LifeMagazine

Alternatives flood into the main stream

Interest rates have slipped below zero and stocks are considered expensive. Where to turn for profits? To alternative investments, more and more investors seem to be thinking.

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Stocks and bonds. They are the main ingredients of a classic investment portfolio. There is also some cash there, waiting for the suitable investment.

In recent years, a third asset class has risen to the level of stocks and bonds: alternative investments, or alts, as they are called for short. Large institutional investors already have a heavy weighting in their portfolios and around half of the largest US funds have had alts allocation for years.

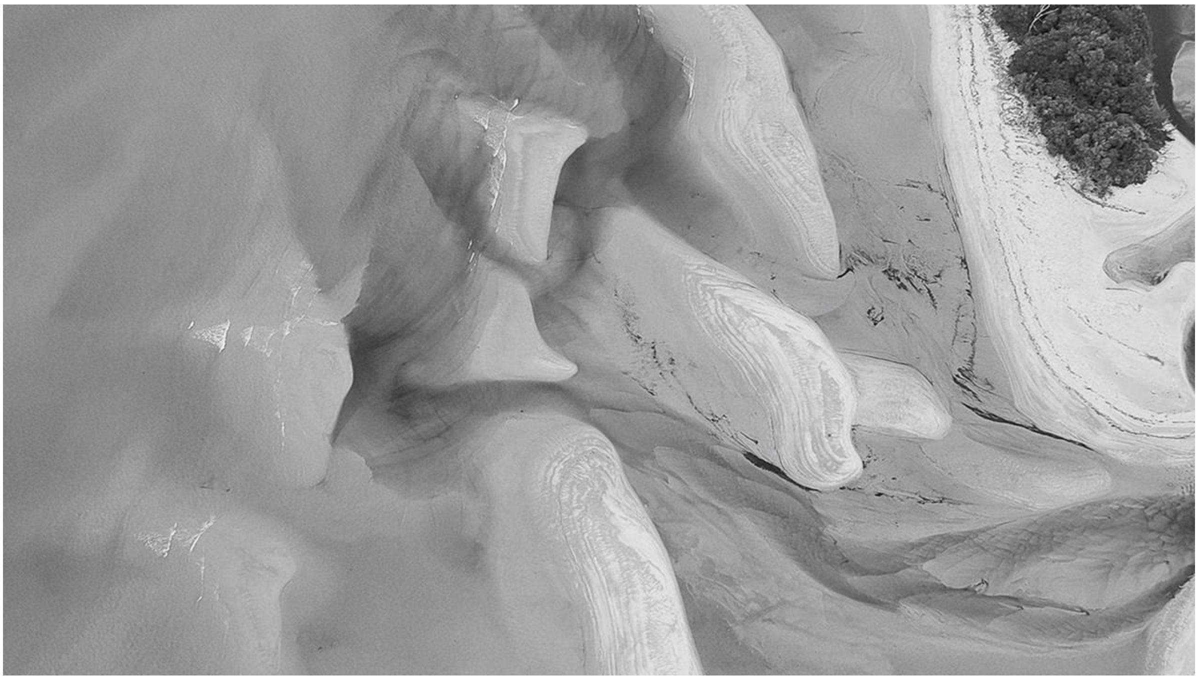
In the portfolios of Finnish institutions, alternatives are starting to become mainstream. For example, in the Church Pension Fund portfolio, their weight is 27 percent. The pension fund started investing in real estate about 20 years ago.

“Ten years ago the share of alternatives was 12 per cent. We always define our investment strategy for the 4 years ahead. We’re doing it again this autumn, and I think the share of alternatives will become larger again”, investment director Ira van der Pals predicts.

Most of the Finnish institutions have similar views.

“Stocks–bonds–alternatives, such a balanced tripod” is how van der Pals sums up her portfolio.

One could almost call it a new paradigm in investment circles: previously small amounts of alternatives were sprinkled like spices into the portfolios but now they’ve become one of the main ingredients. The taste of the investors has certainly evolved.



REAL ESTATE, CORPORATE LOAN, PRIVATE EQUITY, RAW MATERIALS, infrastructure, forest, works of art and a bottle of wine. They are all alternatives.

It is difficult to pinpoint alternative investments because of their wide variety, and the terminology has not yet established itself, especially among retail investors.

Alternatives themselves may be old and well-known instruments, what is new is the popularity they are gaining and the phenomenon that they are classified so clearly as an asset class of their own. For example, from the perspective of a Finnish investor, there is nothing “alternative” in investing in real estate nor forests: they have always been used as investment options. For someone who has grown up in Finland, a country known for its’ forests and forestry, it’s even slightly amusing to read how forests are mentioned as the new and trendy investment alternative in an international business journal.

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However, the reason forests are gaining popularity, is different from the traditional Finnish forest investing: globally forests are seen as a good investment because they are a scarce commodity. Thus their price will go up. Also, the key role it plays in the fight against climate change is also making it a more attractive investment.

Still, both real estate and forests can be defined as alternative investments due to their illiquidity. That is the very thing that sets them apart from stocks and bonds: you can’t sell alternatives by clicking on your computer just like that. You might have to wait to find a buyer or the profitability of the investments develops during a longer time period: forests have to grow from fragile seedlings to long fiber pulp, and real estate investment are based on years of rental income.

As alternative investments are illiquid, the investor can gain a liquidity premium. This means that in order to attract investors, the expected profit thus has to be bigger than in investment products that have the same risk but are more liquid. For example, if you invest in private equity, you expect a bigger profit than if you would invest in the public stock market. That is because you can’t sell you private equity investment whenever you feel inclined. Instead it’s typically sold after the company has been transformed which can take years.

Van der Pals describes alternative investing as a slow process. First you decide on allocation, then you begin to search for the right investments. When you find them, you keep them for a long time. The pension fund of the Evangelical Lutheran Church of Finland began its’ alternative investing with real estate but has since also invested in private equity funds, infrastructure and forests.

“We have time to wait and see and thus gain from the liquidity premium. It can be quite a calm process.” Which sounds nice and peaceful compared with the constant action of stock and bond markets.

INVESTMENT INSTRUMENTS ARE ALWAYS BORN FROM SOME KIND OF DEMAND and they have tight connections to society around them.

“They are the children of their times. The supply and demand appear from somewhere, be it the change in regulation or a new inefficiency being discovered that alternatives can take advantage of. This current boom of alternatives has been created by strong growth in demand. When the interest rates are close to zero and stocks are highly valued, investors find it difficult to figure out where to put their money. Alternatives are a solution to this problem”, says **Matti Suominen,** professor of finance from the Finnish Aalto University.

The alternative of this particular time and financial landscape is private debt. Van der Pals’ church pension fund began systematically to invest in private debt in 2016.

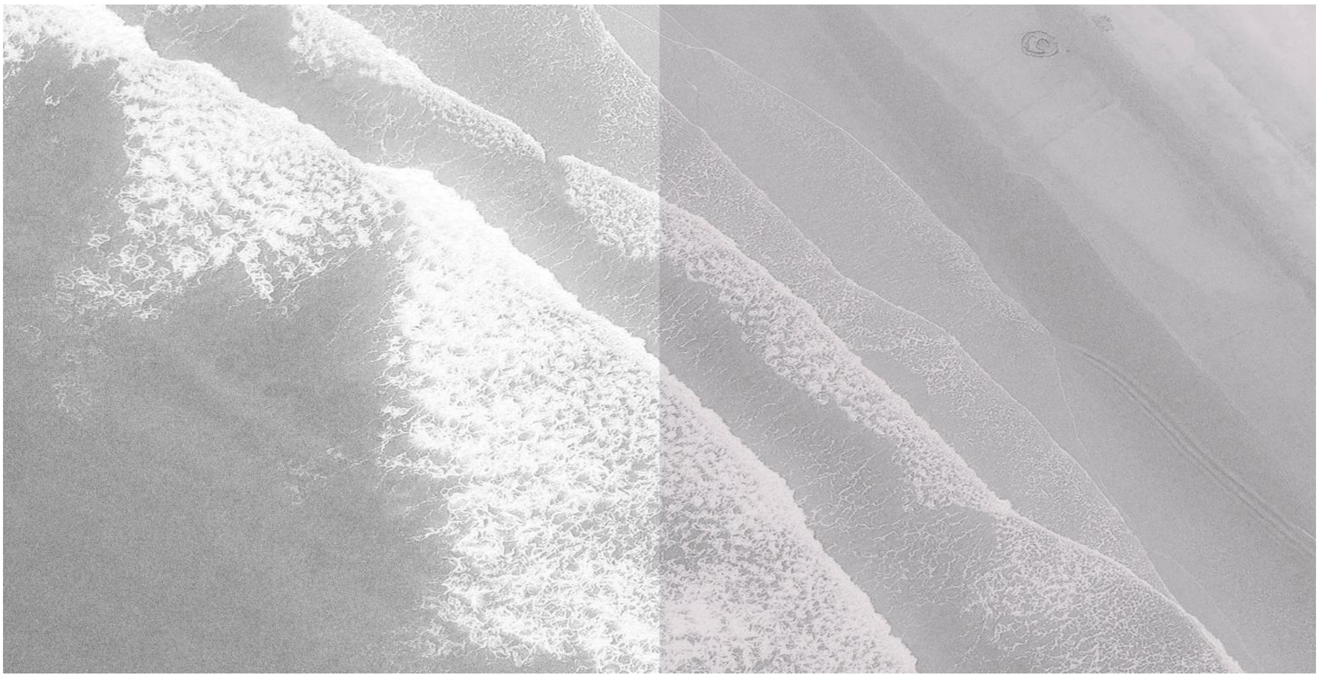
“Our way of thinking changed. We began to ponder which kind of other options there would be from the traditional debt investing, which now accounts for six percent of the portfolio”, she explains.

After the financial crisis the share of the traditional fixed-income, i.e. government bonds, in the fund was “massive”. They were the safe haven of that time. “Now their weight in the portfolios of many institutions is close to zero”, van der Pals says.

Thus in the world of negative interest rates and expensive shares, alternative investments continue to grow and grow.

ILKKA TOMPERI, DIRECTOR OF REAL ESTATE INVESTMENTS, VARMA.

We are living in very strange times with regard to interest rates. Investors are now actually paying for Germany’s debt.



The financial crisis is also the reason behind the accelerated growth of the PRIVATE DEBT MARKET as the capital requirements and regulation for banks were tightened. There was a great deal of political pressure to tighten the regulation because many of the banks were saved by governments. Lots of tax money was burned which heightened political pressure. Elsewhere the central banks were shovelling money into the markets in an attempt to prevent a credit crunch.

As a result of stricter rules, banks are no longer lending money to companies as easily as they once had and so the companies go elsewhere: to the private debt market. In the recent years, the market has grown to be a significant part of the global financial system.

Demand created supply. One of the loan suppliers is the London based **AlbaCore Capital Group** and its’ Chief Investment Officer **David Allen.**

“The popularity of the market is based on the fact that companies have a need for loans and banks are not lending it”.

In the United States the emergence of a private debt market has been accelerated by the ongoing consolidation of the banking sector. The banks have grown so large that they are not interested in loans of 50 million dollars to mid-sized companies. Thus, the companies have to go directly to the investors. In Europe banks are smaller but due to the capital requirements and regulations, they are unable to provide corporate loans and have a forced tightened loan criteria.

Mr Allen looks for big companies, market leaders that for one reason or another are not seeking loans in the public market. AlbaCore, which manages $3.5 billion in assets, offers these companies tailor-made loan solutions.

DAVID ALLEN, CIO, ALBACORE CAPITAL GROUP.

We are selective with our investments and have the patient capital to look and wait for the right fit.

He gives an example: “many investors are afraid of the retail sector these days. There have been several bankruptcies and there is the Amazon effect. However, our biggest investment at the moment is a loan to a large “retailer”. The company owns and operates petrol stations which have Burger Kings, bakeries and other shops on the premises. This is a steady business with strong cash flow and at no risk from internet shopping” says Allen.

However, it might be challenging for this company to get a loan from the public market because so many investors are categorically saying no to retail. Another reason for a company not to tap the public market is that it might not want, or might not have a chance, to market itself in a big roadshow. Or it doesn’t want to take the risk of a damaged reputation in case that the public offer fails, or it doesn’t want information about the loan to spread.

Allen describes finding such opportunities as detective work and as challenging the consensus view. Often ideas come about away from the desk. For example while driving on the Californian coastal roads with his family. “I have a wife and three kids. We stop for a break very often. I noticed that there are always lots of other people stopping and spending time having a break. People inevitably travel, this business is immune to the internet”, Allen continues on to how this particular investment began to take shape.

Because the companies don’t have multiple financing options available to them, AlbaCore is able to bring a unique offering that is attractive for the company and the investor. As this financing solution is often provided during a complex situation and sometimes under a shorter timeframe where a less-nimble institution couldn’t provide a solution, AlbaCore is able to achieve an attractive interest rate in spite of relatively low credit risk.

AlbaCore is a tailored, specialist product in the European private debt market.

The method sounds simple, but in practice it can take a long time to adjust and structure a billion dollar loan negotiation. These transactions are delicate and hard work.

You can also invest in the private debt market through mid-size company lending, high-risk lending or through a business finance fund. There are endless choices.

In the United States, private debt funds are also available to retail investors. However, it is important to remember that they do not have a deposit guarantee and that the loan market is unregulated. Therefore, when the risk materializes, the investment in the loans may be lost and the risk may be large, and the investor will not have the same security as for example on bank deposits.

The popularity of alternative investments is based on the higher gains when compared with the other markets at the moment.

“If before you expected 5–6 per cent profit from real estate, now it might be ok to expect 4–5 per cent. You might receive an interest rate of one per cent in a basic corporate loan but a profit of 4–5 per cent when you lease real estate to the same company”, **Ilkka Tomperi** of Varma comments on the current profit margins.

Tomperi is not fully convinced with real estate being classified as an alternative investment.

“It’s the oldest asset class. When you look at the profits, real estate is somewhere between bond and stock investing. Volatility is higher than in the bonds but so is profit”, he reflects.

According to Tomperi, low yields are acceptable, but the quality or location of investments needs to be taken into consideration. In terms of quality, Tomperi does not mean "expensive and shiny" opportunities but, for example, that a grocery store property may be a better investment than a shopping mall because you have to buy food even in a downturn.

“When there is a shock, you can see the differences in quality. Good quality real estate suffers a lot less in a downturn. The risk–return ratio of real estate is good with the current interest rates. We can’t see the interest rates rising rapidly but it is good to remember that the current real estate cycle is maturing”, Tomperi explains. The traditional real estate cycle follows the general economic cycle. The record-long growth has begun to slow down, and there are signs of a downturn.

Lately Tomperi has been reflecting on different real estate asset classes: commercial premises correlate with GDP, housing and senior homes to a lesser degree. "People have to live even when the economy is shrinking".

Infrastructure investments also provide a steady flow of income as seen in real estate. The builders of roads, power plants and other big projects need loan financing.

Investing in infrastructure for the Church Pension Fund means, for example, clean energy projects. The fund invests responsibly, but according to van der Pals, renewable energy projects are also very worthwhile because of their returns.

Renewable energy projects are a good example of the fact that the risk of an alternative investment product may be low, even though it is suddenly perceived as high.

“The technology for producing renewable energy has gotten a lot cheaper which means the projects are not as dependent on subsidies and tariffs as they used to be. The expected profits look rather good and also the risk is lower because of the long-term contracts and public sector commitment”, van der Pals explains.

The growing pressure to prevent the climate change has made governments more eager to commit to these projects.

These days ALTERNATIVE INVESTMENTS are so popular that there is even competition in trying to get access to them.

The managers of alternative funds can afford to be selective which investors they include. The criterion is typically a sufficiently large sum of money. Or maybe you need to know the right people.

“Sometimes not everybody is accepted. Or you hear from the manager that you can’t invest the amount of money you would like to”, van der Pals describes.

Mandatum Life has tackled this problem by collecting groups of Finnish investors and then investing together with them. A group of several investors is a more significant player in the market than a single investor.

“We invest in the funds of third parties. We meet a lot of candidates. When we find a suitable one, we launch a process in which comprehensively review the opportunity”, Jussi Tanninen, the director for alternative investments of Mandatum Life says.

How will it be in the future? How does it affect the financial markets in general that the scope of alternative investments is getting wider? There are no certain answers. The only sure thing is that the different trends in finance and the various instruments affect the rest of society one way or another.

“Hedge funds, born in the 1990s, have made stock market trading more efficient, the start-up funding of 2000s came from an urgent need and private equity has made many companies more profitable”, Matti Suominen, professor of finance states.

Naturally, there can also be some unexpected implications. Think about the subprime crisis in the United States, for instance.

Some see the risk that the alternative investment market is not as transparent as the public market. On the other hand, it is precisely opacity, or lack of efficiency, that contributes to higher returns than the public market. However transparency is also growing in the alternative market.

Alternative investments might not alone change the world but the world has certainly changed while they’ve been gaining popularity. It would therefore be strange if, in the world of central bank financing, rising regulation, turning points in economic policy, sovereign debt, climate change, artificial intelligence and increasingly efficient trading, the financial markets did not look for new strategies and targets for returns.

“Something is going on”, stated James Bullard, the head of US Federal Reserve at the yearly meeting of the world’s central bankers in Jackson Hole, St Louis back in August. In an interview with the Financial Times, Bullard referred to Japan's low-interest era, the threat of a trade war and general uncertainty, which began a couple of decades ago.

Insecurity and radical change always creates opportunity. Varma’s Ilkka Tomperi reflected “We really have to think about whether the global economic system has changed profoundly. It is not wrong to draw the conclusion that Europe is following Japan because of the aging population we have and it is worth thinking on what this could mean”.