

STUDY SESSION 18

ALTERNATIVE INVESTMENTS

Due to diversification benefits and higher expectations of investment returns, investors are increasingly turning to alternative investments. This study session describes the common types of alternative investments, methods for their valuation, unique risks and opportunities associated with them, and the relation between alternative investments and traditional investments.

Although finding a single definition of an “alternative” investment is difficult, certain features (e.g., limited liquidity, infrequent valuations, and unique legal structures) are typically associated with alternative investments. This study session discusses these features and how to evaluate their impact on expected returns and investment decisions in more detail. The reading provides an overview of the major categories of alternative investments, including real estate, private equity, venture capital, hedge funds, closely held companies, distressed securities, and commodities.

Each one of these categories has several unique characteristics, and the readings discuss valuation methods for illiquid assets (such as direct real estate or closely held companies), performance measures for private equity and venture capital investments, differences between various hedge fund strategies, and implementation vehicles for investments in alternative assets.

READING ASSIGNMENTS

- Reading 73** [Alternative Investments](#)
Global Investments, Sixth Edition, by Bruno Solnik and Dennis McLeavey, CFA
- Reading 74** [Investing in Commodities](#)
Global Perspectives on Investment Management: Learning from the Leaders, edited by Rodney N. Sullivan, CFA

LEARNING OUTCOMES

Reading 73: Alternative Investments

The candidate should be able to:

- a. differentiate between an open-end and a closed-end fund, and explain how net asset value of a fund is calculated and the nature of fees charged by investment companies;
- b. distinguish among style, sector, index, global, and stable value strategies in equity investment and among exchange traded funds (ETFs), traditional mutual funds, and closed end funds;
- c. explain the advantages and risks of ETFs;
- d. describe the forms of real estate investment and explain their characteristics as an investable asset class;
- e. describe the various approaches to the valuation of real estate;
- f. calculate the net operating income (NOI) from a real estate investment, the value of a property using the sales comparison and income approaches, and the after-tax cash flows, net present value, and yield of a real estate investment;
- g. explain the stages in venture capital investing, venture capital investment characteristics, and challenges to venture capital valuation and performance measurement;
- h. calculate the net present value (NPV) of a venture capital project, given the project's possible payoff and conditional failure probabilities;
- i. discuss the descriptive accuracy of the term "hedge fund," define hedge fund in terms of objectives, legal structure, and fee structure, and describe the various classifications of hedge funds;
- j. explain the benefits and drawbacks to fund of funds investing;
- k. discuss the leverage and unique risks of hedge funds;
- l. discuss the performance of hedge funds, the biases present in hedge fund performance measurement, and explain the effect of survivorship bias on the reported return and risk measures for a hedge fund database;
- m. explain how the legal environment affects the valuation of closely held companies;
- n. describe alternative valuation methods for closely held companies and distinguish among the bases for the discounts and premiums for these companies;
- o. discuss distressed securities investing and compare venture capital investing with distressed securities investing;
- p. discuss the role of commodities as a vehicle for investing in production and consumption;
- q. explain the motivation for investing in commodities, commodities derivatives, and commodity-linked securities;
- r. discuss the sources of return on a collateralized commodity futures position.

Reading 74: Investing in Commodities

The candidate should be able to:

- a. explain the relationship between spot prices and expected future prices in terms of contango and backwardation;

- b.** describe the sources of return and risk for a commodity investment and the effect on a portfolio of adding a long-term commodity class;
- c.** explain why even a commodity index strategy should be considered an active investment.