taken could be attractive across the business cycle.

Contact Us:

ChapmanCraig Limited
2507 Tower Two, Lippo Center, 89 Queensway Road, Hong Kong
www.ChapmanCraig.com T: 852 2521 7218 E: Info@ChapmanCraig.com

ChapmanCraig Limited is licensed by Hong Kong's Securities and Futures Commission to advise on securities and manage investment assets. We are not licensed to provide legal advice. The materials included above are intended to be descriptive and are not intended to be advice or the basis upon which any individual makes investment or other financial decisions. If you believe that you could be impacted by anything described herein, you may want to contact appropriately trained professional advisors to discuss your particular circumstances.