An Alternative Introduction

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As far as years go, 2016 will not quickly be forgotten by the people of today and the history books of tomorrow.

The rise of populism on the back of the Global Financial Crisis (GFC) and the plight of the proletariat dealing with high unemployment and stagnant real wages (while the rich get richer), has led to some significant and surprising elections around the world. The two most significant were of course the British vote to exit the European Union, and the US presidential vote for Donald Trump.

Much of the blame for populism has been placed on globalisation and specifically the free movement of labour. Although many people will recognise that globalisation has lifted most of the global population significantly out of abject poverty, many do not care as they have not been the direct beneficiaries of this. They see the rich getting richer and being bailed out when they make catastrophic mistakes, while the poor or middle class are being left behind.

As far as "movements" go, this tide is unlikely to turn very quickly and we will probably continue to see the swell of populism rising for years and decades to come. We therefore need to think about what this means to all of us as citizens and managers of capital in this "new world order".

Our theme for this quarter is therefore in many ways apropos. Given the changing landscape, we may need to rethink the investment opportunities of tomorrow. More specifically, alternative investments may actually help to address many of the issues that we are grappling with globally.

Let us not waste a great opportunity to create and shape our destiny!

An alternative definition

In investment terms, what are alternatives exactly? Like many other abstract concepts in investments, you will fail to find a single answer, or to get everyone to agree on a single definition. You can however ensure that everyone knows what you mean by a term you use, by clearly defining it upfront. People can then disagree with your definition, but still understand the discussion and arguments presented.

So let me define what I mean by alternative investments before discussing them in more detail. The most basic way of defining alternatives, is to include everything that is not considered "traditional".

One of the first points of contention is usually whether it refers to asset classes only, or to investment strategies as well e.g. hedge funds (which are definitely not an asset class). I will define alternatives to include alternative investment strategies, which are substantially different from traditional investment strategies. As with any exercise attempting to label "things", when the number of labels is limited you will always have difficulties. Let us not allow this to stall the discussion here.

Another point of contention is the label for real estate (property) as an alternative asset class, with many correctly arguing that real estate was in fact the first (and hence "most" traditional) asset class.

Most contemporary investors are typically more comfortable including it in their alternatives bucket, especially when it is in the form of direct ownership of land and buildings (instead of wrapped in a listed form).

If you therefore consider that anything other than listed company (including property companies) shares (equity), listed corporate, government bonds, and money market instruments, is defined as alternatives, you will see that the range of investment possibilities is indeed very broad. Alternatives is such a large category, it can itself be sub-classified into more traditional alternatives (like the unlisted equivalents of the traditional asset classes e.g. unlisted or private equity and bonds), and more alternative alternatives: art, wine, and other collectibles (perhaps record labels, stamp and coin collections or even first edition comic books). Other asset classes like land, direct property, and commodities (e.g. precious and industrial metals, energy, food etc.) probably lie somewhere in the middle of the spectrum.

An alternative context and history

Wealthy individual investors have invested in alternatives for a very long time, but institutional investors have been much slower to adopt them for some very important reasons. There is actually an interesting life cycle to markets and investments, whereby alternatives will dominate markets without deep and liquid listed markets (which define traditional investments). As markets become more developed (liquid and deep), more money chases these traditional investments because of the benefits they provide. As these markets become increasingly efficient, many investors look for alternatives to provide some diversification and potential for higher returns (and access to new market segments e.g. emerging technologies). Alternative strategies on the other hand, trade in traditional asset classes (in many instances), but in novel and complex ways, requiring even more mature and developed markets (the derivatives market being a great example of this).

The US alternatives market is amongst the most developed globally, and many prominent investors have had great success by investing in this part of the market (the very large pension funds and university endowments are an example of these). This has led to research investigating the case for alternatives, and the slow adoption by other market participants. The Myner's Report (in the UK to HM Treasury in 2001 on institutional investors) was a great example of this, and found that advisers (e.g. pension fund trustees) may not have been acting in the beneficiaries' best interest by not dedicating enough resources into evaluating the case for unlisted equity.

As markets become increasingly efficient, many investors want to look for higher returns in segments of the market with less competition and greater opportunities. The efficient allocation of capital is also an important consideration as listed companies, through their monopoly on raising capital in the listed market, may allocate their assets in less efficient ways (bad projects), and investors need alternatives to penalise these companies and reward those who are allocating capital efficiently.

As bond yields have turned negative, and the economic outlook globally looks muted, investors may feel that traditional assets are overvalued and will want to look elsewhere, for themselves or for those for whom they act as fiduciaries, for higher returns. Sometimes this is as simple as looking at what fewer people are doing (so the implication being that there is more opportunity for information asymmetry on which to act), or where others will not have the ability or appetite to invest. Chris Roelofse and Richo Venter will explore this in more detail in their articles in this publication.

The above, and many other factors, have led to an increase in the allocation to alternatives globally, and although there has been some bumps along the way (GFC was one), the trend of increasing allocation remains strongly in place.

But what about South Africa?

An alternative South Africa

Fortunately, South Africa has a long and very distinguished financial services market, including a stock exchange dating back to 1887 (130 years). It is however a fairly small market by some international

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standards (it is the 19th largest stock market globally by market cap), although large by African continent standards (where it is the largest). It also has a well-developed derivatives market (ranked sixth and ninth for single stock futures and currency derivatives traded respectively in 2012).

This has meant that the need to develop an alternatives market has generally had less priority, although alternative markets have existed in South Africa for some time. The uptake from institutional investors has therefore been fairly slow. It has not helped that the regulatory environment for institutional investors (specifically retirement funds) has not been particularly conducive to investing in alternatives. The fact that boards of trustees in South Africa have predominantly been constituted by individuals without investment expertise has also not helped.

As in the rest of the world, the biggest opportunity from alternatives is for high returns, made possible because of the limited amount of investment capital available. This means that investors can generally be very selective in investing in only the opportunities that have a great chance of success for high returns. This is exactly the opposite of what we find in the listed space, where most professional money managers feel that the highest quality companies are significantly overpriced and therefore offer no margin of safety and hence high risk.

Fortunately, alternatives received a substantial boost a number of years ago with an update to Regulation 28 (of the Pensions Fund Act dealing with prudential limits relating to asset classes, issuers and instruments), where various alternative investments were specifically named and their limits increased above their previous classification in "other assets" which had a limit of 2.5%.

This was all placed at risk recently when national treasury in draft papers began pushing a "passives" agenda and "war on fees" with little recognition that fees on their own offer little in the way of protection of savers, and less in the way of value! From a return perspective, it is net returns that are important, not fees, contrary to the narrative being pushed by passive product providers. More importantly however, are the other benefits that are on offer from alternatives, including less risk (if listed equities have been pushed to valuations that are not sustainable), and the opportunity to re-allocate capital from existing companies in sunset industries to the companies and industries of tomorrow e.g. technology (bio, nano, hardware, software, internet, artificial intelligence, machine learning, predictive analytics etc.). Fortunately, this seems to have been put back on track with the latest draft papers following an outcry from the industry.

The massive opportunity that exists by moving the flow of capital from traditional to alternative investments, lies in the opportunity to develop these markets and create employment and other social benefits, in addition to higher returns which is non-negotiable for most investors. With official unemployment figures for South Africa as high as 27% (the unofficial numbers being well above 50%), this provides a spotlight on the old (and seriously flawed adage) that markets are a "zero sum game".

By allocating resources and exerting effort on this important segment of the economy, we can truly transform a country for generations to come. Although investors are right to be fearful of government intervention in driving this agenda (because of their lack of credibility across many initiatives), this doesn't make the case for alternatives any less exciting. We would be serving our investors and the general public and country well by taking these matters into our own hands.

A couple of themes that will resonate with most South Africans today, include investing in energy (rolling blackouts), specifically clean energy (wind farms and solar, on the back of global warming), water/dams (droughts and floods, again on the back of global warming), other infrastructure (roads, bridges, airports, trains/rail, ports), and agriculture (again on the back of global warming).

An alternative challenge

Unfortunately, the best things in life are not free, and this is where the balance between costs, fees, and value is important. In this case, the adage that "price is what you pay and value is what you get" is apropos. Alternatives are generally expensive and there are often very good reasons for this. It is very insightful to understand this in detail because it often forms the basis of decision making. I sometimes find that people make bad decisions because they are acting on bad information.

Consider two managers each charging 50 basis points (0.5% per annum) for managing a listed equity mandate. Assume now that one manager has R200 billion in assets under management, while the other manager has R2 billion. The annual fee for the larger manager is R1 billion, while for the smaller manager it is only R10 million. Both managers could be analysing the same shares, and have similar teams of portfolio managers and analysts, yet they make a very different amount of money. Why is this? Surely the fee would be similar in rand amount if it was based on the cost of the underlying function (i.e. managing the money). It is however rather based on the value provided i.e. the opportunity to make returns is shared between the investor and the manager. It is important to note that this is not entirely accurate, as we haven't addressed why the fee was set at 50 basis points. Clearly this is a function of the potential assets that could be managed, as well as the competition in the market. Great managers can charge more, and managers operating in smaller markets can charge more, than their counterparts in both cases.

This is the same in alternatives, to the extent that the market is much smaller, the fees need to be higher to attract market participants (the money managers), or to make the same rand amount. To the extent that the value provided is much higher, the fees can also be much higher. This is simply the result of demand and supply in free markets. A great example can be found in Renaissance Technologies (manager of the Medallion Fund) which charges a fixed fee of 5% and a performance fee of 44% (numbers that are literally off the charts). Most investors would think that these numbers are ridiculous, and would not invest with this manager if they had the opportunity. Unfortunately, most investors will not have the opportunity as the manager is only open to employees.

Now consider an investor considering the above and the allocation of an additional R1 million. If they gave this money to the large or the small equity manager, do they think that the manager would undertake any additional work to invest the R1 million? Surely no additional research is required as the managers have already researched all the shares of interest to them. The money is invested without much further consideration into the existing shares held by the manager.

What would this look like for an additional R1 million invested in alternatives? Although it may vary significantly from one alternative proposition to the next, the reality is that the marginal investment in alternatives will need to find new opportunities, along with all the other new flows to alternatives. This could be deployed into new infrastructure or new employment - or both. What value is therefore created with this transaction, even before any return is realised?

The rest of the articles in this publication will explore the challenges in a lot more detail.

And finally... an alternative conclusion

It is important for investors and their advisers to realise that the world is changing, and the pace of change is accelerating. Business as usual and investing as usual, will not be appropriate and you could correctly argue that it has never been appropriate which is why the world has continued to change to reflect these imperatives. We are however seeing some significant moves that will present new challenges and opportunities, and alternatives may be poised to benefit from many of these.

Investors should therefore resist the urge keep things the same, and begin questioning their service providers around solutions for tomorrow. In turn, service providers as experts with the combination of skills and information, should be proactive in finding solutions of tomorrow for their clients. To the extent that these service providers can stand back and appreciate the bigger opportunities, they will realise that the opportunities go way beyond just great returns for their clients, but a better future for everyone.

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