TRENDS IN ALTERNATIVES

Capital flows show how key asset classes are shaping up.

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Capital continues to flow into alternative investments and recent activity indicates that this is likely to continue, with steady growth in well-established areas such as private equity and funds of hedge funds as well as a surge of new investment into infrastructure and commodities. Here is a look at some of the top trends in alternative investing.

When the final numbers are tallied, private equity could well have set a new record for capital received in a single year—as much as $US250 billion. Global allocations to private equity are expected to reach record levels by 2007. The increasing commitments to this alternative asset class are being driven by the fact that, for the first time, the first net distributions to limited partners have now overtaken contributions. For approximately 25% of all limited partners, their actual current allocation is less than 50% of their target allocation. As a result, they must increase their commitments just to reach their existing target, let alone reach an increased allocation. As a result, the buyouts are attracting the biggest share of new capital and the buyout funds are getting bigger while doing even larger deals. There has been a flurry of new buyout funds launched in the $5 to $10 billion range, a scale that would not have been contemplated just a few years ago.

Real estate continues its extended recovery from the meltdown of the early 1990s. For many institutional investors, real estate has become a core asset class and, over the next few years, allocations are expected to settle in the 10% to 15% range.

Interest in hedge funds, and hedge funds of funds in particular, continues to be strong, although the frantic growth of the previous couple of years is tapering off. In the last two years, allocations to hedge funds of funds have doubled: in 1990, there were just 50 funds of funds; today there are over 3,000.

There are clouds on the they horizon, however. For many investors, fund of funds represent their first exposure to hedge funds. While they expected to trade some returns for the lower volatility of a well-diversified fund of funds portfolio, performance disappointment is bubbling just below the surface. Looking at single-digit returns, investors are grumbling about the fee burden and wondering where the stellar returns of a few years ago have gone. A comparison of fund of funds' composite returns and hedge fund composite returns reveals a larger gap than can be explained by the fee differential alone. The conclusion being drawn by many investors is that over-diversification and weak fund selection have further eroded returns.

In spite of growth among those three alternatives, the fastest growing are infrastructure and commodities. Index funds tracking various commodity indexes like the Goldman Sachs Commodity Index have quadrupled since 2002. One survey found that allocations to commodities grew by 50% last year. Investors are drawn to commodities by the sustained rally in commodity prices over the last couple of years, in particular the spectacular run-up in the price of oil. There is widespread conviction that accelerating demand from India and China will continue, thus sustaining prices. While exposure to commodities has paid off handsomely for the last two years, some investors seem oblivious to the fact that investing in commodity indexes is a passive, one-way, long-only bet. A more logical approach is to engage a Commodity Trading Advisor (CTA) to implement a managed futures program, which provides an actively managed exposure to commodities, both long and short. However, relatively few investors have taken up this option. The managed futures industry has grown substantially, doubling over the last four years, but the rate of growth lags that of the commodity indexes.

Infrastructure has drawn a great deal of attention from Canadian institutional investors. A number of large Canadian pension funds now have allocations as high as 15%. They see it as a near-perfect pension asset: long life, high, predictable current income, little risk of catastrophic devaluation and a positive correlation to inflation. The most common infrastructure investments at present include airports, toll road and bridges, electricity generation and distribution, pipelines and water distribution. ■