Introduction

In this rapidly evolving market environment, it is not surprising that asset allocations for institutions are expected to follow suit and undergo many changes in the near term. Institutional investors worldwide are anticipating more asset allocation changes in the next one to two years than in 2012 and 2014, according to the Fidelity Global Institutional Investor Survey. Now in its fourteenth year, the survey indicates that 72% of institutional investors plan to increase their allocation of illiquid alternatives in 2017 and 2018.

Alternative investments can be used alone to address unique investment objectives, or together within a portfolio to complement other strategies that have different risk and return profiles. We believe that investing in alternatives can offer a range of benefits to investors, including the potential for uncorrelated returns, reduced volatility and, in some cases, additional tail risk protection. Investments in real estate and infrastructure also have the potential to generate sizable yield. In this paper, we will look at a variety of alternative investment strategies and the potential strengths they have when added to a diversified portfolio.
Private equity and venture capital have always offered the potential for outsized returns compared to public markets, but investors should consider focusing on certain areas of the market to maximize the utility of these asset classes. Smaller deal sizes in private equity and earlier stage investments in venture capital offer a significant opportunity to generate outsized returns, provided that investors conduct thorough research and due diligence.

Private equity: Opportunities in the lower middle market

Over the last five years, the private equity industry has returned a substantial amount of cash to investors. In turn, the overwhelmingly positive sentiment surrounding private equity has resulted in increased reinvestment in the asset class, driving the market to unsustainably high valuation levels. General partners are raising capital for increasingly larger funds at a faster pace than ever before, leading to record amounts of “dry powder” and the prospect of weaker returns. At the same time, many investors may wonder whether private equity has become a victim of its own success.

While this environment can be challenging, it is still ripe with opportunity. Private equity investments with attractive valuations still exist in this space if you know where to look. We believe the lower middle market segment represents the least efficient segment of the private equity spectrum. The lower middle market is characterized by a disproportionately small amount of private capital relative to the greatest number of companies and actionable investment opportunities.

Deep research and detailed due diligence are key to identifying relatively inefficient segments of the markets and capitalizing on these areas. It may make sense to outsource these duties to an experienced third party. Some features to look for when selecting a private equity manager include:

• Global resources with investment expertise that cover a wide range of geographies, stages, strategies and industry sectors
• Worldwide network of longstanding relationships with private equity managers
• Investments in both the primary and secondary markets, as well as co-investment strategies across a range of stages including buyout, venture capital and distressed/special situations

Delegating this function to an experienced investment manager would help save time and resources because private equity managers in the lower-middle market can be either difficult to find, diligence and/or access. An outsourced fund-of-funds approach helps provide a central point of access for many different types of opportunities within private equity and can assist with determining an optimal allocation to various types of investments.

Venture capital: The land of unicorns

In the world of venture capital, start-up companies that were valued at more than $1 billion were once so rare that they came to be known as unicorns.

Today, the global herd of unicorns has swelled to more than 175 members with a total cumulative valuation of $646 billion, according to CB Insights. Many of these leading startups were born and bred in Silicon Valley, which is likely to remain the epicenter of technology given its density of engineering talent and pervasive innovation culture. But centers of entrepreneurship are spreading outside the U.S., and venture capitalists could benefit by widening their lens outside the California region.

Europe, Israel and Asia have increasingly attracted the attention of local and international venture capital investors. Recent heady valuations in the U.S. also play a part in the desire to find opportunities off the beaten path.

But as investors, the search for viable companies and by extension, venture capital managers, is no easy feat. As many startups find success, a higher number also fail. It takes years to decipher which companies might be unicorns in the making, and which are not. With growth stage capital easy to come by in recent years, operational discipline has taken a back seat in favor of the quest for growth. Companies have delayed going public in favor of taking on relatively non-dilutive capital from non-traditional venture capital investors.

Still, venture capital is a hits-driven business. This means the unicorns that ultimately succeed will have to find a way to become longstanding, profitable enterprises.

It will be these defining companies that drive returns in the upcoming innovation cycle, just as they have in past cycles. It will also be these companies that will continue to drive the vast spread between median and top quartile industry-level returns that are common in venture capital.

Of course, there may not actually be 175 unicorns in existence right now. It seems difficult to believe that there can really be so many companies worth so much, and this is an uncertain valuation period. But we believe access, diversification and an increasingly global approach to venture capital is the best way to handle an asset class filled with so many mythical creatures.
Real assets: Mid-stream energy and timberland

Within real assets there are several sub-asset classes including: energy (including upstream and midstream oil and gas, power, and infrastructure assets), mining and minerals, timber, and agriculture. This diversity adds complexity, and investors should consider partnering with an experienced and skilled team to be able to identify particular investment themes and opportunities and match them with the right general partner (GP) or operator to fully exploit the opportunity.

Midstream Energy
What is the midstream segment? It is the processing, storage, gathering and transport of energy. We would see these as pipelines, rail cars and processing plants. We just don’t always notice them, at least not when it comes to investment opportunities.

There are three primary ways that investors can access U.S. midstream energy. The first is through large diversified energy companies, a traditional form of investing in assets. The second and third are somewhat less conventional. These are master limited partnerships (MLPs) and private equity (investing directly and through fund vehicles).

MLPs are yield-oriented, publicly-traded partnerships. They are typically listed on exchanges such as the New York Stock Exchange (NYSE). The bulk of their operating income is paid out in the form of quarterly cash distributions. MLPs are tax-advantaged entities because they have flow-through structures similar to that of Real Estate Investment Trusts (REITs). MLPs have historically been held by retail investors, although more recently have witnessed an influx of institutional capital.

The third investment method is private equity. Although there have historically been few dedicated midstream managers, the universe is growing in response to the attractive underlying dynamics. This ongoing deployment of private capital could provide a healthy and needed boost to the midstream energy sector.

As energy needs continue to expand, midstream energy infrastructure will play a critical role in making sure that energy can be properly stored and transported so it can power homes, factories, schools, hospitals and offices around the world.

Timberland
Timberland assets can provide good returns driven by biological growth. There is little or no storage cost and spoilage because trees can remain on the stump and continue to gain value. Timberland investments have historically had low volatility and low correlation to traditional asset classes. Timber has also traditionally performed well in inflationary environments.

Although commercial timberland plantations can be found in all parts of the world, investing in these assets originated largely in the U.S. because of the abundant and diverse types of timber that are naturally present in the country.

As the U.S. market has matured over the past 20 years, institutional investors are increasingly turning their attention to timberland opportunities outside the U.S., especially in the Southern Hemisphere which boasts higher growth rates.

There are two core attributes that distinguish international timber assets from those in the U.S. First is land tenure. There is often a greater lack of clarity around ownership with international timber, which increases the latent illiquidity of the asset. Nearly all U.S. timberland assets are held in simple ownership fees. In other words, there is an undivided ownership of the land with attached rights and responsibilities.

The second is a bit more obvious, and that is tree species. In the U.S., practically all of the major commercial timberlands are made up of tree species that are native to North America. In other parts of the world, native forests are not available for investment. Instead, investors acquire plantations stocked with timber that has been introduced to that geography.

The structure of timber markets is another challenge because it varies in almost every country. Some are characterized by a few dominant players who distort prices to benefit their own production. Some have healthy levels of competition but rely on external demand from other countries, which introduces exchange rate risk. And some others don’t have any transparency on pricing at all.

For these reasons, specialized knowledge in how timber markets work in a specific geography is critical for investment success. This is true even when there are trustworthy global benchmarks. It is all too easy to be seduced by the thought of investing in something different, but by asking the right questions, we believe there is little reason why investors can’t make income off an asset with a prolonged expiration date.
Infrastructure

Private infrastructure capital needs have increased as global governments work to rebuild or advance their countries. Mature infrastructure assets can provide stable income over the long-term, while growth and development infrastructure assets can generate strong capital appreciation. Across these lifecycles, infrastructure is a fast-growing asset class that may be enhanced with proper active management.

A closer look at Latin America

Infrastructure projects are critical to the growth of any economy, especially emerging ones. Such projects can improve a country’s quality of life and provide jobs. Public-private partnerships (PPPs) are one way that investors have accessed these government-approved programs.

Governments often seek the help of outside financiers to fund a range of plans with varied scales, from building new schools to fixing pipelines and roads. With the increased popularity of private equity, many governments have proposed PPP schemes for much of their capital needs and foregone traditional lenders.

Investors can benefit from long-term growth in countries where infrastructure projects are more of a bare necessity rather than advancement. Emerging Latin America is one example. The infrastructure gap is wide in Latin American countries. Many of its government leaders have advocated for vital build-outs and re-hauls. The focus may be on the top three largest economies (Brazil, Mexico and Argentina), but some investors would find the following three more suitable.

Colombia, Peru and Chile are the fourth-, fifth- and sixth-largest Latin American economies, respectively. The governments of these countries are executing the largest infrastructure plans in their history, with a significant number of projects on the agenda within social infrastructure. Social infrastructure is a subset of the infrastructure sector where assets involve the social services. These are projects such as hospitals, schools and community housing. Infrastructure can be particularly attractive to investors looking for:

- Investments that make a high social impact
- Stable, long-term, inflation-linked and government banked cash flows
- Assets where the exchange rate is favorable for foreign capital investment
- Early entry points into relatively untapped parts of emerging markets

Infrastructure assets can generate significant value for investors, but access will be one of the defining factors in whether or not the investments can have potential. High-quality investor standards will be vital in helping to fund new or improved public facilities. Investors should seek seasoned managers with strong regional footprints and track records. They should also pay attention to the level of local PPP structuring experience a manager has, as the local capabilities could make all the difference when trying to understand the governments and financial anatomies of any economy.
Hedge funds

Global economic uncertainty has renewed investor interest in hedge funds. Hedge fund assets include an array of strategies that can help diversify risk while generating returns. But not all hedge funds are the same, which means thorough due diligence and a deep understanding of individual strategies may be critical in making advantageous investments.

The multi-manager advantage

The changing investment landscape, in particular ongoing volatility in equities and the beginning of a rising rates environment, has generated significant interest among investors in strategies that can be used to hedge market and interest rate risk, such as those employed by hedge fund managers.

Unlike long-only investments, hedge fund strategies provide potential diversification through both long and short exposure and also offer differentiated return streams by investing in options, futures, derivatives and commodities.

Although there are dozens of different hedge fund strategies, Aberdeen divides them into a four distinct groups: Event Driven, which seeks to benefit from major corporate action such as mergers or spin-offs; Relative Value, which takes simultaneous long and short positions in similar securities, seeking to benefit from price corrections; Equity Hedge, which aims to identify winning and losing stocks based on fundamentals, and Global Macro, which tries to take advantage of global trends and the macro-dynamics of different asset classes, sectors and countries.

Some investment vehicles use a “multi-strategy” approach, which means that the adviser allocates assets to a group of carefully selected hedge fund managers, or sub-advisers, that use different strategies. The adviser determines which strategies have the most opportunity in the current economic environment and then picks the managers who specialize in that particular strategy who they believe to be the most capable of generating attractive returns. A blend of strategies—say, Event Driven combined with Relative Value and Equity Hedge—provides complementary return streams and a more balanced portfolio.

A multi-strategy approach also gives the adviser the ability to react more nimbly to changing environments and rebalance the portfolio accordingly. This structure provides diversification typically not available through a single manager and may further reduce risk.

Investing always poses some risk, but we feel that the traditional combination of long-only stocks and bonds is particularly vulnerable at this point in time. Investments with low correlations to these markets, or strategies with the ability to trade from both long and short sides of the portfolio, can provide defensive positions and true diversification.

Matrix of common alternatives

<table>
<thead>
<tr>
<th>Factor</th>
<th>Asset class</th>
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<tbody>
<tr>
<td>Credit/insurance</td>
<td>Emerging Market Debt (EMD) and high yield Trade finance Catastrophe risk</td>
</tr>
<tr>
<td>Corporate earnings</td>
<td>Long/short equity Event driven equity Distressed debt</td>
</tr>
<tr>
<td>Illiquid</td>
<td>Residential Mortgage-Backed Securities (RMBS) funds</td>
</tr>
<tr>
<td>opportunities/</td>
<td>Relative value Global macro Equity market neutral</td>
</tr>
<tr>
<td>value add</td>
<td>Tail risk hedge funds</td>
</tr>
<tr>
<td>Real assets</td>
<td>Commodity</td>
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<tr>
<td>Alpha³ opportunities</td>
<td>Alternative risk premia Merger arbitrage</td>
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<tr>
<td>Tail risk</td>
<td>Volatility</td>
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<tr>
<td>hedge funds</td>
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<tr>
<td>Private equity</td>
<td>Private debt Impact bonds</td>
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<tr>
<td>Listed private equity</td>
<td>Buy-out Growth Venture capital</td>
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<tr>
<td>Impact bonds</td>
<td>Farmland Timberland Mitigation banking</td>
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<tr>
<td>Property</td>
<td>Real estate debt</td>
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<tr>
<td>Value-add property</td>
<td>Core property Real estate investment trusts</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Infrastructure debt</td>
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<tr>
<td>Core infrastructure Master Limited Partnerships (MLPs)</td>
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Property multi-manager

Property can be an important source of diversification within a multi-asset portfolio. In today’s “lower for longer” interest-rate environment, it is one of the few asset classes that can still offer opportunities for significant yield, as well as the potential for growth.

Opportunities in the real estate secondaries market

Despite its rapid growth, the real estate secondaries market remains specialized and inherently inefficient. This offers pricing advantages that can result in property assets being acquired at a discount relative to direct investments. Moreover, secondaries investors can be rewarded for injecting liquidity into an illiquid asset class. This opportunity is bolstered by additional inefficiencies created by the Brexit vote, resulting in a very attractive current market environment to invest in the asset class. These combined factors can result in the prospect for attractive risk adjusted returns for the strategy.

Additionally, these inefficiencies found in the current European secondaries market combined with weak currencies compared to both the U.S. and Canadian dollars have created a unique opportunity for North American investors looking to increase their property exposure abroad.

In 2016, both sterling and the euro dropped to their lowest levels against the U.S. dollar in 31 and 13 years respectively. Aberdeen’s view is that the European ex-UK property markets are more fairly valued compared to both the U.S. and Asia Pacific before layering in FX implications. Moreover, deal flow in the secondaries market is expected to continue to increase due to a number of factors including: Brexit turmoil, regulatory requirements, growing use of secondaries as a way to accelerate liquidity, increased activity from non-US investors and as a means to extend the life of more mature funds.

Yield hierarchy

Conclusion: intelligent diversification

Alternatives offer a vast array of different strategies and styles to fit a variety of investor risk and return objectives. Each alternative investment strategy has unique characteristics that make it well-suited for its purpose. That purpose may be to generate new sources of alpha within a portfolio, mitigate risk in distressed markets or unlock new opportunities within a largely unconstrained investable universe.

While the use of alternatives has become much more widespread in recent years, investors should keep in mind that these are complex strategies, and as such they require an in-depth understanding gained through extensive and often time-consuming research. Partnering with an institutional alternatives platform can offer the resources needed to identify complementary strategies for a diversified portfolio.

Having an allocation to one or more alternative strategies is like having a specialized toolkit to help you with your goals. Finding the right strategies for your objectives and deciding upon an appropriate allocation within your portfolio can help you enhance a diversified allocation and gain new sources of investment returns. With alternatives, there are a variety of solutions that investors can employ to diversify their portfolios.

For more information visit aberdeen-asset.com/alts.

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