

Alternative Investments

CAIA Level I

FOURTH EDITION

DONALD R. CHAMBERS
MARK J. P. ANSON, KEITH H. BLACK, HOSSEIN B. KAZEMI

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Alternative Investments

CAIA Level I

Fourth Edition

Donald R. Chambers
Mark J.P. Anson
Keith H. Black
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Preface

Alternative Investments is designed as the primary reading resource for the Level I exam of the Chartered Alternative Investment Analyst (CAIA) Association's Charter program, as well as a textbook for university courses and a resource for alternative investment professionals. This book began three editions ago as a revision of Mark Anson's *Handbook of Alternative Assets* and represents another milestone in our efforts to continuously improve and update the CAIA curriculum. This edition includes material from a variety of contributors to the third edition of the CAIA Level II textbook. To ensure that the material best reflects up-to-date practices in the area of alternative investments, the CAIA Association invited a group of leading industry professionals to review the series, covering core areas of alternative investments: real assets, hedge funds, private equity/credit, and structured products.

Foundation

Since its inception in 2002, the CAIA Association has strived to be the leader in alternative investment education worldwide, and to be the catalyst for the best education in the field wherever it lies. The CAIA program was established with the help of a core group of faculty and industry experts who were associated with the University of Massachusetts and the Alternative Investment Management Association (AIMA). From the beginning, the Association recognized that a meaningful portion of its curriculum must be devoted to codes of conduct and ethical behavior in the investment profession. To this end, with permission and cooperation of the CFA Institute, we have incorporated its Code of Ethics and the *CFA Standards of Practice Handbook* into our curriculum. Further, we leverage the experience and contributions of our members and other alternative investment professionals who serve on our board and committees to create and update the CAIA Association program's curriculum and its associated readings.

The quality, rigor, and relevance of our curriculum readings derive from the ideals upon which the CAIA Association was based. The CAIA program offered its first Level I examination in February 2003. Our first class consisted of 43 dedicated investment professionals who passed the Level I and Level II exams and met the other requirements of membership. Many of these founding members were instrumental in establishing the CAIA designation as the global mark of excellence in alternative investment education. Through their support and with the help of the founding cosponsors, the AIMA and the Center for the International Securities and Derivatives Markets (CISDM), the CAIA Association is now firmly established as the most comprehensive and credible designation in the rapidly growing sphere of alternative investments.

The AIMA is the hedge fund industry's global, not-for-profit trade association, with over 2,000 corporate members worldwide. Members include leading hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting services, and fund administrators. They all benefit from the AIMA's active influence in policy development; its leadership in industry initiatives, including education and sound practice manuals; and its excellent reputation with regulators.

The CISDM of the Isenberg School of Management of the University of Massachusetts, Amherst seeks to enhance the understanding of the field of alternative investments through research, education, and networking opportunities for member donors, industry professionals, and academics.

The CAIA Association has experienced rapid growth in its membership over the past 17 years. It is now a truly global professional organization with over 11,000 members in over 90 countries. We strive to stay nimble in our process so that curriculum remains relevant and keeps pace with the constant changes in this dynamic industry.

Benefits

Although the CAIA Association's origins are largely based in the efforts of professionals in the hedge fund and managed futures space, these founders correctly identified a void in the wider understanding of alternative investments as a whole. From the beginning, the CAIA curriculum has also covered private equity, commodities, and real assets, always with an eye toward shifts in the industry. Today, several hundred CAIA members identify their main area of expertise as real estate or private equity; several hundred more members are from family offices, pension funds, endowments, and sovereign wealth funds that allocate across multiple classes within the alternative investment industry. To ensure benefit to the widest spectrum of members, we have developed curriculum subcommittees that represent each area of coverage within the curriculum. Alternative investment areas and products share some distinct features, such as the relative freedom on the part of investment managers to act in the best interests of their investors, alignment of interests between asset owners and asset managers, and relative illiquidity of investment positions of some investment products. These characteristics necessitate conceptual and actual modifications to the standard investment performance analysis and decision-making paradigms.

Our curriculum readings are designed with two goals in mind. First, to provide the readers with tools needed to solve problems they counter in performing their professional duties. Second, to provide them with a conceptual framework that is essential for investment professionals who strive to keep up with new developments in the alternative investment industry.

Readers will find the publications in our series to be beneficial, whether from the standpoint of allocating to new asset classes and strategies in order to gain broader diversification or from the standpoint of a specialist needing to understand better the competing options available to sophisticated investors globally. In both cases, readers will be better equipped to serve their clients' needs.

The CAIA Programs and the CAIA Alternative Investment Analyst Series

The CAIA Level I required readings are contained in this one text, supplemented only by the CFA Institute's *Standards of Practice Handbook*. Level I candidates are assumed to have mastered some knowledge of financial markets, securities pricing, and derivatives markets in advance of commencing studies for the Level I exam.

Many resources are freely available on our website (caia.org). We will continue to update the *CAIA Level I Study Guide* every six months (each exam cycle). The study guide outlines all of the readings and corresponding learning objectives (LOs) that candidates are responsible for meeting. The guide also contains important information for candidates regarding the use of LOs, testing policies, topic weightings, where to find and report errata, and much more. The entire exam process is outlined in the *CAIA Candidate Handbook* and is available at caia.org. Candidates can also access a workbook that solves the problems presented at the end of each chapter of this book and other important study aids.

We believe you will find this series to be the most comprehensive, rigorous, and globally relevant source of educational material available within the field of alternative investments.

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The CAIA Association is an independent, not-for-profit global organization committed to education and professionalism in the field of alternative investments. The Association was established in 2002 by industry leaders under the guidance of the Alternative Investment Management Association (AIMA) and the Center for International Securities and Derivatives Markets (CISDM) with the belief that a strong foundation of knowledge is essential for all professionals. The curriculum includes two exams (Level I and Level II) administered to professional analysts in this growing field so that, upon successful completion, the individuals are designated “Chartered Alternative Investment Analysts” (CAIA). The CAIA designation has a great deal of prestige in the global community. Members come from over 80 countries on six continents.

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PART One

Introduction to Alternative Investments

[Part 1](#) begins with an introduction to alternative investments and a description of the environment of alternative investing. [Chapters 3](#) to [6](#) include primers on quantitative methods, statistics, and financial economics as they relate to alternative investments, as well as a chapter on derivatives and risk-neutral valuation. The last two chapters of [Part 1](#) discuss measures of risk and performance, as well as alpha, beta, and hypothesis testing. The material is designed to provide a foundation for Parts 2 to 5, which detail each of the four main categories of alternative investments.

CHAPTER 1

What Is an Alternative Investment?

Definitions of what constitutes an alternative investment vary considerably. One reason for these differences lies in the purposes for which the definitions are being used. But definitions also vary because alternative investing is largely a new field for which consensus has not emerged, as well as a rapidly changing field for which consensus will probably always remain elusive. Analyzing these various definitions provides a useful starting point to understanding alternative investments. So we begin this introductory chapter by examining commonly used methods of defining alternative investments.

1.1 Alternative Investments by Exclusion

Alternative investments are sometimes viewed as including any investment that is not simply a long position in traditional investments. Typically, **traditional investments** include publicly traded equities, fixed-income securities, and cash. For example, if an investment such as private equity is not commonly covered in detail in most books on investing, then many people would view it as an alternative investment.

The alternative-investments-by-exclusion definition is overly broad for the purposes of the CAIA curriculum. First, the term *investment* covers a very broad spectrum. A good definition of an **investment** is that it is deferred consumption. Any net outlay of cash made with the prospect of receiving future benefits might be considered an investment. So investments can range from planting a tree to buying stocks to acquiring a college education. As such, a more accurate definition of alternative investments requires more specificity than simply that of being nontraditional.

This book and the overall CAIA curriculum are focused on institutional-quality alternative investments. An **institutional-quality investment** is the type of investment that financial institutions such as pension funds or endowments might include in their holdings because they are expected to deliver reasonable returns at an acceptable level of risk. For example, a pension fund would consider holding the publicly traded equities of a major corporation but may be reluctant to hold collectibles such as baseball cards or stamps. Also, investments in very small and very speculative projects are typically viewed as being inappropriate for such an institution due to its responsibility to select investments that offer suitable risk levels and financial return prospects for its clients.

Not every financial institution, or even every type of financial institution, invests in alternative investments. Some financial institutions, such as some brokerage firms, are not focused on making long-term investments; rather, they hold securities to provide services to their clients. Other financial institutions, such as deposit-taking institutions like banks (especially smaller banks) might invest in only traditional investments because of government regulations or because of lack of expertise.

Of course, institutional-quality alternative investments are also held by entities other than financial institutions. [Chapter 2](#) of this book discusses the alternative investment environment, including the various entities that commonly hold them (e.g., endowment funds and wealthy individuals).

1.2 Alternative Investments by Inclusion

Another method of identifying alternative investments is to define explicitly which investments are considered to be alternative. In this book, we classify four types of alternative investments:

1. Real assets (including natural resources, commodities, real estate, infrastructure, and intellectual property)
2. Hedge funds (including managed futures)
3. Private equity and private credit
4. Structured products (including credit derivatives)

These four categories correspond to Parts 2 to 5 of this book. Our list is not an exhaustive list of all alternative investments, especially because the CAIA curriculum is focused on institutional-quality investments. Furthermore, some of the investments on the list can be classified as traditional investments rather than alternative investments. For example, real estate and especially real estate investment trusts are frequently viewed as being traditional institutional-quality investments. Nevertheless, this list includes most institutional-quality investments that are currently commonly viewed as alternative. [Exhibit 1.1](#) illustrates the relative proportion of these four categories of alternative investments.

The following sections provide brief introductions to the four categories.

1.2.1 Real Assets

Real assets are investments in which the underlying assets involve direct ownership of nonfinancial assets rather than ownership through financial assets, such as the securities of manufacturing or service enterprises. Real assets tend to represent more direct claims on consumption than do common stocks, and they tend to do so with less reliance on factors that create value in a company, such as intangible assets and managerial skill. So while a corporation such as Google holds real estate and other real assets, the value to its common stock is highly reliant on perceptions of the ability of the firm's management to oversee creation and sales of its goods and services. An aspect that distinguishes types of real assets is the extent to which the ownership of the real assets involves operational aspects, such as day-to-day management decisions that have substantial impacts on the performance of the assets. For example, in many instances, direct ownership of oil reserves or stockpiles of copper involve substantially less day-to-day managerial attention than does direct ownership of real estate, infrastructure, or intellectual property.

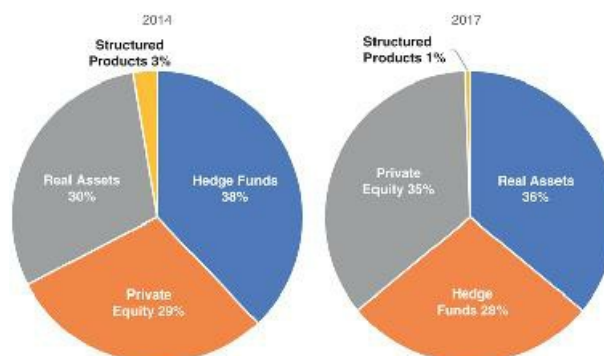


Exhibit 1.1 Major Alternative Asset Categories (percentages approximate), 2017

Source: Global Alternatives Survey 2017, Willis Towers Watson; CAIA Association estimates.

Natural resources focus on direct ownership of real assets that have received little or no alteration by humans, such as mineral and energy rights or reserves. Commodities are differentiated from natural resources by their emphasis on having been extracted or produced. **Commodities** are homogeneous goods available in large quantities, such as energy products, agricultural products, metals, and building materials. Most of the investments covered in the commodities section of the CAIA curriculum involve futures contracts, so understanding futures contracts is an important part of understanding commodities. Futures contracts are regulated distinctly and have well-defined economic characteristics. For example, the analysis of futures contracts typically emphasizes notional amounts rather than the amount of money posted as collateral or margin to acquire positions.

Commodities as an investment class refer to investment products with somewhat passive (i.e., buy-and-hold) exposure to commodity prices. This exposure can be obtained through futures contracts, physical commodities, natural resource companies, and exchange-traded funds.

Some real assets are operationally focused. For the purposes of the CAIA curriculum, **operationally focused real assets** include real estate, land, infrastructure, and intellectual property. The performance of these types of real assets is substantially affected by the skill and success of regular and relatively frequent managerial decision-making. Traditional common stocks are typically even more highly operationally focused.

Real estate focuses on land and improvements that are permanently affixed, like buildings. Real estate was a significant asset class long before stocks and bonds became important. Prior to the Industrial Age, land was the single most valuable asset class. Only a century ago, real estate was the most valuable asset of most individuals, because ownership of a primary residence was more common than ownership of financial investments.

Land comprises a variety of forms, including undeveloped land, timberland, and farmland. Although undeveloped land might appear to belong under the category of natural resources rather than operationally focused real assets, the option to develop land often requires substantial and ongoing managerial decision-making. **Timberland** includes both the land and the timber of forests of tree species typically used in the forest products industry. While the underlying land is a natural resource, timberland requires some level of ongoing management. Finally, **farmland** consists of land cultivated for row crops (e.g., vegetables and grains) and permanent crops (e.g., orchards and vineyards). Farmland necessitates substantial operations and managerial decisions.

Infrastructure investments are claims on the income of toll roads, regulated utilities, ports, airports, and other real assets that are traditionally held and controlled by the public sector (i.e., various levels of government). Investable infrastructure opportunities include securities generated by the privatization of existing infrastructure or by the private creation of new infrastructure via private financing.

Finally, while some descriptions of real assets limit the category to tangible assets, we define real assets to include intangible assets, such as intellectual property (e.g., patents, copyrights, and trademarks, as well as music, film, and publishing royalties). The opposite of a real asset is a financial asset, not an intangible asset. A **financial asset** is not a real asset—it is a claim on cash flows, such as a share of stock or a bond. Intangible assets, such as technology, directly facilitate production, thereby creating increased value. It can be argued that intangible assets represent a very large and rapidly increasing role in the wealth of society.

1.2.2 Hedge Funds

Hedge funds represent perhaps the most visible category of alternative investments. While hedge funds are often associated with particular fee structures or levels of risk taking, we define a **hedge fund** as a privately organized investment vehicle that uses its less regulated nature to generate investment opportunities that are substantially distinct from those offered by traditional investment vehicles, which are subject to regulations such as those restricting their use of derivatives and leverage. Hedge funds represent a wide-ranging set of vehicles that are differentiated primarily by the investment strategy or strategies implemented. Managed futures funds are included as hedge funds in [Part 3](#).

1.2.3 Private Equity

The term **private equity** is used in the CAIA curriculum to include both equity and debt positions that, among other things, are not publicly traded. In most cases, the debt positions contain so much risk from cash flow uncertainty that their short-term return behavior is similar to that of equity positions. In other words, the value of the debt positions in a highly leveraged company, discussed within the category of private equity, behaves much like that of the equity positions in the same firm, especially in the short run. Private equity investments emerge primarily from funding new ventures, known as venture capital; from the equity of leveraged buyouts of existing businesses; from mezzanine financing of leveraged buyouts or other ventures; and from distressed debt resulting from the decline in the health of previously healthy firms.

Venture capital refers to support via equity financing to start-up companies that do not have a sufficient size, track record, or desire to attract capital from traditional sources, such as public capital markets or lending institutions. Venture capitalists fund these high-risk, illiquid, and unproven ideas by purchasing senior equity stakes while the start-up companies are still privately held. The ultimate goal is to generate large profits primarily through the business success of the companies and their development into enterprises capable of attracting public investment capital (typically through an initial public offering, or IPO) or via their sale to other companies. In the context of investment management, venture capital is sometimes treated as a separate asset class from other types of private equity.

Leveraged buyouts (LBOs) refer to those transactions in which the equity of a publicly traded company is purchased using a small amount of investor capital and a large amount of borrowed funds in order to take the firm private. The borrowed funds are secured by the assets or cash flows of the target company. The goals can include exploiting tax advantages of debt financing, improving the operating efficiency and the profitability of the company, and ultimately taking the company public again (i.e., making an IPO of its new equity). Management buyouts and management buy-ins are types of LBOs with specific managerial changes.

Mezzanine debt derives its name from its position in the capital structure of a firm: between the ceiling of senior secured debt and the floor of equity. Mezzanine debt refers to a spectrum of risky claims, including preferred stock, convertible debt, and debt that includes equity kickers (i.e., options that allow investors to benefit from any upside success in the underlying business, also called hybrid securities).

Distressed debt refers to the debt of companies that have filed or are likely to file in the near future for bankruptcy protection. Even though these securities are fixed-income securities, distressed debt is included in our discussion of private equity because the future cash flows of the securities are highly risky and highly dependent on the financial success of the distressed companies, and thus share many similarities with common stock. Private equity firms investing in distressed debt tend to take longer-term ownership positions in the companies after converting all or some portion of their debt position to equity. Some

hedge funds also invest in distressed debt, but they tend to do so with a shorter-term trading orientation.

Private debt and direct lending strategies include loans made to borrowers outside of the banking system, specifically by hedge funds, private equity funds, and private credit funds. As regulations increased after the global financial crisis, banks facing stress tests and capital adequacy requirements backed away from lending, especially to non-investment-grade middle-market companies. Companies needing financing now need to approach direct lenders who are likely to make the loans easier and more quickly than banks, but at higher total interest costs.

1.2.4 Structured Products

Structured products are instruments created to exhibit particular return, risk, taxation, or other attributes. These instruments generate unique cash flows as a result of partitioning the cash flows from a traditional investment or linking the returns of the structured product to one or more market values. The simplest and most common example of a structured product is the creation of debt securities and equity securities in a traditional corporation. The cash flows and risks of the corporation's assets are structured into a lower-risk fixed cash flow stream (bonds) and a higher-risk residual cash flow stream (stock). The structuring of the financing sources of a corporation creates option-like characteristics for the resulting securities.

Collateralized debt obligations (CDOs) and similar instruments are among the best-known types of structured products. CDOs partition the actual or synthetic returns from a portfolio of assets (the collateral) into securities with varied levels of seniority (the tranches).

Credit derivatives, another popular type of structured product, facilitate the transfer of credit risk. Most commonly, credit derivatives allow an entity (the credit protection buyer) to transfer some or all of a credit risk associated with a specific exposure to the party on the other side of the derivative (the credit protection seller). The credit protection seller might be diversifying into the given credit risk, speculating on the given credit risk, or hedging a preexisting credit exposure.

Historically, the term *structured products* has referred to a very broad spectrum of products, including CDOs and credit derivatives. In recent decades, however, the term is being used to describe a narrower set of financially engineered products. These products are issued largely with the intention of meeting the preferences of investors, such as providing precisely crafted exposures to the returns of an index or a security. For example, a major bank may issue a product designed to offer downside risk protection to investors while also offering the potential for the investor to receive a portion of the upside performance in an index. [Part 5](#) discusses these specially designed structured products along with more generic structured products, including credit derivatives and CDOs.

When the structuring process creates instruments that do not behave like traditional investments, those instruments are considered alternative investments.

1.2.5 Limits on the Categorizations

These four categories of alternative investments are the focus of the CAIA curriculum. While the categorization helps us understand the spectrum of alternative investments, the various alternative investment categories may overlap. For example, some hedge fund portfolios may contain substantial private equity or structured product exposures and may even substantially alternate the focus of their holdings through time. This being said, the four categories discussed in the previous sections represent the investment types central to

the Level I curriculum of the CAIA program.

1.3 The Blurred Lines Between Traditional and Alternative Investments

The previous sections defined the category of alternative investments by describing the investments that are or are not commonly thought of as alternative. But the question remains as to what the defining characteristics of investments are that cause them to be classified as alternative. For example, why is private equity considered an alternative investment but other equities are considered traditional investments? What is the key characteristic or attribute that differentiates these equities? The answer is that traditional equities are listed on major stock exchanges whereas private equity is not. In this case, traditional equities possess the characteristic of being publicly traded, while private equity does not.

Alternative Investments	Assets Often Characterized as Traditional or Alternative	Analogous Traditional Assets
Hedge funds	Liquid alternative mutual funds	Ordinary mutual funds
Private equity	Closed-end funds with illiquid holdings	Public equities
Real assets	Public real estate and public equities of corporations with performance dominated by stable positions in real assets	Public equities with performance dominated by managerial decisions
Complex structured products	Simple structured products offering relatively stable and common risk and return characteristics	Simple derivatives used as part of a strategy with stable risk exposures

Exhibit 1.2 The Blurred Lines Between Traditional and Alternative Assets

The lines between traditional and alternative assets are not distinct and universal. [Exhibit 1.2](#) depicts the four categories of alternative investments (in the left column), assets that are sometimes listed as alternative and sometimes as traditional (in the middle column), and assets viewed only as traditional (in the right column). [Exhibit 1.2](#) illustrates the lack of clear lines between alternative and traditional assets. This book will focus on those assets that are most universally described as alternative.

Note in [Exhibit 1.2](#) that hedge fund–like returns are now available in publicly traded “liquid alternative” mutual funds. Not all hedge fund strategies are available through these public mutual funds—that is, the U.S. Investment Company Act of 1940 (the ’40 Act) or Undertakings for Collective Investment in Transferable Securities (UCITS) funds—because of regulatory limits on leverage and illiquidity. So-called ’40 Act (1940 Act) funds are those regulated under the U.S. Investment Company Act of 1940. Some alternative strategies are available through closed-end fund structures.

Private equity is inherently illiquid and generally is not available via ’40 Act funds or other public investment pools, although several closed-end structures, such as business development corporations, hold private equity as their underlying investments. Closed-end fund structures can use modest amounts of leverage and illiquid underlying assets because the investment companies are not generally required to redeem investor shares on demand.

Among the category of real assets, real estate is most often characterized as both traditional and alternative, especially when the real estate is accessed through publicly

traded investment pools, such as REITs. Some publicly traded common stocks with value primarily derived from holdings of natural resources, such as oil reserves, mineral rights, or land, are often classified as real assets. However, to the extent that a stock's value is driven by such managerial expertise as marketing, trading of assets, or technology, the returns will not be dominated by the values of underlying real assets and the stocks are more appropriately viewed as traditional operating firms.

Finally, the category of structured products varies from rather simple financial derivatives that are often classified as traditional investments (e.g., credit default swaps) to more complex derivatives, such as collateralized loan obligations, that are usually classified as alternative. Furthermore, some financial derivatives, such as futures contracts and forward contracts, can be used to replicate traditional asset exposures and thus clearly fall within the realm of traditional investing. For example, a portfolio of cash plus a long position in a forward contract on an equity index synthetically replicates a long position in the equities underlying the index. The decision of whether to classify a structured product as an alternative investment should be based on the extent to which the product offers nontraditional risk and return exposures and requires investment management methods that differ markedly from traditional investment management methods.

1.4 A History of Alternative Investing: The U.S. Case

[Exhibit 1.3](#) provides a general overview of the investments typically held by institutional investors, such as banks, pension funds, endowments, and insurance companies. Throughout much of the twentieth century, each institutional-quality investment was evaluated primarily on the safety of its income and principal and tended to be evaluated on a standalone basis.

Beginning in the 1950s and 1960s, modern portfolio theory established the mechanics and advantages of diversification. Modern portfolio theory evaluates risk on a portfolio basis—formalizing the idea that much risk can be diversified away by holding a broad mix of available investments. In the 1980s and 1990s, the appropriateness of investments for institutions increasingly began to be evaluated on a portfolio basis.

The change in law and investment practices from evaluating risk on a standalone basis to a portfolio-as-a-whole basis is evidenced in [Exhibit 1.3](#).

Beginning in the 1980s, inclusion of such assets as small-company stocks, low-quality corporate bonds, and alternative assets became more common among financial institutions, such as banks, pension funds, endowment funds, and insurance companies. Evaluated on a standalone basis, many of these assets had little or no reliable income and were at risk for loss of the original investment. But when held in a portfolio, these relatively high-risk investments could lower the total risk of the portfolio because of their ability to provide improved diversification.

1890–1920	Government debt, real estate, mortgages, preferred stock
1920–1950	Add high-quality corporate bonds, domestic equities, agricultural debt
1950–1980	Add average-quality corporate bonds, international equities
1980–Present	Add high-yield debt, small stocks, structured products, private equity, hedge funds, real assets

[Exhibit 1.3](#) Popular Institutional Quality Assets, 1890–Present

[Exhibit 1.3](#) indicates that institutions usually did not hold common stocks prior to 1920. Most institutional-quality investments more than 100 years ago were those secured by tangible assets, such as real estate.

The underlying determinants of economic performance are changing with increasing speed. Take, for instance, the composition of the major stocks in the United States. In early 1901, the Dow Jones Industrial Average included 12 stocks: 10 common stocks and two preferred stocks. Almost every one of the 12 stocks was a commodity producer (copper, sugar, tobacco, paper, lead, coal, leather, rubber, and steel).

By 1960, the top seven Fortune 500 firms in the United States were General Motors Company, Standard Oil Company of New Jersey, Ford Motor Company, General Electric, U.S. Steel, Mobil, and Gulf Oil. The list included three oil companies and one steel company as well as two automobile manufacturers and one electrical equipment manufacturer.

Now, top firms are dominated by services and technology. The top five U.S. firms in terms of market capitalization in 2017 were Apple Inc., Alphabet Inc., Microsoft Corporation, Amazon.com Inc., and Berkshire Hathaway Inc. Facebook, Inc., was seventh in mid-2017 with a market capitalization of more than \$500 billion, no inventory, and fixed assets of only about \$10 billion. Clearly, it is inappropriate to view traditional assets as solid and alternative assets as speculative.

Investments closely tied to commodity prices are now viewed as alternative investments, yet they constituted most of the industrial investment opportunities in 1900. With such dramatic and increasingly rapid changes in the components of an economy, it is difficult to conclude that conservative and traditional investment principles consist of maintaining unchanging investment practices. In effect, sticking with traditional investment practices moves the risk and diversification of a portfolio through time as the economy underlying the investment opportunities shifts. It is only through a dynamic approach to asset allocation (one that adjusts to new industries, securities, and other economic changes) that a portfolio can maintain good principles of diversification.

1.5 Investments are Distinguished by Return Characteristics

A popular way of distinguishing between traditional and alternative investments is by their return characteristics. Investment opportunities exhibiting returns that are substantially distinct from the returns of long only position in traditional stocks and bonds might be viewed as being alternative investments. Stock returns in this context refer to the returns of publicly traded equities; similarly, bond returns refer to the returns of publicly traded fixed-income securities.

1.5.1 Diversification

An investment opportunity with returns that are uncorrelated with or only slightly correlated with traditional investments is often viewed as an alternative investment. An attractive aspect of this lack of correlation is that it indicates the potential to diversify risk. In this context, many alternative investments are referred to as diversifiers. A **diversifier** is an investment with a primary purpose of contributing diversification benefits to its owner. **Absolute return products** are investment products viewed as having little or no return correlation with traditional assets, and have investment performance that is often analyzed on an absolute basis rather than relative to the performance of traditional investments. The term *absolute returns* in this context should not be confused with the mathematical use of the term *absolute value* to indicate a numerical value that is always nonnegative. Diversification can lower risk without necessarily causing an offsetting reduction in expected return and is therefore generally viewed as a highly desirable method of generating improved risk-adjusted returns.

Sometimes alternative assets are viewed as synonymous with diversifiers or absolute return products. But clearly most types of investments, such as private equity, REITs, and particular styles of hedge funds, have returns that are at least modestly correlated with public equities over medium- to long-term time horizons and are still viewed as alternative investments. Accordingly, this non-correlation-based view of alternative investments does not provide a precise demarcation between alternative and traditional investments. Nevertheless, having distinct returns is often an important characteristic in differentiating alternative investments from traditional investments.

Alternative investments may be viewed as being likely to have return characteristics that are different from stocks and bonds, as demonstrated by their lack of correlation with stocks and bonds. The distinctions between traditional and alternative investments are also indicated by several common return characteristics found among alternative investments that either are not found in traditional investments or are found to a different degree. The following three sections discuss the most important potential return characteristic distinctions.

1.5.2 Illiquidity

Traditional investments have the institutional structure of tending to be frequently traded in financial markets with substantial volume and a high number of participants. Therefore, their returns tend to be based on liquid prices observed from reasonably frequent trades at reasonable levels of volume. Many alternative investments are illiquid. In this context, **illiquidity** means that the investment trades infrequently or with low volume (i.e., thinly). Illiquidity implies that returns are difficult to observe due to lack of trading, and that realized returns may be affected by the trading decisions of just a few participants. Other assets, often termed **lumpy assets**, are assets that can be bought and sold only in specific quantities, such as a large real estate project. Thin trading causes a more uncertain relationship between the most recently observed price and the likely price of the next

transaction. Generally, illiquid assets tend to fall under the alternative investment classification, whereas traditional assets tend to be liquid assets. However, liquid assets can be found inside alternative investment structures such as hedge funds and structured products.

The risk of illiquid assets may be compensated for by higher returns. An illiquid asset can be difficult or expensive to sell, as thin volume or lockup provisions prevent the immediate sale of the asset at a price close to its potential sales value. The urgent sale of an illiquid asset can therefore be at a price that is considerably lower than the value that could be obtained from a long-term comprehensive search for a buyer. Given the difficulties of selling and valuing illiquid investments, many investors demand a risk premium, or a price discount, for investing in illiquid assets. While some investors may avoid illiquid investments at all costs, others specifically increase their allocation to illiquid investments in order to earn this risk premium.

1.5.3 Inefficiency

The prices of most traditional investments are determined in markets with relatively high degrees of competition and therefore with relatively high informational efficiency. In this context, competition is described as numerous well-informed traders able to take long and short positions with relatively low transaction costs and with high speed. **Efficiency** (i.e., informational efficiency) refers to the tendency of market prices to reflect all available information.

Efficient market theory asserts that arbitrage opportunities and superior risk-adjusted returns are more likely to be identified in markets that are less competitively traded and less informationally efficient. (Market efficiency is detailed in [Chapter 5](#).) Many alternative investments have the institutional structure of trading at inefficient prices. **Inefficiency** refers to the deviation of actual prices from valuations that would be anticipated in an efficient market. Informationally inefficient markets are less competitive, with fewer investors, higher transaction costs, and/or an inability to take both long and short positions. Accordingly, alternative investments may be more likely than traditional investments to offer returns driven by pricing inefficiencies.

1.5.4 Non-Normality

To some extent, the returns of almost all investments, especially the short-term returns on traditional investments, can be approximated as being normally distributed. The normal distribution is the commonly discussed bell-shaped distribution, with its peaked center and its symmetric and diminishing tails. The return distributions of most investment opportunities become nearer to the shape of the normal distribution as the time interval of the return computation nears zero and as the probability and magnitude of jumps or large moves over a short period of time decrease. However, over longer time intervals, the returns of many alternative investments exhibit non-normality, in that they cannot be accurately approximated using the standard bell curve. The non-normality of medium- and long-term returns is a potentially important characteristic of many alternative investments.

What structures cause non-normality of returns? First and foremost, many alternative investments are structured so that they are infrequently traded; therefore, their market returns are measured over longer periods of time. These longer time intervals combine with other aspects of alternative investment returns to make alternative investments especially prone to return distributions that are poorly approximated using the normal distribution. These irregular return distributions may arise from several sources, including (1) securities structuring, such as with a derivative product that is nonlinearly related to its

underlying security or with an equity in a highly leveraged firm, and (2) trading structures, such as an active investment management strategy alternating rapidly between long and short positions.

Non-normality of returns introduces a host of complexities and lessens the effectiveness of using methods based on the assumption of normally distributed returns. Many alternative investments have especially non-normal returns compared to traditional investments; therefore, the category of alternative investments is often associated with non-normality of returns.

1.6 Investments are Distinguished by Methods of Analysis

The previous section outlined return characteristics of alternative investments that distinguished them from traditional investments: diversifying, illiquid, inefficient, and non-normal. Alternative investments can also be distinguished from traditional investments through the methods used to analyze, measure, and manage their returns and risks. As in the previous case, the reasons for the difference lie in the underlying structures: Alternative investments have distinct regulatory, securities, trading, compensation, and institutional structures that necessitate distinct methods of analysis. Public equity returns are extensively examined using both theoretical analysis and empirical analysis. Theoretical models, such as the capital asset pricing model, and empirical models, such as the Fama-French three-factor model, detailed later in the CAIA curriculum, are examples of the extensive and highly developed methods used in public equity return analysis. Analogously, theories and empirical studies of the term structure of interest rates and credit spreads arm traditional fixed-income investors with tools for predicting returns and managing risks. But alternative investments do not tend to have an extensive history of well-established analysis, and in many cases the methods of analysis used for traditional investments are not appropriate for these investments due to their structural differences.

Alternative investing requires alternative methods of analysis. In summary, a potential definition of an alternative investment is any investment for which traditional investment methods are clearly inadequate. There are four main types of methods that form the core of alternative investment return analysis.

1.6.1 Return Computation Methods

Return analysis of publicly traded stocks and bonds is relatively straightforward, given the transparency in regularly observable market prices, dividends, and interest payments. Returns to some alternative investments, especially illiquid investments, can be problematic. One major issue is that in many cases, a reliable value of the investment can be determined only at limited points in time. In the extreme, such as in most private equity deals, there may be no reliable measure of investment value at any point in time other than at termination, when the investment's value is the amount of the final liquidating cash flow. This institutional structure of infrequent trading drives the need for different return computation methods.

Return computation methods for investments are driven by their structures and can include such concepts as internal rate of return (IRR), the computation of which over multiple time periods uses the size and timing of the intervening cash flows rather than the intervening market values. Also, return computation methods for many alternative investments may take into account the effects of leverage. While traditional investments typically require the full cash outlay of the investment's market value, many alternative contracts can be entered into with no outlay other than possibly the posting of collateral or margin or, as in the case of private equity, commitments to make a series of cash contributions over time. In the case of no investment outlay, the return computations may use alternative concepts of valuation, such as notional principal amounts. While IRR is commonly used in traditional investments, especially in the case of multiple cash contribution commitments, alternative investments such as private equity may use other methods. [Chapter 3](#) provides details regarding return computation methods, such as IRR, that facilitate analysis of alternative investments. The chapters on private equity explain more commonly used methods, including Public Market Equivalent (PME).

1.6.2 Statistical Methods

The traditional assumption of near-normal returns for traditional investments offers numerous simplifications. First, the entire distribution of an investment with normally or near-normally distributed returns can be specified with only two parameters: (1) the mean of the distribution, and (2) the standard deviation, or variance, of the distribution. Much of traditional investment analysis is based on the representation of an investment's return distribution using only the mean and standard deviation. Further, numerous statistics, tests, tables, and software functions are readily available to facilitate the analysis of a normally distributed variable.

But as indicated previously in this chapter, many alternative investments exhibit especially non-normally distributed returns over medium- and long-term time intervals. Non-normality is usually addressed through the analysis of higher moments of the return distributions, such as skewness and kurtosis. Accordingly, the analysis of alternative investments typically requires familiarity with statistical methods designed to address this non-normality caused by institutional structures like thin trading, securities structures like tranching, and trading structures like alternating risk exposures. An example of a specialized method is in risk management: While a normal distribution is symmetrical, the distributions of some alternative investments can be highly asymmetrical and therefore require specialized risk measures that specifically focus on the downside risks. [Chapter 7](#) introduces some of these methods.

1.6.3 Valuation Methods

Fundamental and technical methods for valuing traditional securities and potentially identifying mispriced securities constitute a moderately important part of the methods used in traditional investments. In traditional investments, fundamental equity valuation tends to focus on relatively healthy corporations engaged in manufacturing products or providing services, and tends to use methods such as financial statement analysis and ratio analysis. Many hedge fund managers use the same general fundamental and technical methods in attempting to identify mispriced stocks and bonds. However, hedge fund managers may also use methods specific to alternative investments, such as those used in highly active trading strategies and strategies based on identifying relative mispricings. For example, a quantitative equity manager might use a complex statistical model to identify a pair of relatively overpriced and underpriced stocks that respond to similar risk factors and are believed to be likely to converge in relative value over the next day or two. Additionally, alternative investing tends to focus on the evaluation of fund managers, while traditional investing tends to focus more on the valuation of securities.

Methods for valuing some types of alternative investments are quite distinct from the traditional methods used for valuing stocks and bonds. Here are several examples:

- Alternative investment management may include analyzing active and rapid trading that focuses on shorter-term price fluctuations.
- Alternative investment analysis often requires addressing challenges imposed by the inability to observe transaction-based prices on a frequent and regular basis. The challenges in illiquid markets relate to determining data for comparison (i.e., benchmarking), since reliable market values are not continuously available.
- Alternative investments such as real estate, private equity, and structured products tend to have unique cash flow forecasting challenges.
- Alternative investments such as some intellectual property and private equity funds use appraisal methods that are estimates of the current value of the asset, which may differ from the price that the asset would achieve if marketed to other investors.

These specialized pricing and valuation methods are driven by the structures that determine the characteristics of alternative investments.

1.6.4 Portfolio Management Methods

Finally, issues such as illiquidity, non-normal returns, and increased potential for inefficient pricing introduce complexities for portfolio management techniques. Most of the methods used in traditional portfolio management rely on assumptions such as the ability to transact quickly, relatively low transaction costs, and often the ability to confine an analysis to the mean and variance of the portfolio's return.

In contrast, portfolio management of alternative investments often requires the application of techniques designed to address such issues as the non-normality of returns and barriers to continuous portfolio adjustments. Non-normality techniques may involve skewness and kurtosis, as opposed to just the mean and variance. In traditional investments, the ability to transact quickly and at low cost often allows for the use of short-term time horizons, since the portfolio manager can quickly adjust positions as conditions change. The inability to trade some alternative investments, like private equity, quickly and at low cost adds complexity to the portfolio management process, such as liquidity management, and mandates understanding of specialized methods. Finally, alternative investment portfolio management tends to focus more on the potential for assets to generate superior returns.

1.7 Eight Other Characteristics that Distinguish Alternative and Traditional Investments

Previous sections discuss differentiating alternative and traditional investments by their return characteristics and the methods by which they are analyzed. This section discusses eight additional characteristics or factors that often play a role in distinguishing alternative and traditional investments.

1. **Regulatory factors** in the context of investing refer to the role of government, including both regulation and taxation, in influencing the nature of an investment. For example, hedge funds (but not their managers) are often less regulated and typically must be formed in particular ways to avoid higher levels of regulation. Taxation is another important feature of government influence that can motivate the existence of some investment products and plays a major role in the transformation of underlying asset cash flows into investment products.
2. **Structuring** refers to the partitioning of claims to cash flows through leverage and securitization. Securitization is the process of transforming asset ownership into tradable units. Cash flows may be securitized simply on a pass-through basis (i.e., a pro rata or pari passu basis). Cash flows can also be partitioned into financial claims with different levels of risk or other characteristics, such as the timing or taxability of cash flows. The use of securities and security structuring transforms asset ownership into potentially distinct and diverse tradable investment opportunities. The nature of this transformation drives and shapes the nature of the resulting investments, the characteristics of the resulting returns, and the types of methods that are needed for investment analysis. On the other hand, lack of easily tradable ownership units can drive the selection and implementation of investment methods.
3. **Trading strategies** refer to the role of an investment vehicle's investment managers in developing and implementing trading strategies that alter the nature of an investment. A buy-and-hold management strategy will have a minor influence on underlying investment returns, while an aggressive, complex, fast-paced trading strategy can cause the ultimate cash flows from a fund to differ markedly from the cash flows of the underlying assets. The trading strategy embedded in an alternative asset such as a fixed-income arbitrage hedge fund is often the most important factor in determining the investment's characteristics.
4. **Compensation structures** refer to the ways that organizations distribute rewards. In the case of a hedge fund, compensation structures would include the financial arrangements contained in the limited partnership formed by the investors and the entity used by the fund's managers. Such arrangements usually determine the exposure of the fund's investment managers to the financial risk of the investment, the fee structures used to compensate and reward managers, and the potential conflicts of interest between parties. Compensation structures within investments, especially alternative investments, have implications for the agency costs generated by owner-manager relationships.
5. **Institutional factors** refer to the financial markets (and their policies, such as restrictions on short selling, leverage, and trading) and financial institutions related to a particular investment, such as whether the investment is publicly traded. Public trading or the listing of a security is an essential driver of an investment's nature. For example, some hotels are owned by investors as shares of publicly traded corporations, such as Hyatt and Marriott, which are usually considered to be traditional investments. Other hotels, such as those owned by investors as real estate

investment trusts (e.g., Host Hotels & Resorts Inc.) and those held privately (e.g., Omni Hotels), are usually considered to be alternative investments. Other institutional structures can determine whether an investment is regularly traded, is held by individuals at the retail level, or tends to be traded and held by large financial institutions such as pension funds and foundations.

6. **Information asymmetries** refer to the extent to which market participants possess different data and knowledge. In traditional investments, most securities are regulated and are required to disclose substantial information to the public. Many alternative investments are private placements, and therefore the potential for large information asymmetries is greater. These information asymmetries raise substantial issues for financial analysis and portfolio management.
7. **Incomplete markets** refer to markets with insufficient distinct investment opportunities. The lack of distinct investment opportunities can prevent market participants from implementing an investment strategy that satisfies their exact preferences, such as their preferences regarding risk exposures. In an ideal world, securities could be costlessly created to meet every investor need. For example, an investor may desire an insurance contract that contains a specific clause regarding payouts, but regulations may prohibit such clauses. Or perhaps a contract with regard to a potential risk may be subject to unacceptable moral hazard. **Moral hazard** is risk that the behavior of one or more parties will change after entering into a contract. As a result of this inability to contract efficiently, the investor might be unable to diversify perfectly. Trading restrictions in some alternative investments, such as large minimum investment sizes, can be viewed as exacerbating the problem of incomplete markets and the investment challenges that accompany them.
8. **Innovation** is the application of creativity. In this context, innovation has three major influences. First, especially in venture capital, innovation from nascent enterprises raises challenges regarding methods of cash flow projections, financial analysis, and portfolio management that distinguish the study of alternative investments from the study of traditional investments. Second, substantial degrees of innovation permeate the institutions surrounding alternative investments such as new structured products and derivatives. These innovations tend to inject new opportunities and challenges more in alternative investing than in traditional investing. Finally, innovation often serves as the source of superior returns in alternative assets, especially private equity.

1.8 Five Goals of Alternative Investing

Having defined *what* alternative investments are from a variety of perspectives, we introduce the questions of *how* and *why* people pursue alternative investing. Understanding the goals of alternative investing is essential; the following sections provide an introduction to the most important of these goals.

1.8.1 Adding Value through Active Management

Active management refers to efforts of buying and selling securities in pursuit of superior combinations of risk and return. Alternative investment analysis typically focuses on evaluating active managers and their systems of active management, since most alternative investments are actively managed. Active management is the converse of passive investing. **Passive investing** tends to focus on buying and holding securities in an effort to match the risk and return of a target, such as a highly diversified index. An investor's risk and return target is often expressed in the form of a **benchmark**, which is a performance standard for a portfolio that reflects the preferences of an investor with regard to risk and return. For example, a global equity investment program may have the MSCI World Index as its benchmark. The returns of the fund would typically be compared to the **benchmark return**, which is the return of the benchmark index or benchmark portfolio.

Active management typically generates active risk and active return. **Active risk** is that risk that causes a portfolio's return to deviate from the return of a benchmark due to active management. **Active return** is the difference between the return of a portfolio and its benchmark that is due to active management. An important goal in alternative investing is to use active management to generate an improved combination of risk and return.

Active management is an important characteristic of almost all alternative investments. Unlike traditional investing, in which the focus is increasingly on passive portfolio management, the focus of alternative investing is often on analyzing the ability of a fund or other investment to generate attractive returns through active management.

1.8.2 Achieving Absolute and Relative Returns

The concepts of benchmark returns, absolute return products, and investment diversifiers have been briefly introduced in this chapter. Let's examine these and other concepts in more detail. In alternative investing, there are two major standards against which to evaluate returns: absolute and relative.

An **absolute return standard** means that returns are to be evaluated relative to zero, a fixed rate, or relative to the riskless rate, and therefore independently of performance in equity markets, debt markets, or any other markets. Thus, an investment program with an absolute return strategy seeks attractive absolute returns—returns unaffected by market directions. An example of an absolute return investment fund is an equity market-neutral hedge fund with equal-size long and short positions in stocks that the manager perceives as being undervalued and overvalued, respectively. The fund's goal is to hedge away the return risk related to the level of the equity market and to exploit security mispricings to generate returns in excess of the riskless rate.

A **relative return standard** means that returns are to be evaluated relative to a variable benchmark. An investment program with a relative return standard seeks attractive relative returns—returns that move in tandem with a particular market but consistently outperform that market. An example of a fund with a relative return strategy is a long-only global equity fund that diversifies across various equity sectors and uses security selection

in an attempt to identify underpriced stocks. The fund's goal is to earn the benchmark return from the fund's exposure to the global equity market and to earn a consistent premium on top of that return through superior security selection.

1.8.3 Pursuing Arbitrage and Return Enhancement

The concept of arbitrage is an active absolute return strategy. **Pure arbitrage** is the attempt to earn risk-free profits through the simultaneous purchase and sale of identical positions trading at different prices in different markets. Modern finance often derives pricing relationships based on the idea that the actions of arbitrageurs will force the prices of identical assets toward being equal, such that pure arbitrage opportunities do not exist or at least do not persist. [Chapter 5](#) provides details on arbitrage-free modeling.

The term *arbitrage* is often used to represent efforts to earn superior returns even when risk is not eliminated because the long and short positions are not in identical assets or are not held over the same time intervals. To the extent that investment professionals use the term *arbitrage* more loosely, these investment programs can be said to contain active risk and to generate relative returns.

An obvious goal of virtually any investor is to earn a superior combination of risk and return. If the primary objective of including an investment product in a portfolio is the superior average returns that it is believed to offer, then that product is often referred to as a **return enhancer**. If the primary objective of including the product is the reduction in the portfolio's risk that it is believed to offer through its lack of correlation with the portfolio's other assets, then that product is often referred to as a **return diversifier**.

1.8.4 Reduced Risk through Diversification

A primary goal of alternative investing is to reduce risk through diversification. One of the distinguishing features of most alternative investments is their lack of correlation with the major traditional asset classes of public equities and public fixed-income assets. A portfolio containing a variety of alternative assets may offer reduced risk without a proportionate reduction in expected return.

1.8.5 Avoiding Obsolescence

As evidenced by [Exhibit 1.3](#), the asset classes viewed as appropriate for institutional investing have changed dramatically over time. Surely the asset classes used in the future for institutional investing will continue to change. Institutional investors who are the last adopters of institutional-quality asset classes will find that prices have adjusted such that the greatest opportunities have been missed. In the chapters on private equity, we will discuss the first mover advantage, whereby the first institutions to find attractive investment opportunities will derive the greatest benefits. In a similar vein, those asset allocators who are last to embrace change are likely to yield disappointing performance. In other words, those who wait to invest in alternative assets until they have become so mainstream as to be considered to be traditional may suffer from a “last-mover disadvantage.”

1.9 Two Pillars of Alternative Investment Management

For well over a century, the set of assets deemed to be traditional institutional assets has changed dramatically. Institutional investors must decide which new asset classes to include in their portfolio and when to include those assets. Conservatism in allocating to “new” institutional investment classes runs the risk of missing out on improved diversification and perhaps missing stellar early first-mover returns (i.e., high returns resulting from institutions pouring new money into an asset class that is increasingly viewed as appropriate for them to hold). Boldly venturing into asset classes not previously included in institutional portfolios, however, also exposes institutions to the risk of underperforming their more conservative peers.

The challenge for an institutional investor is to decide, as skillfully as possible, which new types of assets to include in a portfolio and which to exclude. How does an investor make such difficult decisions? This section advocates relying on two pillars: empirical analysis and economic reasoning.

1.9.1 Empirical Analysis

Investment literature abounds with the warning that “future investment performance” should not “be inferred from or predicted based on past investment performance.” This overstated warning is taken from Rule 156 of the Securities Act of 1933. In practice, much—if not most—investment analysis and decision-making is ultimately based on historical risk-adjusted performance. For example, it is primarily through historical observation that investment managers have developed opinions on the extent to which investing in equities differs from investing in bonds.

Conversely, the empirical methods used to explain the performance of alternative investments tend not to be as reliable and developed as the methods used to evaluate the performance of traditional investments. Investment professionals seek investments that can enhance the risk-adjusted performance of portfolios. But with huge numbers of potential strategies and powerful tools to backtest performance, it is risky to select opportunities based on empirical analysis alone.

1.9.2 Economic Reasoning

Historical analysis alone is insufficient for determining asset allocations. For example, in the late 1990s the performance of U.S. growth stocks was consistently and strongly positive. The outstanding performance of this sector generated historic returns with extremely attractive statistics: high mean returns, very low variances, and virtually no major drawdowns. The empirical results were so uniformly positive that they led one major investment research firm specializing in mutual funds to assign attractively low risk ratings to many U.S. equity growth funds—then came the dot-com crash of 2000, when plummeting values of growth stock funds resulted in huge losses for their investors.

Investors should be especially skeptical of empirical analyses that sound too good to be true. Economic reasoning can serve as a reliable reality check. Does solid theory support the contention that a particular asset will enhance risk-adjusted return? The addition of any new type of alternative investment into a well-diversified portfolio should be supported to the greatest extent possible by both empirics and theory.

Philosophers debate the two major approaches to the acquisition of knowledge (i.e., theory and empirics). Rationalists argue that most or all knowledge is ultimately understood through reasoning. Empiricists argue that reasoning is derived from observation. We would argue that both are needed.

The crux of the matter is that best practices in alternative investing include striving to make decisions that are supported by both sound analysis of past performance data and careful economic reasoning. This goal is executed with a balance of the two pillars: (1) evidence based on objective analysis of empirical data and (2) evidence based on an unbiased assessment of theories based on economic reasoning.

		Trading Characteristics	
		Publicly Traded	Privately Traded
	Enhanced Returns	Hedge Funds	Private Equity/Credit
Primary Goal			
	Diversification/Risk Mgmt.	Structured Products	Real Assets

Exhibit 1.4 A 2×2 Framework of Alternative Assets

1.9.3 Viewing Alternative Assets in a 2×2 Framework

The four major categories of alternative investments (real assets, hedge funds, private equity/credit, and structured products) can be roughly viewed along two dimensions, as illustrated in [Exhibit 1.4](#).

The distinction between publicly and privately traded assets along the horizontal dimension is rather straightforward. However, the distinction along the vertical dimension is less definitive. The top two boxes contain assets that tend to be selected more for their potential ability to deliver enhanced returns or alpha (i.e., to serve as return enhancers). In other words, superior risk-adjusted return is often the primary goal of these assets. The bottom two boxes contain assets that tend to be favored to a substantial degree by their ability to diversify a portfolio (i.e., diversifiers) or to serve as a tool to manage risk.

The distinction between the return enhancers and the diversification/risk tools is not sharp—most alternative assets are generally regarded as offering degrees of both return enhancement and risk management. Nevertheless, [Exhibit 1.4](#) can serve as a discussion point for the crucial decision of asset allocation.

1.10 Overview of This Book

The CAIA curriculum is organized into two levels, with Level I providing a broad introduction to alternative asset classes and the tools and techniques used to evaluate the risk-return attributes of each asset class. Level II concentrates on the skills and knowledge that a portfolio manager or an asset allocator must possess to manage an institutional-quality portfolio with both traditional and alternative assets.

Thus, Level I focuses on understanding each category of alternative investments and the methods for analyzing each. This book has been written with the expectation that readers have a moderate background in traditional investments and quantitative techniques. In some places, a Foundation Check is inserted to alert readers to particular content that is necessary background for the ensuing material. Readers may find the following sources useful in obtaining background information: *Quantitative Investment Analysis* by DeFusco, McLeavey, Pinto, and Runkle (John Wiley & Sons, 3rd edition, 2015) and *Investments* by Bodie, Kane, and Marcus (McGraw-Hill, 10th global edition, 2014).

This book is organized into five parts: [Part 1](#) introduces foundational material for alternative investments. Parts 2–5 cover the four categories of alternative investments in the CAIA curriculum by providing extensive introductions to each:

[Part 2](#): Real Assets

[Part 3](#): Hedge Funds

[Part 4](#): Private Securities

[Part 5](#): Structured Products

Review Questions

1. Define *investment*.
2. List four major types of real assets other than land and other types of real estate.
3. List the three major types of alternative investments other than real assets in the CAIA curriculum.
4. Name assets that are often characterized as traditional by some and as alternatives by others for each of the following categories: hedge funds, private equity, and real assets.
5. Approximately when did average-quality corporate bonds and international equities become commonly viewed as institutional-quality investments in the United States?
6. Name the four return characteristics that differentiate traditional and alternative investments.
7. Name four major methods of analysis that distinguish alternative investments from traditional investments.
8. Describe an incomplete market.
9. Define *active management*.
10. What distinguishes use of the term *pure arbitrage* from the more general use of the term *arbitrage*?

CHAPTER 2

The Environment of Alternative Investments

This chapter provides an introduction to the environment of alternative investing, including the participants, the financial markets, liquid alternatives, and taxation. Its focus is on explaining the purposes and functions of these components so that readers gain an understanding of why the investing environment is structured the way it is and how the different components interact.

2.1 The Participants

Participants can be divided into four major categories: the buy side, the sell side, outside service providers, and regulators. This section briefly describes the primary roles of the first three categories of participants; the primary role of regulators is discussed in section 2.5 .

2.1.1 The Buy Side

Buy side refers to the institutions and entities that buy large quantities of securities for the portfolios they manage. Buy side entities include asset owners and asset managers. The buy side contrasts with the sell side (detailed in section 2.1.2), which focuses on distributing securities to the public. Examples of buy-side institutions follow, with an emphasis on the perspective of alternative investing.

PLAN SPONSORS: A **plan sponsor** is a designated party, such as a company or an employer, that establishes a health care or retirement plan (pension) for employees that has special legal or taxation status, such as a 401(k) retirement plan in the United States or a superannuation fund in Australia. Plan sponsors are companies or other collectives that establish the health care and retirement plans for the benefit of the organization's employees or members. Plan sponsors are responsible for determining membership parameters and investment choices and, in some cases, providing contribution payments in the form of cash or stock (or both). In many cases, one individual, the plan trustee, is designated with overall responsibility for managing the plan's assets, whereas the plan administrator is charged with overseeing the plan's day-to-day operations. Both the trustee and the administrator are identified in the plan's summary plan description. As described in CAIA Level II, these funds can be designed as defined contribution plans or defined benefit plans. In defined contribution plans, employees take the investment risk, while that risk is borne by the employer in defined benefit plans.

FOUNDATIONS AND ENDOWMENTS: A **foundation** is a not-for-profit organization that donates funds and support to other organizations for its own charitable purposes. An **endowment** is a fund bestowed on an individual or institution (e.g., a museum, university, or hospital) to be used by that entity for specific purposes and with principal preservation in mind.

FAMILY OFFICE AND PRIVATE WEALTH: Family office and private wealth institutions are private management advisory firms that serve ultra-high-net-worth investors. A **family office** is a group of investors joined by familial or other ties who manage their personal investments as a single entity, usually hiring professionals to manage money for members of the office.

SOVEREIGN WEALTH FUNDS: **Sovereign wealth funds** are state-owned investment funds held for the purpose of future generations and/or to stabilize the state currency. These funds may emanate from budgetary and trade surpluses, perhaps through exportation of natural resources and raw materials such as oil, copper, or diamonds. Because of the high volatility of resource prices, unpredictability of extraction, and exhaustibility of resources, sovereign wealth funds are accumulated to help provide financial stability and future opportunities for citizens and governments. Sovereign wealth funds can also be built using the proceeds of international trade, such as countries with a large surplus in their trade balance generated by a large export sector.

PRIVATE LIMITED PARTNERSHIPS: **Private limited partnerships** are a form of

business organization that potentially offers the benefit of limited liability to the organization's limited partners (similar to that enjoyed by shareholders of corporations) but not to its general partner. For tax purposes, limited partnerships tend to flow taxable revenue and expenses directly through to their partners rather than being taxed at the partnership level.

PRIVATE INVESTMENT POOLS: Hedge funds, funds of funds, private equity funds, managed futures funds, commodity trading advisers (CTAs), and the like are private investment pools that focus on serving as intermediaries between investors and alternative investments. Most U.S. funds are structured as limited partnerships and offer incentive-based compensation schemes to their managers. These limited partnerships are usually managed by the general partner, while most of the invested funds are provided by the limited partners. These structures are detailed in section 2.2

SEPARATELY MANAGED ACCOUNTS: Separately managed accounts (SMAs) are individual investment accounts offered by a brokerage firm and managed by independent investment management firms. The relationship between an investment adviser and a client to whom advice is provided is typically documented by a written investment management agreement. SMAs can be thought of as being similar to pooled investment arrangements, such as mutual funds, in that a customer pays a fee to a money manager for managing the customer's investment, but SMAs tend to be differentiated from funds in five major ways:

1. A fund investor owns shares of a company (the fund) that in turn owns other investments, whereas an SMA investor actually owns the invested assets as the owner on record.
2. A fund invests for the common purposes of multiple investors, whereas an SMA may have objectives tailored to suit the specific needs of its only investor, such as tax efficiency.
3. A fund is often opaque to its investors to promote confidentiality; an SMA offers transparency to its investor.
4. Fund investors may suffer adverse consequences from other investors' redemptions (withdrawals) and subscriptions (deposits), but an SMA provides protection from these liquidity issues for its only investor.
5. Whereas the fund structure may allow investors to have limited liability, the SMA format may allow losses to be greater than the capital contribution when leverage or derivatives are used.

From an investor's perspective, the advantages of the first four distinctions typically outweigh the disadvantages of the last distinction. However, fund managers prefer the simplicity and convenience of pooled arrangements (funds).

MUTUAL FUNDS ('40 ACT FUNDS): Mutual funds, or '40 Act funds, are registered investment pools offering their shareholders pro rata claims on the fund's portfolio of assets. In the United States, mutual funds that offer their shares for sale to the public are known as '40 Act funds due to the regulations that permit their offering by registered investment advisers: the U.S. Investment Company Act of 1940. In recent years, '40 Act funds have increasingly offered alternative asset exposures through these retail fund structures. A general discussion is provided in section 2.6 , along with more specific discussions throughout Parts 2 through 5.

UCITS (UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES): Regulation of public funds in Europe centers on the concept of UCITS.

UCITS allow retail access and marketing of hedge-fund-like investment pools, somewhat akin to the retail access and marketing of '40 Act funds in the United States. UCITS conform to European regulations such that the product can be sold throughout the various members of the EU. They are subject to strict regulations, including investment restrictions, diversification requirements, minimum size requirements, an annual audit, and meeting standards involving the promoters and other parties related to the UCITS creation, distribution, and management.

MASTER LIMITED PARTNERSHIPS: Master limited partnerships (MLPs) are publicly traded investment pools that are structured as limited partnerships and that offer their owners pro rata claims. Like equities, MLP units are traded on major stock exchanges, but they have legal and tax structures similar to those of private limited partnerships.

2.1.2 The Sell Side

In contrast to buy-side institutions, **sell-side** institutions, such as large dealer banks, act as agents for investors when they trade securities. Sell-side institutions make their research available to their clients and are more focused on facilitating transactions than on managing money.

LARGE DEALER BANKS: Large dealer banks are major financial institutions, such as Goldman Sachs, Deutsche Bank, and the Barclays Group, that deal in securities and derivatives. Although based on the same economic principles as typical retail banks, large dealer banks are much bigger and more complex. The macroeconomic impact of a large dealer bank failure may be more widespread because of the central role this type of bank plays in the economic system at large. Generally, most large dealer banks act as intermediaries in the markets for securities, repurchase agreements, securities lending, and over-the-counter (OTC) derivatives. In addition, large dealer banks are often engaged in proprietary trading.

Large dealer banks also have large asset management divisions that cater to the investment management needs of institutional and wealthy individual clients. This involves custody of securities, cash management, brokerage, and investment in alternative investment vehicles, such as hedge funds and private equity partnerships. Some of these types of banks operate internal hedge funds and take on private equity partnerships as part of their business management service. In this role, the bank acts as a general partner with limited-partner clients.

The role of dealer banks in the primary market is to intermediate between issuers and investors, to provide liquidity, and to act as underwriters of investments. In secondary securities markets, large dealer banks trade with one another and with brokers/dealers directly over the computer or the phone, as well as play an intermediating role of facilitating trades.

Large dealer banks also engage in proprietary trading. **Proprietary trading** occurs when a firm trades securities with its own money in order to make a profit. Large dealer banks serve as counterparties to OTC derivatives such as options, forwards, and swaps that require the participation of a counterparty dealer who meets customer demand by taking the opposite side of a desired position. Dealers may accept the risk or use a matched book dealer operation, in which the dealer lays off the derivative risk by taking an offsetting position.

As part of their business management activities, large dealer banks are active as prime brokers that offer professional services specifically to hedge funds and other large institutional customers. (Prime brokers are discussed in more detail in section 2.1.3 .)