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New Perspectives on Alternative Investments

For the Institute and Faculty of Actuaries



Today's speakers and topics are as follows:

- ▶ Ian Kitchenham, *BlackRock Alternative Investors*
 - Defining “alternative” investments

- ▶ Ted Logan, *Hedge Fund Solutions*
 - Measuring performance and the importance of selection

- ▶ Mark Long, *Real Estate*
 - Investment features across a broad asset class

- ▶ Sverker Akerblom, *Renewable Power Group*
 - Providing secure income from an alternative source

What are alternative investments?

1. Not “traditional”, i.e. stocks, bonds or cash

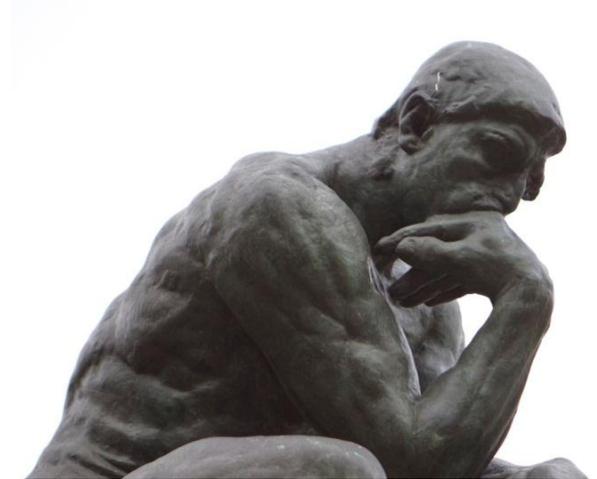
- ▶ Returns not directly linked to returns available from a publicly traded asset

2. Asset(s) where the return is, at least partially, a function of factors that are not easily observable

- ▶ Examples can include ‘illiquidity premium’ or ‘alpha skill’

3. A different way of investing in “traditional” assets

- ▶ For example, hedge funds and traditional long-only equity investors may both trade publicly available shares but hedge funds can look to make profits when share prices fall by short selling



Alternatives cover a broad range of investments



Commodities

Energy
Metals
Agriculture
Other Softs



Hedge Funds

Relative Value
Event Driven
Fundamental L/S
Direct Sourcing
Global Macro /
Directional
Trading



Real Estate

Core
Value-Add
Opportunistic
Mezzanine Debt



Private Equity

Buyout
Distressed
Venture Capital
Growth Capital
Mezzanine



Infrastructure

Core
Value Add
Debt
Renewables

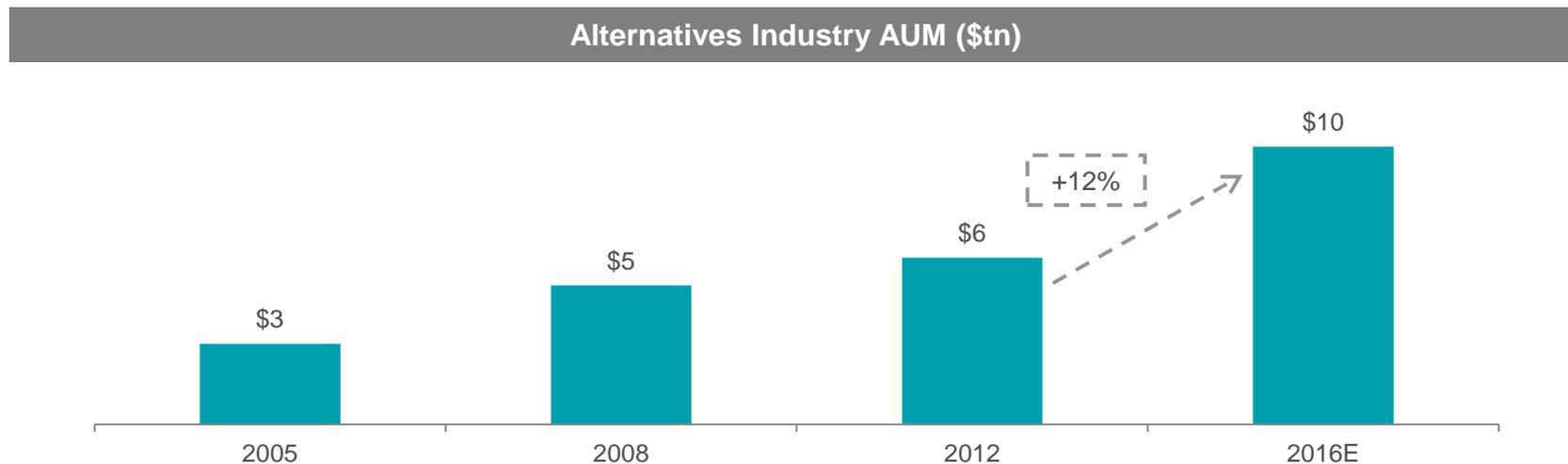
Short-Term
Opportunities

Intermediate-Term
Opportunities

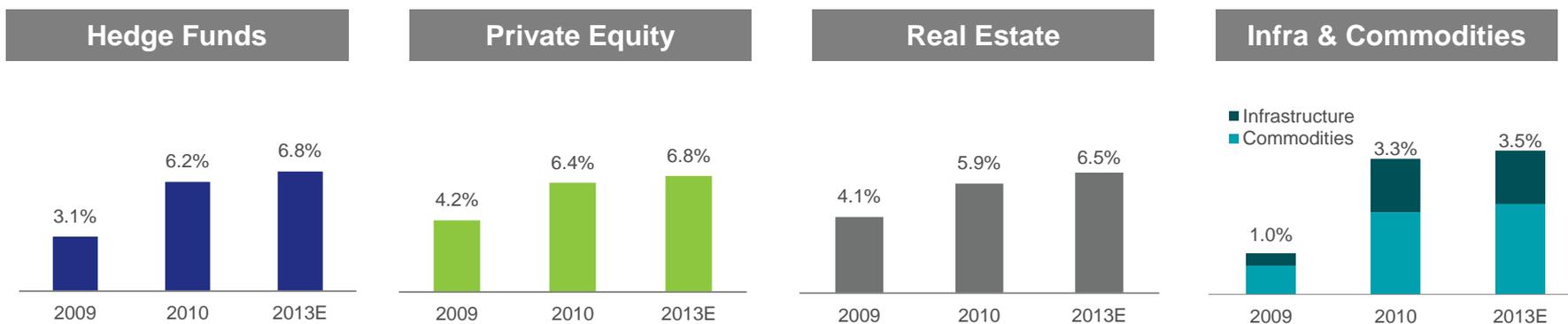
Long-Term
Opportunities

Allocation to alternatives is increasing

- ▶ Institutional investors are expected to increase allocations across alternative asset classes



- ▶ Alternatives industry is about \$6 trillion and expected to grow at 12% annually



Source: BCG Global Asset Management 2013 Capitalizing on The Recovery; McKinsey/Institutional Investor Global Survey on Institutional Investing, 2011

Why are investors allocating to alternatives?



We believe investors are finding new appeal in alternatives as a necessary source of investment returns in a low yield, low growth, high volatility environment...

- ▶ **Low correlation** with traditional asset classes to combat persistent volatility
- ▶ **Diversified income to combat low yield** as clients seek new opportunities outside traditional assets
- ▶ **Illiquidity premium** opportunities to capture

...and investors are overcoming the myths and concerns of alternative investing

- ▶ **Risk factor** portfolio analysis and allocation brings alternatives to the core of client investments
- ▶ **Liability matching** and long term income modeling is improving
- ▶ **Transparency and infrastructure** can be provided by partnering with institutional quality managers

Alternatives can address a range of investment needs



Client need	Asset characteristic	Hedge Funds	Illiquid Credit	Private Equity	Infrastructure	Real Estate
Income	Contracted Cash Flows		✓		✓	✓
Growth	High Target Returns	✓	✓	✓		✓
Inflation Protection	Inflation-linked Cash Flows			✓	✓	✓
Diversification	Low Correlation	✓	✓	✓	✓	✓
Reduce Volatility	Low Volatility	✓	✓		✓	✓

- However, alternatives are not heterogeneous and one size does not fit all

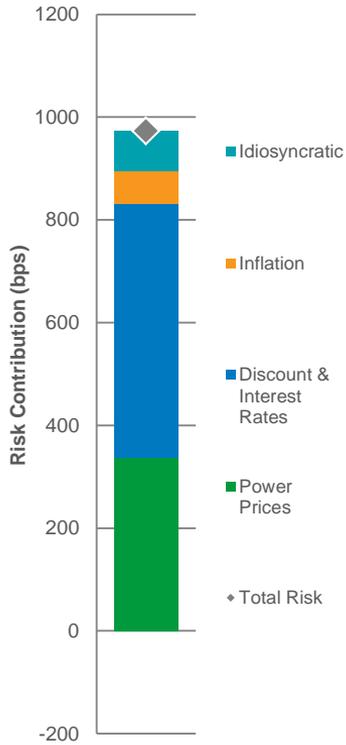
Source: BlackRock Strategic Product Management, from Towers Watson survey, client interviews, BLK team materials, Deutsche Bank survey, CitiBank, Pyramis Survey
 Investing in alternative assets may involve higher risks and fees than traditional investments and is not suitable for all investors. They may engage in leverage or speculative investment techniques that may magnify potential losses or gains.

Identifying a suitable allocation can be challenging

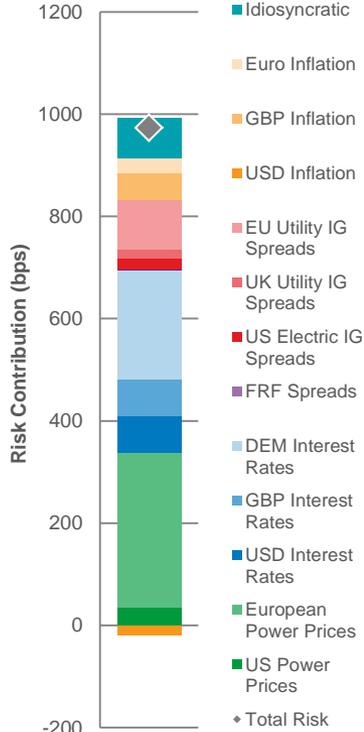
Risk factor modelling provides a common language...

...that allows efficient portfolio construction at a scheme-wide level

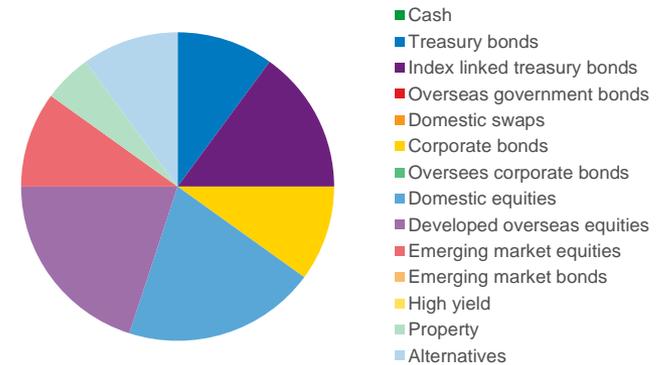
Example Secure Income asset Risk Contribution by Macro Factor



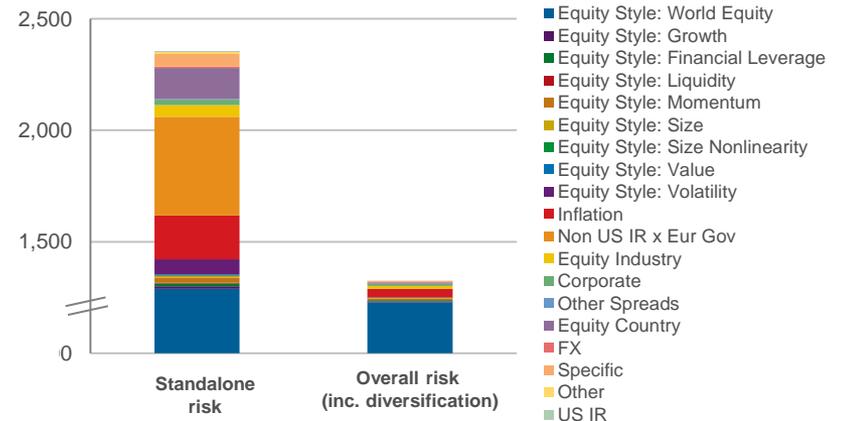
Example Secure Income asset Risk Contribution by Factor



Asset allocation: Example Pension Scheme



Risk decomposition: Example Pension Scheme



Hedge Funds

The challenges facing pension plans today

Problem

- ▶ Market and liability risk volatility
- ▶ Low return/ yield makes achieving objectives difficult
- ▶ Effective diversification is challenging due to high correlation in traditional asset classes
- ▶ Increased requirements for governance and transparency

Questions

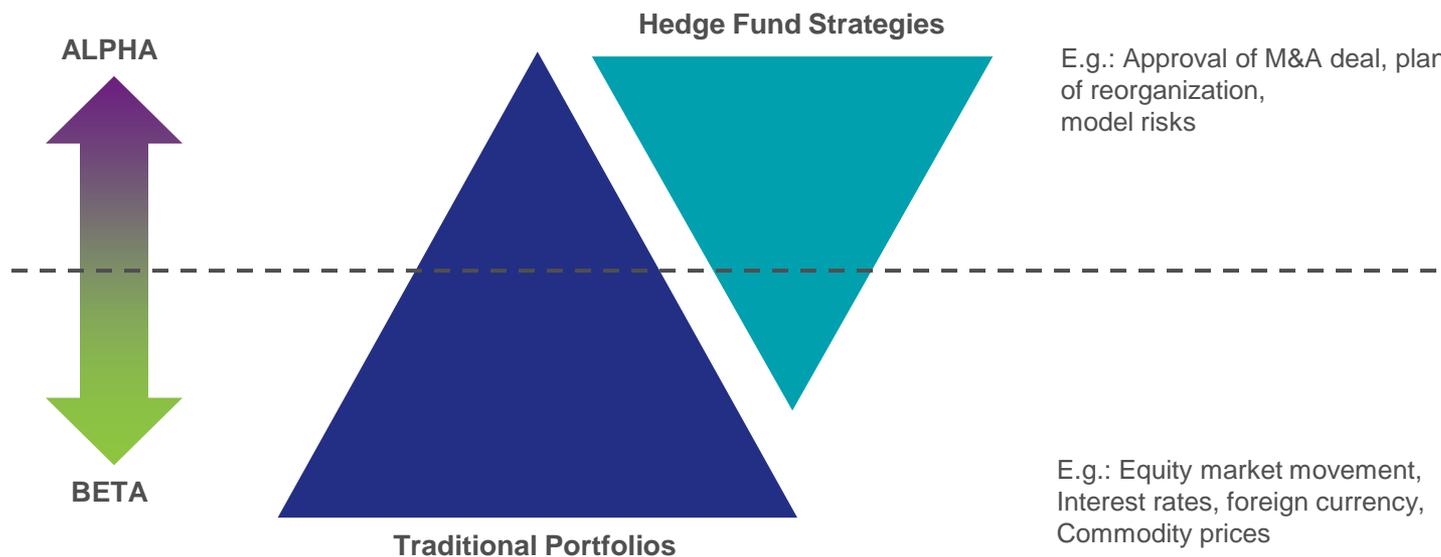
- ▶ Can I generate returns with a different profile than traditional equity and fixed income?
- ▶ What risks do I need/need to avoid?
- ▶ How can I do this in a cost-efficient way?

Solution

- ▶ Risk-based approach to replace 'performance chasing' as basis for asset allocation decisions

Hedge Funds diversify by risks, not returns

Sources of Risk and Return

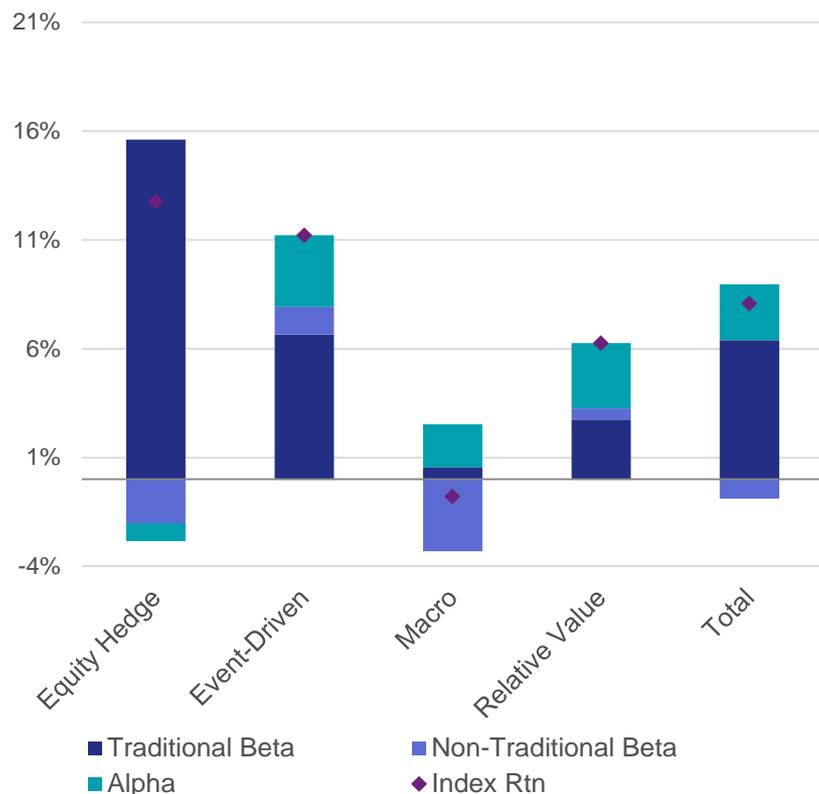


- ▶ Risks are the input, returns are the output
- ▶ Hedge funds seek to generate different returns via a different set of risks than traditional, long-only investments
- ▶ Idiosyncratic risks (alpha) are difficult to replicate

Selection can enhance portfolio alpha

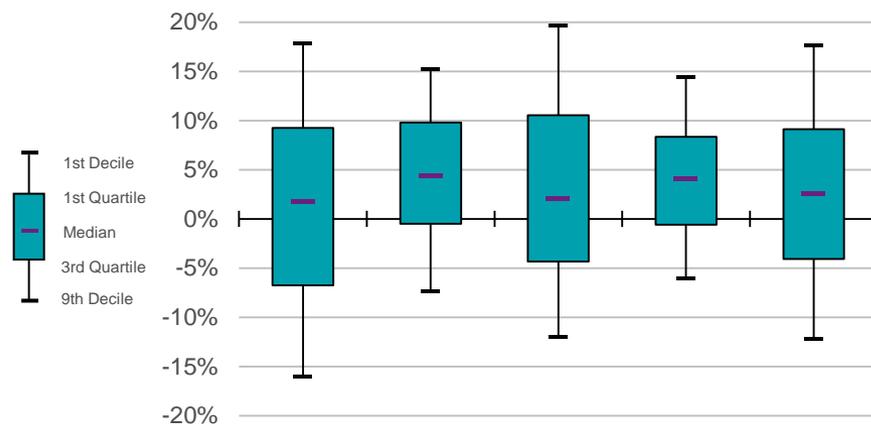
- ▶ Hedge funds do offer alpha
- ▶ Highest return \neq highest alpha
- ▶ Selecting the right managers can enhance the alpha

Contribution to Hedge Fund Index Performance by Risk Type (2013 to end Nov)



Source: HFR, Inc., BlackRock

Dispersion of Hedge Fund Manager Alpha (2013 to end Nov)



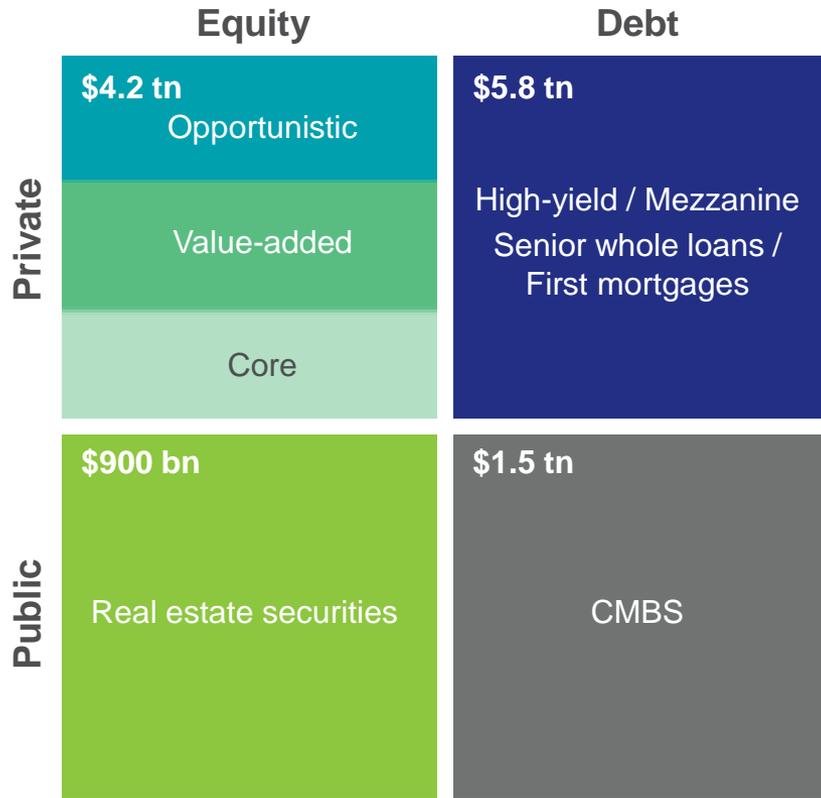
	Equity Hedge	Event Driven	Macro	Relative Value	Total
90%	17.8%	15.2%	19.6%	14.4%	17.6%
75%	9.2%	9.8%	10.5%	8.3%	9.1%
50%	1.7%	4.3%	2.0%	4.0%	2.5%
25%	-6.7%	-0.5%	-4.3%	-0.6%	-4.1%
10%	-16.1%	-7.4%	-12.0%	-6.0%	-12.2%
Interdecile range	33.9%	22.6%	31.6%	20.4%	29.8%
Interquartile range	16.0%	10.3%	14.9%	8.9%	13.2%
Fund Count	744	167	350	287	1548

Real Estate

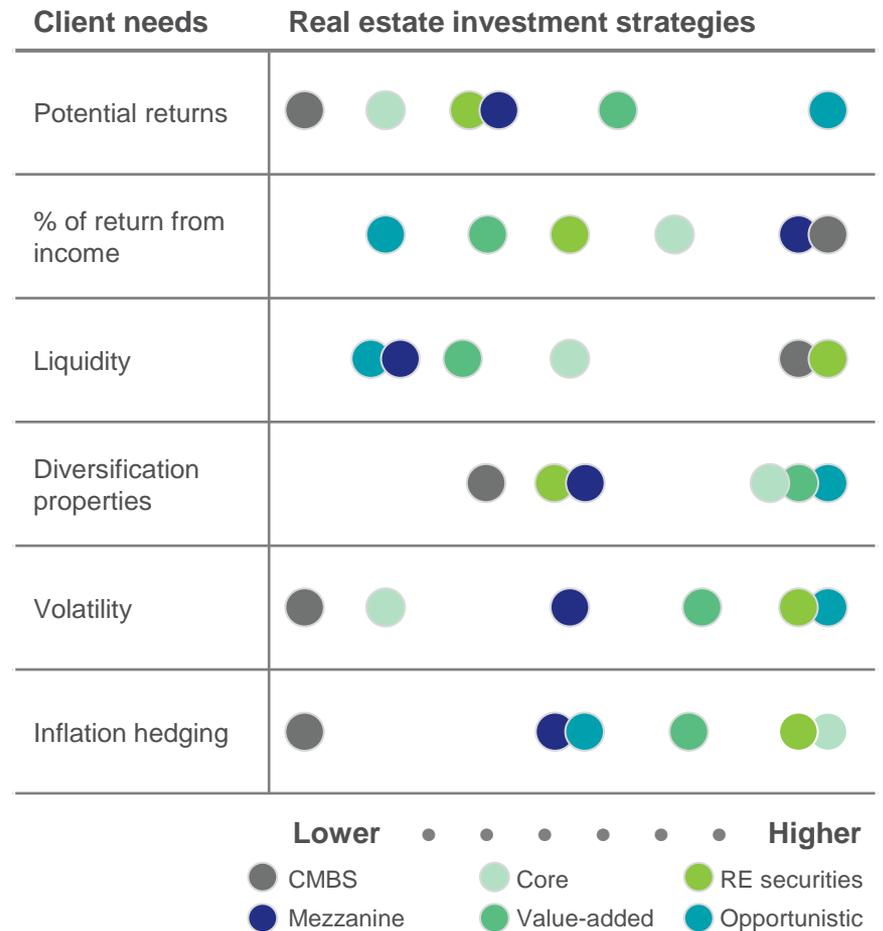
Broad range of Real Estate strategies and vehicles



\$12 trillion market of distinct strategies¹



Performance attributes vary²

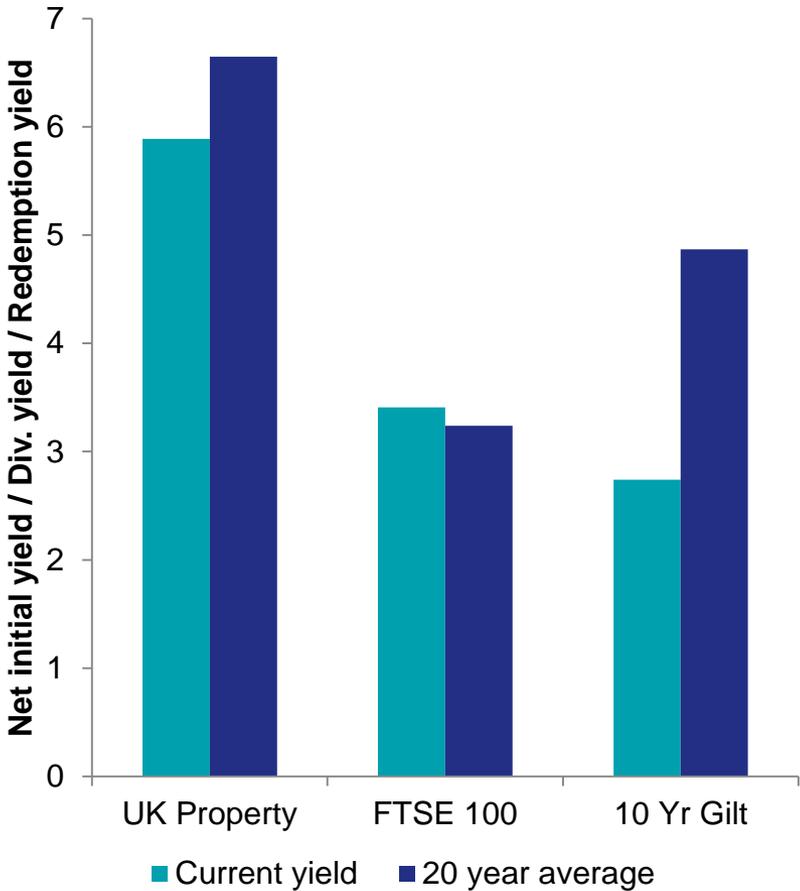


1. DTZ Research, BlackRock; as of December 2013
 2. BlackRock

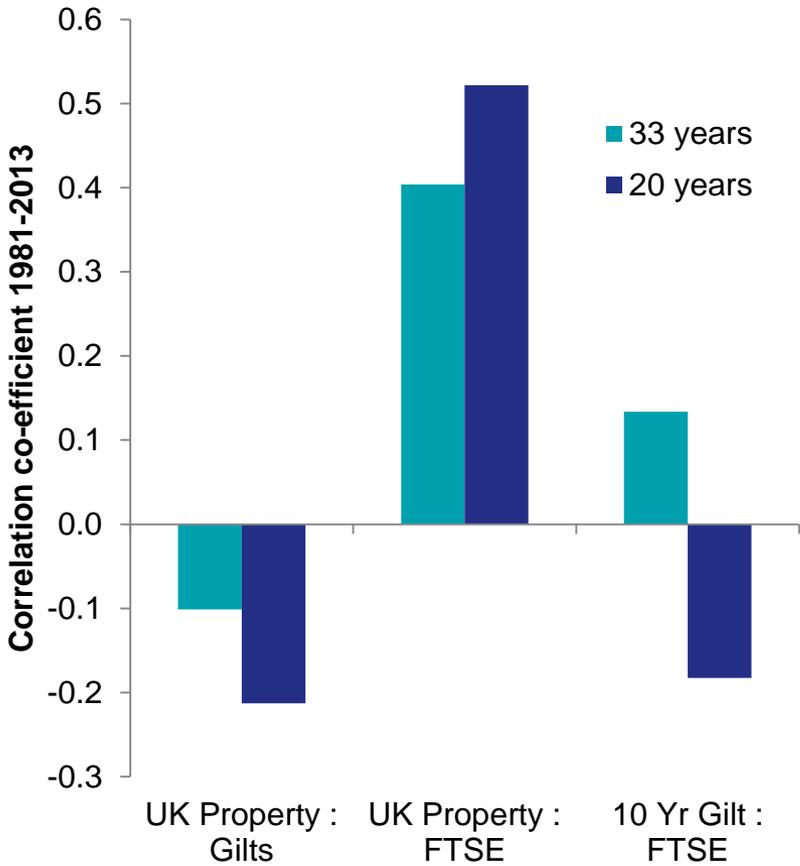
Income and diversification



Property delivers a higher level of income¹



Property offers strong diversification benefits²



¹ IPD UK Monthly Index March 2013
¹ IPD UK Annual Index Dec 2013

Characteristics of underlying real estate equity investments



- **Diversification benefits**
- **Real asset – inflation hedging**
- **High level of income**
- **Asset-Liability matching**



- **Smoothing**
- **Heterogeneity**
- **Illiquidity**
- **Lack of divisibility**
- **Management intensive**

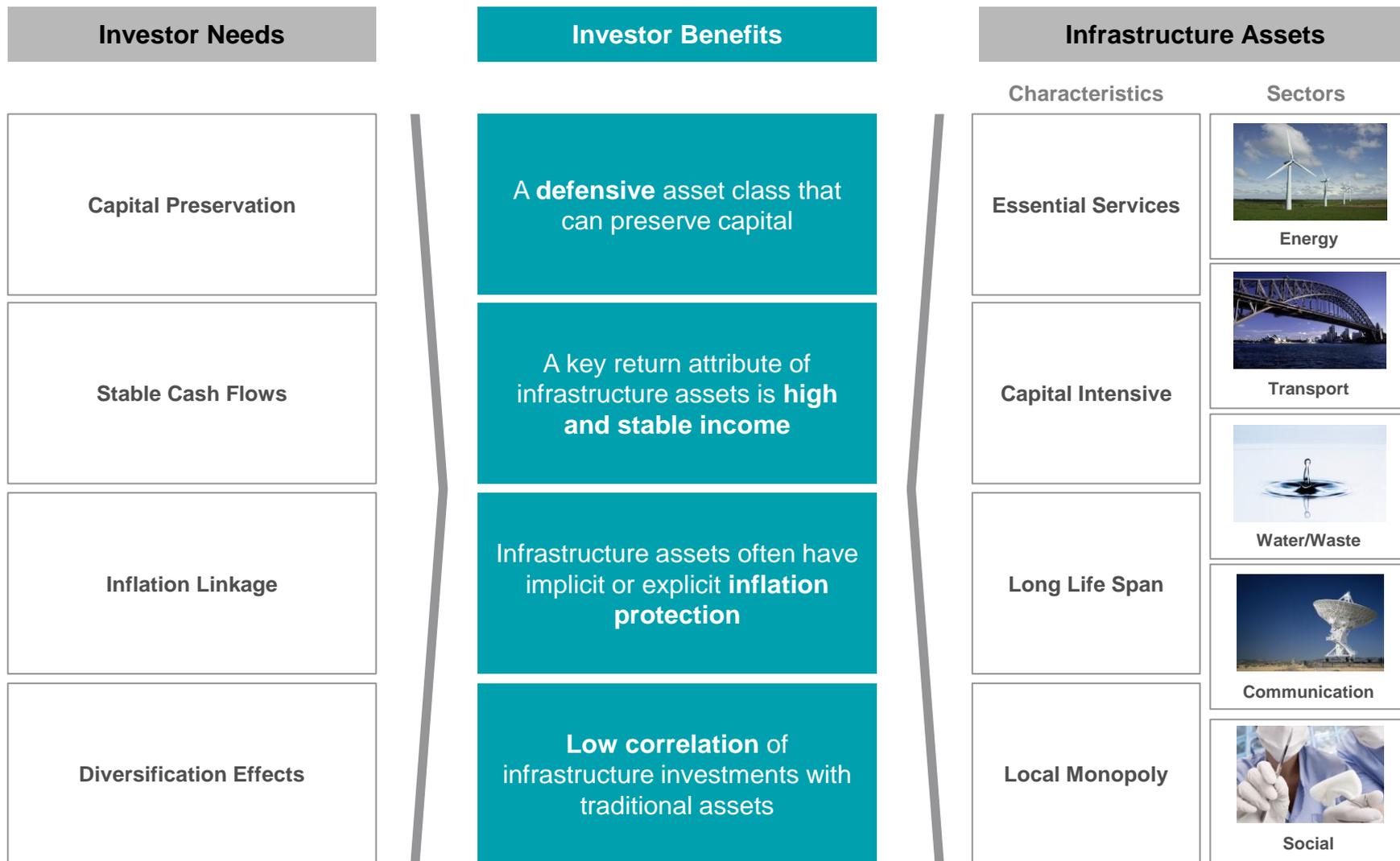
Types of Real Estate investments: Equity



Core	Value Added	Opportunistic
<ul style="list-style-type: none"> ▶ Traditional property types ▶ Fully leased / minimal leasing risk ▶ Minimal development risk ▶ Well diversified ▶ Balanced alternative strategies 	<ul style="list-style-type: none"> ▶ Asset Repositioning and refurbishment ▶ Leasing risk ▶ Prime & secondary markets ▶ Listed securities (REITs) ▶ No specific diversification requirement 	<ul style="list-style-type: none"> ▶ Full scale development and redevelopment projects ▶ Often low income distribution ▶ Back-end loaded return ▶ Typically High Leverage
<p>Total return 6-8% 80%+ rental income</p>	<p>Total return 8-10% 50-80% income</p>	<p>Total return 10%+ >50% capital</p>
<p>Multi-asset diversifier Stable Income Open-end funds & Separate Accounts</p>	<p>Diversification plus alpha Income and Growth Open-end, Closed-end funds & Separate Accounts</p>	<p>Alpha generation Income & capital growth Closed-end funds</p>
<p style="text-align: center;">Increased risk/return </p>		

Renewable income investing

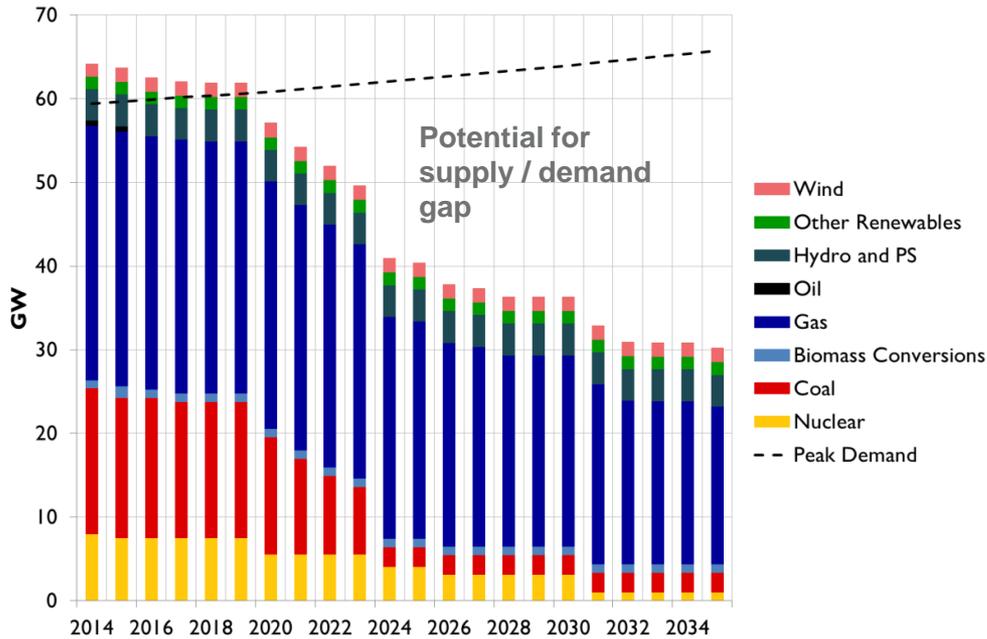
What are Infrastructure investments?



Source: BlackRock (April 2014)

Renewable Power – UK Market Opportunity

UK Energy Shortfall



Material conventional plant closures:

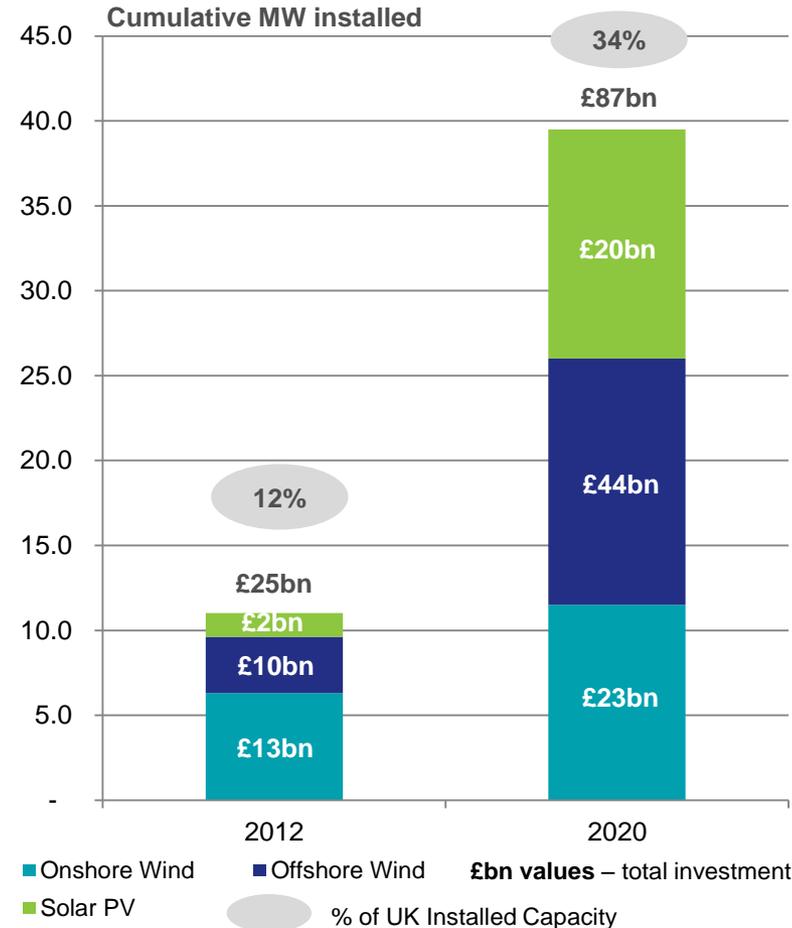
- c.9GW of fossil plants recently closed (2012-2013), with material additional closures expected

Rising electricity prices:

- Shortfall in supply will likely lead to significant increases in UK power prices

Source: UK Power Consultant (Q4 2013)

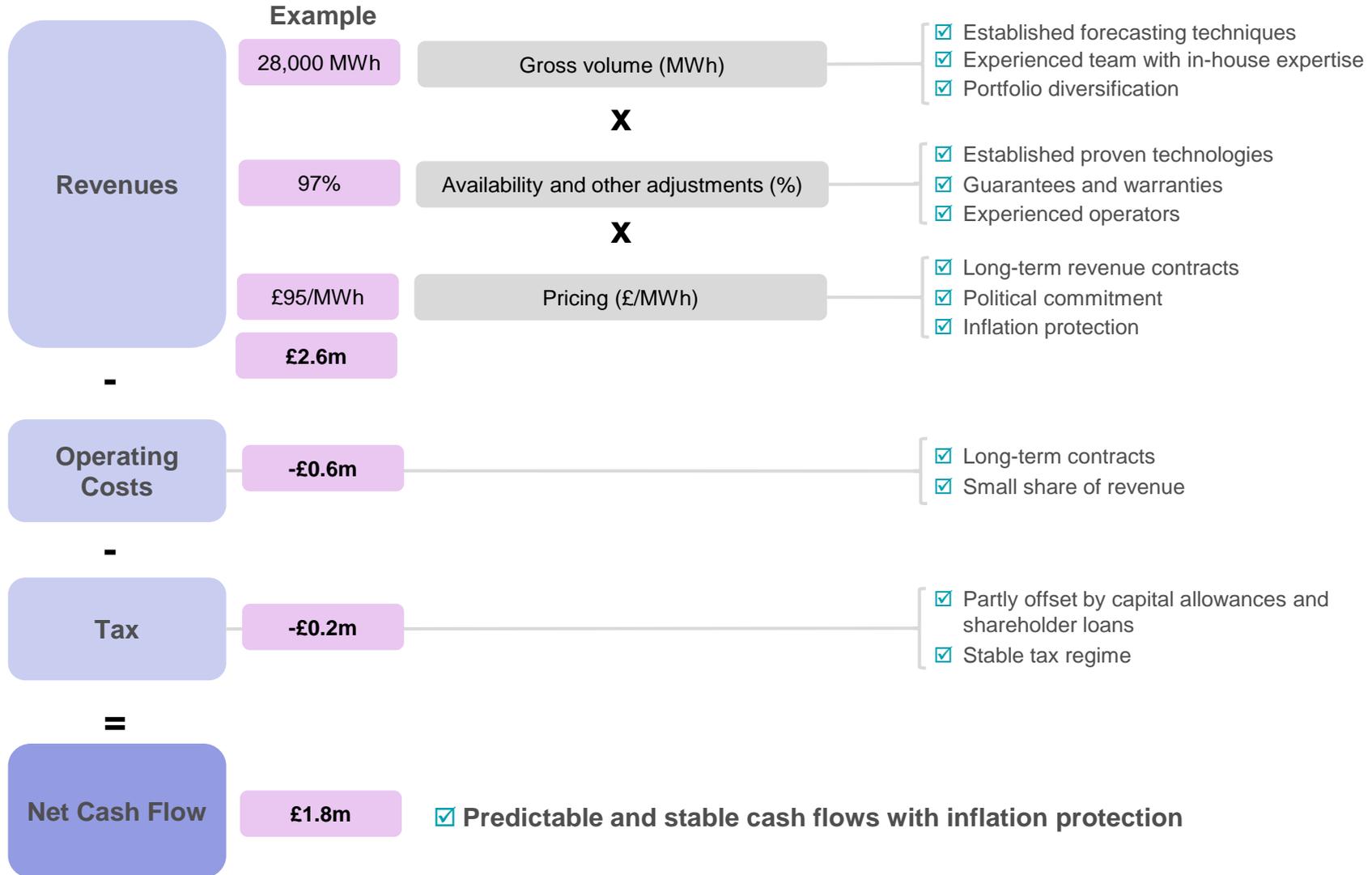
UK Renewable Capacity & Investments



Sources

2012 Capacity: Wind Statistics - RenewableUK (4 Jul 2013), PV Statistics – DECC (Nov 2012), Capacity Forecast – National Grid (Sep 2012)
 2020 Capacity: DECC UK Renewable Energy Roadmap 2011 (and 2012 update), average of central scenario range
 Note: Enterprise value assumes £2m/MW for Onshore Wind, £3m/MW for Offshore Wind and £1.4m/MW for Solar PV

Renewable Power Projects – Key Economic Drivers

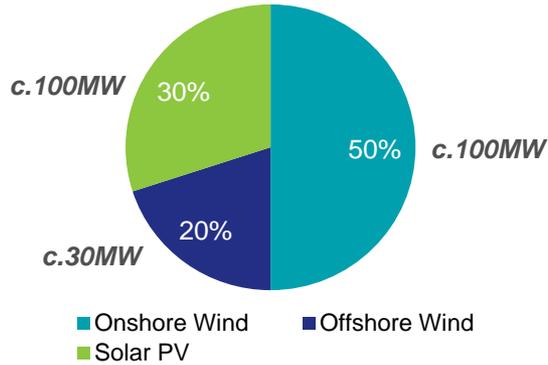


Source: BlackRock (April 2014)

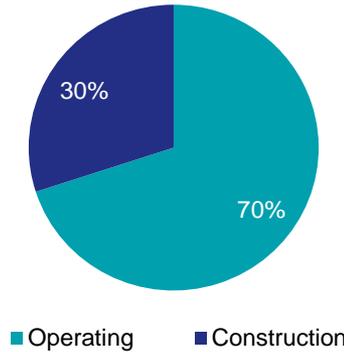
Portfolio Analysis – Illustrative £400m UK Portfolio



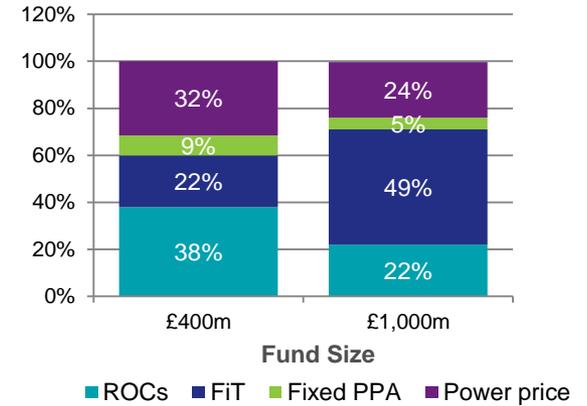
Technology Split



Construction Exposure



Revenue Split

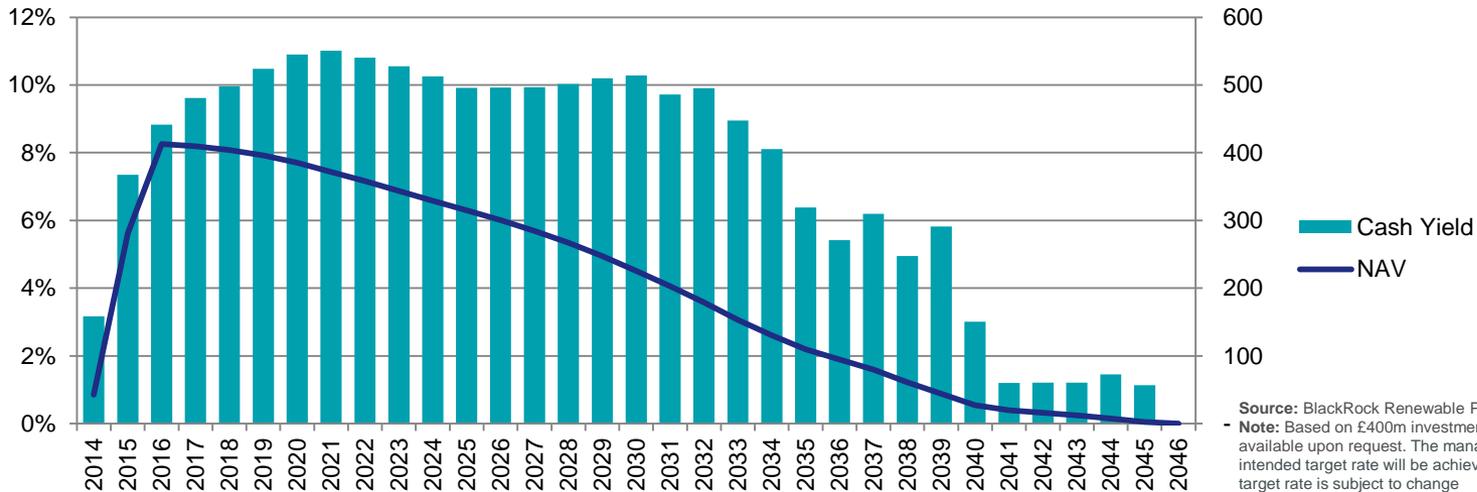


Source: BlackRock Renewable Power model (October 2013)

Note: % of committed capital based on £400m fund size
Source: BlackRock Renewable Power model (January 2014)

Source: BlackRock Renewable Power model (January 2014)

Estimated Gross Cash Yield and Net Asset Value



Source: BlackRock Renewable Power model (January 2014)
Note: Based on £400m investment size. Additional assumptions available upon request. The manager cannot guarantee that the intended target rate will be achieved. In addition, over time the target rate is subject to change

Portfolio would generate an 8%+ gross IRR, with benefit of inflation protection

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