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Donnerstag, 4. Juli 2019 (München)

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Save the date: Mittwoch, 22. und Donnerstag, 23. April 2020 (Frankfurt)

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Niche Alternatives: How to Access the Differentiating Alpha

by Flurin Grond and Dr. Thomas Kochanek, Progressive Capital Partners Ltd

The alternative asset management industry is faced with growing pressure and a credibility problem, as liquid alternative investment strategies have delivered disappointing returns for some time now.

At the illiquid end of the spectrum, the wave of capital chasing the strong historical returns of private equity has pushed valuation to levels that cause financial analysts to forecast substantially lower future returns (Blackrock, 2018).

Still, global financial markets should offer plenty of attractive investment opportunities today. Therefore, an investor should be able to build a diversified portfolio that is positioned on the efficient frontier, and dynamically adjust the holdings to the changing market conditions to keep moving towards the desired investment goal. The reality tends to be entirely different. The majority of the investment industry still uses asset allocation approaches that propose a mostly static allocation to each asset class and sub-categories. As a consequence, many professional investors are not able to capitalise on the value opportunities that financial markets regularly offer, as their investment process is not fast and flexible enough to act during the limited time window.

There is a section within the alternative investment space where inefficiencies are numerous, competition is low, and active management by skilled and focused investment specialists can add substantial value. We call this segment "Niche Alternatives".

Niche Alternatives is an investment universe where there is low competition. It offers a very attractive risk/reward trade-off and can help strengthen and diversify existing traditional, but more importantly alternative asset allocations.

Typically, these are areas where there is limited historical data available for backtesting and portfolio optimisation, or markets which had been over-hyped in the distant past and since have done poorly for a long time. Therefore, such assets, industries or countries are often regarded as "un-investable" by many at that time.

For professional investors, being associated with such failures is often considered a career risk, and therefore the wider investment community still tries to exit positions in such assets. This pushes the price below fair value.

Another reason for outsized expected returns can be that a mix of increased regulation and the silo-effect among allocators that prevent capital to flow to areas that are not strictly complying with defined investment guidelines. Currently, this is the case for many investments which require a 2-5 year time horizon as they neither fit the liquid nor the private equity buckets. Not only because of that but also due to the regulation glut and the quantitative easing policies by global central banks distorting the term-structure for risk since the global financial crisis, an allocation to semi-liquid Niche Alternative and co-investment strategies becomes particularly attractive today.

A common explanation for these extra return premiums is that financial investors are not assessing certain pockets in the market from a purely economic point of view. Quite often such omissions can be entirely rational from the perspective of the particular allocator.

For example, for a large asset manager to analyse and monitor a USD 20 million niche opportunity requires the same time as to assess a USD 100 million classic opportunity. Therefore, to deploy the same capital in smaller Niche Alternative opportunities needs five times the resources. Consequently, the decision to focus on the more sizeable opportunity might be the rational thing to do.

Even more so, a dedicated team of Niche Alternative specialists is needed to harvest most of the offered risk premiums by looking beyond the "silo-ing" of asset classes, by objectively assessing the risk/reward characteristics of the opportunities, and by creating a portfolio of asymmetric return streams.

Being active in Niche Alternatives means to look for investments, where the broader investment community feels uncomfortable to invest; or even better where the current holders of positions feel they need to sell an investment and are willing to accept a fire sale price to exit an otherwise good asset.

A common example is a liquidator of collateral for whom the primary goal is to cover the defaulted loan as soon as possible, rather than wait and optimise the future return of the collateral.

Due to the broad field and the specific characteristics in Niche Alternatives, the best approach to look at this investment segment is to apply a value and contrarian led investment methodology.

That is, over the business cycle, capital should be deployed in areas which are temporarily out of favour – in some cases even considered un-investable by the wider investment community, and shifted away from markets and asset classes where investors feel over-confident, mostly due to past good performance, but offer little risk premium anymore.

Those smaller opportunities attract low competition as large asset managers, and investment banks focus on more established, larger capacity opportunities, where they can allocate more capital or generate higher fees, which in return enhanced the already beneficial risk/reward profile.

Banks – from their perspective – made a perfectly rational decision to pull-out of lending against legal claims, as the overall market size, the relative complexity of the business, and the capital requirements on their balance sheet made this market segment not the best use of their finite time and capital. As a result, the risk premium for lending against legal claims increased by more than 100%.

Further areas where the market currently offers outsized risk- and illiquidity-premia are music royalties, shipping, or specialty-infrastructure, such as class-A warehouses in Russia. In summary, acquiring Niche Alternative investments at attractive valuations is a vital element in the path to generate a decent outperformance. However, even though building-up and exiting an investment is a critical element to performance, the key to long-term success ultimately lies in selecting solid opportunities and right-sizing these in holistic portfolio construction.

Conventional alternative investment approaches are often considered proven and reliable because they are broadly used, have historical returns available and are seemingly less risky. In comparison Niche Alternative opportunities often bring much more complexity. The wide-ranging field of the opportunity set, the required network of specialists, the very case-specific data or lack of thereof, the significant volume of potential opportunities to sort through and analyse can be overwhelming compared to more traditional areas of the alternative investment space.

Some investment approaches are going to develop and mature and will grow into conventional alternative assets, whereas others offer striking risk/return opportunities merely for a restricted time window. That makes it essential to decide where to assign the limited time of the investment team most effectively.

As with any other investment opportunity, the benefits and challenges must be weighted. Careful consideration must be given to how one will approach such investments during the limited time window the market offers such attractive returns. Moreover, it is necessary to have a harvesting plan before entering into a niche strategy position because the liquidity can often be more challenging on the way out.

Contrariwise, since the return distribution among different Niche Alternative opportunities and co-investments can diverge broadly, picking a single niche opportunity or a single strategy can be very risky. Hence, one approach to investing in Niche Alternatives is through a holistic portfolio, where built-in diversification reduces the idiosyncratic deal risk. Also, this makes the wider dispersion of returns work in favour of the beneficiaries. This is classic finance theory of diversification leading to lower pool risk than the specific risk related to any single investment in the portfolio.

Again, whereas Niche Alternative opportunities have a superior risk/return profile compared to more conventional alternative investments, they also deliver a considerable array of possible outcomes. This dispersion needs to be accounted for in the portfolio management approach. We tackle this challenge by assigning maximum exposures to different risk factors and then decide if the projected return, sensitivity and correlation characteristics are sufficiently robust for the specific investment to win a spot in the portfolio.

For analysis purposes, one methodology is to group different niche opportunities in buckets with similar characteristics and to use the same lenses for assessing the fundamental attractiveness, the various risks, and the payout structure for the different opportunities.

Niche Alternatives can be invested in via "listed vehicles", i.e. exchange-listed funds where good assets trade at substantial discounts to NAV, and where a path can be seen to closing this discount over a reasonable period. Such discounts arise typically due to irrational selling following periods for disappointing performance or occasionally they are triggered by technical dislocation.

"Appraisal rights/litigation financing" are legal related investment opportunities. It is a wide investment field, ranging from financing commercial litigation to international arbitration, to lending against legal claims, or making use of minority shareholder rights, which are structured to have option-like pay-off profiles. While competition in the space is limited and therefore expected returns very attractive, we appreciate the low correlation to financial markets as the investment outcome is not related to the economy but based on the grounds of the law.

Given a semi-liquid investment mandate, focus on "secondary alternatives" can be on tail-end private equity and side-pocket buying. This field is characterised by information asymmetry and working with well-connected partners which is the basis to add alpha. Moreover, it is important to acknowledge that this opportunity-set as well as pricing is highly cyclical and therefore pro-actively navigating the exposure adds to the margins-of-safety.

Additionally, co-investment opportunities are often interesting in the event-driven space, where regulatory barriers or human behavioural patterns have created irrational pricing and asymmetric risk/reward patters.

A portfolio edge can be built by ignoring the classic asset-class categorisation and by combining solidly established alpha sources with attractive niche opportunities that are not overcrowded at the time of our investment. Having an allocation to each of the above categories at all times should not be the ultimate goal, but rather shifting capital to the areas which offer the best risk/rewards over the cycle.

Adding Niche Alternative exposure into a blend of traditional asset classes and established alternative investments increases the portfolio returns while reducing the risk of capital loss. Niche Alternatives are a way to achieve the original purpose of alternative assets in the portfolio context. Even more, Niche Alternatives can improve the quality of the overall portfolio, by adding superior return streams with complementary correlation characteristics. This is realised by accessing the differentiating alpha these strategies generate, and doing so through a complementary allocation could be highly additive to a broader portfolio.

The rewards of Niche Alternatives are clear: this segment of the alternative investment market has a strong track record of outperformance, and is currently very attractively priced in comparison to traditional as well as established alternative asset classes.

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