KASNEB

ADVANCED LEVEL

ALTERNATIVE INVESTMENTS ANALYSIS

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STUDY PACK

INTRODUCTION

Following our continued effort to provide quality study and revision materials at an affordable price for the private students who study on their own, full time and part time students, we partnered with other team of professionals to make this possible.

This Study Text covers KASNEB syllabus and contains past examination past papers and our suggested answers as examples which are provided by a team of lecturers who are experts in their area of training. The book is intended to help the learner do enough study and practice on how to handle exam questions and this makes it easy to pass kasneb exams.

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0728 776 317

UNIT DESCRIPTION

This paper is intended to equip the candidate with the knowledge, skills and attitudes that willenable him/her to value and analyse alternative investments.

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Identify the principal classes of alternative investments
- Demonstrate knowledge of the environment and various players in the alternativeinvestment market.
- Apply valuation techniques to price and value alternative investments
- Advise clients on how to incorporate alternative investments to their portfolio accordingto stated investment objectives and risk tolerance
- Evaluate the importance of alternative investments as asset classes for portfoliomanagement

CONTENT

1. **Introduction to alternative investments**
   - 1.1 Distinction between alternative investments and conventional investments
   - 1.2 Historical evolution of alternative investments
   - 1.3 Features of alternative investments
   - 1.4 Types of alternative investment structures: regulatory, securities, trading,compensation, institutional
   - 1.5 Goals of alternative investing

0728 776 317

2. **The environment of alternative investments**
   - 2.1 Participants in the alternative investing environment:
   - 2.2 Buy side participants (plan sponsors; foundations and endowments; private wealth institutions; hedge funds; funds of funds; private equity funds; commodity trading advisors; separately managed accounts) and their roles in the alternative investing environment
   - 2.3 Sell side participants (large dealer banks, brokers) and their roles in the alternative investing environment
   - 2.4 Outside service providers (prime brokers, accountants and auditors, advocates, fund administrators, hedge fund infrastructure, consultants, depositories and custodians, commercial banks) and their roles in the alternative investing environment
   - 2.5 Features of fund structures
   - 2.6 Documents used in establishing and maintaining hedge fund, private equity fund and other private partnerships (private-placement memoranda, partnership agreement, subscription agreement, management company operating agreement)
   - 2.7 Moral hazard and adverse selection in alternative investments
   - 2.8 Components of investments objectives, fund size, and fund terms

within a limitedpartnership agreement

2.9 Regulatory issues related to alternative investments: Global regulations (markets in financial instruments directive (MiFID), MiFID II, alternative investment fund managers directive (AIFMD) and their impact on asset allocation

2.10 Role of financial markets in alternative investments: primary, secondary, third and fourth markets

2.11 Effect of taxation on alternative investments: income taxes (taxes on capital gains, dividends, interest), non-income tax conventions (real estate taxes, VAT), effect of variation in income tax conventions around the world on investmentsand investment decisions

3. Real assets investment

3.1 Characteristics of real assets

3.2 Land as an alternative asset; land banking, types of land lots (paper lots, blue toplots, and finished lots); investment in undeveloped land as a call option; binomial option pricing technique for valuing land as a call option risks and returns of investing in land; expected return of land investments

3.3 Timber and timberland as alternative assets; characteristics of timber and timberland, risks and returns of timberland investments; methods of gainingexposure to timberland, benefits and disadvantages of timber investment

3.4 Farmland as an alternative asset; characteristics of farmland investments, reasons for preserving farmland, value of farmland based on annual operating income and the cap rate, benefits and disadvantages of farmland investment

3.5 Infrastructure as an alternative asset; elements that help identify investable infrastructure, role of public-private partnerships in infrastructure investing, risks and government regulation of infrastructure investing, stages of infrastructure investing, infrastructure investment vehicles

3.6 Intellectual property; characteristics of intellectual property, models of intellectual property

3.7 Effect of smoothing on the valuation and volatility of real assets investments: smoothing of prices and returns, smoothed returns with market returns

3.8 Real estate assets and debt; categories of real estate, equity versus debt, advantages, disadvantages, and styles of real estate investments as well as advantages and disadvantages of investing in real estate, challenges of international real estate investments, residential vs. commercial real estate, private vs. public real estate, real estate categorization based on market size, styles of real estate investing, attributes of differentiating real estate styles, purposes of real estate

0728 776 317

style analysis and real estate style boxes, analysis of default risk of commercial mortgages, financial ratios employed in the analysis of commercial mortgage. Role of real estate in an investment portfolio, types of real estate investment trusts (REITs), advantages and disadvantages of REITsas an alternative investment.

3.9 Residential Mortgages-variable rate, gradual payment, option adjusted rate and balloon payments

3.10 Real estate equity investments; real estate development in the context of alternative investments, development phase of real estate, importance of commercial real estate equity exposures,

3.11 Commercial real estate valuation : comparable sale prices approach, profit and cost approaches to real estate valuation, cap rates and perpetuity valuation approach to a real estate project, income approach as a major real estate valuation approach and transaction-based methods to real estate valuation, advantages and disadvantages of appraisal-based models over transaction- based models, discounted cash flow approach (income approach) to the calculation of net operating income, real estate project's discount rate and the risk premium approach, role of taxes in estimating discount rates and the cash flows of a real estate project, appraised value of an office building using the income approach, private equity real estate funds, commingled real estate funds,syndications and joint ventures, limited partnerships, and concepts of gearing and loan-to-value (LTV) ratios, open-end real estate mutual funds, exchange- traded funds and closed-end real estate mutual funds, equity real estate investment trusts, knowledge of equity REIT returns, private and public REITs and illiquidity premiums in public REITs , REIT valuation (net asset value per share (NAVPS), funds from operations (FFO) and adjusted funds from operations(AFFO)) , comparison of net asset value, relative value (price-to-FFO and price- to-AFFO) and discounted cash flow approaches

0728 776 317

4. Hedge funds

4.1 Features of hedge funds; three primary elements of hedge funds; reasons for hedge fund industry growth and concentration

4.2 Classification of hedge funds; single-manager hedge funds, funds of funds and multi-strategy funds

4.3 Hedge fund fees: the approach for determining total annual hedge fund fees; the effects of high-water marks (HWM) and hurdle rates on hedge fund fees over time; effects of incentive fees on hedge fund manager behaviour; annuity view of hedge funds fees; option view of incentive fees and its implications on manager behaviour

4.4 Hedge fund strategies: types of hedge fund strategies (Equity based strategies, arbitrage-based strategies, opportunistic strategies, multiple

strategies)

4.5 Reasons for incorporating hedge funds into an investment program: return enhancement and diversification potential of hedge funds as additions to portfolios of traditional assets; characteristics and potential benefits of opportunistic hedge fund investing

4.6 Hedge fund indices: asset-weighted hedge fund indices and equal-weighted hedge fund indices; concepts of representativeness and data biases (survivorship, selection, instant history, liquidation) and their effects on hedge fund returns reported by databases

4.7 Determinants of investability of hedge fund indices

4.8 Funds of hedge funds; multi-strategy funds; process of investing in funds of hedge funds, building a portfolio of single hedge funds, multialternatives andother hedge fund liquid alternatives

5. Private equity

5.1 Background of private equity

5.2 Structure of private equity funds and investments

5.3 Roles of various entities involved in private equity investments

5.4 Major forms of private equity investments that involve direct ownership of equity: leveraged buyouts(LBOs), management buyouts(MBOs), venture capital, merchant banking and their characteristics

5.5 Major forms of private equity that involve direct ownership of debt securities: mezzanine debt, distressed debt securities, debt covenants, leverage loan securities and factors contributing to their growth

5.6 Trends and innovations in private equity markets: secondary markets in the context of private equity; private investment in public equity (PIPE) transactions; hedge fund participation in private equity, contrast between private equity funds and hedge funds

5.7 Venture capital: role of venture capital and leverage buyouts as sources of funding for corporations through their life cycle, role of business plans and exit plans in venture capital investment, structure of venture capital funds, stages of the life cycle of venture capital funds and portfolio companies, compound option embedded in most venture capital investments, the concept of the J-curve in the context of a start-up company; risk and return characteristics of venture capital investments, sources of return (risk premiums) to venture capital investments equities

5.8 Growth equity: growth equity investments and protective provisions as a key deal characteristic in growth equity investment, characteristics of growth equity investment, valuation of growth equity based on revenue

5.9 Leveraged buyout (LBO) transactions: structure of LBO funds and the role of various entities involved in LBO transactions; fees associated with investments in LBO funds; effects of leverage on the payoffs and

0728776 317

returns of LBO transactions; exit strategies of LBOs; risk and return characteristics of LBOs

5.10 Private investments in public equity (PIPEs); characteristics and types of securities issues through PIPEs, motivations of buyers and sellers in PIPEs.

5.11 Private credit and distressed debt; types of fund private credit vehicles; private credit and distressed debt investments, interval funds, drawdown funds, Funds with a loan-to-own objective, fulcrum securities and reorganization; credit risk analysis and the bankruptcy process, basic credit ratings, yields, and financial ratios, interpret credit spreads and credit risk, credit risk and its relationship to risk of default, covenants on debt, ways that covenants can control risk, distressed debt and the bankruptcy process, leveraged loans; basics of leveraged loans, growth in leveraged loans, liquidity and demand for leveraged loans, mezzanine debt, structures of mezzanine debt and lowering the weighted average cost of capital, mezzanine debt financing vs. other forms of financing, major types of investors in mezzanine debt, characteristics of mezzanine debt.

5.12 Corporate governance structures in private funds

0728 776 317

6. Structured Products

6.1 Introduction

6.1.1 Overview of structuring; major types/forms of structuring, key elements of a structured products, reasons for structuring, advantages and disadvantages of structuring, structuring with tranches and how structured products are created, the primary economic role of structuring, economic role of structured products

6.1.2 Motivations of structured products; investor related and tax-related motivations for investors

6.1.3 Structured investment products in the structured products market; capital protected, yield enhancement and leverage structured products

6.2 Asset-backed securities

6.2.1 Basic structural features of, and parties to a structuring transaction; the roles they play, and the legal structures involved

6.2.2 Types of tranching; prepayment tranching and credit tranching

6.2.3 Payment structure and collateral structure of structuring backed by amortising assets and non-amortising assets

6.2.4 Types of external and internal credit enhancements; cash flow and prepayment characteristics for securities backed by home equity loans, manufactured housing loans, automobile loans, student loans and credit card receivables; financial ratios as used in analysis of commercial mortgages (Loan-to-Value, interest

coverage ratio, and debt service coverage ratio); collateralised debt obligations (CDOs): cash and synthetic CDOs; primary motivations for creating a collateralised debt obligation (arbitrage and balance sheet transactions)

6.2.5 Credit derivative markets: how a bank can use credit derivatives to transfer credit risk, classification of credit derivatives (single name versus multi-name, funded versus unfunded, sovereign versus non sovereign). four stages of credit derivative activity

6.2.6 Credit default swaps: mechanics of credit default swaps, credit optionsand credit-linked notes, risks of credit derivatives

6.2.7 Collateralised debt obligations (CDOs): general structure and life cycle ofa CDO, balance sheet CDOs and arbitrage CDOs, cash-funded CDOs and synthetic CDOs, cash flow and market value CDOs, credit risk and enhancement of CDOs, new developments in CDOs (distressed debt CDOs, hedge fund CDOs, single-tranche CDOs).

6.3 Mortgage-backed securities

6.3.1 Collateralised mortgage obligations (CMOs): characteristics, sequential-pay CMOs, other types of CMO structures and tranches (Planned Amortisation Class, Targeted Amortisation Class, Principal-only CMO and Floating-rate)

6.3.2 Mortgage loans: cash flow characteristics of a fixed-rate mortgage, level paymentand fully amortised mortgage

6.3.3 Mortgage pass-through securities: investment characteristics, payment characteristics and risks; repayment amount on a mortgage pass-through security for a month, given the single monthly mortality rate; conditional prepayment rate (CPR); Public Securities Association (PSA) prepaymentbenchmark

6.3.4 Relevance of average life of a mortgage-backed with respect to the security's maturity; factors that affect prepayments and the types of prepayment risks

6.3.5 Collateralised mortgage obligation (CMO): creation of a collateralised mortgage obligation and its use in matching of assets and liabilities for institutional investors

6.3.6 Mortgage tranches in a CMO: Sequential pay tranche; the accrual tranche, the planned amortisation class tranche and the support tranche; risk characteristics and relative performance of each type of CMO tranche, given changes in the interest rate environment; investment characteristics of stripped mortgage- backed securities; agency and non-agency mortgage-backed securities; credit risk analysis of commercial and residential non-agency mortgage-backed securities; basic structure of a commercial mortgage-backed security (CMBS)

0728 776 317

;ways in which a CMBS investor may realise call protection at the loan level and by means of the CMBS structure

7. Valuing mortgage-backed and asset-backed securities

7.1 Computation, use and limitations of the cash flow yield, nominal spread and zero-volatility spread for a mortgage-backed security and an asset-backed security
7.2 Monte Carlo simulation model for valuing a mortgage-backed security
7.3 Path dependency in pass-through securities and the implications for valuationmodels
7.4 Calculation of option-adjusted spread using the Monte Carlo simulation modeland its interpretation
7.5 Evaluation of a mortgage-backed security using option-adjusted spread analysis
7.6 Reasons for having different effective durations reported by various dealers and vendors; interest rate risk of a security, given the security's effective duration andeffective convexity; cash flow, coupon curve and empirical measures of duration and limitations of each in relation to mortgage-backed securities Use of nominal spread, zero-volatility spread, or option-adjusted spread in evaluating a specific fixed income security

8. Commodities

8.1 Types of market participants in commodity futures markets, ways of participating in commodity markets
8.2 Advantages and disadvantages of direct investment in physical commodities, Hotelling's theory, Julian Simon's argument related to direct commodity returns
8.3 Overview of forward and futures contracts; marking-to-market of futures positions, initial margin to futures positions, maintenance margins to futurespositions
8.4 Return characteristics of commodity investments
8.5 Roll process of futures contracts: process of creating and maintaining long-term futures exposures through short-term futures positions; effects of rollover decisions on the returns of long-term futures exposures
8.6 Term structure of forward prices and the pricing models of futures and forward prices: arbitrage-free pricing models and its application on pricing physical assets, convenience yield
8.7 The concepts of backwardation, normal backwardation, contango, and normal contango; relationships between forward prices and spot prices under normal backwardation and normal contango; expected returns to spot positions and forward positions (long and short) under normal backwardation and normal contango
8.8 Potential diversification benefits offered by commodities;

0728 776 317

commodities in thecontext of equilibrium diversification; commodities as a diversifier of inflation risk; commodities as potential return enhancers

8.9 Insurance perspective, the hedging pressure hypothesis and the theory of storage and their implications for futures prices and expected future spot prices

8.10 Investing in commodities without futures (through related equity instruments,exchange-traded funds (ETFs), commodity linked notes)

8.11 Commodity indices; the process of construction of commodity futures indices, characteristics of commodity indices, production-weighted long only commodity indexes, market liquidity-weighted long only commodity indexes

8.12 Commodity risk attributes; characteristics of commodities with respect to event risks, commodities as a defensive investment, institutional investing demand and its effect on commodity prices

9. Crowd funding

9.1 Introduction to crowd funding and prediction markets

9.2 Structure, benefits and weakness

9.3 Reward crowdfunding

9.4 Equity crowdfunding

9.5 Peer 2 Peer lending

0728 776 317

TOPIC **PAGE**

1. Introduction to alternative investments……………………………………….12
2. The environment of alternative investments…………………………………18
3. Real assets investments………………………………………………………41
4. Hedge funds……………………………………………………………………...107
5. Private equity…………………………………………………………………….135
6. Structured products……………………………………………………........168
7. Valuing mortgage-backed and asset-backed securities………………………..234
8. Commodities…………………………………………………………………..250
9. Crowd Funding………………………………………………………………..271

0728 776 317

CHAPTER ONE

OVERVIEW OF ALTERNATIVE INVESTMENTS

Alternative investment is sometimes viewed as including any investment that is not simply a long position in traditional investment. Typically traditional investments include;

1. Equity
2. Fixed income
3. Cash

Classes of Alternative investments include;

1. **Private equity** - Includes both equity and debt positions that among other things are not publicly traded. In most cases the debt positions contain so much risk in cash flow uncertainty that their short-term return behavior is similar to that of equity position.
2. **Venture capital** - refers to support via equity finance to start-up companies that do not have sufficient size, track record or desire to attract capital from traditional sources such as public markets or lending institutions.
3. **Leverage buy-outs** – Refers to those transactions which the equity of a publicly traded company is purchased using a small amount of investor capital and a large amount of borrowed funds in order to take the firm private. The borrowed funds are secured by the assets or cash flows of the target.
4. **Mezzanine debt** –Derives its name from its position in the capital structure of a firm between the ceiling of senior structure debt and the floor of equity. Refers to a spectrum of claims including preference shares, convertible debt and debt that includes equity kickers that allow the investors to benefits from any upside success in the underlying business also called hybrid securities.
5. **Hedge funds** - They are privately organized investment vehicles that uses its less regulated nature to generate investment opportunities that are substantially distinct from opportunities offered by traditional investment vehicles which are subject to regulations such as those restricting the use of leverage and derivatives.
6. **Real assets** –Involves direct ownership of non-financial assets rather than ownership through financial assets such as securities.

0728 776 317

7. **Structured Products**-Are instruments created to exhibit particular return, risk, taxation or other attributes. These instruments generate cash flows from a partitioning of the cash flows from a traditional investment or linking the return of the investment product to one or more market values.
8. **Commodities** e.g. precious metals

STRUCTURES AMONG ALTERNATIVE INVESTMENTS

Structures are descriptive and definitional components of alternative investment, they are crucial to analysis of asset classes that create the alternative investment.
Structures denote a related set of important aspects that identify investments and distinguish them from other investments. There are 5 types of structures;

1. Regulatory structures

Refers to the role of government including both regulation and taxation in influencing the nature of investment. E.g. Hedge funds (HF) are loosely regulated and typically must be formed in particular ways to avoid high levels of regulations.
Taxation can motivate the existence of some investment products and plays an important role in the transformation of the underlying cash flows into the investment products.

0728 776 317

2. Securities structures

Refers to structuring of cash flows through securitization. Securitization is the process of transforming asset ownership into tradable units. Cash flows may be securitized simply on a pass-through basis (pro-rata). Cash flows can also be structured through partitioning into financial claims with different levels of risk or other characteristics or timing of cash flows.

3. Trading structures

Refers to the role of investment vehicles, investment managers in developing and implementing trading strategies. A buy and hold management strategy will have a minor influence on underlying investment returns while aggressive, complex, fast-paced trading strategy can cause the ultimate cash flows for a fund to differ from the cash flows of the underlying assets.

4. Compensation structures

Refers to the ways that organizational issues especially compensation schemes influence particular investments thus in the case of hedge fund organizational structure would

include the financial arrangements contained in the partnership formed by the investors and the entry used by the fund managers such as arrangements usually determine the exposure of the fund's investment managers to the financial risk of the investment, determine the fee structure used to compensate and reward managers and determine conflict of interest between parties.

5. Institutional structures

Refers to the financial markets and financial institutions related to a particular investment such as whether the investment is publicly traded. Public trading of a security is an essential driver of an investment nature.

STRUCTURES AND THE 5 ALTERNATIVE INVESTMENT TYPES

It would be difficult to find a major investment that is not shaped or influenced in at least some small way by each of the 5 listed structures.
However, many investments tend to be heavily influenced by only a subset of these structures.

1. Real Assets

0728 776 317

It is a category dominated by real estate. Most real estates have an institutional structure of being privately held and traded REITS. The use of securities in the structuring of cash flows and securitization has also been important in driving the nature of real estate investments.

2. Hedge funds

Are primarily traded by the trading structure; the use of active, complex and proprietary trading strategies. Are also distinguished by regulatory structures (use of offshores structures due to tax regulations) and compensation structures including the use of heavily influenced other structures.

3. Commodities

Are primarily driven by their securities structure since they are usually traded using future contracts but tend not to be heavily influenced by other structures.

4. Private equity

Is clearly distinguished by the institutional structure that it is not publicly traded. Compensation on securities and trading structures also play non-trial roles in changing the nature of private equity.

5. Structured products

Are clearly distinguished by securities structure. However, structured products are typically moderately influenced by institutional, regulatory and compensation structures.
Distinction Between Alternative Investment (AI) And Traditional Investment (TI) Based On:

A) Return characteristics

Investment characteristics exhibit returns that are substantially from return of traditional stock and bonds might be viewed as being AI.

1. **Diversification**
   An investment opportunity with returns that are uncorrelated with/only or slightly correlated with traditional investments is often viewed as an AI. An attractive aspect of this correlation is that it indicates the potential to diversify risk. In the context, AI are synonymous with diversifiers.
   Investment products viewed as having little or low correlation with TI are also termed as absolute return products since their returns should generally be internalized on an absolute basis rather than returns of TI.
2. **Illiquidity**
   TI have institutional structure that they tend to be frequently traded in financial markets with substantial volume and high number of participants. Therefore, the returns tend to be based on liquid prices observed from reasonably frequent trades at reasonable levels of volume. AI are illiquid implying that the investment trades infrequently or with low volumes.
3. **Inefficiency**
   The prices of most TI are determined in markets with relatively high degree of competition and therefore with relatively high efficiency.
   Inefficiency refers to the deviation of actual variations from these variations that would be anticipated in the efficient market.
4. **Non-normality**
   Returns of TI can be approximated as being normally distributed. AI exhibits non-normally in that they cannot be accurately approximated using standard bell-curve.

B) Method of analysis

AI can also be distinguished from TI through the methods used to analyze measure and manage their returns and risks.

1. Return computative methodologies

0728 776 317