

INSIGHTS

ASSET MANAGEMENT

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Mainstreamed alternatives face stern test

● *Traditional asset classes have again started to deliver returns, writes Pedro van Gaalen*

While interest in alternative assets has risen steadily over the past decade, the appetite for these investments among investors surged in 2022.

In response to the geopolitical turmoil and volatility in equity and bond markets, asset managers increasingly looked to private equity, hedge funds, private credit, venture capital and infrastructure and real estate funds for diversification and uncorrelated, risk-adjusted returns.

The resultant demand has ushered in a new investment trend within the broader asset management space that McKinsey&Company terms “the mainstreaming of alternative investments”.

And growth in these assets



Nabeel Laher ... policy shift.

seems unlikely to abate, with emerging opportunities in art, ESG-linked investments, and digital assets such as cryptocurrencies, tokenised assets and nonfungible tokens (NFTs), among others, adding to the universe of potential options.

According to estimates from Preqin, global assets under management (AUM) in alternative investments will grow from \$12.5-trillion in 2022 to more than \$20-trillion by the end of 2025.

BANKS RESPOND

However, significant market shifts since last year will test alternative investments as central banks respond to



Clyde Rossouw ... relevance.

stubbornly high inflation.

“The shift in policy from accommodation to tightening midway through 2022 catalysed a slowdown in private equity activity,” says Nabeel Laher, Head of International Private Equity at Old Mutual Alternative Investments.

Alternative assets have also come under pressure recently as rising interest rates mean traditional asset classes have again started to deliver returns, explains Neville Chester, senior portfolio manager at Coronation Fund Managers.

“This shift reduces the need for asset allocators to find more exotic means to deliver returns. The collapse of speculative tech



Justin Cousins ... returns.

and the rise in the cost of funding have also meant that private equity and early IPO funds have all become less attractive vehicles.”

Laher adds that the uncertainty caused by the invasion of Ukraine, growing political tensions and increased fears over the health of the global banking system impacted deal-making.

“Multiple contractions in early-stage, long-duration, cash-burning companies, and the failure of Silicon Valley Bank, which was deeply entrenched in the US venture capital ecosystem, acutely affected venture managers,” says Laher.

“A back-to-basics mentality

with a greater focus on fundamentals, valuations and pathways to profitability now pervades the venture and growth equity industries, coupled with a decline in valuation expectations and slower pacing. Similarly, the buy-out world is increasingly focused on cash flow and capital structure management.”

However, alternative assets still offer opportunities, with the release of numerous AI models and their rapid adoption highlighting the impact and opportunities venture investing can present, believes Laher.

“Many managers are also using this time to lean into different origination channels and value-creation activities. In this regard, we expect to see more public to private and carve-out transactions. Buy-and-build strategies are also increasingly popular, where high quality companies can use add-ons to average down entry multiples and consolidate fragmented verticals,” says Laher.

For firms focused on value and special situations, Laher believes that the sector could experience a once-in-a-decade period of heightened activity. “This is already starting to play out with strong pipeline activity.”

In addition, asset managers

are leveraging hedge funds in the prevailing market conditions to deliver alpha.

“As a hedge fund, we aim to take advantage of sector mispricing through pair trades that offer returns that are independent of the direction of the overall market by exploiting valuation discrepancies within sectors,” explains Justin Cousins, Executive Director and Portfolio Manager at Peregrine Capital.

UNLOCKING VALUE

Peregrine is also actively looking to take larger positions in unloved companies of reasonable quality to unlock value through active engagement strategies.

“When panic engulfs markets like it did last year, we

consistently look for distressed debt opportunities in listed bonds of companies we know well. This is the sort of market where participants will need to kiss many frogs to discover the odd prince or princess.”

Adds Chester: “In SA, funding vehicles created to fund investment in renewable energy will potentially emerge as the biggest driver of alternative assets, which does not always lend itself to the traditional listed markets.”

In the broader context, Clyde Rossouw, Head of Quality at Ninety One, explains that infrastructure assets benefit from a combination of defensive fundamentals and structural growth drivers, with the ability to generate inflation-protected

income.

“They also typically have a low correlation with other assets, low sensitivity to the economic cycle and sustainable cash flows.”

From a local perspective, Rossouw believes infrastructure funding could hold significant relevance given the deterioration of government’s fiscal position and effectiveness and the lack of funding within state-owned enterprises.

“However, infrastructure investments carry two significant risks – they are illiquid and investors may find it challenging to sell at the time they plan to exit. These investments are also typically highly leveraged, which results in a heavy interest burden.”