Why investors should start learning more about alternative investments

RIAN SMIT
Senior Private Equity Fund Manager at Momentum Investments

KAMINI NAIDOO
Portfolio Manager at Momentum Investments

Alternative investments have become far more mainstream in South Africa since the advent of the Covid-19 pandemic. Especially in the lower-yield environment that the investment market currently finds itself, the hunt for diversifiers and enhanced yield has made alternative investment a critical component of any investor's portfolio. It is therefore important for investors to start learning more about the opportunities and pitfalls of the alternative investment landscape.

Particularly in terms of liquidity, it is crucial that investors begin to look at their portfolio and their investment options differently. Over the last few years, and especially since the Covid-19 pandemic, the volatility of returns on listed equities has increased considerably. In this environment, including alternative investments such as private equity, hedge funds, venture capital or debt financing adds some much-needed diversification to investors' portfolios. It has also been proven to minimise investors' risks in the current market.

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Private equity has quite a unique offering for investors as an alternative investment. Private equity is very much a long-term investment, with the typical life of a private equity investment spanning around ten years (which is often extended). It is a commitment made by the investor, and that investment is drawn over a five-year investment period and realisation period of an additional five years until the fund reaches the end of its life. While long-term commitments in this market seem like a scary proposition, it actually offers good long-term benefits and liquidity to a portfolio.

Private equity investors commonly receive interim distributions of dividends, interest or capital repayments throughout the life of the fund. Therefore, the holding period is not, in actual fact, the full ten or 12 years of the fund's lifetime – it is closer to around seven years on a weighted average basis. If there is a liquidity crunch that forces investors to consider selling off their interest in the fund, it has also become much easier to get capital out via secondary investors.

Another prominent kind of alternative investment is the hedge fund. Hedge funds are considered to be the more liquid of the alternative strategies, and they actually complement less liquid private market strategies quite well. Not only can hedge funds provide more liquidity, but they also offer investors access to different risk premia – the outperformance of a risk-free asset is generated through alternative risk sources.

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Hedge funds can help investors to take better advantage of volatility in the market and harness it to their advantage: hedge funds are more liquid by their nature because they tend to invest in more liquid counters, whether these are listed equities or derivatives.

Unfortunately, hedge funds' biggest challenge is escaping from the negative perception that it has gained in the market over the years. Hedge funds have a reputation for being risky, not able to keep up with markets, and being too expensive. However, a lot of work has been done over the years to manage the cost of these investment types and to bring much greater transparency to the industry. Where hedge funds were previously a point of heated debate, we've reached a point where there is very little question about whether they should form part of a healthy investment portfolio.

The different types of alternative investments cater to different requirements in investment portfolios while also unlocking a wider array of prospects for investors. Investing is personal and it is becoming crucial for forward-thinking investors to start looking for alternative investment opportunities that speak to the specific and personal needs of their portfolio.

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