

Understanding Alternative Investments (1): Types & Benefits



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Introduction

Alternative investments encompass a broad range of assets classes that fall outside the scope of traditional investments. These non-traditional investment vehicles offer investors the opportunity to explore different market sectors, ultimately diversifying their portfolios and potentially enhancing overall returns. The growing interest in alternative investments is driven by macro-economic factors such as low interest rates, market volatility, and the search for uncorrelated assets that can provide stability and growth during uncertain economic times.

Essentially, alternative investments provide investors access to opportunities that may not be available through traditional asset classes. They often have low correlation with traditional assets, offering a valuable diversification tool to hedge against portfolio risk.



Types of Alternative Investment Asset Classes

Alternative investments comprise a diverse array of asset classes, each with its own unique characteristics and risk-return profiles. Some of the most common types of alternative investments include:

1. **Hedge Funds:** Actively managed investment vehicles that trade liquid assets, employing a wide range of strategies, such as long/short equity, market neutral, and many others. They aim to generate positive returns regardless of market conditions but often require high minimum investments, high risk appetite and are less transparent.
2. **Private Equity:** Investments in private companies or acquisition of controlling interests in public companies with the aim to take them private. They have several strategies, including but not limited to leveraged buyouts (LBOs), growth capital, secondaries, fund of funds, private credit, impact investing, amongst other. They have the potential for significant returns through operational improvements but typically have a longer investment horizon and higher risk.



3. **Venture Capital:** Arguably an asset class branching out from a Private Equity investment strategy, these are investments in early-stage high-growth companies, with investments often conducted in rounds: seed funding, series A, B, C, etc. These are high-risk, high-reward opportunities, often with a focus on technology and innovation.
4. **Real Estate:** Direct ownership of properties or indirect investments through real estate investment trusts (REITs). These investments vary from commercial real estate to rental properties and real estate funds. They can provide income streams and potential for capital appreciation but can be illiquid and require significant capital.
5. **Commodities:** Investments in physical commodities like precious metals, energy, agricultural products, or their derivatives. Strategies can range from direct ownership and trading of the physical products to investment or trading their derivatives, including futures contract, Commodities ETFs, amongst others. They can serve as a hedge against inflation and an effective means of portfolio diversification but can be volatile and influenced by geopolitical events.



6. **Collectibles:** Investments in physical items like art, antiques, rare coins, stamps, and luxury goods. These tangible assets can appreciate in value over time and often hold cultural or historical significance. Collectibles can provide significant returns, but their value is highly subjective and can fluctuate based on market demand and trends.

Potential Benefits of Alternative Investments

One of the primary advantages of alternative investments lies in their ability to provide diversification benefits. Many of these assets can mitigate portfolio risk and volatility during market declines, which is appealing to investors seeking to protect their portfolios from the impact of market fluctuations. Additionally, alternative investments include a diverse range of asset classes and investment structures, affording investors the flexibility to select options that closely align with their individual preferences, risk tolerances, and investment objectives.

Higher Returns

Alternative investments, such as private equity and venture capital, aim to exploit unique opportunities by investing in early and growth stage companies with significant growth potential. While these investments are inherently riskier, they can potentially generate enormous returns for investors willing to accept higher levels of risk and illiquidity.



Access to Niche Markets

Alternative investments provide access to niche markets and sectors that may be difficult to access through traditional investment vehicles. Real estate investments, for instance, can offer steady income streams from rental properties or the potential for capital appreciation. Commodities can serve as a hedge against inflation, as their values tend to rise with increasing inflation rates.

Inflation Hedge

Investments in physical assets, like real estate and commodities, can act as a hedge against inflation. For example, during periods of rising inflation, the value of real assets typically increases, protecting the purchasing power of investors.

Conclusion

Alternative investments offer the potential for diversification and higher returns, making them an attractive option for sophisticated investors. However, they are not suitable for everyone, particularly those with low risk tolerance or short-term investment horizons. Retail investors with more modest portfolios may find it challenging to access and properly evaluate alternative investments due to their complexity and high minimum investment requirements.

By understanding the various types of alternative investments, their benefits, and associated risks, investors can make informed decisions and potentially enhance their portfolio performance in today's complex financial landscape.

