EnterpriseUK
The Financial Ecosystem

A Guide to ALTERNATIVE INVESTMENTS

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I. WHAT IS AN ALTERNATIVE INVESTMENT?

The simplest description of an alternative investment is one that covers asset classes other than equities, bonds or cash. Drops in global interest rates have left investors searching for higher yields, as their retail bonds offer virtually no return on their cash. Long term investors have been driven to seek higher rates of return by deploying a larger allocation of capital to alternative assets. The performance of these assets tends to be less correlated, and in some cases inversely proportional, to more traditional investments such as equities. When stock markets dropped sharply in the first weeks of 2016 the value of many alternative investments was unaffected. The right mix of alternatives can add an additional layer of diversification to any portfolio.

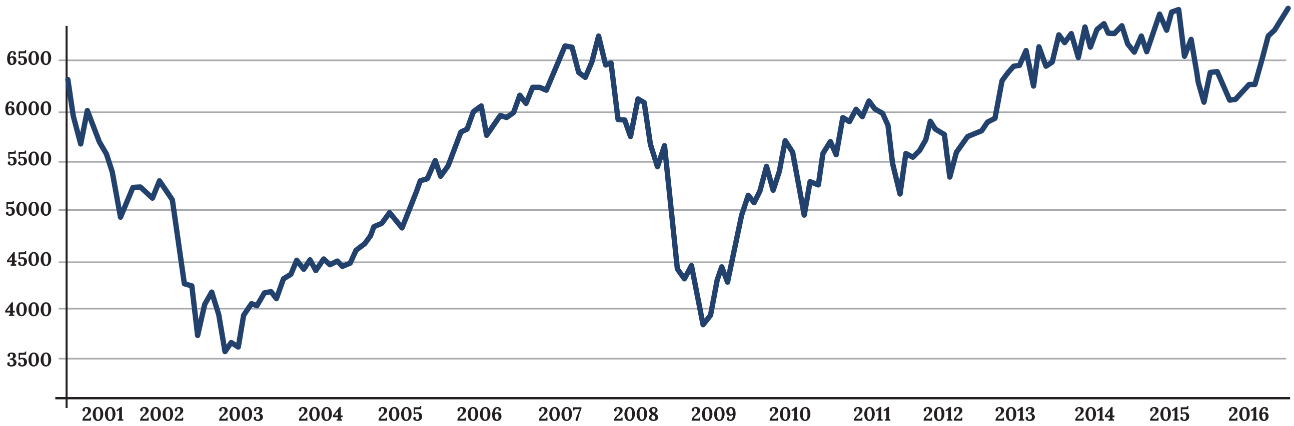

Chart 1. FTSE 100 Index Performance in the last 15 years
Source: Yahoo Finance UK

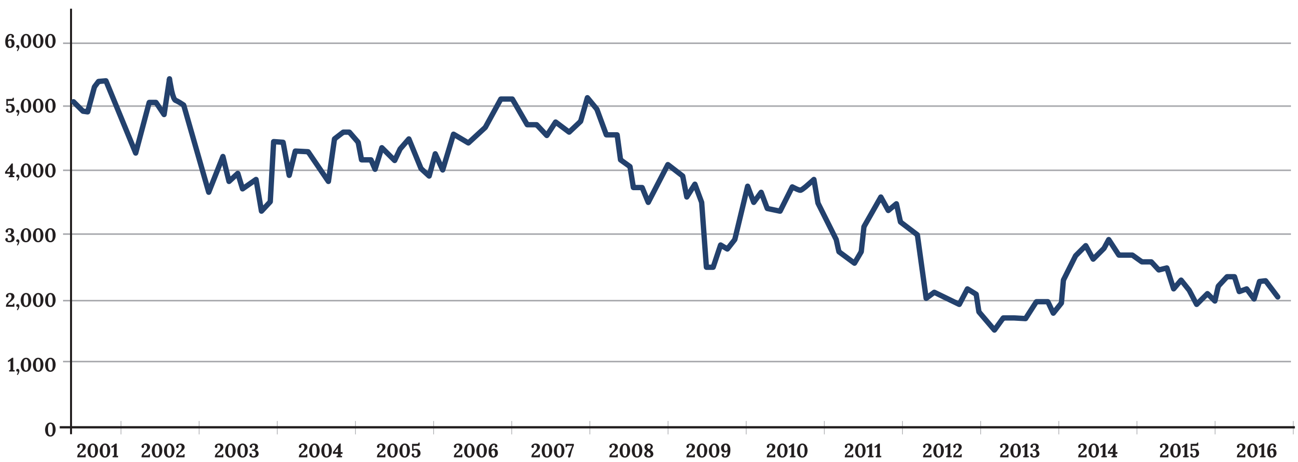

Chart 2. US 10-Year Bond Yield in last 15 years
Source: Yahoo Finance UK

Chart 3. Gold futures performance in the last 15 years
Source: English Housing Survey

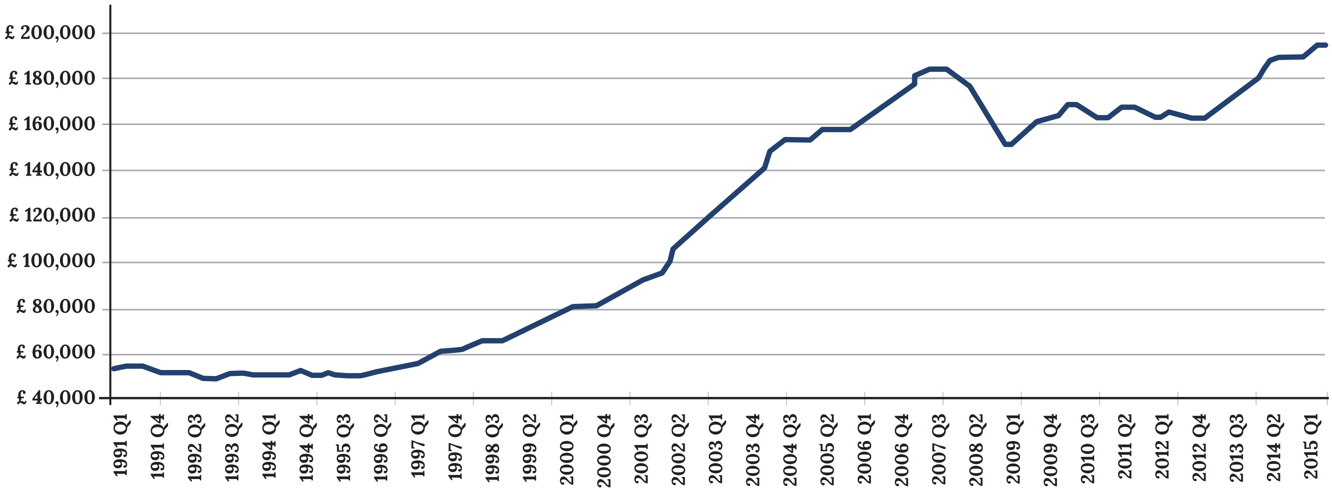

Chart 4. UK House prices in past few decades
Source: Economicshelp.org | Nationwide

II. WHY DO WE NEED THEM?

Alternative investments can play a part in strategies used to improve returns to investors when equity returns are low or negative, as well as to diversify investment risk profiles – reducing the potential negative impact of market shocks. The choice of investment opportunities is largely unrestricted. Outside the familiar world of stocks, bonds, exchange-traded funds and other pre-packaged products, there is a whole universe of alternative investment vehicles that we need to be aware of.

Older investors, who made a small fortune on his shares through the golden years of investing, can now afford to adopt a more exclusive approach to protecting the value of their pension pots. For those who are able to access hedge funds and other institutional alternative investments the available yield is often less important than capital security offered. Many are happy with benchmark returns as long as their net wealth is not in decline.

The bursting of the dot com bubble in 2000 has left many current investors feeling battered and bruised. Younger and middle aged investors cannot afford to sit and wait for a turnaround in the global economy. Neither can they afford the opportunity cost of investing in hedge funds – not only are the entry levels out of reach, but the current rates of returns being offered to investors offer no means to an early retirement.

Understanding the Investment Risk Pyramid

With great risk comes great reward. When weighting your options, first understand where your potential investments fall on the investment risk pyramid

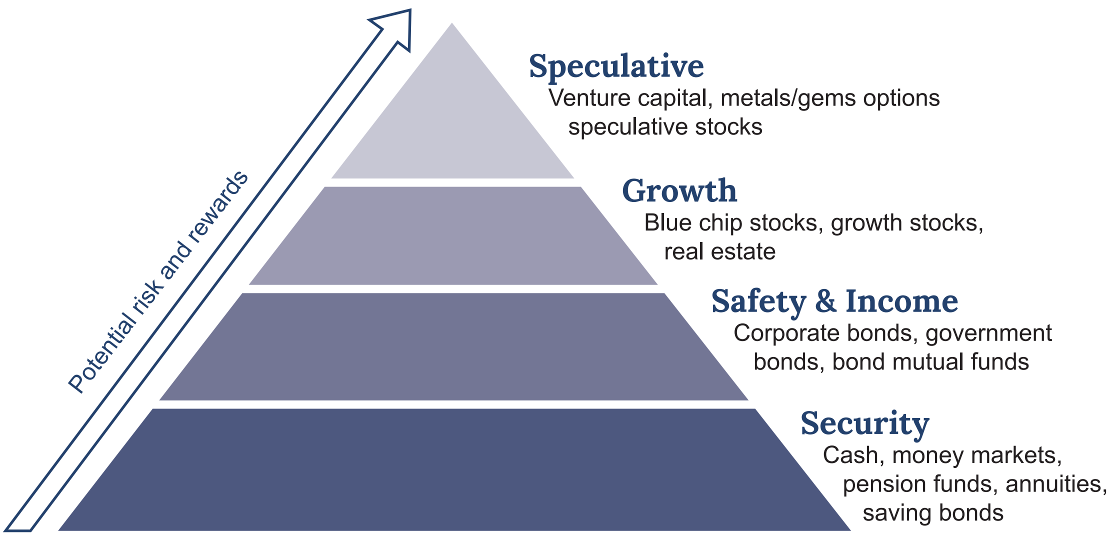

Chart 5. Investment Risk Pyramid

III. TYPES OF ALTERNATIVES INSTITUTIONAL V. RETAIL

There are many different types of alternative investments available which can add some diversity to an investment portfolio. It is important, when weighing up the benefits of high returns, to understand that many alternatives are more illiquid in nature and may carry more risk than some traditional investments. There are several alternative solutions which are widely used by pension funds and high net worth investors. Many large managed funds specialise in:

Commodities • materials such as grains, metals, or basic materials

Hedge funds • pooled funds that speculate using credit or borrowed capital

Derivatives • futures or options contracts, including carbon credits and foreign exchange

Collectables • fine art, wine, stamps, classic cars, coins, antiques or other tangible assets with strong fan-bases willing to pay a premium

Real Estate • directly or through tax efficient pooled investments such as Real Estate Investment Trusts (REITS)

Insurance risk • bonds linked to events that lead to insurance losses, such as natural disasters

With some exceptions, only accredited investors can invest directly in the assets described above. This restriction exists because many fund managers rely on private placement registration exemptions that limit their investor base to sophisticated investors. These investments are growing in popularity as institutional investors including pension and endowment funds are increasingly allocating money to alternative investments as they realise the long-term benefits of this asset class.

The retail investor has fewer options. Many of the ideas are unregulated structures offered by companies within the private sector, which carry varied levels of risk and return. Regulations limiting many kinds of alternative investments to accredited investors are meant to be both a sophistication test as well as a protective measure. Legislation hasn’t been finalised to open these alternative investments to the retail market yet. The most common type of alternative investments available to retail investors are private equity, direct investments in start-ups and private companies, enterprise investment schemes, real assets, asset-backed securities, commodities, peer to peer lending and investment properties.

Private Equity

Some Private equity firms raise funds and take capital from non-institutional investors. The funds will then place the capital invested into promising private companies. The capital is returned to investors upon an exit event such as an IPO or acquisition after the firm takes its management and performance fees. Private equity is a general classification that includes the investment in start-ups, venture capital, and financing throughout phases of a company's growth.

Direct investments in start-ups and private companies

Investors can directly invest into the shares of start-ups or private companies rather than via a private-equity fund. Investing seed capital directly in start-ups is sometimes referred to as angel investing. This is a strategy widely used by investors seeking high returns. A private company will seek investors through a private placement based on a certain valuation. Retail investors can participate in some offerings depending on the type of registration exemption the company relies upon. Companies seek investment capital throughout their life cycles', so more mature companies can also be targeted for investment.

Enterprise Investment Schemes (EIS)

EIS is a HMRC approved scheme with some very attractive tax features and has attracted many of Britain's strongest smaller companies, spanning all the major sectors, to become part of the scheme. HMRC shares directly with the investor in the risk of the company, by refunding the investor 30% of the amount invested (via an income tax refund). The qualifying profits from EIS are exempt from capital gains tax and there are several other attractive features available, especially for those looking for tax efficient alternatives to SIPP's and ISA's.

Real Assets

Real assets are physical or tangible assets that have intrinsic value such as real estate, oil, precious metal commodities, and agriculture land. Luxury and collectable goods also fall into this category, including wine, art, rare coins and other collectibles. Investors can buy into niche structures where returns are generated from the increase in value of the alternative asset.

Asset-backed securities (ABS)

These are bonds or notes issued by private companies and backed by tangible assets such as property. It is important to consider the strength of the prevailing assets backing the bond or note, and understand the risks involved with investing into a promissory note with a private company. However there are many reputable companies, offering yields much higher than those of retail bonds, with a strong track record of making coupon payments on time and returning investor capital. Typically, these type of investments may pay 8-12% yields.

Commodities

The strongest providers allow retail investors to access institutional grade investments in the commodities sector – many projects are generally unavailable to retail investors so it is important to choose a strong investment partner – Some of these providers often have ideas housed within smart/innovative investment vehicles.

Peer to Peer Lending

Largely due to the unavailability of credit to many people, many companies have been formed recently offering peer to peer lending. Simplistically the lending company makes loans to private individuals and charges an interest rate based on their ability to repay the loan. The type of transactions include pay-day loans, doorstep loans as well as loans to private companies. Investors receive a varied rate of interest based on their desired investment timeframe - the investors' money is then loaned out. Typical returns may be as high as 10-16% per annum but it is important to closely examine the lending policy and track record of companies operating within this area.

Investment Properties

These investments can take many forms, from sole ownership property purchases to buy-to-let/ student accommodation schemes and high-yielding loan notes (or asset backed bonds) issued by property companies. The hard asset generally acts as security/collateral and so volatility and risk may be reduced. Investors should always ensure that they are comfortable with all aspects of the structure, including the capital security and title of ownership, before any investment is made.

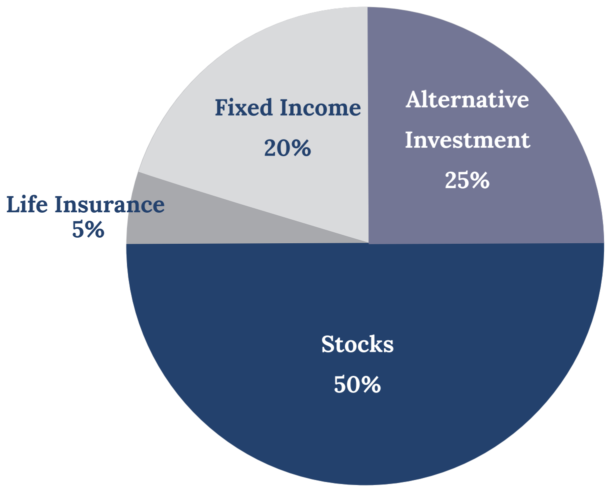

Chart 6. New Asset allocation Model

IV. TOO GOOD TO BE TRUE OR FOOLISH TO MISS OUT ON?

There are alternative investments that offer good opportunities to participate in different markets and many alternative investment firms have strategies which are not available to the general investing public. It is always important to keep in mind that while these alternatives may offer higher return potential, they also involve special risk factors that must be taken into consideration.

Most investors, who are high net worth or sophisticated investors, consider alternative investments as a key part of their asset allocation model and active management strategies. Just as no single stock sector always has the highest performance, no single alternative investment outperforms the market and its peers all the time. As always, diversification is the key to a successful portfolio.

Sometimes it is necessary to consider things other than the familiar. There is a lot of negative media around on the alternative investment arena – often contributed to by regulated companies who are anxious about fund flow away from their own firms – and due diligence is always important when considering an idea.

V. FINDING THE RIGHT PARTNER

As with any investment, alternative investments must be consistent with an investors overall financial goals and risk tolerance.

Determining whether alternative investments are suitable for you may or may not be something you feel comfortable doing for yourself. Investors should be encouraged to seek out the services of a qualified Investment Advisor if they need help to evaluate any alternative Investment that they are considering.

It is always a good idea to work with an alternative investment provider who can demonstrate strong performance across a range of different products and over a defined investment timeframe. Many investors prefer to work with one trusted provider who may have access to a number of different ideas spanning different sectors.

VI. MYTHS OR MISCONCEPTION?

"A lot of misunderstanding surrounds alternative investments. Some investors still think of them as high-risk, exotic funds reserved for ultra-high-net-worth individuals and sophisticated institutions. However, the reality is that alternatives have a place in nearly every portfolio."

– BlackRock

Haven't alternatives failed to protect investors during the financial crisis?

- Whenever there is a financial crisis there is often a convergence in correlations across nearly all investments but many alternative investments have seen smaller draw-downs than stocks.

I thought investors couldn't access their money if they invest in alternatives?

- The liquidity of alternative investments depends on the individual investment. Some alternative mutual funds provide daily access to cash. Ideas issued by Limited partnerships, can have restrictions and may be more illiquid in nature.

Surely investing into an alternative investment fund is my best bet?

- Just as adding one stock or mutual fund does not lead to significant diversification, so too a single alternative investment may have limited impact. Investing in only one alternative strategy may provide some diversification benefits, but can also concentrate risks.

Not anyone can invest into alternative investments, surely?

- Individual investors have greater access to alternatives than ever before due to innovations in product structures. Many products now have low barriers to investing and offer returns in excess of more traditional benchmarks.

Aren't they all incredibly risky?

- There are thousands of different investments on offer and generally the higher the returns the higher the risk. Don't shy away from innovative ideas however always make sure you fully understand the mechanics of the opportunity and the risks involved before parting with your hard-earned loot!

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EXCELLENCE IN AN EVER EVOLVING FINANCIAL WORLD.

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You are responsible for your own investment research and investment decisions.

AmazonaGroup

Small things make a big difference.

We support NGO´s that focus on preserving the Amazon and supporting the local people who protect and nurture this beautiful land.

We commit 1% of our revenue to environmental causes close to our heart.

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