



Insights on...

## ALTERNATIVE INVESTMENTS

### THE FUTURE OF THE ALTERNATIVES INDUSTRY

A focus on private equity and real assets

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*Northern Trust assembled a panel of leading experts in the field of alternative assets for a forward-looking discussion on the most promising areas of investment*

**Managers with a value orientation and heavy operational focus may be best-positioned to capitalise.**

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In June 2009, Northern Trust hosted a panel of industry leaders in the alternative alpha space. The event, chaired by Professor Amin Rajan of Create Research, tackled some of the most crucial issues facing the alternative investment industry today while identifying some key areas of growth for the next two to three years, and beyond. Panellists included Reza Vishkai, head of alternative investments at Insight Investment; Raj Vora, vice president of private equity at Northern Trust; Rufus Warner, CEO at Earth Capital Partners; and Sean Whelan, managing director at ECI Partners.

During the lively discussion, two primary areas of consensus emerged: Private equity remains a strong investment in a period of market instability, and the next few years are likely to mark a substantial migration towards “real” assets.

### THE APPEAL OF PRIVATE EQUITY

Members of the panel agreed on the continued stability of private equity investments. Although deal flow recently has been hindered by a general slowing of credit and fewer exit opportunities, mild market distress can be a boon to private equity investments, as it permits managers to acquire companies at lower valuations.

Yet in order to take advantage of these opportunities, managers of all asset classes, including private equity, must re-evaluate their use of leverage. “The prudent use of leverage will be a key factor in the success of private equity funds going forward,” Vora explained. Clearly, turbo-charging returns through excessive leverage can no longer occur in this environment. “As a result, managers with a value orientation and heavy operational focus, for example, may be best positioned to capitalise,” Vora added.

When compared to other alternative investments, panel members deemed private equity’s use of leverage prudent. As Whelan explained, leverage is applied differently in private equity structures, which can offer several advantages.

- Private equity leverage is generally applied on an individual company basis, with little cross-exposure. If a portfolio is composed of 15-20 companies, for instance, the collapse of one may not severely affect the future of the fund.



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- Private equity investments made through funds-of-funds can provide even more diversification and further reduce risk. Furthermore, most funds of funds do not apply leverage on the FOF level, and therefore risks are not increased by using this structure.
- Although private equity firms must value their companies on a quarterly basis, the funds are not marked-to-market in the same way that stocks are. Therefore, a manager is generally only required to finance borrowing, and not declines, in assets. This is in contrast to investments in stocks, where falls can trigger a restriction of leverage and require ill-timed sell-offs.
- Private equity fund managers build their investment forecasts, strategy, and timing around long-term investment cycles. Therefore, private equity may be better prepared for downturns and recessions, particularly if the firms are in a position to make investments during weak markets. Firms with a longer-term focus and a patient investor base can play “offense” in this market environment, buying weaker competitors and strengthening their businesses in order to exit at higher valuations in the future.

#### THE STRENGTH OF REAL ASSETS

As concerns about the sustainability of the earth’s resources become more pronounced, investors are more interested in sustainable funds—funds that, in addition to generating an investment return, generate a non-investment return, or “earth dividend.” Investment themes such as clean technology and renewable energy meet these criteria.

As we come off a historic period of market volatility, investors are demanding more stable investments that can, in essence, serve as a hedge against market volatility. Agriculture and farmland meet these criteria, and as such are attracting the eyes of prudent investors. The goal of farmland funds is to benefit from agricultural commodity sales through increasing prices, improved productivity and appreciation of land values. Many farmland funds are diversified across geographies and products including soybeans, wheat, sugar, sheep and cattle.

The tangible nature of these asset classes is proving tempting to many. “Investors are being more careful, really digging in and conducting more due diligence,” Warner said. “They want to understand the investments. If they can, they will go in.” He added that as an added way to reduce risk, diversification has gained importance.

Other targeted assets have emerged as result of current geopolitical themes, explained Reza. These are industries that may not be as tangible as real assets, but have a clear demand that is expected to continue. Examples include industries surrounding outsourcing, homeland security and regulation of software and IT security. Reza has seen that rather than focusing strongly on innovation, investors are looking for sound companies that demonstrate growth.



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Accessing these real asset opportunities, however, may prove a bigger challenge than in the past. In the early to mid 2000s, investors sought alternative asset vehicles – such as hedge funds, real estate and private equity – that simultaneously offered daily liquidity. These types of investments were particularly appealing to pension funds looking for high returns without lengthy commitments.

The days of this dichotomy are over, Warner said. “Funds with a long-term investment horizon cannot offer daily liquidity,” he explained. In recent months, investors have often been surprised to learn that without the necessary volume, even funds touted as having “daily liquidity” were impossible to exit on short notice. In essence, investors who want to harness the benefits of real assets must be prepared to commit capital for a period of several years.

#### **LOOKING FORWARD**

Although changes to the industry may be apparent, it is difficult to predict the investment climate of the next few years. Investors of all sorts are experiencing the resulting uncertainty. Rajan cited a recent report from Create Research, which reported that 82% of 87 pensions surveyed expect there to be two more crises between now and the end of the next decade.

Yet despite these uncertainties and the difficulties that alternative asset funds, investors and managers have faced in the past year, the panel’s general message was one of optimism and a belief in the future of the alternative investment industry, particularly private equity.

As Rajan summarised, “This has been a terrible thing, but it will leave the industry leaner, meaner and more efficient.”



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