Alternative asset is a risky class

by Rajmohan Krishnan, 26th May, 2014

Alternate Investments

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The typical investment format of an Indian investor is either to invest in fixed income or in equity. Together, these form the biggest chunk of anybody's asset allocation. The only exception is real estate. From around the mid-2000s, a new asset class, called alternative asset class, came into the Indian market. While it originally started with investments primarily in real estate and unlisted companies, subsequently, many other avenues were added to this group. The options today include commodities, stamps, art, wine, coins, antiques and even hedge funds.

Alternative assets are generally viewed as less liquid than regular assets. For example, most of these assets, such as art, antiques, stamps and wine, gain their value over a long period. Others such as real estate funds, private equity (PE), venture capital and infrastructure-related projects may take about 7-9 or even 12 years to gain significant value. Hence, investors considering such assets are doing it with an eye on the future.

Investing into these assets or products helps investors diversify their portfolio. Since these are long-term investments and there are no day-to-day movements like that in stock markets or interest rates, they are less volatile. Since these offer lower liquidity, alternative assets are often mispriced, which offer opportunities for arbitrage in case of untimely exits or distress sale. Alternative assets are more complex than, say, fixed income or equity. Due to their non-traditional nature, alternative assets are more difficult to add to a portfolio. The funds are structured in a fashion that the ticket size ranges from Rs.1 crore to Rs.2.5 crore as minimum per product opportunity and the money is drawn down based on tied up investments. Typically, the full commitment will be drawn down across 2-3 years.

The charges to manage and hold such assets are extremely high, especially when compared with other asset classes. There is a placement fee, management fee, profit sharing fee and a custodial fee to manage these assets. For instance, PE strategies typically have a 2% set-up or placement fee at the time of making the investment.

Further, the fund would charge a 1.25-2.00% annual management fee. Over and above this, typical PE funds may also have a profit sharing structure above a specified threshold. The multi-layered fees and the lack of readily available valuations pose a problem while pricing such offerings.

In comparison, debt and equity mutual fund (MF) net asset values are readily available. Moreover, this figure is after the asset management company expense and hence it's easier for an investor to understand real returns.

Furthermore, depending on the returns realized from the asset, taxation could vary from product to product. Income generated from a real estate securities-oriented fund gets taxed at the hand of investors as interest income at investor's marginal rates, whereas incomes from a PE fund may enjoy tax benefits of equity.

The alternative asset class lacks liquidity and is seen as a huge disadvantage since liquidating, as well as getting a valuation done, is time consuming. Since a lot of the underlying investments are done in the unlisted space, liquidity is cumbersome and is normally available only at specific time intervals. This hampers valuation on an ongoing basis, which is why most alternative funds value their portfolios only at periodic intervals.

Alternative asset class investments are not publicly traded and are closed-end instruments. Hence, there is a no secondary market available for these products and these have to be traded based on a buyer being available. The price discovery mechanism is also not structured. All this makes it a very time consuming process and would take months to years to exit.

Any investment into alternative asset funds are ideal for high net worth individuals (HNIs) or ultra-HNIs wanting to diversify their portfolio. Those with little time to manage direct real estate or direct investment into unlisted entities can go through the fund route to indirectly own an asset and participate in the gains. Though the gains are limited, as there is a definite time period of exiting the investments made, it would definitely be a good diversification from their traditional investments.

Moreover, since alternative asset class investments don't move with stock markets and interest rates, the investor can have a portfolio which will be balanced without much volatility.

Furthermore, the financial institution or intermediary must wait until it receives the valuation from the fund house or product manufacturer to update and reflect the correct value of the asset. This could mean that year-end valuation is not provided until the middle of the next year, which could jeopardize the year-end return calculations.

Funds such as venture capital invest into companies at an early stage and are hence exposed to the risk of some of these investments not turning a decent return.

Similar is the case with realty or even PE, while lifestyle-oriented funds such as wine or art may find it difficult to produce returns in case the underlying markets turn sour.

Investing in alternative asset class can be tempting for the investor who wants to diversify her portfolio. But she needs to consider various factors such as product features, performance track record of the fund house, charges and fees, tenor, potential risk and finally, whether the products fits her risk profile. It would be better if the investor takes expert advice before taking a decision.