Let’s Quickly Define **Alternatives**

**Simple definition:**
- In general, any asset or strategy that isn’t simply long, public markets and stocks.
  - Examples:
    - Private equity
    - Real Assets (e.g., Real Estate, Infrastructure, Timber)
    - Commodities
    - Hedge Funds

“**Alternative**” alternative definition:
- Any asset or strategy with low correlation to stocks and bonds.
  - This is a more valuable definition, and is much harder to determine.
- You would have a truly excellent investment portfolio if it was composed of a variety of asset classes featuring reasonable (equity-like) returns, and low correlations.
Reasonable average returns and low correlations are wonderful things, BUT…

- Return prospects can be distorted by Presentation Bias.
- Return statistics for alternatives, including beta, standard deviation, correlation and others, are hard to measure accurately - figures presented in marketing books often paint a flattering picture relative to reality.
- This tends to be a major issue in real estate, private equity, and venture capital, and somewhat less of an issue for hedge funds, but you need to understand the details in each case.
- One main problem in measurement is the smoothing effect of lagged returns.
Alternative Investments

**Characteristics:**

- Prone to changing the game in “non-normal markets”.
- Complex risk caused by:
  - Leverage
  - Lack of liquidity
  - Limited transparency
- Fees
  - Generally higher fees
  - Varying fee structures
Potential True Diversification

How might an alternative strategy achieve low correlation to stocks and bonds?

• Hold very different assets
  – Real Estate & Timber

• Own assets where manager directs change
  – Private Equity

• Own assets that are difficult to value
  – Venture capital

• Own assets long/short instead of only long
Real Estate

Broad range of formats, expected risk, return, and correlation

• **REITs**
  – Public securities that have real estate assets
  – Liquid because they are part of the stock market
  – Can be highly correlated to market at times

• **Private vehicles**
  – Can last 7 to 10 years
  – Generally raised on a 3-5 year cycle
  – Can be domestic or international
3 Major Real Estate Opportunities

- **Core**
  - Investing in stable, income-producing properties in major cities
  - Significant fixed income character

- **Value Add**
  - Properties that need physical improvement, re-leasing, or other help
  - Properties in major cities and are unlikely to have dramatic changes in valuation

- **Opportunistic**
  - True equity risk
  - Might be new development or specialized property
  - Properties located in second-or third-tier city
Assume a “Value Add” private real estate partnership acquires a few properties at the beginning of 2017

- For the first 3 quarters of 2017, the stock market gains a smooth 4% per quarter. The properties grow in value, partly due to the General Partner’s efforts and partly due to economic growth. There is no new property appraisal so the properties are held at cost in the partnership.

- In the 4th quarter of 2017, the stock market drops by 5%, but one of the properties is sold at a price 10% above its cost, and you share in the partnership’s increase in value.

- The General Partner cites this as an example of a reasonable return with low risk and low correlation, since you gained in a quarter when the stock market was down.
Generally very long-term private partnership vehicles with goal to drive change

- **Private Equity**
  - Target company can be public, private or in transition
  - Transactions in large companies often involve a syndicate of buyers
  - Value add can be primarily operational, financial, or a combination, but in many cases it creates a highly leveraged company
  - Need a decent batting average, so check all the “at-bats”

- **Venture Capital**
  - Target company usually very early in its life cycle, but exact stage is very important (A, B, & C rounds of financing)
  - Often a significant amount of technical insight required
    - Healthcare companies
    - Technology companies
  - A few winners in a portfolio of 10-15 companies can make a fund
  - More about the slugging percentage than the batting average

- **For both private equity and venture capital, vintage diversification is essential**
Hedge Funds

Private investment partnerships

- Long/short style is fundamentally different than long only (Coke vs. Pepsi)
- More liquid than most other alternatives, but still a wide range across styles
- Can involve wide range of assets: stocks, bonds, commodities, currencies, derivatives, etc.
- Risk/return goals, and the accompanying degree of correlation, can be conservative, balanced, or aggressive
- Risks can be complex and partially hidden by limited transparency, smoothing, etc.
## Types of Alternative Investment Strategies

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Distinguishing Factors</th>
<th>Items to Remember</th>
</tr>
</thead>
</table>
| Real Assets               | • Generally not publicly traded  
• Risk can be similar to fixed income or equity  
• Assets can be generic or special use | • Generally long lock-up required  
• Perform best in inflationary conditions |
| Private Equity & Venture Capital | • Direct exposure to operating businesses  
• Often not publicly traded assets | • Long lock-up period required  
• Often highly leveraged |
| Hedge Funds               | • Trading structures (shorting, leverage)  
• Can be aggressive or conservative  
• Flexible mandates | • Limited liquidity  
• Impact of asset growth |
Gradual increase in alternatives has come from reductions in equities and fixed income.

Source: Pensions & Investments
Alternative Usage by Public Plans

Source: Institutional Investor, 2014 Survey

For Educational Purposes Only
### One Example of Capital Market Projections

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Projected Annual Return</th>
<th>Projected Annual Volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate - Private</td>
<td>8.65%</td>
<td>18.05%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>12.95%</td>
<td>27.40%</td>
</tr>
<tr>
<td>Hedge Funds - Equity</td>
<td>5.75%</td>
<td>12.00%</td>
</tr>
<tr>
<td>U.S. Equity – Core Large Cap</td>
<td>7.50%</td>
<td>15.35%</td>
</tr>
<tr>
<td>Fixed Income – U.S. Core</td>
<td>2.50%</td>
<td>4.35%</td>
</tr>
</tbody>
</table>

Source: PNC

*PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS*
Selecting alternatives well can be highly rewarding

<table>
<thead>
<tr>
<th></th>
<th>Endowments Over $1bn</th>
<th>Endowments Under $25mn</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Return</td>
<td>4.3%</td>
<td>2.3%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Domestic Equity</td>
<td>7.0%</td>
<td>6.5%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>0.5%</td>
<td>0.7%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>International Equity</td>
<td>-0.9%</td>
<td>-2.7%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Alternative Strategies</td>
<td>6.5%</td>
<td>-6.5%</td>
<td>13%</td>
</tr>
</tbody>
</table>

Source: 2015 NACUBO Commonfund Study of Endowments

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS

For Educational Purposes Only
What to Watch Out for in Real Estate and Private Equity/Venture Capital

• Details of the track record
• Does it include all their investment funds?
• Is current performance based only on a few realized deals?
• How have assets under management evolved?
• Have returns been driven by:
  – Operational improvements
  – Careful market selection
  – General economic growth and leverage
• Are economic benefits shared fairly with mid-level professionals who will drive value in the future?
What to Watch Out for in Hedge Funds

- Details of the track record
- Does it include all their investment funds?
- How have assets under management evolved?
- Is there enough transparency to be comfortable?
- Are economic benefits shared fairly with mid-level professionals who will drive value in the future?
Investment Product Formats

- Pooled Vehicles
  - Limited partnership
  - Mutual Fund
  - Commingled Account
- Separate Account a.k.a “Single Client Account”
- Direct Investments or Fund of Funds
## Typical Fee Structures – Private Investments

<table>
<thead>
<tr>
<th></th>
<th>Private Equity</th>
<th>Real Estate</th>
<th>Hedge Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Base Management Fee</strong></td>
<td>1.0% - 1.5%</td>
<td>0.75% - 1.5%</td>
<td>1.0% - 2.0%</td>
</tr>
<tr>
<td><strong>Performance Fee</strong></td>
<td>20%</td>
<td>10% - 20%</td>
<td>15% - 20%</td>
</tr>
<tr>
<td><strong>FOF Fees</strong></td>
<td>0.75% - 1.0%</td>
<td>0.75% - 1.0%</td>
<td>0.75% - 1.0%</td>
</tr>
</tbody>
</table>

**Bottom Line:**
High fees aren’t necessarily bad as long as they are for realized net of fee alpha...something that really benefits your portfolio and something that can really only be sourced through that specific manager.
# Formats for Accessing Hedge Funds

<table>
<thead>
<tr>
<th>Options</th>
<th>Commingled Fund of Funds</th>
<th>Direct Investing</th>
</tr>
</thead>
</table>
| **Pros** | • Diversified easy to use solution  
• Potential access to closed managers  
• Potential for improved liquidity | • Ability to tailor portfolio to specific needs  
• Allows control over beneficial ownership of underlying investments |
| **Cons** | • Unable to tailor exposures to each investor’s needs  
• Potentially higher fees | • Requires significant scale ($100mn)  
• Potential capacity issues  
• Increased internal or external resources needed (staff, legal, oversight) |
What to Look for in a Manager Presentation

- **Firm Background**
  - Longevity, quality of investors, stability of key management

- **Investment Philosophy**
  - Plausible attempt to add value beyond general economic growth
  - Consistently applied

- **Investment Process**
  - How do they source investment opportunities?
  - Has the process changed as assets have grown

- **Transparency**
  - Need an unbiased look at their investing history
Beta Fees for Beta; Alpha Fees for Realized Alpha

- In general, a large component of many “alternative” investment returns can be explained by beta, (general economic growth) not alpha (true value added). This isn’t a big deal as long as your fee structure reflects this.

- Ideally, pay beta fees for beta and alpha fees for realized alpha
  - Market clout allows many investment managers to flout this principle
  - You can avoid this with newer, hungrier managers, but that has its own risks
Why Have Alternatives?

• Hope to generate equity-like returns and reduce overall portfolio risks, which…
  – Provides for potential defense in times of stress
  – Delivers a new source of return to your program
  – Adds wealth preservation characteristics
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Selling securities short involves selling securities that one does not own and could expose the short seller to an unlimited loss in the event of an unlimited increase in the market price of a borrowed security, and securities necessary to cover a short position may not be available for purchase. Any regulatory limitations or bans on the short-selling of financial sector securities also may cause material losses.