Behavioral and Personal Finance
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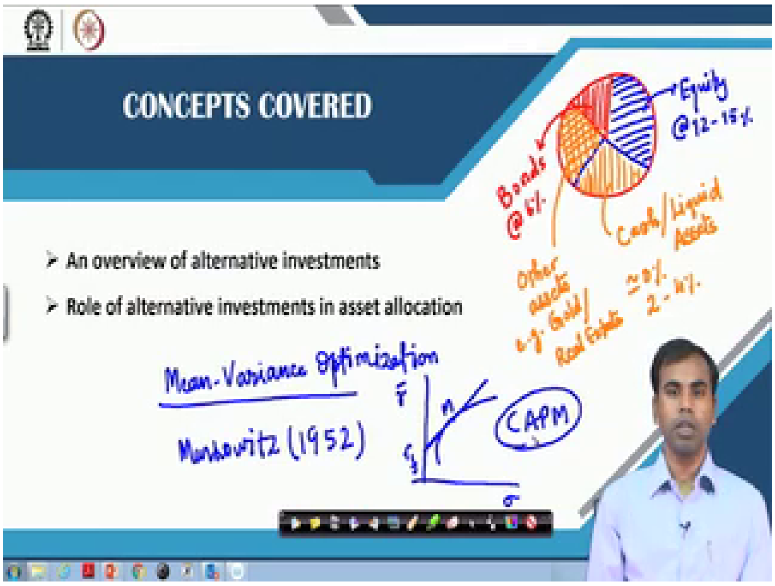
Module – 02
Personal Finance
Lecture – 38
Alternative Investment

Hi there, welcome back to the course Behavioral and Personal Finance. In this week, we will learn about Alternative Investment and related portfolio strategies. I am sure you must have heard of several a new asset classes that have emerged over the recent years, because of the advent of technology.

Well, one of the new asset classes that has been in limelight in recent past is cryptocurrencies. Have you heard of Bitcoins or any other cryptocurrencies? These cryptocurrencies have emerged as new asset classes, where people would like to invest their money and obtain substantially high return in short period of time.

There are several new asset classes that have emerged recently; including private equity, venture capital, even the traditional asset classes or the medium of exchange in past that is commodities, have also come up as new asset classes that people would like to invest in.

This week we will learn about these asset classes and related characteristics and how we can use these asset classes in our portfolios. (Refer Slide Time: 01:36)



This session basically focuses on two concepts the basic idea of alternative investment and how these alternative investment can serve as the asset allocation strategies over and above the traditional asset classes. First of all, we would like to know why these new asset classes have to be understood well before you actually incorporate in the portfolios that you would like to hold.

Typically, we have learnt that the asset allocation strategies are done on the basis of optimizing risk and return. Well, when we me when we talk about asset allocation, we basically mean the amount of money distributed across different asset choices that you have, and the money that you have kept aside for investment.

So essentially, asset allocation implies that if you have 100 rupees of money and you want to invest let us say certain amount of money in one asset class and remaining amount of money in other asset class ; basically, it is kind of a pie chart, where suppose this portion of your money has been invested in bonds.

Let us say, you want to keep it aside; so, bonds that gives you 6 percent of return. And then, you would like to invest some part of money in equities. So this is your equity investment that might give a return anywhere suppose 12 to 15 percent.

And then, you would like to hold a some amount of money in cash. So, this is your liquid asset. So, let us call it cash or liquid asset. That has almost nil return or somewhere maybe in certain cases you earn 2 to 4 percent of return on these assets also. And then, you have certain assets in terms of money that you have put aside in.

So, this is your investment in some other asset class. Let us say gold or real estate and so on. So, when we talk about asset allocation, we essentially mean this kind of portfolio that you are holding.

So, if you have certain amount of money you can keep some amount of money in cash, some amount of money be invested in equities, some amount of money invested in bonds and remaining money can be invested in other asset class classes such as gold or other precious metals, real estate or any other assets that you want to hold as your portfolio investment.

Now, the allocation of this asset portfolio; where you have multiple assets, can be done on the basis of a traditional method that we have already learned earlier; where, we know that there is one method called mean variance optimization, where we try to optimize the risk and return associated with portfolios. And then we try to find a suitable weight which can give us some appropriate or optimal return on our investment. And if you have you are able to recall, we had discussed earlier when we tried to learn about capital asset pricing model.

We know that if this is how the risky portfolio frontier looks like, if we include a risk-free asset you have some point called the tangent point that is a market portfolio. And this is your risk-free rate of return and, you can hold any portfolio that will be lying across this line. And you can make optimal allocation of assets based on this mean variance optimization given by Markowitz.

So, if you remember we had discussed this approach in detail. And we try to find a method known as CAPM which is capital asset pricing model that gives us the expected rate of return for any asset given certain risk-free rate and the return on market asset; and the beta that we try to understand with the help of optimization of risk and return.

Now so far, these approaches and methods can be applied directly and with much ease to the traditional investments or traditional avenues of investments. Such as equities, bonds and other related assets. But when it comes to alternative investments, or the new asset classes such as real estate, commodities, cryptocurrencies, private equity, venture capital and other similar asset classes that have emerged because of the new technology and new areas of investment, we try to understand how this traditional mean variance optimization to form asset allocation can be modified with the help of new asset classes to generate higher returns. Remember, the ultimate objective of any individual any investor would be or to earn more than a normal return, which is basically outperform the benchmark and earn substantially higher return than the benchmark return.

With this objective, we try to learn more about alternative investment as investment strategy and how these alternative investment avenues can be allocated in our portfolios.

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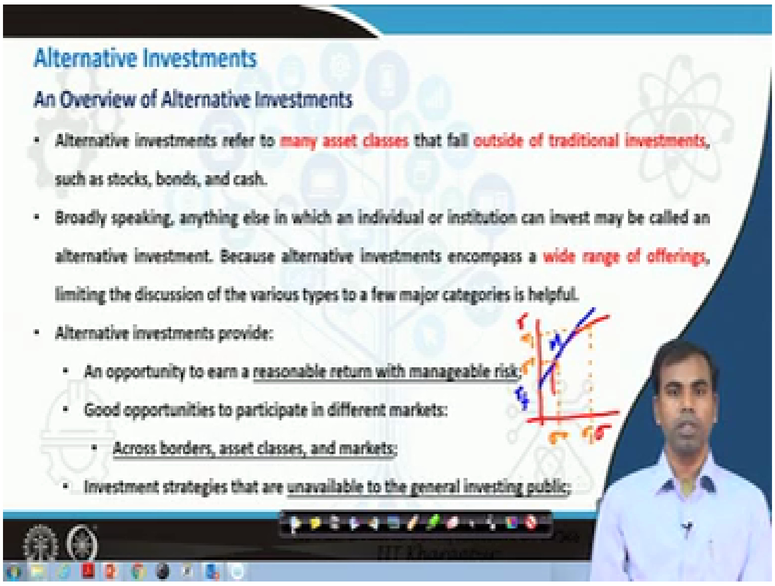

So to start with, alternative investments can be defined as the new asset classes that fall outside of traditional investment such as stocks, bonds and cash. Well, here we highlight new asset classes or many emerging asset classes including private equity, venture capital, real estate commodities and so on. Because, they fall outside the purview of traditional asset classes such as equities, which are basically investment in shares, bonds which are fixed income investments and cash; which are basically no return or almost nil return investment.

So, when we talk about alternative investment anything else in which an individual or institution can invest may be called an alternative investment. Because, alternative investment represents or rather it includes a wide range of offerings. But, limit the discussion is limited to the various type of major categories that can be used as investment avenue by the investors. The basic characteristic of alternative investment is they provide an opportunity to earn a reasonable return with a manageable risk. Because, remember the ultimate objective of any investor is to earn highest possible return with a lowest possible risk; or at least, highest possible return for a given level of risk.

So, even if you try to contextualize this with the traditional approach of asset allocation, which is mean variance optimization. And subsequently, we derive the capital asset pricing model. We know that, an investor can earn the highest possible return for a given level of risk in such a way that can be derived like this.

So, if you have a 2 frontier portfolio case where you have risk and you have return. You know that, there will be a risky asset frontier. And then you have a risk-free asset which tan which is tangent from tangent with your risky frontier.

So this portfolio will give you a frontier where you can invest at any point of time in along with this particular curve. So suppose, you want to invest here which gives you this much amount of risk and this much amount of return. So you know that for any given level of return, you have to carry this much amount of risk.

Now similarly, if you have an objective to achieve certain level of risk, you know that you cannot bear more than that that much of risk. You can figure out how much return you are going to get. So for example, suppose this is the maximum level of return risk you can bear. So, for this level of risk you know that this is the return that you are going to get.

So, this is why alternative investment also fulfills this objective of earning a reasonable rate of return; or rather reasonable rate of high return at a manageable risk level for an investor. Alternative investment also provides a good opportunity to participate in different markets.

Because, with the help of alternative investments, you cannot only diversify your portfolio across markets, you can also diversify your portfolio across asset classes and in fact, across different countries as well. So, here what it provides you with is, you can invest in assets which have exposure to markets other than your home market.

For example, if you are sitting in India, you can invest in assets as alternative investment that have exposure to foreign countries or foreign economies. For example, if you invest in Bitcoin, you know that Bitcoins are affected or the prices of Bitcoin are influenced by several factors across globe. So, you are actually taking an exposure that have influence or relevance across the border.

Similarly, if you invest in alternative investment such as let us say, real estate or private equity. You have an option to diversify your portfolio across assets and you can not only invest in equity market, but also invest at the same time in private equity or private debt. Or similarly, you can also invest in let us say distressed equity or any other asset class that you would like to hold your investment in.

And finally, the alternative investment approaches provide you strategies or investment methods that can be made available only to exclusive set of investors. And it is not the set of assets or it is not typically available for general investing public as is the case with stock, bond and other investment traditional investment avenues.

So, here alternative investment provides you an opportunity that are very exclusive and you can invest and take advantage of that particular opportunity.

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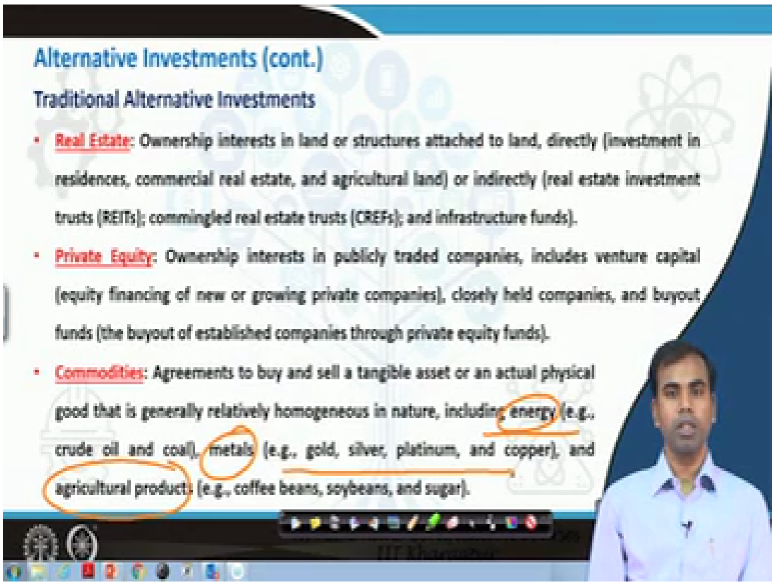

Now, let us discuss a bit about different types of alternative investments. So, these are categorized into 2 broad themes; traditional alternative investments and modern alternative investment. So, traditional alternative investments are basically Real Estate, Private Equity and Commodities.

So, when we talk about real estate as an investment avenue; basically, it is the ownership interest in land or structured build attached to the land. It could be direct ownership or indirect ownership. So, when we talk about direct ownership in Real Estate, it is basically investment in residences, commercial real estate properties and agricultural land.

It could be industrial it could be other type of land or properties built on land. And if it is about indirect holding or indirect ownership in real estate, basically it includes REITs which are real estate investment trusts.

These are investment channels or investment avenues which expose which are exposed to real estate properties and real estate companies. But they are managed as separate trusts just like mutual fund. Indirect ownership in real estate could also be a real estate trust or infrastructure fund such as, funds or mutual funds which have investment in companies, which are involved in infrastructure development. So basically, the idea of having real estate as an alternative investment is to take an exposure for your investment towards real estate or related companies. And it could be direct or indirect ownership.

Second type of traditional alternative investment is Private Equity. Basically, private equity is the class of investment that has ownership interest in publicly traded companies. It also includes venture capital firms. So, venture capital by definition are equity financing or of new or growing companies which are privately held. It could be closely held companies as well and buyout funds.

So, the buyout funds of established companies through private equity fund is also possible to be held as alternative investment. So when we talk about private equity, we essentially mean that you hold some amount of ownership in a publicly traded company or privately held company or companies that have ownership stake or that has some investment as buyout funds.

These are basically more popular because smaller companies or companies which I have not gone public yet; can raise funds through private equity, and they are considered to be more riskier, of course. But at the same time, there is a very high scope for earning substantial amount of return in such investment.

Third type of traditional investment in alternative class is Commodities. Although, commodities are traditionally used as investment and a medium of exchange since the evolution of human civilization. But, in modern context commodities as an alternative investment are basically the agreements to buy or sell a tangible asset or an actual physical good that is generally or relatively homogeneous in nature.

Basically, it includes 3 types of commodities or 3 categories of commodities. It could be energy-related commodities such as coal or crude oil, even electricity or power. It could be metal related commodities such as gold, silver, aluminum, platinum, copper any other such commodity metals. And third category is agriculture product related commodities; such as coffee beans, wheat, soya bean and sugar. These are just in not exhaustive list.

They these are just indicative to different examples of 3 type of commodities energy, metals and agricultural product of agricultural commodities. So basically, if you want to hold investment directly or indirectly in commodities, you can either directly hold in terms of buy or sell-off tangible asset or physical goods such as energy, metals or agricultural product.

An alternative way to hold commodity investment is to invest in commodity related funds because of free. In recent times, we have seen that there are funds which have investment exposure in energy as a as an investment class. They also hold precious metals such as gold, silver, platinum, copper and they also have some investment in agricultural product ; in order to help the companies involved in agricultural produce to manage their risk.

So, these 3 examples are for traditional alternative investment.

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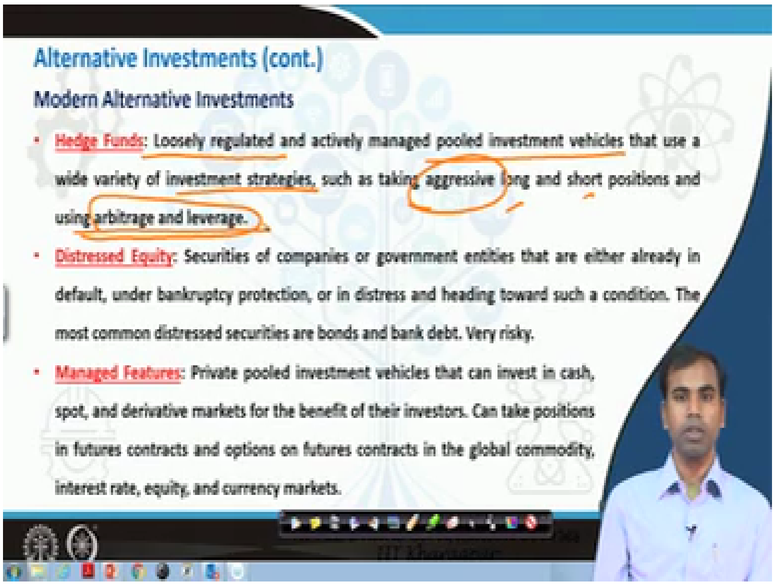

Now, let us move on to modern alternative investment. So, modern alternative investment also consists of 3 broad examples. Basically, these are hedge funds. So, hedge funds are loosely defined as the investment funds that are regulated to little less rigorously. And, they are actively managed by expert financial managers and they collate or compile pooled investment from a different type of investors or different investor categories, as a special vehicle that uses a wide variety of investment strategies. And these strategies include aggressive long or short positions and using arbitrage and leverages.

So, if you talk about hedge fund in little more details, there are certain characteristic or unique features of hedge funds. And first unique feature is they have very loose regulation. In most of the markets, hedge funds are less stringently regulated than a typical mutual fund or any other investment fund.

Just like any other fund it has pooled investments collected from different investors. And then they can take strategies which are very aggressive typically, and they uses arbitrage and leverage. So, these are some important characteristic of hedge funds. So, when we invest in hedge funds we rely on the expertise of hedge fund managers who can take aggressive positions both long and short. So, when we talk about long and short position, which means they can either buy into such assets or such investments or they can take a position of short-selling or holding that is not the in their own hands.

As investment strategy their focus is always on arbitrage and leverage. Because, arbitrage gives an them an opportunity to earn more than normal or more than the market return always. And leverage basically gives them an advantage of using money that have been borrowed from different sources and use that money to invest in assets which are going to give them higher rate of return [noise].

Second class of modern alternative investment is, distressed equity. So by definition, distressed equity includes securities of companies or government entities that are either already in default or under bankruptcy product protection or in distress and heading towards such a condition.

So, basically these are companies or entities that have been defunct or bankrupt or they are almost on the verge of bankruptcy. So, the idea of any investment manager or investor to invest in such asset, such as, distressed equity is to make sure that the asset is worth taking up and the investment that they are going to make might be used for reviving the company and earning some amount of return, that is substantially higher than the traditional investment returns.

The most common feature or the most common approach of distressed securities are bonds and bank debt. They are obviously, very risky because you are investing in almost dead investment or dead assets, which might not revive. So, if you are investing in distressed equity you typically rely on the management skill and the potential of the manager or investment managers.

To be precise, in in order to revive that companies or at least get some return or earn some return from that investment in distressed equity.

Many times, it might happen that Fund Managers or those who are investing in distressed equity, they secure some expertise from outside; their fund, and use that management expertise to revise that company or entities, so that they can generate substantially high return for their investors.

An alternative approach could be; they buy-out into such distressed equity or entities which are almost bankrupt or bankrupt already. And then they try to sell out whatever assets that particular entity or company has. And then, the return is generated sufficiently to gives exposure to the investors that they have a collector compiled on.

Third example of alternative modern alternative investment is, managed features. So basically, these are assets or these are investments which fall into a category that includes privately pooled investment. They basically invest in cash or a spot or derivative market for the benefit of their investors. They can take short or long position in future contracts; and options in future contract in the global commodities, interest rate derivatives, equity and other currency market.

So basically, when we intend to invest in managed features we want to invest in assets; which has exposure to derivative market largely. And that derivative market exposure could be related to commodities or interest rate derivatives, equity derivatives or even currency derivatives.

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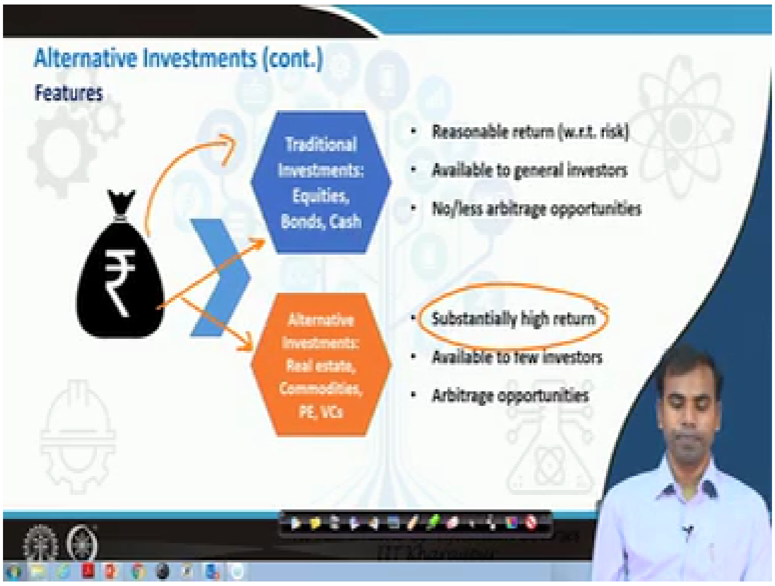

So, these are 3 broad examples of modern alternative investment. Having understood the traditional and modern alternative investment, basically, we want to know what more characteristics can be understood in terms of the features or attributes of alternative investments. So that, we can consider this as a potential tool to invest our money in.

So, the idea here is you have some amount of money to be invested in, and you have a choice to invest your all your money in traditional investment; such as equities, bonds and cash. Or you have a choice to invest part of your money in traditional assets and remaining money in alternative investments such as real estate, commodities, private equity, venture capital and so on.

Most of us have some investment exposure to real estate in one way or the other. If we have some investment in a real estate in the form of let us say second home or any other house, land or building or any other house properties. It could be considered as part of investment portfolio.

So, yes we do have some alternative investment already in our portfolio. The reason or the characteristic of these 2 separate categories of investment are the difference between the return that typical alternative investment holds or generates.

So if you know, typically alternative investment generates substantially high return because, they are highly risky as well. So, suppose you invest in land or house property 20 years ago at a very reasonable price, today that property has become worth multiple times your investment, because of several other social, economic and political factors. So, you have a choice or you have a score for earning substantially high return.

Another feature is, it is also available to very specific set of investors. Not everyone can invest in all alternative investment avenues. For several reason, including the amount of money that is required to invest including the regulations and even information asymmetry. Because, not all investing public might be knowing about the opportunities to invest in alternate investment fund.

And then there are arbitrage opportunities that are available to investors of alternative investment fund. So, these are 3 categories or 3 features basically. Because of which alternative investment funds are more attractive to general investment public. And this is why people should typically include alternative investment opportunities as part of their traditional portfolio so that they can outperform the market and most of the other investing public. In this session this is it.

Thank you very much.