INVITED EDITORIAL COMMENT: Foreword for JAI Special Issue on New Frontiers of Alternative Investments

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GREGORY BROWN

Over the last 25 years, the global investment landscape has experienced a fundamental shift. As any reader of *The Journal of Alternative Investments* knows, the set of investible assets has grown both in breadth and depth. For example, the hedge fund market now exceeds \$3 trillion in assets under management (AUM), and combined capital committed to private equity funds over the last 25 years totals \$6 trillion.[1] Furthermore, the proliferation of new investment strategies continues, with recent innovations in real asset vehicles, hedge funds operating at the boundary of public and private markets, and a burst in growth of private credit strategies.

This special issue helps readers understand both the recent trends in alternatives as well as some of the latest developments on the frontiers of the alternatives landscape. To provide a broader context, we begin by taking a step back and looking at recent developments as part of a broader evolution of capital markets in the post-war period.

Coming out of World War II, there remained a profound skepticism about financial assets of all types after deep and sustained losses in stocks and corporate bonds during the great depression. Many institutions and individuals shared the belief that investing in stocks and bonds was akin to gambling and consequently not a prudent undertaking for preservation and growth of capital. As faith in public equity markets returned in the 1950s and 1960s, the number of public companies grew dramatically. Many of these companies were younger or more innovative firms that benefited from the rapid growth and modernization of the global economy. Innovation in financial market structure and the regulatory environment also facilitated increased allocations to risky assets in institutional portfolios. For example, the advent in 1971 of NASDAQ—the world's first automated stock market—facilitated growth in equities trading and new listings. These, among many other factors, helped propel the rebirth of confidence in the role of public markets allocating new capital to the corporate sector.

While activity in public equity markets continued to grow through the 1970s to 1990s, a new and more important second wave of financial innovation emerged in the 1970s. Through a combination of new information technology and theoretical advances, the market for financial derivatives was born. Although commodity derivatives (especially futures contracts) have been traded for centuries, it was not until the 1970s that institutions and financial engineers devised ways for investors to efficiently trade derivatives on equities, currencies, and fixed income products. Financial engineering also allowed for the creation of a large and sophisticated structured finance market (e.g., asset-backed securitizations). This second wave of financial innovation exploded in the 1980s and 1990s with developments in options, swaps, and securitized products.

[1] See "HFR 2017 Global Hedge Fund Industry Report" (https://www.hedgefundresearch.com/news/hfr-global-hedge-fund-industry-report-year-end-2017-published) and Burgiss PrivateIQ (https://www.burgiss.com/research/).

The advances in market structure and breadth allowed for the rapid growth of pooled investment products (e.g., hedge funds) that could take financial risks not previously viable. These changes allowed for a substantial realization of excess returns from both better risk-sharing and arbitrage opportunities.

Despite the continued growth in derivatives and structured finance assets, innovation in this space moderated in the 2000s. Perhaps the last significant new derivative product was the credit default swap (CDS), which was first structured in the mid-1990s. Instead, the 2000s experienced a third wave of innovation in the form of private investment vehicles operating with a closed-end drawdown structure. While a limited number of private equity (e.g., venture capital and buyout) firms operated in the 1970s and 1980s, the structure surged in popularity in the 1990s and 2000s. According to data from Burgiss, the number of new institutional-quality funds exploded from an average of 35 a year in the 1980s, to about 100 a year in the 1990s, to around 300 a year since 2000.[2] In addition, the range of fund strategies has expanded, with substantial growth in real asset and private credit funds. This growth has coincided with a moderation in the global growth of publicly listed companies and substantial decline in the number of publicly listed companies in the United States.

Understanding these mega-trends in the investment space is essential to understanding where we stand currently with alternative investments as well as where new opportunities will present themselves in coming years. With this background, we now turn to providing context for the set of excellent articles appearing in this special issue.

The first article, "Private Equity: *Rethinking the Neoclassical Axioms of Capital Markets*," by Eli Talmor challenges us to reconsider the roles of public and private markets in the financial intermediation process and more broadly the fundamental principles of corporate finance. While better risk-sharing and gains from diversification likely drove the expansion of publicly listed companies through the 1990s, these gains may have reached their limits. The costs of being public have grown with an increased regulatory burden. However, agency costs in the form of poor governance and management incentives can also be substantial for companies with too diffuse a shareholder base. Private equity has grown in part because it provides a remedy for both of these costs. Certainly, the primary role of public markets will continue, but as private markets become larger and more institutionalized, the alternative to a public listing becomes financially compelling in more cases.

While Talmor questions the efficiency of corporate governance and finance in the public structure, there is no question that the mechanics of trading public securities have evolved tremendously in the last few decades. Direct trading costs (e.g., commissions) have declined substantially, and perhaps more importantly, the cost of information acquisition has plummeted with the growth of the internet and systems like Bloomberg. Given these trends, it is logical to investigate their impact on the ability to profit from trading on information. In "The Decline of Informed Trading in the Equity and Options Markets," Charles Cao, David Gempesaw, and Timothy Simin examine the relationship between measures of informed trading (i.e., that motivated by proprietary research) and trade profitability. They carefully document that the profitability (i.e., alpha) from informed trading in both equities and equity options declined substantially during the 2000s and has remained low. The patterns in these declines closely match estimated (rolling) alphas from HFRI Equity Hedge (Total) Index, suggesting a causal relationship between increases in market efficiency and a decline in hedge fund alpha.

If the public equity space is shrinking and profits from informed trading are declining, what are the new frontiers for alternative investments? The remaining three articles in this issue examine recent market developments.

One of the hottest areas in private markets has been private credit. Capital committed to private credit strategies grew five-fold in the decade between 2006 and 2016. In addition, the private credit market has experienced important growth in what were previously niche strategies, such as direct lending. In "Performance of Private Credit Funds: *A First Look*," by Shawn Munday, Wendy Hu, Tobias True, and Jian Zhang, the authors investigate both historical returns and risk of private credit funds as a whole as well as for individual substrategies, such as mezzanine debt and direct lending. Importantly, they also examine alternatives for benchmarking for private credit strategies given the lack of an accepted standard. The authors find that risk-adjusted returns

[2] See Burgiss PrivateIQ (https://www.burgiss.com/research/).

vary across strategies, but that there are likely gains from diversification relative to other investible credit assets (such as leveraged loans and high-yield bonds).

The next article examines volatility as an asset class—a topic that has received substantial attention in the last few years. At a fundamental level, trading options is analogous to trading volatility because volatility is a primary determinant of option prices (as well as other nonlinear derivative prices). As a consequence, time-varying equity volatility is increasingly modeled as a fundamental risk factor in capital markets. A logical extension of this has been the development of volatility as an asset class because of its appealing statistical properties. In particular, equity volatility is a mean-reverting process exhibiting a strong negative correlation with stock returns. This makes volatility a potentially valuable tool for pushing out the efficient frontier of optimal portfolios (in the Markowitz mean–variance framework).

Volatility is an unusual asset, however, because it is not traded directly. Instead, only derivatives based on volatility are available to investors, and the return properties of these derivatives can be quite different beasts. In "Volatility as an Asset Class: *Holding VIX in a Portfolio*," Jason Berkowitz and Jared DeLisle examine the viability of using assets based on the CBOE Volatility Index (VIX) in a portfolio. The authors show that obtaining realized benefits from adding volatility exposure is harder than would be expected when considering the properties of the VIX. Not only do VIX products have a negative expected return on average (as suggested by their negative market beta), but the products themselves can house structural risks. These risks were experienced in February of 2018 by investors in the "inverse-VIX" ETN (ticker symbol: XIV), which was liquidated after a one-day 80% decline in value. Taken together, the results suggest that benefits of diversification with long positions in VIX products (and more broadly, any volatility-based product) are unlikely to be realized by investors.

Finally, on the true frontiers of alternative investments is the quest for new investment strategies with returns that are weakly correlated with other assets and yet have the potential for significant financial gains over time. One area that has been generating increased interest is collectibles. In fact, several institutional-quality funds have launched in recent years that undertake strategies seeking to profit from investment in such assets as rare stamps and coins, automobiles, art, and even fine wine. In "When Rationality Meets Passion: *On the Financial Performance of Collectibles*," Philippe Masset and Jean-Philippe Weisskopf estimate the historical performance and risk of art, wine, and classic automobiles. The authors document that returns have been good on a nominal basis, but only classic automobiles have provided significant excess (i.e., risk-adjusted) returns. A nice feature of this analysis is that it also provides a method for assessing the effect of adding collectibles to portfolios for individuals who derive personal utility from ownership.

As we move into a period where alternative investments have become a standard part of most institutional portfolios, it is important to reconsider the fundamental economic forces driving investment returns for alternative assets. First, any investment represents a commitment of capital to a profitable endeavor or a claim on an asset of value. Consequently, long-run returns must necessarily be tied to the economic value-added of underlying assets. When markets operate efficiently, this return will be (on average) the compensation investors require for bearing the risk in the investment. In order to earn returns in excess of this fair level of return, there must be some market efficiency that provides for value to be created and not simply bid away by market participants. Certainly, these opportunities evolve and change over time. Whereas hedge funds and private equity funds provided significant excess returns 20 years ago, more recent evidence suggests the returns are converging to those of more traditional investments. This does not mean that these are bad investments, just that the benefits are likely to be derived more from increased diversification than from excess risk-adjusted returns. To the extent that newer markets (such as private credit and collectibles) are less efficient, there is the possibility that excess returns can be obtained. But there is, of course, no guarantee that an inefficient market is underpriced (e.g., the venture capital tech bubble of the late 1990s), so investors must still do their own research and analysis to identify opportunities. Our hope is that the articles in this special issue help investors understand better how to undertake this process and find opportunity at the frontiers of alternative investments.

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