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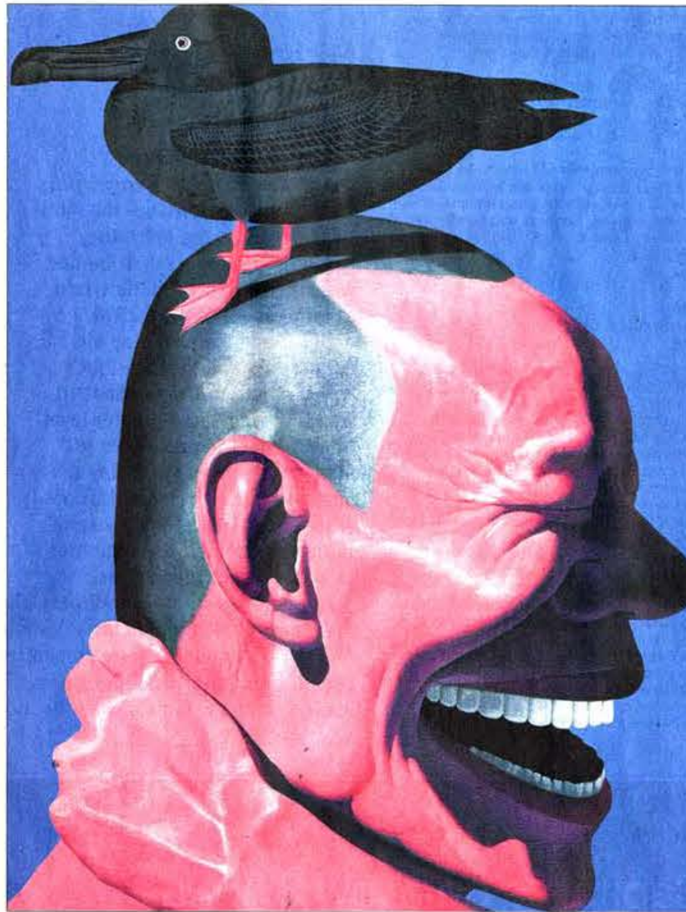

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**Unconventional assets:** *Investing in fine wine, art such as Yue Minjun's 'Black Bird', and silver and gold helps provide an investment portfolio with a buffer mainly because of their low correlation to traditional securities like stocks and bonds*

**The popularity of wine and fine art as investment instruments has been driven predominantly by the growth of high net worth individuals in emerging markets such as China . . . Logically, an increase in global wealth through economic prosperity will lead to an increase in demand for wine and art, leading to price appreciation.**

# Getting the hang of dabbling in alternative investments

The key advantage of such instruments is in the diversification they provide to a portfolio, says **ANG BEN YOU**

A few of my friends overseas buy and sell playing cards. The notion that such an endeavour would amount to any sort of business or investment seemed far-fetched – until the news came that someone in Norway had successfully funded his purchase of an Audi by selling rare out-of-print "Jerry's Nuggets" cards at 200 euros (S$339) per deck.

Right now, companies and even individuals are printing their own decks, keeping them limited to depress supply, holding them in their personal inventories and then selling them in the hope of making a killing. It is not uncommon to see a newly-released deck of cards selling out in a few hours, only to reappear later on eBay, sometimes costing 10 times more.

One can see how playing cards could be a viable – if unconventional – investment. They can be lumped under the category of alternative investments, which refer to any form of investment not considered part of the traditional portfolio of stocks, bonds and cash.

But the term evolves with investment trends.

In recent years, alternative assets such as wine and art have become the rage. Like the popular term for emerging markets BRIC – a grouping comprising Brazil, Russia, India and China – the popularity of alternative assets has given rise to a new acronym, SWAG – for Silver, Wine, Art and Gold.

Such unconventional asset classes are needed in an investment portfolio mainly because of their low correlation to traditional securities. Gold, the traditional safe haven during economic distress, is now joined by several other alternative asset classes.

## Wine and art

The popularity of wine and fine art as investment instruments has been driven predominantly by the growth of high net worth individuals (HNWIs) in emerging markets such as China. If investing in such exotic assets is your cup of tea, it is useful to understand some of the forces behind art and wine prices.

The key winds behind market movements will also apply to art and wine, albeit sometimes in an opposite way, reflecting their low correlation to the market. Some of these forces involve general economic conditions and inflation. Logically, an increase in global wealth through economic prosperity will lead to an increase in demand for wine and art, leading to price appreciation.

Non-systematic and specific factors for art include interest in certain genres, trends and even culture. Thus even within art genres like Impressionism or Realism, returns can be different.

Other factors contributing towards the value of an art piece include the artist's critical acclaim, whether it is supported by leading art dealers and its previous ownership if owned by reputable collectors or art galleries.

Economic conditions determine the value of these items. With wines, for example, it is important to understand that not all wines are "investment grade", so going down to the neighbourhood NTUC FairPrice store to buy a bottle of red wine in anticipation of price appreciation is probably not a good idea.

As a general rule of thumb, red wines from key French estates are investable, but investors need to look for quality and scarcity. Intermediaries like brokers, consultants and private banks may be able to advise on such investments.

To gain exposure to such assets, one can possibly buy into funds. Funds that invest in art are still rare, but are rapidly growing with the increase in HNWIs. For the financially capable, hoarding art pieces from notable artists can be a possible portfolio strategy. A notable example of a foray into an art investment portfolio was made by the British Rail Pension fund after 1974. The portfolio comprised some 2,500 individual works of art, built as a response to the financial crises of the time in the UK.

The Economist's Guide to Investment Strategy said that from 1974 to 2003, when the last piece of art from the portfolio was sold, the portfolio appreciated from £41.1 million to £170.4 million; this worked out to a net gain of £129.3 million and an annual return of 3.7 per cent net of commission, fees and taxes, excluding storage and insurance costs. This is evidence that investments of passion can be used successfully in the context of a portfolio strategy.

But is there an opportunity for entering the art and wine market?

The size of the art market is now insignificant relative to disposable wealth. Reports suggest that it is the same for the wine market. What this means is that any move by a substantial investor to establish or extend a major collection of art or wine may provide considerable support to prices. Thus, entering the market for such investments now could be prudent in anticipation of future gains from this standpoint.

## Other alternative investments

While wine, antiques, fine art and even playing cards may be considered alternative investments, let us also consider more passion-neutral and liquid classes of alternative financial assets.

In the context of an investment portfolio, alternative investments are also defined as investments that are not constrained by the limitations of long-only listed investments. These include real estate, private equity, hedge funds, managed futures and even distressed securities. With the exception of real estate, these assets are usually part of a larger investment portfolio of, say, a mutual fund.

Investors in alternative non-passion financial assets are usually institutional investors or HNWIs rather than regular retail clients. This is not unusual because such instruments are usually more complicated. While this is a limitation, retail clients can still participate through more accessible financial products such as real estate investment trusts (Reits) and exchange-traded funds (ETFs).

## Features of such investments

Some important features of alternative investments are worth noting:

Alternative investments, being unconventional in nature, can sometimes have low levels of liquidity. This is sometimes not well understood by investors and is the reason why a liquidity premium is required.

Other features of certain alternative investments, specifically funds, that are deemed less attractive include a high due-diligence cost, difficulty in valuation and a lack of access to information.

The comparatively higher costs in due diligence come from the additional research and monitoring required stemming from limited information. Limited information is in turn a result of poor transparency and pricing difficulties, requiring more specialised professionals. For example, fees for alternative investments, specifically funds, can include an annual management fee of one to 2 per cent in addition to an incentive fee of 10 to 20 per cent. These fees may not be justified, considering their returns, when compared with the returns and costs of investing in traditional assets.

## The role of alternative investments

The key advantage of alternative instruments is in the diversification they provide to a portfolio. This is because of possibly better risk-adjusted returns – which mean lower volatility, together with better gains or less painful losses. Alternatives can thus diversify a traditional long-only portfolio of stocks and bonds.

However, do take note that diversification does not insure against loss. A better risk-adjusted return is achieved by selecting instruments with returns that are not correlated with traditional assets. By reducing the correlation between individual assets in a portfolio, volatility will be reduced, lowering a portfolio's overall risk.

One can also use alternative investments as a hedge in a portfolio. Since the returns of such products are usually not correlated with the core instruments in a portfolio, we can use them to protect against certain downside risks.

## Risks of alternative investments

As the saying goes, never invest in something you don't understand.

Alternative investments are usually more complex. That being the case, they are usually also less transparent. For example, hedge funds, a lightly-regulated alternative investment instrument, are not obliged to disclose much publicly. You can't be sure that the tools employed by managers within a hedge fund are well suited towards making investment decisions.

In addition to the issue of trust, alternative investments can also disappoint in bull markets. A bull market can usually be observed during periods of rapid economic growth, where assets appreciate strongly. The period between the dot-com bubble to the 2008 crisis is an example of such a market. While returns of instruments that are not correlated with traditional assets can protect a portfolio against losses, let's not forget that this also means that gains will be capped. For example, short-selling strategies used to generate an absolute return tend to lag long-only strategies in a strong bull market.

Alternative investments can also possibly disappoint in extreme down markets, where correlations converge due to herd mentality.

## Invest in moderation

To conclude, when used in moderation, alternative investments can be a prudent way to invest. An appropriate allocation to alternatives within a portfolio would be 10 to 20 per cent. This is large enough to impact returns and to reduce risk, and also small enough to keep due-diligence fees from becoming exorbitant.

It is also prudent to opt for a conservative approach by going for strategies with a proven track record. This is of course based on the assumption that the investment team chosen is somehow more skilled and knowledgeable.

While we understand the irrationality of the markets and the limits of models in predictability, we can also potentially use such alternative investments to benefit from market uncertainty. Such an outlook will typically employ a further layer of allocation towards alternatives which are extremely high-risk, high-reward.

Psychologically, one should be prepared for loss, but a small bet could potentially reap unexpectedly huge gains – it all boils down to playing your cards right.

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