STUDY SESSION 13
ALTERNATIVE INVESTMENTS FOR PORTFOLIO MANAGEMENT

Alternative investments comprise groups of investments with risk and return characteristics that differ markedly from those of traditional stock and bond investments. Common features of alternative investments include:

1. relative illiquidity, which tends to be associated with a return premium as compensation;
2. diversifying potential relative to a portfolio of stocks and bonds;
3. high due diligence costs; and
4. performance appraisal that is unusually difficult, as a result of the complexity of establishing valid benchmarks.

Many institutional and high-net-worth individuals make portfolio allocations to alternative investments that are comparable in size to those they make to the traditional asset classes of stocks and bonds. In doing so, such investors may be seeking risk diversification and/or greater opportunities to apply active management skills and capture alpha. Portfolio managers who take advantage of the opportunities presented by alternative investments may have a substantial advantage over those who do not.

The first reading presents an overview of the investment classes generally considered as alternative investments. The balance of the study session examines the role of swaps, forwards, and futures in managing certain alternative investments.

READING ASSIGNMENTS

Reading 36 Alternative Investments Portfolio Management
Managing Investment Portfolios: A Dynamic Process, Third Edition, John L. Maginn, CFA, Donald L. Tuttle, CFA, Jerald E. Pinto, CFA, and Dennis W. McLeavey, CFA, editors

Reading 37 Swaps
Derivatives Markets, Second Edition, by Robert L. McDonald

Reading 38 Commodity Forwards and Futures
Derivatives Markets, Second Edition, by Robert L. McDonald

LEARNING OUTCOMES

Reading 36: Alternative Investments Portfolio Management

The candidate should be able to:

a. characterize the common features of alternative investments and their markets and discuss how they may be grouped by the role they typically play in a portfolio;

b. explain and justify the major due diligence checkpoints involved in selecting active managers of alternative investments;

c. explain the special issues that alternative investments raise for investment advisers of private wealth clients;

d. distinguish among the principal classes of alternative investments, including real estate, private equity, commodity investments, hedge funds, managed futures, buyout funds, infrastructure funds, and distressed securities;

e. discuss the construction and interpretation of benchmarks and the problem of benchmark bias in alternative investment groups;

f. evaluate and justify the return enhancement and/or risk diversification effects of adding an alternative investment to a reference portfolio (for example, a portfolio invested solely in common equity and bonds);

g. evaluate the advantages and disadvantages of direct equity investments in real estate;

h. discuss the major issuers and buyers of venture capital, the stages through which private companies pass (seed stage through exit), the characteristic sources of financing at each stage, and the purpose of such financing;

i. compare and contrast venture capital funds with buyout funds;

j. discuss the use of convertible preferred stock in direct venture capital investment;

k. explain the typical structure of a private equity fund, including the compensation to the fund's sponsor (general partner) and typical timelines;

l. discuss the issues that must be addressed in formulating a private equity investment strategy;

m. compare and contrast indirect and direct commodity investment;

n. explain the three components of return for a commodity futures contract and the effect that an upward- or downward-sloping term structure of futures prices will have on roll yield;

o. discuss the relationship between commodities and inflation and explain why some commodity classes may provide a better hedge against inflation than others;

p. identify and explain the style classification of a hedge fund, given a description of its investment strategy;

q. discuss the typical structure of a hedge fund, including the fee structure, and explain the rationale for high-water mark provisions;

r. explain the purpose and special characteristics of fund-of-funds hedge funds;

s. critique the conventions and special issues involved in hedge fund performance evaluation, including the use of hedge fund indices and the Sharpe ratio;

t. explain the market opportunities that may be exploited to earn excess returns in derivative markets that are otherwise zero-sum games;

u. discuss the sources of distressed securities and explain the major strategies for investing in them;

v. explain the importance of event risk, market liquidity risk, market risk, and "J-factor risk" for distressed securities investors.

Reading 37: Swaps

The candidate should be able to evaluate hedging strategies that rely on swaps and illustrate their inherent risk exposures.

Reading 38: Commodity Forwards and Futures

The candidate should be able to:

a. discuss the unique pricing factors for commodity forwards and futures, including storability, storage costs, production, and demand, and explain their influence on lease rates and the forward curve;

b. identify and explain the arbitrage situations that result from the convenience yield of a commodity and from commodity spreads across related commodities;

c. compare and contrast the basis risk of commodity futures with that of financial futures.