ALTERNATIVE INVESTMENTS CONFIDENCE AMID COVID-19 PANDEMIC

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Abstract: *The COVID-19 pandemic, also known as the coronavirus pandemic, is an ongoing pandemic of coronavirus disease 2019 (COVID-19) caused by severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2).*
The COVID-19 pandemic has caused a severe disruption to global economic activity and has led to both demand and supply-side shocks, affecting different sectors of the world economy to varying degrees.
Amid the current pandemic, one important question for the alternatives industry, is how COVID-19 may have changed investors' views on the performance of their alternative asset allocations and portfolios.
As well as affecting economic prospects, COVID-19 pandemic is having a profound effect on many supply-chain sectors and industries. The private capital market is not excluded and concerns such as interest rates rises, the geopolitical landscape, currency market volatility, regulations and even competition for assets are experiencing an intense interest.
This paper will analysis the investment landscape over the spectrum of Alternative Investments, amid COVID-19 Pandemic, over Private Equity, Private Debt, Hedge Funds, Real Estate and Infrastructure Sectors.

Key words*:* Alternative Investments; Private Equity; Private Debt; Hedge Funds.

JEL Classification Codes : G11, E22, E32.

1. INTRODUCTION

Defined as financial assets which fall outside of conventional investment categories - such as stocks, bonds and cash - alternative investments don't typically correlate with the stock market. As such they can add diversification to an investor's portfolio and help to manage volatility.

At the end of February 2020 financial markets entered a new risk phase, that disrupted the long bull run and high asset valuations. This has taken the financial markets and services by surprise, as most of the investors and fund managers were still committed to their allocations, research and placements while searching for value and opportunities with high returns.

Alternatives were always an option as investors recognized a strong delivery of returns throughout bad and good cycles.

Diversification and resilience are key investment attributes for navigating volatile markets and an uncertain economic outlook. The new normal is lifting up opinions around the potential for alternative investments to add diversity and hedge risk. Financial markets' reactions to the pandemic include plummeting and highly volatile stock markets, and increasing credit spreads.

2. MARKET OUTLOOK

The markets sell-off in March, triggered by the coronavirus pandemic, saw expected correlation patterns disrupted. Global equities, corporate and government bonds, currencies, and oil, all took a hit, as their positive correlations pressured the diversification strategies put in place by asset managers. Spulbar and Birau (2019) suggested that volatility does not diverge to infinity and seems to react significantly different considering the case of high positive or high negative stock returns. Moreover, portfolio diversification strategy is a representative phenomenon of quantitative finance, most often applied in relation to low or negative correlations between financial assets, such as stock market indices.

Dornbusch et al. (2000) researched contagion effect that refers to the relationship among the financial assets, pointing out that the shock of one asset can be transferred to other assets and the contagion effect is tested by correlation. There are complex phenomenon such as financial market integration, liberalization and globalization which have led to intensification of co-movements and contagion between international stock markets from all over the world, and not only. Emerging markets are typically much smaller, less liquid, and more volatile than well-known world financial markets (Domowitz et al., 1998). Moreover, the transmission of financial shocks between emerging markets highlights very attractive investment opportunities considering international portfolio diversification strategies (Spulbar et al., 2020).

With the painful experience of global financial crisis, European debt crisis, and Shanghai shock behind them, central banks around the world had well-stocked toolkits to react swiftly, strongly, and concertedly to the sudden global shock of the COVID-19 pandemic. In the biggest response in at least the past quarter of a century, the central banks in the four major currency areas expanded their balance sheets by 10 points of GDP on average (S&P Global Ratings, 2020).

To mitigate the impact, many managers of multi-asset funds have widened their exposure to alternative assets in order to maintain diversification.

The alternative investment industry is expected to grow around $14trn by 2023, mostly due to alternatives' track record and ability to deliver superior risk-adjusted returns to investors (Preqin, 2020).

Based on the data from International Monetary Fund (IMF) a contraction of 4.9% in Global GDP is forecasted for 2020 (IMF, 2020). The COVID-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated, and the recovery is projected to be more gradual than previously forecast. In 2021 global growth is projected at 5.4% as this would leave 2021 GDP some 6.5 points lower than in the pre-COVID-19 projections of January 2020 (IMF, 2020).

The economic fallout from COVID-19 has not diminished investors' appetite for alternatives. As we take in consideration the data provided by Preqin, the pandemic has not impacted investors' planned commitments for 2020 and further. The explanation is that returns are meeting or beating expectations especially in sectors like hedge funds.

63% of investors have not changed their engagements and commitments with regards to their alternative assets' portfolios for the year of 2020.

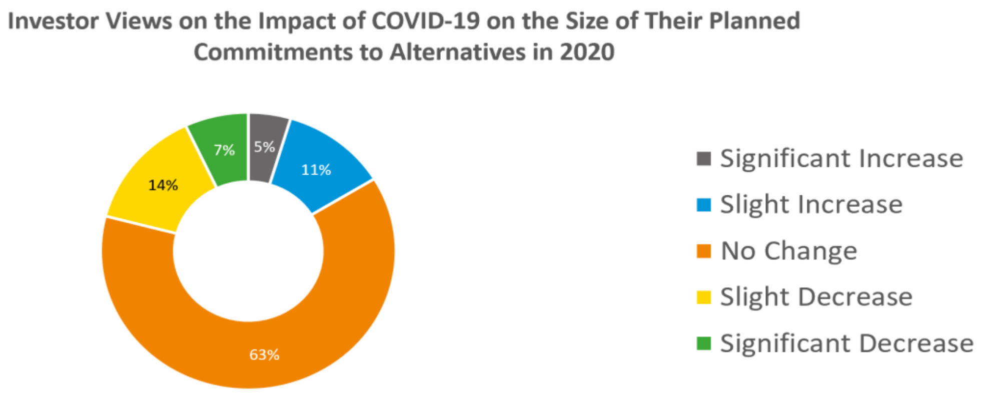

Figure 1. Investors Views on the Impact of COVID-19 on the size of their planned commitments to Alternatives in 2020
Source: Preqin. Retrieved from preqin.com

Balancing the economic shifts and cycles during crisis periods, investors expect COVID-19 to have a negative effect specially on the performance of alternatives portfolios in the long-term. Preqin data, shows that 35% expect a moderately negative impact and 30% expect no change, while 26% think returns will increase.

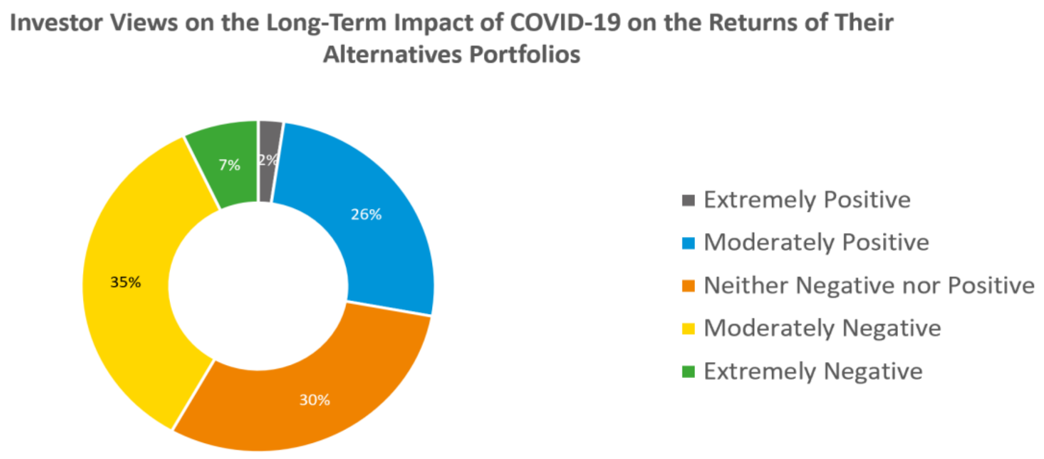

Figure 2. Investor Views on the long-term Impact of COVID-19 on the returns of their Alternatives Portfolio
Source: Preqin. Retrieved from preqin.com

2.1 Infrastructure

Putting in place an investment trust as a closed-end vehicle, has made infrastructure investments more accessible to the everyday investor. Having as advantage their flexible structures, these investment trusts have impressive dividend track records compared to traditional open-ended funds.

Taking in consideration these attributes, investors who are keen to use their money to support communities can provide alternative funding with reassurance of sustainable income. It's worth structuring strategies having in mind that when COVID-19 restrictions ease, expectations from governments to increase budgets for areas like transport and digital infrastructures are viable, as they need to facilitate our new remote working lifestyles.

As nations seal their boarders in order to control the spreading of this virus, supply chains with regards to all sorts of sectors are disrupted. Governments around the world would be more focused on improving healthcare facilities by building more laboratories and hospitals. Also, an important factor that governments will take in consideration is improving the employment rate, which might lead to certain infrastructure spending as the situation normalizes. European shipping and port segments have been directly impacted by factory shutdowns and travel restrictions. Major European airports are expected to see drastic drops in passenger numbers following governmental lockdown. The impact will not be on one sector alone but across these interconnected systems of critical infrastructure services and will need a systems-based approach across sectors to identify the interconnected risks & impacts and to collaborate on where to prioritize efforts to keep the system moving (Threlfall, R., 2020).

2.2 Renewable Energy

For the environmentally-conscious investor, allocations in renewables as an alternative could be a viable option to diversify portfolios, while contributing to a sustainable cause.

There has been continued attraction towards Energy and Renewables due to global focus and regulatory requirement towards decarbonization. In recent years, sustainable investing has experienced growing traction as investors turn their attention towards the pursuit of Environmental, Societal and Governance-focused goals. According to a recent study by Imperial College London (2020) and the International Energy Agency, investments in renewable energy in the UK yielded returns of 75.4% over a five-year period, compared to just 8.8% for fossil fuels. Slower economic growth, especially reduced travel and the temporary shutting of workplaces and factories, will reduce demand for fossil fuels.

2.3 Private Equity (PE)

Companies and industries with recurring revenue models as opposed to transactional revenue models will likely perform better, at least in the short term. Small companies will be the most challenged to survive a sustained downturn. However, private equity firms are sitting on a record $2+ trillion of “dry powder” and are well equipped to deploy capital at more attractive valuations and manage existing portfolios, with many of them dusting off their global financial crisis playbooks (Charlton W.T.Jr, 2020).

We expect to see restructurings, asset sell-offs, and headcount reductions from the more affected portfolio companies as everyone will be assessing what actions they can take to maximize short-term liquidity. The impact looks likely to be concentrated in certain industries and geographies, but the situation is extremely fluid.

The PE Industry’s response has been as expected: they have pushed the pause button on investment and exit activities. While some funds remain opportunistically inclined, many PE funds are shifting their focus to preserving the value of companies in their existing portfolios, and they are working to strengthen relation with their partners and lenders.

COVID-19 is proving to be a crisis of a fundamentally different shape than those the PE Industry has typically capitalized on the in the past.

2.4 Hedge Funds

For hedge funds, opportunities lie in acquiring distressed assets at very low valuations. The impact of COVID-19 will be extensive for most of the countries and hence devising a country or region-specific investment strategy leveraging interest rates and foreign exchange fluctuations would be beneficial for hedge funds.

Hedge funds with sharp and fast abilities to discern the winners and losers in this crisis will certainly generate much higher returns. Amid this outbreak, there are several companies that will perform and show good earnings. Emerging manager funds also continue to attract interest, with half of investors expecting to increase exposure. Indeed, emerging hedge fund managers have proven their ability to outperform their established counterparts, generating 4.9% more than established managers on an annualized basis over the three years to December 2019, as reported in the 2020 Preqin Global Hedge Fund Report.

Based on the data from Preqin, the volatility in the markets have increased the appetite for hedge funds as a substantial 44% of investors expect to increase their commitments to the asset class within the next 12 months, and a further 28% intend to commit the same amount of capital.

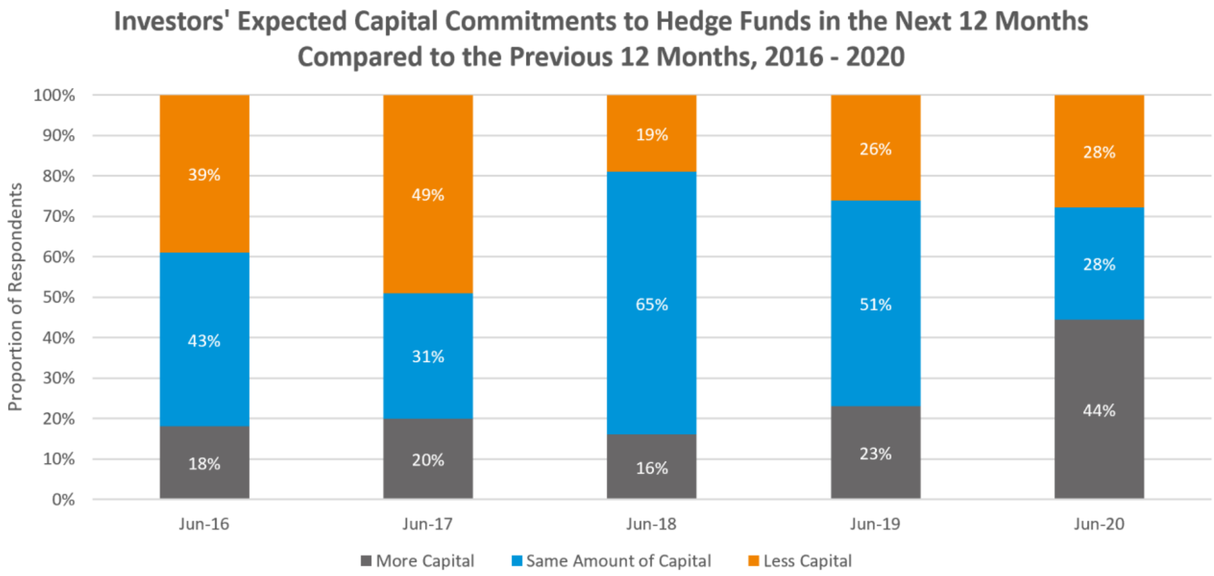

Figure 3. Investors' Expected Capital Commitments to Hedge Funds in the Next 12 Months Compared to the Previous 12 Months, 2016 - 2020

Source: Preqin. Retrieved from preqin.com

Munson R., (Ernst & Young, Graham S., 2020) notes that, given everything that has transpired in 2020, it is a testament to the alternative fund industry that managers were able to quickly pivot operations, minimize disruption to investor engagement and deliver performance during periods of extreme market volatility. These actions and results highlighted the value of alternatives in preserving and growing investor capital in the most challenging of markets.

2.5 Real Estate

Due to unprecedented impact of COVID-19 on how people will live and work in future, real estate industry will face challenges in attracting funds from institutional investors. Apart from the short-term impact in terms of construction delays and stoppage of cash flows, real estate industry will take a hard hit with a long-lasting effect. Lockdowns and other significant restrictions bring a significant curtailment of normal economic activity, leading to business closures, bankruptcies and job losses, despite the growing level of government support (Ernst & Young, 2020). Players will have to think through a new business model considering people might expect physically distancing for a long time even after the end of this pandemic. Work from home may become the new normal, affecting investments in office infrastructure, including the co-working model, which got traction in big cities around the world. Data provided by Preqin shows that 40% of investors expect to commit less capital to the sector in the next 12 months compared with the previous 12 months.

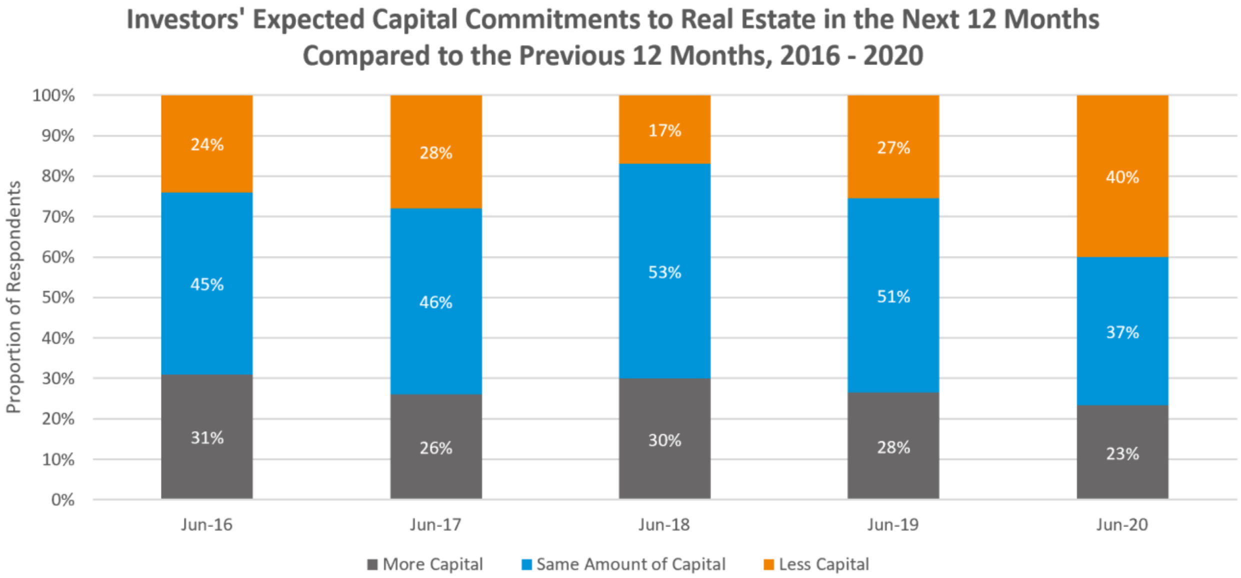

Figure 4. Investors' Expected Capital Commitments to Real Estate in the Next 12 Months Compared to the Previous 12 Months, 2016 – 2020
Source: Preqin. Retrieved from preqin.com

2.6 Private Debt

The income performance of companies in direct lending portfolios will likely differ according to the seasonal cycle returns of their supply chains, revenue, and operating models for their respective industries. The competitive landscape for private debt deals is also expected to change, following a prolonged period where the negotiating position between borrowers and lenders favored borrowers. It is probable that strategic deployments will slow with a number of deals in the pipeline being put on hold. According to the data provided by Preqin, investors welcome a less competitive environment, but they also acknowledge the opportunities in distressed debt that appear. One year ago, 35% of investors felt this investment strategy was a good investment option, this percentage almost doubled, climbing to 69% in June 2020.

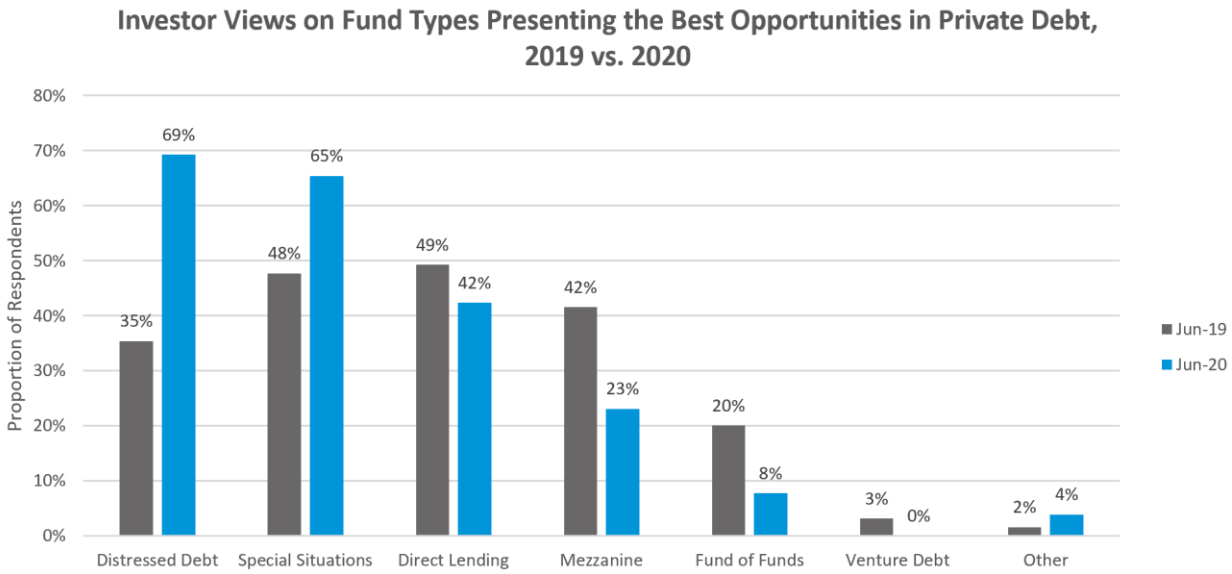

Figure 5. Investor Views on Fund Types Presenting the Best Opportunities in Private Debt, 2019 vs. 2020
Source: Preqin. Retrieved from preqin.com

3. CONCLUSIONS

The economy came to a complete halt as governments around the world imposed shutdowns & lockdowns to curb the spread of the virus and encouraged people to practice physical distancing.

The rapidly evolving COVID-19 crisis is continuing to create severe political, social, and economic uncertainty that is translating into significant public market volatility worldwide. While the impact on alternative assets is less observable so far, it is likely to be not that significant compared to the financial markets (PwC, 2020).

But rather than creating a buying opportunity, the pandemic has only injected a new source of uncertainty that is threatening the survival of companies across many sectors. Government intervention, combined with relaxed loan covenants, have postponed the day of reckoning for many distressed businesses, giving their owners the ability to hold tight for now amid depressed valuations (Olsen, R., 2020).

Prior to COVID-19 there was a lot of liquidity in the private market, with a lot of available “dry powder”, capital allocated to funds but not yet deployed. As public equities have crashed in value over the past few months many portfolios, with exposure to both public and alternative assets, have become automatically overweight in alternatives, since re-balancing these assets intrinsically takes time.

Many investors may have to take a pause before allocating these funds towards alternatives such as venture capital. Portfolio companies are working to shore up financials for the next few quarters in order to ride out the immediate volatility, emphasizing cost control, conserving cash flow, and reassuring key employees.

While the PE industry is still waiting to see the full effects of COVID-19’s disruption on portfolio valuations, many funds have moved to more robust quarterly portfolio valuations in response to limited partners seeking more timely information and ultimately help guiding their asset allocation decisions.

A lot of companies are doing research on government policies, while applying for subsidy programs launched to support small and mid-size enterprises (SMEs).

Most of the industry sectors needs composure and resilience to battle the challenges of COVID-19 crisis and gear up for possible opportunities as we return to a new normal.

Amid increasing public concern on economic and social impact of the pandemic, and reasonably strong fiscal and monetary response by most countries to contain the spread of COVID19, infrastructure may not be a priority for policy makers in the short term as healthcare and unemployment support measures take precedence.

The pandemic has resulted in a demand for innovation and technology in many sectors, to provide resilience and to service people and industries in their new ways of working. In particularly in software, on-line retail, healthcare and life sciences we expect there to be a lot of capital chasing that pushes innovation over the next five years, whilst some sectors such as leisure, tourism and aviation will struggle and may never recover.

Some will see the immediate opportunity in high-demand growth sectors such as life sciences, digital health and software-based technologies and others will come back over the mid-term, as drivers such as low interest rates and volatile public markets, force investors to look to alternatives, such as private equity and venture, for their returns.

Asset managers may benefit from a degree of regulatory tolerance during the heat of a crisis but will need a sustainable approach for what may be an extended period of disruption.

For many, a well-balanced asset plan, which takes advantage of alternative assets, will be one important factor that needs to be taken in consideration, especially for those seeking to safeguard for the future.

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