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## **ALTERNATIVE INVESTMENTS**

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## **Alternative Investments**

Alternative investments are regarded as investment products other than traditional investments such as equities, bonds, money markets and/or cash. They are a category of assets designed to generate absolute returns, independent of market direction and are generally considered to include the following strategies: hedge fund strategies (or absolute return strategies), financial derivatives, commodities, private equity (including venture capital, leveraged buy-outs, mezzanine financing) and real estate. They have a very low correlation with traditional investment products.

Alternative investment strategies can potentially improve the overall performance of a portfolio, while reducing risk giving access to globally diversified investment techniques and opportunities which are specially designed to reduce volatility and improve returns, preserve capital and use diversification to increase performance, often employing a multi manager approach.

Hedge funds offer investors an alternate to traditional market investments, giving them the ability to obtain good returns in spite of market conditions. As investment vehicles they have more complex structures and investment strategies than traditional vehicles. The structures may include such things as performance fees, lock-in periods and capital calls, and the investment strategies may include derivatives, long/short combinations and the use of leverage.

Hedge funds can also be used to offset specific market risks, for example by trading strategies with a low or negative correlation to oil prices. Hedge funds use a range of strategies, including “going short”, to make positive returns whether markets rise or fall. If a Company’s share price is going to fall the hedge fund will buy a derivative that will increase in value as share price falls.

Often viewed as a high risk, certain advisers say that investing in the best hedge funds is the surest way of making money if stock market uncertainty continues. Some hedge funds are high risk but others are designed to preserve capital whilst achieving positive returns whatever the market conditions.

However with banks restricting lending and re-pricing credit lines poses a threat to hedge funds. The US Government Accountability Office found that hedge funds’ inclination to take substantial risks with increasingly large sums of money means that losses can be magnified throughout the financial system, and that banks are not critical enough when assessing risks in complex investment strategies.

New and untested hedge funds are finding it harder as the industry shifts towards institutional investors who prefer large, established funds and proven risk control systems.

Derivatives are financial instruments whose value is derived from the value of something else. The main types of derivatives are futures, forwards, options, and swaps. The main use of derivatives is to reduce risk for one party. The diverse range of potential underlying assets and pay-off alternatives leads to a huge range of derivatives contracts available to be traded in the market. Derivatives can be based on different types of assets such as commodities, equities, bonds, interest rates, exchange rates, or indexes (such as a stock market index, consumer price index or even an index of weather conditions).

A commodity is anything for which there is supply, but which is demanded without qualitative differentiation across a foreign market. Characteristics of commodities are that their prices are determined as a function of their market as a whole. Well established physical commodities have actively traded spot and derivative markets. Generally, these are basic resources and agricultural products such as iron ore, crude oil, coal, ethanol, sugar, soybeans, aluminium, rice, wheat, gold and silver.

Commoditization occurs as a goods or services market loses differentiation across its supply base, often by the diffusion of the intellectual capital necessary to acquire or produce it efficiently. As such, goods that formerly carried premium margins for market participants have become commodities, such as generic pharmaceuticals and silicon chips.

In finance, private equity is an asset class consisting of equity investments in companies that are not traded on a public stock exchange. Investments typically involve a transformational, value-added, active management strategy.

Private equity firms generally receive a return on their investments through one of three ways: an IPO, a sale or merger of the company they control, or a recapitalization. Unlisted securities may be sold directly to investors by the company (called a private offering) or to a private equity fund, which pools contributions from smaller investors to create a capital pool.

Venture capital is a type of private equity capital typically provided by professional, outside investors to new, growth businesses. Venture capital investments are generally made as cash in exchange for shares in the invested company. A venture capitalist is a person who makes such investments. A venture capital fund is a pooled investment vehicle (often a limited partnership) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. Venture capital can also include managerial and technical expertise. Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships. This form of raising capital is popular among new companies, or ventures, with limited operating history, which cannot raise funds through a debt issue. The downside for entrepreneurs is that venture capitalists usually have a say in company decisions, in addition to a portion of the equity.

Where market conditions are challenging the creation of new vehicles is not affected, in the form of private-equity and open ended vehicles, and in particular products established to invest in or acquire the assets of distressed debt issuers.

London's Alternative Investment Market ("AIM") listings continue to be driven by emerging markets, as countries such as China and India come into the UK's capital markets with an AIM listing, gaining shelter from UK tax through a Channel Islands listing vehicle.

In his recent budget, the Chancellor recognised the importance of working with the asset management industry and has introduced new rules to facilitate the development of Fund of Alternative Funds which will enable UK authorised funds to be invested in a wider range of underlying funds, including consideration of full tax exemption for authorised funds so that tax is not paid at both fund and investor level but only at the point of distribution as if the investors held the fund's assets directly. Other changes includes simplification of the "substantial holding" rule for Qualified Investor Schemes and reform of the off-shore funds regime to allow electronic settlement of fund units.

Due to the fast changing investment environment the definition of Alternative Investments should be re-considered over time. However, given the technical nature of these complex investments, and the fact that

they are considered volatile and high risk, their attractiveness as an investment vehicle is more suited to high net worth, institutional and experienced investors.

The recent credit crunch, sparked by the sub-prime crisis in the US, impacted negatively the investor appetite in certain types of alternative investments, calling into question the ability of alternative investment managers to deliver the anticipated uncorrelated returns especially as the momentum for such products are driven by the comparative lower return versus alternatives (rather than overall track record). With this perceived turmoil investors are becoming more demanding in their expectations with respect to the alternative products in which they invest. Increasingly there is the expectation for high value service providers (independent from the Investment Managers), specifically providing independence to the valuation preparation process, good corporate governance, performance measurement (risk/attribution) and corporate secretarial services.

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