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Alternative Ways To Tap Into Alternative Investments

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The author owns shares in JG Boswell, Laurent-Perrier, Carlyle Group, Oaktree Capital and SLC Agricola.

Anything investable that is not a stock, a bond or cash is commonly referred to as an alternative asset. Alternatives run the gamut from "real" assets like commodities, farmland, and timber, to sophisticated debt structures, derivatives contracts and partnership interests in privately-held businesses. Partnerships that involve publicly-traded securities but allow the manager to hedge by selling short are also considered to be alternatives.

Alternatives are popular with institutional investors and wealthy individuals because their returns are perceived to have a low correlation with those of the stock and bond markets. Many consultants, chief investment officers and advisers claim alternative investing combines higher returns with lower risk relative to the stock market.

Investors with less than $5 million of financial net worth have traditionally been shut out of alternative opportunities. The mutual fund industry is now changing this by creating funds comprised of alternative strategies, "liquid alts" in the jargon of the trade.

Mutual funds that invest using alternative strategies generally have higher costs and may expose the investor to the greater risks inherent in alternatives including illiquidity, short selling and using borrowed money. Investors not turned off by the costs and risks can gain exposure through mutual funds in five broad categories: hedged equity, arbitrage, global macro, currencies, and managed futures.

Examples of hedged equity funds include Highland Long/Short Equity (HEOZX) and Neuberger Berman Long/Short (NLSAX). There is an arbitrage fund aptly named The Arbitrage Fund (ARGAX) which is managed by Water Island Capital. Eaton Vance (EIGMX), John Hancock (JHAIX) and

Putnam (PDMYX) all have global macro funds in their arsenal. John Hancock also offers an Absolute Return Currency Fund (JCUAX) and AQR offers a Managed Futures Strategy Fund (AQMNX).

These are considered to be among the better funds in their category, but the track records of all five strategies pale in comparison to the long-term return from equities.

Nonetheless, the siren's call for investing in alternatives has grown louder. It is clear that paltry bond yields are diminishing opportunities in traditional fixed income. Equally, many harbor lingering fears from two stock market crashes in relative recent memory. Then there is the prevalent view that volatility is the same thing as risk versus the old fashioned notion that volatility is simply the price one pays for liquidity.

There are several publicly traded alternative asset management specialists, as opposed to traditional mutual fund managers that happen to offer a few alternative funds. The top five firms–Apollo Global Management (APO), Carlyle Group (CG), Blackstone Group (BX), KKR & Co. (KKR) and Oaktree Capital (OAK)–have been entrusted with over $800 billion of client monies to invest. They collect management fees that typically run to 2% of committed assets under management in their partnerships. Additionally, they can receive an incentive fee that is typically 20% of profits above a certain return level to the investors. This arrangement is extremely lucrative for successful managers.

David M. Rubenstein of Carlyle Group (Wikipedia)

I have always preferred to get exposure to alternatives through the global stock markets because the stockbroker in me will always opt for liquidity. Sure, liquidity can be psychologically difficult when markets are declining but we still prefer it to the forced illiquidity partnerships often require.

There are numerous ways to own alternative assets in the global public markets. They tend to be thinly traded so limit orders are usually necessary. Want to own a profitable farm? There are many opportunities including the secretive and very thinly traded JG Boswell Company (BWEL) in the U.S., and SLC Agricola (BVMF:SLCE3) with 750,000 acres of arable land in Brazil. SLC Agricola is a consistently profitable grower of soybeans, cotton and corn, sells at a 29% discount to NAV at roughly $1,700 an acre and has a credible long-term growth strategy.

Perhaps your taste in agriculture runs more elitist? In luxury agriculture, there are publicly traded opportunities in champagne that should also be classified as an alternative because of the underlying assets. Laurent-Perrier (EPA:LPE) is one of the top five global names with a $590 million market capitalization. What is the value of the Laurent-Perrier, Salon and Delamotte brands? We can only guess but we believe the value of their inventory and vineyards alone exceed the current stock market capitalization.

There are other examples of alternative assets that one can own directly through the global stock markets. A truly eccentric one is Societe des Bains de Mer (EPA:BAIN) that owns many of the famous casinos, beach clubs, restaurants and nightclubs in Monaco, including the Hotel de Paris. Big owners in this company are Monaco's Grimaldi Family and the government of Monaco.

The companies that give the highest degree of exposure to alternative investments, particularly private equity, are the asset managers themselves. If you want an allocation to alternatives with no minimums, lock-up periods, side-pockets or gates but want to profit from a diversified portfolio and benefit from the growth of the industry, then why not partner with the best and own their publicly traded units?

If you run a huge endowment or pension fund and you are required to invest a certain percentage of the fund's assets in alternatives, you will likely allocate the money to at least one or more of the five alternative asset managers mentioned above.

Let's say an allocation is made to a private equity offering from Carlyle because they are considered a best-in-class manager. As an investor your return will mirror the performance of the underlying investments made by Carlyle minus their management fees and incentive fees. In other words, you will underperform the underlying asset's return by the fees garnered by Carlyle over a stretch of time. Investors have historically been pleased with this arrangement because for the most part, despite high fees, Carlyle has delivered good long-term results.

Now consider the same deal from the perspective of a shareholder in The Carlyle Group. The shareholder will have claim on the return from Carlyle's participation in all deals plus the management and incentive fees not paid to employees, less the cost of running the business.

Given this, if an endowment allocates funds to private equity offerings routinely, it is difficult to imagine how its illiquid return over time could be better than a long-term unit holder in the publicly traded partnership. This is

particularly true if the unit holder is able to buy the shares at a discount to net asset value, as is the case today. Carlyle is trading at a 30% discount to what Credit Suisse estimates is a per unit book value of $47.00.

Alternative asset management firms have not been public for long. Carlyle and Oaktree have been public for just over two years each. The granddaddy of them all, Blackstone Group, went public in 2007 amid concerns, proven correct, that we were at a peak in valuations and fund raising ability. Long suffering original investors are now enjoying positive returns but had to endure an 85% drop in Blackstone's unit price during the depths of the financial crisis. Furthermore, despite a 26% increase in the amount of money raised for private equity deals last year, the industry remains 30% below levels reached in 2008.

It is our view that these companies are currently undervalued. Many of the companies are selling below their net asset values. There are hidden catalysts: Oaktree, for example, owns 22% of DoubleLine, a traditional fixed income investor run by the legendary Jeffrey Gundlach. These global alts managers pay very high dividend yields and have heavy insider ownership.

We believe the big global players represent growth businesses because of their proven ability to successfully raise assets under management. They are asset raising machines. Major pension funds, sovereign wealth funds and other large pools of capital want their money managed by the big global brands because they personify stability, consistency of returns and transparency.

The big global managers are well positioned to benefit from numerous trends: the reduction in the number of alternative managers used by the ever larger pools of capital, growth in the emerging markets, and an increased allocation to alternatives by every group. They should benefit from the belief that it is these large professional firms with their talent and economies of scale that are best positioned to add value by improving the operations of a business.
