

The Principles of Alternative Investments Management

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A Study of the Global Market

 Springer

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Preface

“A theory should be made as simple as possible, but not simpler.”

Albert Einstein

The beginning of the twenty-first century was characterized by a rapid increase in the value of the assets being managed as alternative investments. The process of further development of the market continued, despite growing concerns regarding the lack of its transparency and despite a potentially negative impact of selected alternative investments on stability of the financial system.

The concept of alternative investments on contemporary international financial market emerged relatively recently, that is, at the beginning of the twenty-first century. Currently, the subject is attracting more attention due to the magnitude of the capital involved in this sector as well as due to the impact of those investments on functioning of the international financial market. Enrichment of selected social groups and growing involvement of institutional investors in this sector imply development of individual categories of alternative investments and affects the increase in the number of transactions.

This work is a comprehensive study on the subject of alternative investments on the financial market. The main purpose of this work is to collect, systematize, and develop the subject of alternative investments, which is still little known. The choice of the subject also has a practical implication. Enrichment of various social groups affects the increasing demand for financial innovations, which would offer more opportunities for investing funds to those willing to take risks.

Analysis of this sector of international financial market and indication of possible directions of its development seem to be extremely important, not only in terms of its attractiveness in the process of portfolio diversification but also in terms of the possibilities of achieving extraordinary return rates. The knowledge on the development dynamics of individual alternative investment categories is significant from the perspective of their purchasers who manage those investments as well as from the perspective of the entities whose task is to create an appropriate legal

framework for this market. It allows indication of the priorities in management of these investments and also measuring additional risks which these investments bear.

This book's purpose is also to verify the following research hypothesis: globalization and international integration of the financial market will cause the alternative investments on the securities market to penetrate into new areas, including the European Union. The dynamics of this penetration and its development depends on the pace of the citizens' enrichment and on their knowledge about financial innovations. Diversification of the specificity of alternative investments around the world, resultant from cultural and historical predispositions as well as from differences in economic development, can be expected.

The statistical data collected allowed application of research tools involving econometric models. Mechanisms of different alternative investments, on a global scale, have been described using empirical econometric equations. As a result, it was possible to estimate forecast components of the global alternative investment market.

Alternative investments in the literature on the subject are defined in two ways. The first approach distinguishes particular categories within the definition of alternative investments. The second excludes those categories which do not belong to alternative investments. The sequence of subsequent chapters has been subordinated to a detailed analysis of particular classes of alternative investments. Despite many different definitions of alternative investments, it can be assumed that a classical definition includes hedge funds, funds of funds, managed accounts, managed futures, structured products, and private equity/venture capital. Despite the expansion of the catalogue of possible alternative investment categories, it can be considered that the above listed types of alternative investments constitute a classic set and conceptualized in this way will constitute the subject of the considerations in this work. Currently, the category of alternative investments also includes investing in real estate funds and in raw materials, as well as emotional investments, e.g., coins, artifacts, wine, or cars.

Chapter 1 introduces the concept of alternative investments as an innovative form of investing on the international financial market and will describe their possible classifications. Particular attention will be paid to additional types of the risk associated with this category of investment. Practical ways of identification, measurement, and management of this risk are proposed. Importance of alternative investments on the international financial market is brought to attention as well.

Chapter 2 presents hedge funds, which currently are the most well-known alternative investment institutions. Because of the hedge funds' significant impact on the financial market, much book space has been devoted to these institutions. Development of the hedge fund market was fostered by limitations in the manner of investing in traditional investment funds and pension funds as well as limitations in their functioning. Their development also was a consequence of an evolution of innovative financial instruments, such as derivatives. This chapter presents a characteristic, classification, and the structure of modern hedge funds. Legal forms of their creation, depending on the place of fund's registration and the

manner in which financial assets are invested, have been described. Hedge fund databases and indices, which are an important source of information about the activity of this sector, have been presented as well. Presentation of this issue was not possible without indication of the errors the databases bear. In this chapter, an attempt was made to indicate the impact of hedge funds on functioning of the financial market. Data about the current state of the global hedge fund market were presented as well. The chapter has been illustrated with numerous tables and figures.

Chapter 3 is a continuation of the fourth. It will present hedge fund investment strategies. Knowledge of applicable strategies is fundamental in order to create a long-term coherent investment plan. Improper application of investment strategies is associated with a possibility of incurring severe losses. It is the investment strategies used by alternative funds which have a decisive impact on the performance of the institutions of collective investing. The range of instruments and techniques designed for constructing strategies of various risk levels with a potential return rate goes beyond traditional instruments, such as stocks or bonds. This chapter presents main groups of investment strategies: relative values strategies, event-driven strategies, opportunistic strategies, as well as their sub-strategies.

Chapter 4 presents the concept of funds of funds. These institutions play an important role on the market of alternative forms of investment, thus creating an important demand side on the hedge fund market and on the PE market. It presents the types and forms of funds of funds, as well as the pros and cons of choosing this form of collective investing. One of the advantages are lower entrance levels, which allow wider accessibility to investors. This chapter also presents the estimated data illustrating the state of the hedge fund sector worldwide.

Chapter 5 presents Managed Futures transactions, which emerged on the market as an alternative form of investing as early as the 60s of the twentieth century. Currently, Managed Futures transactions are managed by professional investment advisors, called Commodities Trading Advisors (CTAs), who conclude transactions on the global derivatives market. Managed Futures investments belong to relatively liquid investments. They allow release of cash funds within three months. The funds, which engage their assets in transactions on the futures market, are called *commodity pool*. They are obliged to register with the CFTC. An advisor once defined as a CPO or a CTA is subjected to registration with the Commodity Futures Trading Commission (CFTC). This part of the work presents the concept of Managed Futures investments and their forms. Automatic transaction systems in the activities of Commodity Trading Advisors have been briefly characterized as well.

Chapter 6 characterized structured products, which are a blend of traditional investments in stocks and bonds with investments in derivatives. The market of structured products is much more developed in the EU countries than in the USA. Possible forms of structured products, according to their payout profile, are presented. As in previous chapters of this work, analysis of structured products has been illustrated by numerical data representing the state of development of this market worldwide.

Chapter 7 presents PE/VC (*private equity/venture capital*) investments, which belong to alternative forms of investment on the financial market. This approach indicates a possibility of achieving extraordinary return rates as a result of financial participation in the projects of high potential growth. Specificity of these investments entails operating in niche segments of the market, on one side associated with a possibility of achieving high income and on the other bearing high risk. This chapter also presents stock exchange and OTC (over the counter) markets of alternative investments, including the Alternative Investment Market in London.

Each chapter dealing with the analysis of individual investment categories contains an extensive empirical part, which presents my own research results regarding alternative investments worldwide. Rapid development of this sector on the international financial market and growing concerns about activities of individual funds raise questions about the future directions of development of individual alternative investment categories.

Application of quantitative methods in the form of single-equation econometric models, which were specified during the process of multiple testing of their suitability for the developing market, mainly served the objectives of this work and verification of the hypothesis. The prognoses constructed on their basis are meant to present possible scenarios of the market's further development. Evolution of the alternative investments segment leads to development of those categories, which fulfill the expectations of market participants and meet the requirement and expiration of the remaining investments, which do not attract investors and are no longer accepted by them.

Other research methods will be used in this work—beginning with the method of observation being the most basic method of scientific knowledge, through a comparative method, analytical method, monographic method, as well as expert method.

During the course of research, numerous contacts with representatives of foreign financial institutions, whose knowledge was an important means of feedback on the developmental perspectives of the alternative investment sector worldwide, were established.

The work ends with an attempt to summarize new elements. It is a result of investigations on these issues over many years. The need for further research on the matters associated with continuous development of innovative instruments and institutions on the financial market was indicated as well. Their development has important implications for all financial market participants.

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