FAMILY OFFICES ARE TURNING TO ALTERNATIVE INVESTMENTS AND STRATEGIES TO FIND YIELD IN FAST-PACED GLOBAL MARKETS

WHAT IS THE ALTERNATIVE?
Family offices need to explore every opportunity to reach return hurdles, and alternative investments offer a wealth of ways to find yield in rapidly changing global markets. At an event sponsored by Bloomberg Asset and Investment Manager (AIM), a series of conversations among family office experts and alternative investment professionals delivered numerous insights for family offices to consider. The discussions included trends and popular strategies, the exploration of specific markets, approaches to portfolio management and increased operational due diligence on behalf of investors.

INVESTMENT TRENDS
In the past five years, family offices have seen success with ABS, credit and core bond portfolios. The question today is how long this success will continue given changing valuations, declining spreads and rising P/E multiples. This is why so many family offices are looking to alternative investments in niche categories. Bank loan funds have performed well but can be comparatively expensive, especially in the U.S. High-yield bonds are trending despite the fact that spreads are historically thin in the U.S. and even more so in Europe. Lower yields across the bond market are pushing investors into REITs, MLPs and other asset classes to make their return hurdles. Overall, leading family offices favor a more defensive posture and are moving portfolios to more liquidity and active management and less reliance on beta. On the technology side, family offices are emphasizing operational due diligence to ensure the managers they invest with have a sound technical infrastructure in place. As Dan Matthies, Global Head of Bloomberg AIM, recently put it: “Investment firms of all sizes are looking to meet increased investor demands for institutional-grade infrastructure, which allows them to pass due diligence requirements when raising capital. Bloomberg AIM provides just such a solution.”
**STRATEGIC OUTLOOK**
The 2008 crisis created an unwelcome but unprecedented opportunity for corporate restructuring, paving the way for record operating profits and efficiency. But competition is growing, and CEOs are under greater pressure to add value. Some will pursue innovation, but many others will choose acquisition, divestment, special dividends and similar activities, making event-driven strategies a popular choice for family offices. Fundamental credit trading funds may play an important role given overall yield levels and low default rates. Global macro may become more interesting due to QE tapering and a decline in volatility suppression; establishing positions today with preferred managers can provide a hedge to overvalued long equity books as fixed-income and rate volatility tick up. Gold does not seem to be promising, given that its real price is still very high compared to nearly every period in the last century except 1978/79.

**COMMON MISTAKES**
The search for yield has driven riskier behavior, but this is not unique to family offices. Along with institutional investors, many family offices have moved from high-quality core fixed income assets to an unconstrained approach to fixed income. The content of these opportunities has changed dramatically in the past five years, and investors may be pursuing premiums that are too small relative to the risk. Family offices are receiving a lot of pitches for BDCs, which continue to entice but often disappoint. Many claim to have fixed their balance sheets, but uncertainties remain. One alternative to consider for middle-market lending is a private partnership with a hedge fund format, a controlled group of limited partner investors and a controlled financing and liability structure.

**EMERGING MARKETS**
As QE tapers and capital flows back into U.S. markets, family offices are considering emerging markets on a case-by-case basis. The value in these markets, however, is in equities, not credit. Emerging market equities have underperformed compared to the U.S. and the rest of the developed world. Some of the most historically worrisome countries may be at an inflection point. Russia is a surprising example, which could emerge as a net winner after the Ukraine situation resolves. The Russian equity market can’t be fully divorced from oil and energy prices, and energy developments in Poland and the U.S. will have a big impact on Russian valuation. However, there is lead time to consider opportunities. Across the BRICs, changes in equity valuations have set the stage for alternative implementations. Africa is not yet ready for U.S. allocators; China is investing heavily in many nations, but these moves are backed by a strong military presence.

**THE ENERGY RENAISSANCE**
The “American renaissance in energy” refers to the shale revolution, the method by which oil producers can access large, layered hydrocarbon blankets via hydraulic fracturing (“fracking”) and multi-well pads. At the end of 2012, the U.S. produced seven million barrels of oil per day. In 2013, this increased to 8.2 million. This rate of increase is expected to continue for five years, creating $40 billion in new wealth. Energy-oriented capital funds capture profits not only from the oil itself but also from every part of the supply chain required to extract, refine, distribute and market it. These funds have demonstrated impressive results in the past year, but those returns are not expected to continue. No boom unwinds uniformly, so family offices will need to identify the overperformers (whose reserves may run out sooner) and underperformers (who are still delineating layers of hydrocarbons in existing basins).
THE FUTURE OF ENERGY

Industry analysts believe U.S. energy independence may occur as soon as 2020, raising the issue of reversing the ban on U.S. crude oil exports. Although an independent U.S. would change market dynamics somewhat, it should not dampen the total world market. The primary long-term concern for family offices investing in energy MLPs is the international price of oil, which is effectively bounded on the low end by the lowest price at which OPEC nations can meet domestic spending needs and on the high end by the price that would destroy demand. In many subsectors (extraction and production, oil field services, midstream infrastructure and refining/marketing), there is comparatively high volatility. But there is also a “tug of war” because as oil prices rise, E&P companies benefit and refiners do not; the opposite holds true when oil prices fall. By studying this dynamic, funds can effectively dampen volatility.

CO-INVESTING OPPORTUNITIES

In the last six months, many family offices are being pitched an extraordinary number of direct private equity and co-investment opportunities via club deals. When banks are reluctant to lend, even to creditworthy companies, this creates lending opportunities. By working with other family offices and hedge fund managers, family offices can link up with those who have the domain expertise required to evaluate and pursue specific opportunities with confidence. While these deals create a reliable way to avoid fees, family offices should balance these benefits against the unanticipated issues that can arise when managing the operating companies.

UNDERSTANDING SUSTAINABILITY

As a strategy, sustainability has nothing to do with investing in environmentally or socially responsible companies or with negatively screening others. Instead, this strategy forecasts risks associated with natural resource scarcity and demographic trends. It analyzes both ESG and financial performance data to envision what the world will look like in five to 10 years (not what it should look like) and invest accordingly. For example, how would a prolonged drought affect the entire family office portfolio? It would likely affect energy, consumer goods, power, industrials, food, agriculture and many others. A sustainability strategy examines how to absorb these risks, add value for assuming them or manage away from them. It is not a narrow prediction for a specific company or sector but rather a way to analyze portfolios systematically. For family offices, sustainable investing can be a critical way to preserve wealth over the long term.

THE BOTTOM LINE

1. THINK GLOBALLY.
Taking a worldwide view of alternative investing will highlight illustrative regional differences in instruments as well as identify opportunities to capture value from big-picture political, industrial and environmental developments.

2. STAY SKEPTICAL.
Despite strong pressure to find yield, family offices should continue to ask tough questions about any strategy or instrument. Changes in the past five years have significantly changed the risk/reward balance for many alternative investments.

3. FIND PARTNERS.
Teaming up with other family offices (and their networks of partners) provides a way to take advantage of larger deals as well as broaden the range of alternative investments that family offices can pursue with sufficient domain expertise.
MORE POINTS OF VIEW
The discussion doesn’t end here. Experts at Bloomberg are engaging in conversations about these concepts in many ways with professionals from across the financial industry.

Buy-side firms are determining how to create competitive advantages with trusted, reliable data.

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