



**CFA Institute**<sup>®</sup>  
Investment Foundations

**It's Free!**

**Do it!**

## **Module 4: INVESTMENT INSTRUMENTS**

### **Chapter 12: Alternative Investments**

Ted Stephenson, CFA, CPA, CMA, CFP, MBA  
Professor, George Brown College  
St. James Campus  
290 Adelaide St. E.,  
Toronto, Ontario, M5T 2T9  
Canada

[Faculty Bio](#)



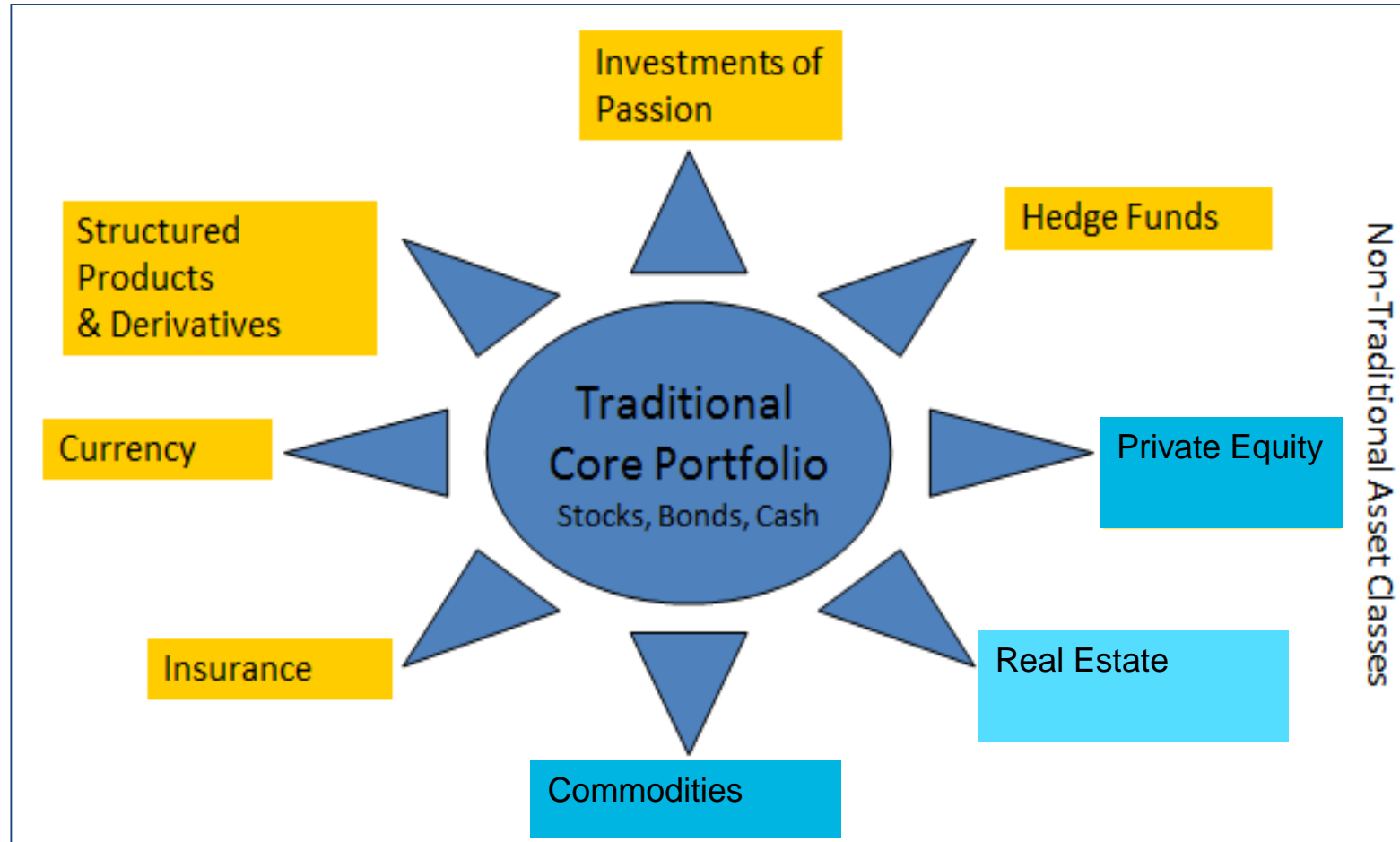
Module	Topic	Weight	LOS	Exam Qs	Hours to Study	Module Practice Qs	Chapter Practice Qs
<b>Module 1</b>	<b>Industry overview</b>	5%	7	6	5	28	28
Chapter 1	The Investment Industry: A Top-Down View						
<b>Module 2</b>	<b>Ethics and regulation</b>	10%	14	12	10	91	
Chapter 2	Ethics and Investment Professionalism						49
Chapter 3	Regulation						42
<b>Module 3</b>	<b>Inputs and tools</b>	20%	50	24	20	291	
Chapter 4	Microeconomics						53
Chapter 5	Macroeconomics						57
Chapter 6	Economics of International Trade						47
Chapter 7	Financial Statements						70
Chapter 8	Quantitative Concepts						64
<b>Module 4</b>	<b>Investment instruments</b>	20%	29	24	20	213	
Chapter 9	Debt Securities						69
Chapter 10	Equity Securities						72
Chapter 11	Derivatives						42
Chapter 12	Alternative Investments						30
<b>Module 5</b>	<b>Industry structure</b>	20%	27	24	20	96	
Chapter 13	Structure of the Investment Industry						28
Chapter 14	Investment Vehicles						29
Chapter 15	The Functioning of Financial Markets						39
<b>Module 6</b>	<b>Serving client needs</b>	5%	12	6	5	76	
Chapter 16	Investors and Their Needs						35
Chapter 17	Investment Management						41
<b>Module 7</b>	<b>Industry controls</b>	20%	24	24	20	154	
Chapter 18	Risk Management						51
Chapter 19	Performance Evaluation						53
Chapter 20	Investment Industry Documentation						50
	<b>Total</b>	<b>100%</b>	<b>163</b>	<b>120</b>	<b>100</b>	<b>949</b>	<b>949</b>

## AFTER COMPLETING THIS CHAPTER, YOU SHOULD BE ABLE TO DO THE FOLLOWING:

- a) Describe advantages and limitations of alternative investments;
- b) Describe private equity investments;
- c) Describe real estate investments;
- d) Describe commodity investments.

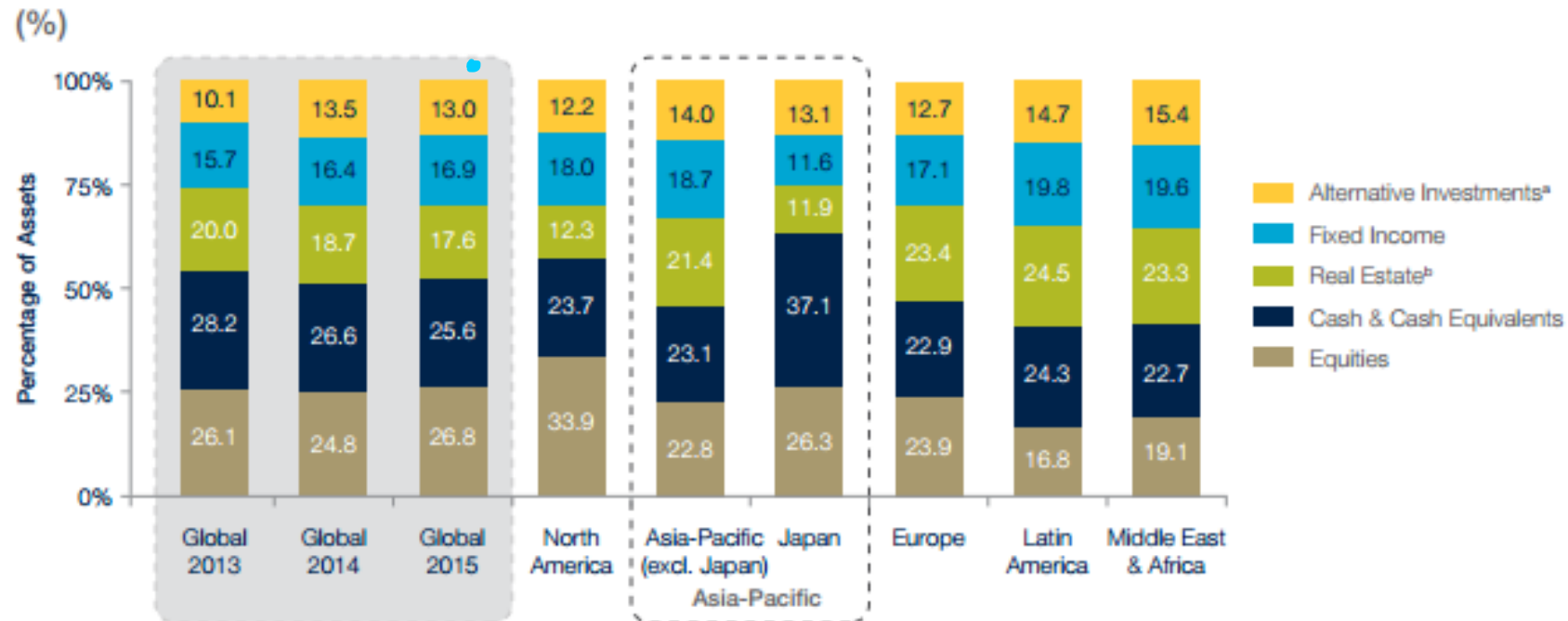
# STEPS TOWARD AN ACTUAL CORE PORTFOLIO

## Core-Satellite Investing



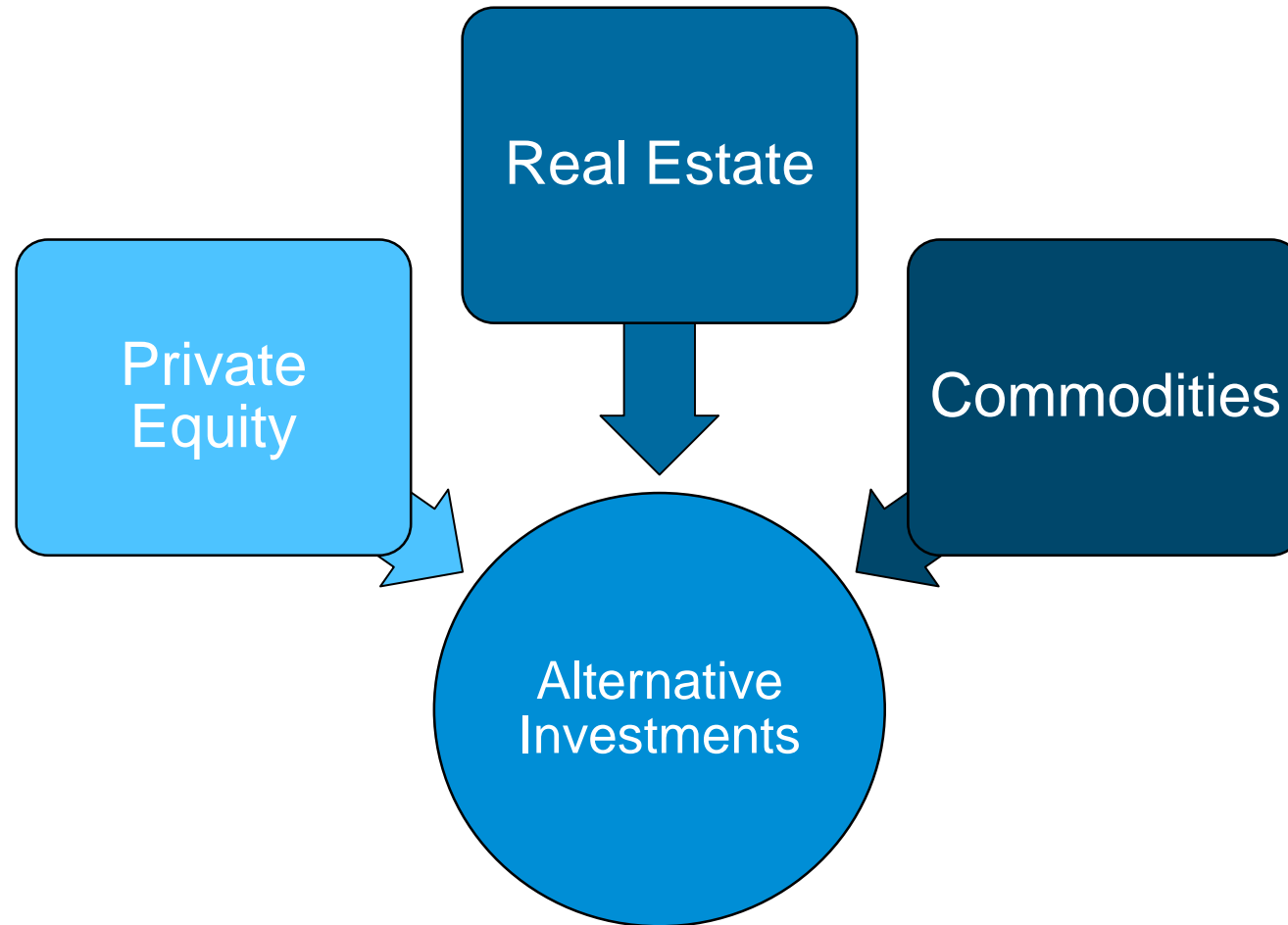
# WORLD WEALTH REPORT

Breakdown of HNWI Financial Assets (by Region)



1. Investing is converting cash to another asset class
2. Equity investing in the MENA region is lower other regions
3. Real Estate investing in the MENA region is higher than other regions

# ALTERNATIVE INVESTMENTS



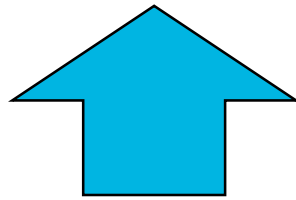
LOS a: Describe advantages and limitations of alternative investments.

# GLOBAL SURVEY ON INSTITUTIONAL ASSET ALLOCATION

Type of Asset	Percentage of Respondents Holding This Type of Asset	Average Percentage of the Portfolio Invested in This Type of Asset
Equity	98%	41.0%
Fixed income (debt)	99%	33.2%
Cash	61%	3.2%
Alternatives (total)	94%	22.4%
Private equity	64%	5.1%
Private real estate	66%	4.7%
Public real estate	32%	1.3%
Commodities	22%	1.0%

LOS a: Describe advantages and limitations of alternative investments.

# ADVANTAGES OF ALTERNATIVE INVESTMENTS



Enhance Portfolio Returns

Reduce Portfolio Risk

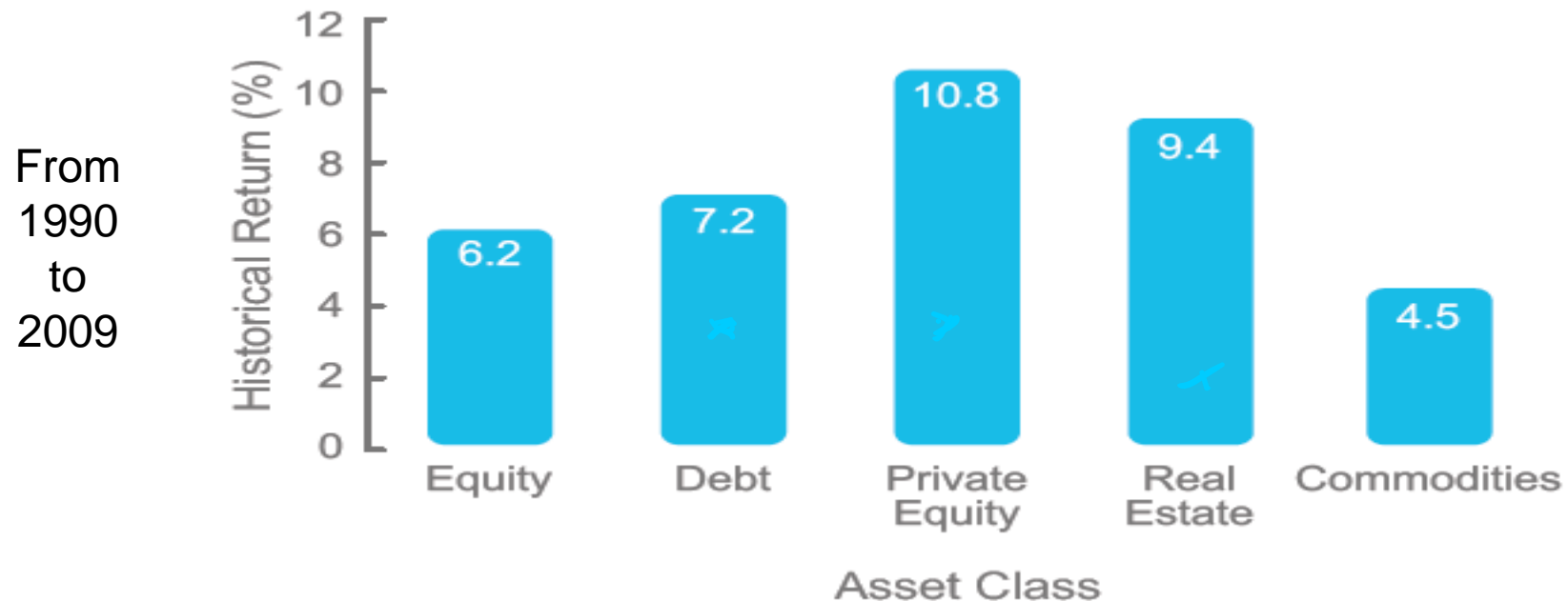
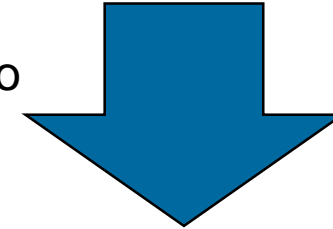


Exhibit 2

LOS a: Describe advantages and limitations of alternative investments.



# Asset class returns

																2003 - 2017	
2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	Ann.	Vol.
EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Small Cap 11.5%	EM Equity 12.7%	EM Equity 23.0%
Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Large Cap 10.6%	Small Cap 11.2%	REITs 22.3%
DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. 25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	Asset Alloc. 2.9%	REITs 11.1%	Small Cap 18.8%
REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	REITs 1.8%	Large Cap 9.9%	Comdty. 18.8%
High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Cash 1.3%	High Yield 9.6%	DM Equity 18.4%
Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 16.5%	High Yield 14.8%	Asset Alloc. 0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	High Yield -0.6%	DM Equity 8.6%	Large Cap 14.5%
Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	DM Equity -1.0%	Asset Alloc. 8.3%	High Yield 11.3%
Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Fixed Income -1.6%	Fixed Income 4.1%	Asset Alloc. 11.0%
Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	Comdty. -2.0%	Cash 1.2%	Fixed Income 3.3%
Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -7.4%	Comdty. -0.3%	Cash 0.8%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.  
 Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg Barclays US Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg Barclays US Aggregate, 5% in the Bloomberg Barclays 1-3m Treasury, 5% in the Bloomberg Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/02 – 12/31/17. Please see disclosure page at end for index definitions. All data represents total return for stated period. Past performance is not indicative of future returns.  
 Guide to the Markets – U.S. Data are as of September 30, 2018.



LOS a: Describe advantages and limitations of alternative investments.

# STEPS TOWARD AN ACTUAL PORTFOLIO

## Correlations and volatility

GTM - U.S. | 55

	U.S. Large Cap	EAFE	EME	Bonds	Corp. HY	Munis	Currency	EMD	Comdty.	REITs	Hedge funds	Private equity	Ann. Volatility
U.S. Large Cap	1.00	0.89	0.79	-0.31	0.72	-0.18	-0.51	0.58	0.66	0.83	0.87	0.85	15%
EAFE		1.00	0.90	-0.17	0.77	-0.06	-0.67	0.69	0.64	0.75	0.85	0.79	18%
EME			1.00	-0.09	0.88	0.01	-0.70	0.84	0.70	0.66	0.85	0.73	22%
Bonds				1.00	-0.04	0.83	-0.12	0.27	-0.22	0.04	-0.29	-0.39	3%
Corp. HY					1.00	0.08	-0.53	0.87	0.71	0.72	0.83	0.68	12%
Munis						1.00	-0.14	0.43	-0.19	0.10	-0.12	-0.26	4%
Currencies							1.00	-0.61	-0.56	-0.44	-0.44	-0.54	7%
EMD								1.00	0.59	0.63	0.69	0.53	8%
Commodities									1.00	0.56	0.72	0.76	17%
REITs										1.00	0.71	0.74	25%
Hedge funds											1.00	0.84	6%
Private equity												1.00	10%

Source: Barclays Inc., Bloomberg, Cambridge Associates, Credit Suisse/Tremont, FactSet, Federal Reserve, MSCI, NCREIF, Standard & Poor's, J.P. Morgan Asset Management.  
 Indices used – Large Cap: S&P 500 Index; Currencies: Federal Reserve Trade Weighted Dollar; EAFE: MSCI EAFE; EME: MSCI Emerging Markets; Bonds: Bloomberg Barclays Aggregate; Corp HY: Bloomberg Barclays Corporate High Yield; EMD: Bloomberg Barclays Emerging Market; Comdty.: Bloomberg Commodity Index; Real Estate: NAREIT ODCE Index; Hedge Funds: CS/Tremont Hedge Fund Index; Private equity: Cambridge Associates Global Buyout & Growth Index. Private equity data are reported on a one-quarter lag. All correlation coefficients and annualized volatility are calculated based on quarterly total return data for period 9/30/08 to 9/30/18, except for Private equity, which is based on the period from 6/30/08 to 6/30/18. This chart is for illustrative purposes only.  
 Guide to the Markets – U.S. Data are as of September 30, 2018.

**J.P.Morgan**  
 Asset Management

LOS a: Describe advantages and limitations of alternative investments.

# LIMITATIONS OF ALTERNATIVE INVESTMENTS

Less Regulation and Less Transparency

Illiquid: Difficult to Sell Quickly

Difficult to Value

LOS a: Describe advantages and limitations of alternative investments.

# PRIVATE EQUITY STRATEGIES

## Venture Capital

A private equity investment strategy that consists of financing the early stage of companies that have an innovative business idea

Considered the riskiest type of private equity investment strategy because many more companies fail than succeed

LOS b: Describe private equity investments.

# PRIVATE EQUITY STRATEGIES

## **Growth Equity**

A private equity investment strategy that usually focuses on financing companies with proven business models, good customer bases, and positive cash flows or profits.

## **Buyout**

A private equity investment strategy that consists of financing established companies that require money to restructure and facilitate a change of ownership.

LOS b: Describe private equity investments.

# PRIVATE EQUITY STRATEGIES

## **Distressed Investing**

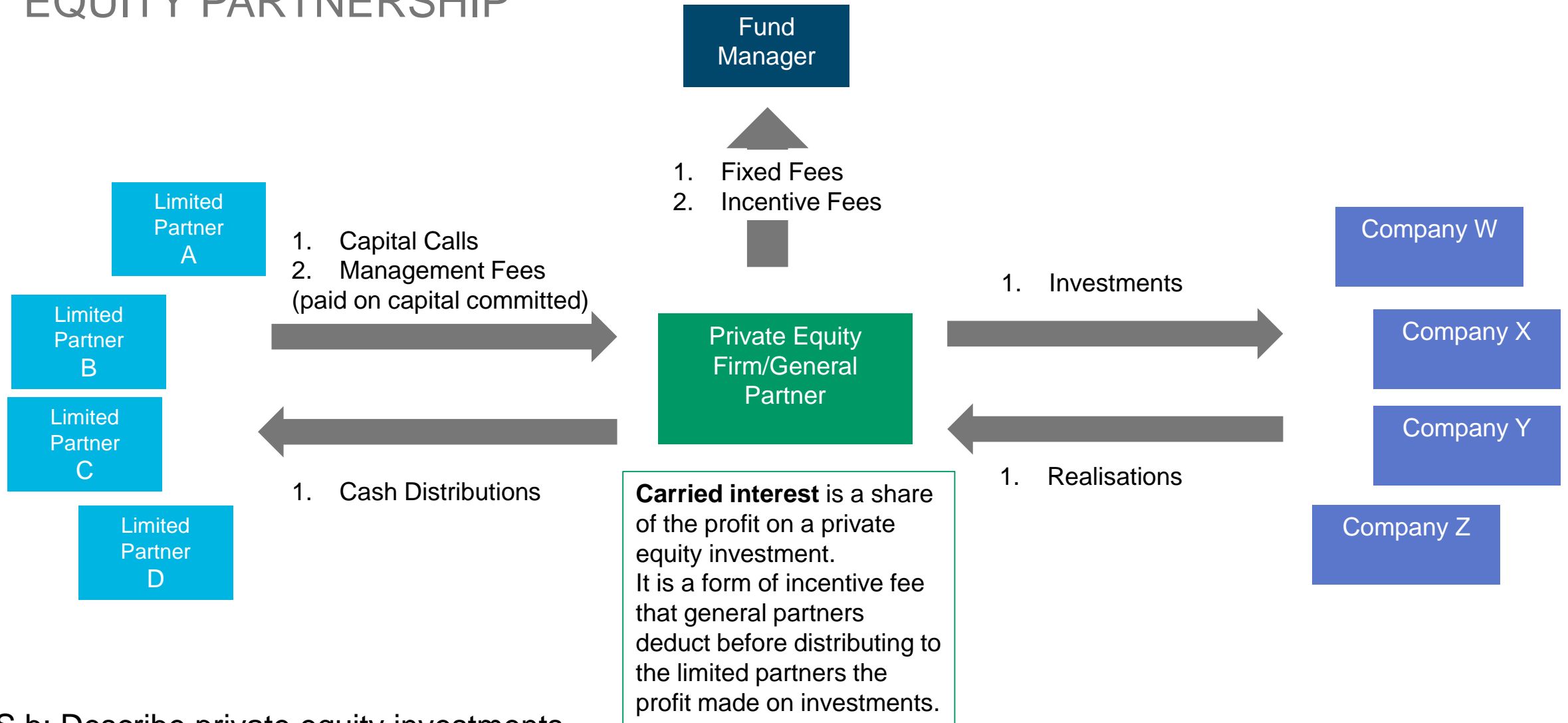
Focuses on purchasing the debt of troubled companies that may have defaulted or are on the brink of defaulting

## **Secondaries**

Involves buying or selling existing private equity investments

LOS b: Describe private equity investments.

# STRUCTURE AND MECHANICS OF A PRIVATE EQUITY PARTNERSHIP



LOS b: Describe private equity investments.

## PRACTICE Q: EXPERT

In the area of private equity investing, carried interest is:

- A. the interest paid on committed capital.
- B. the management fees paid by the limited partner.
- C. the share of profits retained by the general partner.



## PRACTICE Q: EXPERT

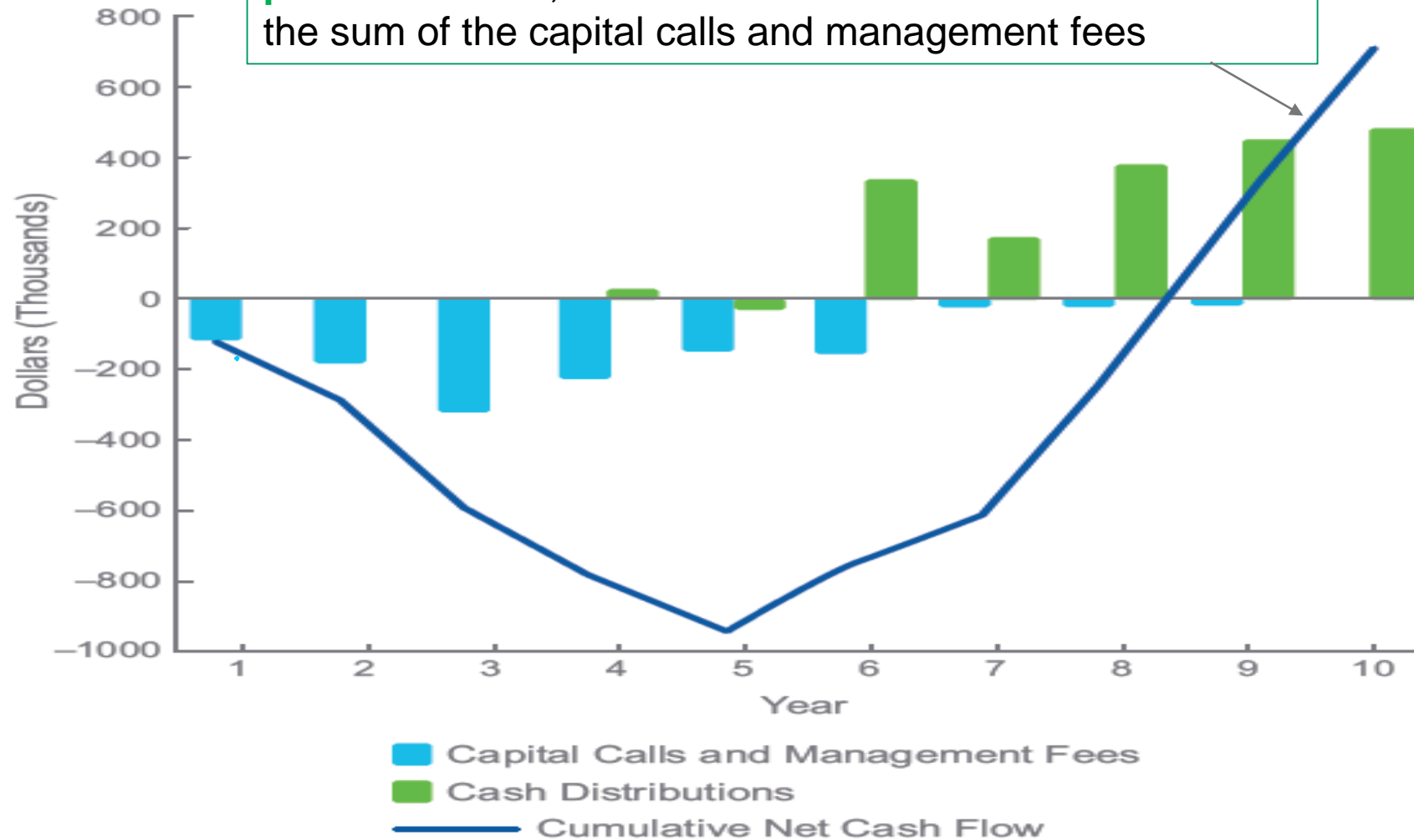
In the area of private equity investing, carried interest is:

- A. the interest paid on committed capital.
- B. the management fees paid by the limited partner.
- C. the share of profits retained by the general partner.**

**C is correct.** Carried interest is the share of profits that the general partner retains before returning capital to the limited partner.

# THE J CURVE

The line is the cumulative net cash flow to the **limited partner**—that is, the sum of the cash distributions minus the sum of the capital calls and management fees



LOS b: Describe private equity investments.

## PRACTICE Q: DIFFICULT

In the private equity realm, the J curve refers to the pattern of:

- A. carried interest received by the limited partners.
- B. cumulative net cash flows to the limited partners.
- C. drawdown in capital committed by the limited partners.

## PRACTICE Q: DIFFICULT

In the private equity realm, the J curve refers to the pattern of:

- A. carried interest received by the limited partners.
- B. cumulative net cash flows to the limited partners.**
- C. drawdown in capital committed by the limited partners.

**B is correct.** The J curve refers to the pattern of cumulative net cash flow (distributions minus capital calls) received by limited partners.

Carried interest is the share of profits that accrues to the general partner

# REAL ESTATE

## Real estate investments take different forms.

For many people, it is the purchase of **their home**, which may be a significant portion of their net worth.

- Houses, apartments, and other residential properties that are owner occupied are indeed the foundation of many individuals' financial plans.
- However, although considered part of their financial plan, most residential real estate is not included in individuals' investment portfolios.

Many investors focus their real estate investments on what is commonly referred to as **commercial real estate**—that is, income-generating real estate.

LOS c: Describe real estate investments.

# COUNTRY CONCENTRATIONS OF COMMERCIAL REAL ESTATE

Country	Country Share
United States	25.4%
Japan	10.1%
China	7.0%
Germany	6.1%
United Kingdom	5.2%
France	4.7%
Italy	3.7%
Brazil	3.3%
Canada	2.9%

Country	Country Share
Spain	2.6%
Australia	2.5%
Russia	2.3%
South Korea	1.8%
Netherlands	1.4%
Mexico	1.4%
India	1.3%
Switzerland	1.1%
Remaining Countries	17.2%

LOS c: Describe real estate investments.

## COMMERCIAL REAL ESTATE SEGMENTS

**Land** can be highly speculative because there are no cash inflows from tenants or occupants.

**Offices** are usually owned by real estate investment companies that lease space to tenants in varying terms.

**Multifamily residential dwellings** are rented to individuals or families.

LOS c: Describe real estate investments.

## COMMERCIAL REAL ESTATE SEGMENTS

**Retail Properties:** Such assets as shopping malls, commercial shopping centres, and other buildings designated for retail purposes.

**Industrial:** Such properties as manufacturing facilities, research and development space, and warehouse/distribution space.

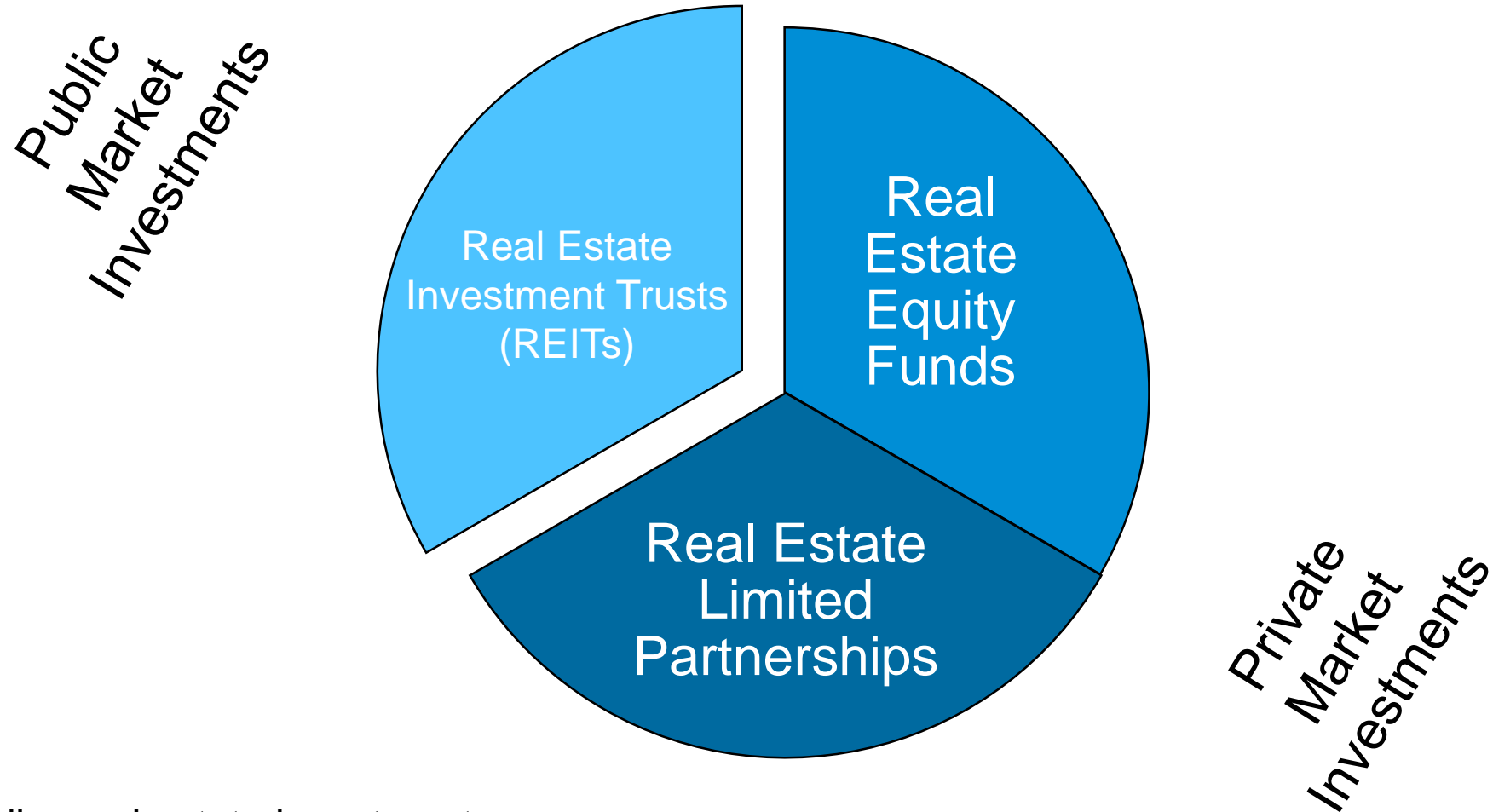
**Hotels:** Branded short-term stay facilities and longer-stay facilities catering to contract workers in remote locations, as well as boutique and independent facilities.

**Other Segments:** For example, senior housing designed for people aged 55+ and student housing for post-secondary education

LOS c: Describe real estate investments.



# REAL ESTATE INVESTMENT VEHICLES



LOS c: Describe real estate investments.

## PRACTICE Q: DIFFICULT

A private market investment vehicle holding hundreds of commercial properties that are diversified by geography, property type, and vintage year is best described as a real estate:

- A. equity fund.
- B. investment trust.
- C. limited partnership

## PRACTICE Q: DIFFICULT

A **private** market investment vehicle holding hundreds of commercial properties that are diversified by geography, property type, and vintage year is best described as a real estate:

- A. equity fund.
- B. investment trust.
- C. limited partnership

**A is correct.** A real estate equity fund is a private market investment vehicle that holds hundreds of commercial properties that are diversified by geography, property type, and vintage year (year the purchase was made).

B is incorrect because a real estate investment trust (REIT) is an investment through **public** rather than private markets. A REIT is a company that mainly owns, and in most cases operates, income-producing real estate.

C is incorrect because a real estate limited partnership is a **private** market investment vehicle that typically **focuses on a smaller number of commercial properties**, such as the construction of a housing subdivision or an apartment complex.

## PRACTICE Q: DIFFICULT

In which type of real estate investment does the investor supply capital to a general partner who then invests the capital?

- A. A real estate equity fund
- B. A real estate investment trust
- C. A real estate limited partnership

## PRACTICE Q: DIFFICULT

In which type of real estate investment does the investor supply capital to a general partner who then invests the capital?

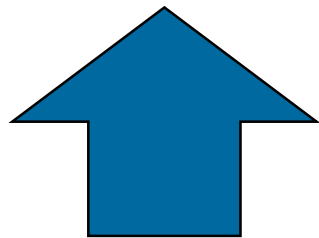
- A. A real estate equity fund
- B. A real estate investment trust
- C. A real estate limited partnership**

**C is correct.** A real estate limited partnership is structured like a private equity partnership, in which the investor is the limited partner that supplies capital to the general partner who then invests the money in real estate projects.

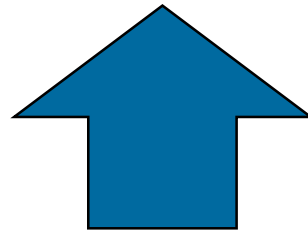
A is incorrect. Real estate equity funds are open-ended funds that issue or redeem funds when investors wish to buy into the fund or sell out of it.

B is incorrect. Real estate investment trusts are closed-end funds that trade on major exchanges much like equities.

# COMMODITIES



Inflation



Commodity  
Prices

Commodities, such as precious and base metals, energy products, and agricultural products, tend to rise in price with inflation.

LOS d: Describe commodity investments.

# GAINING EXPOSURE TO COMMODITIES

Purchase of the Physical Commodity

Purchase of Natural Resources or  
Commodity-Related Stocks

Use of Commodity Derivatives

LOS d: Describe commodity investments.