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Outside chances for wary investors

Alternative asset classes are a good way to diversify a portfolio but shouldn't be a primary driver of returns, writes **Zoë Fielding**.

Alternative investments such as commodities, agribusiness, infrastructure and private equity may be a welcome harbour from sharemarket volatility, but if you don't know how to access them, they can be difficult for individual investors to trade.

When people talk about buying gold as an investment, it's unlikely that they want to stockpile bullion. Similarly, it would be rare, to say the least, for a retail investor who wants exposure to soft commodities to purchase soy beans directly, or for that matter coffee or Kansas wheat.

However, there are ways to invest in these assets even if you're not an expert and don't have hundreds of thousands of dollars to commit.

Macquarie Securities Group's division director Kurt Jeston says that through structures and products retail investors can access alternative investments including capital guaranteed products, installment warrants, contracts for difference, exchange-traded funds, listed investment companies, hedge funds, absolute-return funds and managed funds.

Macquarie defines alternatives as assets or product structures outside the traditional investment classes of cash, bonds, property or shares.

Other investment managers define alternatives in narrower terms, but most agree that alternatives include commodities, infrastructure, private equity and hedge funds.

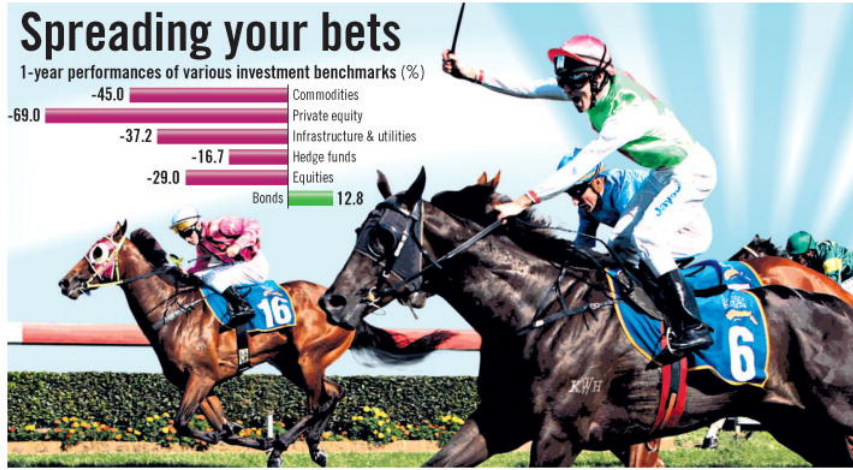
In falling sharemarkets, the performance of traditional assets has proved to be closely correlated (just think of the plunge in corporate bond prices).

This is encouraging some people to take a more active interest in alternative investments, which are not as closely linked to the fortunes of the sharemarket.

Last November, Macquarie commissioned researcher Investment Trends to identify financial advisers' attitudes to

Spreading your bets

1-year performances of various investment benchmarks (%)



alternative investments. The research showed 87 per cent of planners intended to invest new client money into at least one alternative investment in the following 12 months.

A total of \$17.1 billion is expected to be directed into alternative investments in the year ahead.

The market downturn has shown there is a role for alternative and exotic investments in portfolios, AMP Capital Investors chief economist Shane Oliver says, but he warns that the benefits of diversification should not be exaggerated. However, he noted in a report that "there is no real substitute for government bonds as a defensive asset class".

Researcher Lonsec's general manager, Grant Kennaway, says before investors rush into alternative investments, they need to be sure they want that kind of exposure and really understand what they are getting into.

Some types of assets in the alternative investment universe, such as commodities and precious

You need to go into these things with your eyes wide open because you can be in for a wild ride.

LONSEC'S GRANT KENNAWAY

metals, can be extremely volatile. "You need to go into these things with your eyes wide open because you can be in for a wild ride," Kennaway says.

Axa Australia's investment research manager, Hamish Trumbull, says investors need to be careful not to over-allocate to alternatives as they should be a diversifier for a portfolio, rather than the primary driver of returns. He says investors should not commit more than 20 to 30 per cent of their portfolio to such investments.

Lonsec's house view is that investors should not allocate more than 10 per cent of their portfolio to alternatives. Researcher Zenith Investment Partners says 10 per cent is usually suitable as a maximum allocation for retail investors.

"If you look at where people have got into trouble, it's often because they were dazzled by the story or the marketing," Axa's Trumbull says.

It is essential investors understand the risk factors that affect alternative investments and where the returns come from, he says.

Private equity and infrastructure can share some common risk factors with equities and bonds, for example. They may be highly leveraged, which is risky in environments where credit is hard to come by.

Liquidity can also be a concern for alternative investments, says Aviva Australia's distribution development manager of investment product, Stuart Fechner.

Unlisted alternatives usually trade infrequently and it may be difficult for investors to withdraw their money on demand.

"Liquidity may come into play in how often the investor can access their investment," Fechner says.

Some products, such as diversified open-ended unit trusts, allow retail investors to take part in a wide range of alternatives without locking up their money.

Select Asset Management has an alternatives portfolio that invests in a diversified bundle of hedge funds, private equity, commodities, precious metals and other assets.

Continued next page

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Some alternatives buck downward trend

Performance

Zoe Fielding

While alternative investments across most sectors have suffered poor returns over the past 12 months, commodities, infrastructure and utilities and single-strategy hedge fund indices have outperformed share markets and there are signs of recovery on the horizon.

The S&P/ASX 200 lost 29.52 per cent in the year to March 2009. Over the same time frame, the Credit Suisse/Tremont Hedge Fund Index lost 16.71 per cent and but posted slight gains in March.

Outside chances for wary investors

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The minimum initial investment is \$25,000. Applications and redemptions can be done weekly and monthly. There is a 1.28 per cent management fee, plus a 10 per cent performance fee.

Mercer Global Investments also has a diversified alternatives fund. For an annual management fee, excluding platform fees, of 1.5 per cent and a performance fee of between zero and 1 per cent, investors gain exposure to hedge funds run by Barclays Global Investors, Invesco and Alliance Bernstein, and an infrastructure income fund operated by Commonwealth Bank of Australia.

For individual investors, buying into pooled trusts such as these makes more sense than trying to build a diversified portfolio of alternatives independently, Lonsac's Kennaway says.

The investor gets exposure to a broad range of assets that otherwise would not be possible with small sums and the portfolio is managed by professionals who track the investments and factors affecting them daily.

The benefits of diversification should not be exaggerated, says AMP's Shane Oliver.
Photo: ROB HOMER



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The index tracks the returns of more than 5000 hedge funds, which must have a minimum of \$US50 million (\$70 million) under management, a 12-month track record and audited financial statements to be included. It follows the returns of 10 different classifications of hedge funds.

While dedicated short-biased hedge funds lost 5.47 per cent and managed futures hedge funds lost 2.18 per cent for the month, all other types posted gains.

Emerging markets hedge funds performed well, returning 2.24 per cent as hedge-fund managers benefited from stronger

commodities markets and government fiscal stimulus plans.

Commodities also fared better in March. The Dow Jones-AIG Commodity Total Return Index was up 3.6 per cent in that month, following eight consecutive months of decline.

The index was down 45 per cent over the year but fund manager Credit Suisse believes the commodities market bottomed in February and that US spending could reinforce inflation risk in future, which will benefit the commodities sector.

With commodities prices on the rise and an increased focus on inflationary tendencies, investors are

again looking to commodities for their portfolio diversification and inflation hedging capabilities," says Christopher Burton, co-lead portfolio manager for the Credit Suisse Total Commodity Return Strategy.

Copper was the strongest performer for the month, gaining 19.92 per cent on news that China would restock the metal. Zinc was up 3.29 per cent mainly due to increased production cuts along with projected growth in infrastructure spending.

Other alternatives indices also suffered over the year but have started to pick up again.

The S&P Listed Private Equity Index, which was launched in

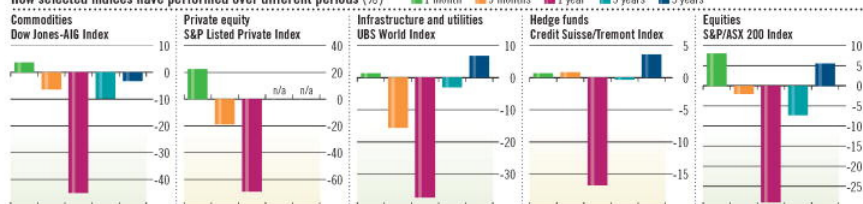
March 2007, lost 68.54 per cent to the end of this March. Its one-month performance was strong, however, with the index posting a 22.5 per cent gain in March 2009.

The UBS Global Infrastructure & Utilities index was down 37.2 per cent for the year and the Commonwealth Bank Agribusiness index, established in April 2000, dropped 54.7 per cent over the year to mid-April 2009.

The important thing to note with alternatives investments is that they vary considerably in construction and performance and manager skill is critical, Axa Australia's investment research manager Hamish Trumbull says.

Form guide

How selected indices have performed over different periods (%)



One downside of a diversified unit trust is that the investor has no control over the portfolio's holdings, although few people are experts in alternatives and would probably prefer to outsource the investment selection.

For a narrower exposure within the alternatives universe, investors can opt for sector-specific funds, says the director of Zenith Investment Partners, David Wright. In the past, these types of products were available only to institutional investors, but some product providers have issued funds with lower entry thresholds.

Macquarie Group has a global private equity securities fund that savers with at least \$50,000 to contribute can invest in. AMP Capital offers a core infrastructure fund with a minimum initial investment of \$30,000.

Agribusiness managed investment schemes are also available, although these typically have closed structures and investors are locked in for a long time, often decades. Traditionally, investors have been attracted to agribusiness schemes because of their tax effectiveness.

Expenses incurred through the schemes can be offset with tax deductions, but the investments also have a low correlation with sharemarkets, says ITC's technical services manager, Kim Cowie. There is at present no secondary market for agribusiness investments so once the money is invested, it's difficult to get out. Returns are subject to a range of risks including climate as well as business and economic risks.

In addition to holding alternatives through traditional managed fund structures, investors can buy into the assets using some structured products, capital guaranteed products and instalment warrants.

These types of investments gained popularity in Australia through the bull market as a way of gaining exposure to alternatives such as soft commodities. But the products can be complicated and difficult to understand.

Citigroup's Optimiser 5 capital guaranteed structured product closed in March 2007 with a \$5000 minimum investment. The product, which is due to mature in 2011, had returns based on the best-performing of three multi-asset investment profiles, which included the Goldman Sachs US Energy Index, Goldman Sachs US Precious Metals Index and Goldman Sachs US Agriculture Excess Return Index as some of its reference assets.

In the latest update on the product's performance the commodities-biased investment basket was the best performer of the three reference assets, having lost 21.58 per cent compared with a 35.21 per cent loss for its equities-biased basket and 27.45 per cent for the balanced profile investment.

More recent structured product issuers have turned away from alternatives as underlying reference assets in favour of more mainstream investments. Commonwealth Bank of Australia has just closed its latest Capital Series product, Australia II, which has a capital-protected

portfolio invested in the benchmark S&P/ASX 200 Index.

Issuers are finding that investors are more interested in capital guarantees over asset classes with which they are more familiar, says CBA's head of business development for structured investments, Moghseen Jadwat.

Hedge funds and absolute-return funds are often considered to be their own sub-branch of alternative assets. This grouping covers a wide range of investments and strategies that vary significantly in approach and performance.

They are intended to generate investment returns without relying on sharemarket results, but in fact many have proved to be closely correlated with equity markets.

sectors, says Silvan Ridge Financial Services' certified financial planner, Dallas Ludeman.

Stocks such as Macarthur Coal, Woodside Petroleum and BHP Billiton expose investors to commodity markets. Buying shares in companies such as Leighton Holdings or Transurban allows investors to participate in infrastructure trends.

"Being a stock picker will get you that exposure," Ludeman says. Direct shares are easily traded by retail investors and the investment's liquidity is rarely a concern.

However, shares are mainstream assets and are affected by market forces, which detracts from the diversification benefits that investing in alternatives is intended to provide in the portfolio.

Investors can also buy commodities on the Australian Stock Exchange through exchange-traded commodities (ETC) products.

ETCs track the performance of commodity indices such as gold, silver, platinum and palladium. The first of these to launch in Australia was the exchange-traded gold product in 2003.

These products can be bought and sold like ordinary shares.

They have an open-ended structure so more units in the ETC can be issued as required.

Gold bullion securities can also be purchased directly on the Australian Securities Exchange in much the same way as any other share can be bought.

This is literally buying gold directly. The gold bars are held by a custodian in vaults in London and a separate trust is established for each holder of the gold, giving them the absolute entitlement to that gold bullion.

"You can physically take possession of the gold if you want it, although very few investors do that," Zenith's Wright says.

Issuers are finding that investors are more interested in capital guarantees over asset classes with which they are more familiar.

CBA'S MOGHSEEN JADWAT

It is difficult for retail investors to pick a good hedge fund manager and to understand the workings of the funds but Axa's Trumbull says for any investment that aims to generate returns through manager skill, manager selection is critical.

Hedge funds-of-funds are also available, but many of these have achieved disappointing results.

In fact, a more simplistic way of participating in trends in alternative assets such as commodities and infrastructure is by purchasing direct shares in companies whose core business focuses on these