DIVERSIFYING OF INVESTMENTS PORTFOLIOS BY ALTERNATIVE ASSETS

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Abstract

A well-diversified portfolio means investments în stocks, bonds, cash or alternative assets, such as cryptocurrencies, commodities, real estate, art pieces, wine collections or even collections of cars or diamonds. Alternative investments have been used for long time by investors, but these have been diversified permanently, depending on the interest of investors for new categories of assets, depending on the level of demand, as well as on returns and risks of these assets.

The development of the capital market also had the effect of updating the legislation in the field. At the beginning of 2020, the Romanian legislation, aiming to increase investors' confidence in alternative investments, regulated the operation of alternative investment funds, as well as their obligation to request authorization from the Financial Supervisory Authority.

This article aims to present a number of advantages and specifics of investments on the capital market in diversified portfolios, as well as in investment funds.

Keywords: *financial market, alternative assets, cryptocurrencies, portfolio management, alternative investments.*

1. Introduction

The capital market is the market in which financial instruments are sold and bought. Financial instruments are represented by various forms of holdings that can be easily traded on the capital market: shares, bonds, government securities, futures contracts, options, fund units, etc. But investors can also choose to invest in alternative assets as forms of efficient investment, the advantage of which is the low correlation with traditional assets.

One of the basic laws for the investment portfolios efficient management is diversification. This involves investments in different assets across multiple markets, so that portfolio risk can be minimized. Each type of asset has a certain specific risk, but at the same time is accompanied by a certain systematic risk of the market in which it is traded. Therefore, investors need to invest in the most profitable assets in a given market or looking for the most profitable markets at one moment in time for trading securities, and the best solution is to investing in as many types of profitable assets as possible in different markets. Thus, the potential loss of a particular asset will affect the performance of the portfolio only in proportion to the asset's participation in the portfolio.

2. Investments on the capital market

Regarding to investments on the capital market, each investor, depending on his profile (riskofil person or riskofobic person) will choose to build a more or less risky portfolio. Financial securities are characterized by a certain level of profitability and a specific risk, i.e.:

- shares - are risky securities with a level of risk, which is proportional to the specific return, but also to the systemic risk of the market on which they are listed;
- bonds – are financial securities with a lower level of risk, but which, at the same time, will offer a lower level of profitability;
- government bonds (including municipal bonds) – are low-risk securities that offer a minimum return (in minimum risk conditions)

In these circumstances, if the investor seeks to achieve as much gain as possible in the shortest possible time, he should invest in very risky securities. However, prudent management of the investment portfolio requires that only 15% – 20% of the investment be made in very risky securities.

Financial theory describes two models of investment portfolios strategies:

- passive strategy
- active strategy

Passive and active investment strategies properly impose to check if the results meet the objectives. Thus, investment passive manager has to check if portfolio return rate is at the same level as stock index performance. Instead, the manager who prefer to apply an active strategy of the investments and who has to manage the informational efficiency of the market, too, should check if the excess return level achieved is big enough to offset the risk supplement level.

3. Investment portfolio strategies

The decision of how to manage the portfolio (active or passive strategy) depends on whether the manager has access to superior analysts. A portfolio

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manager with superior analysts or an investor who believes that he has the time and expertise to be a superior investor can manage a portfolio actively by looking for undervalued or overvalued securities and trading accordingly. In contrast, without access to superior investor, the manager should manage passively and assume that all securities are properly priced based on their levels of risk.

A portfolio manager with access to superior analysts, who have unique and analytical ability, should fellow their recommendations. The superior analysts should make investment recommendations for a certain proportion of the portfolio, and the portfolio manager should ensure that the risk preferences of the client are maintained[1].

3.1. Passive investment portfolio strategy

(or indexing strategy) starts from the premise that the investor has no information that would make him giving of his portfolio a different structure of the market portfolio, in which case, the portfolio risk is only the systematic risk. Passive investment management involves minimal trading, based on the belief that is impossible to beat averages on a risk – adjusted basis consistently.

The equations underlying this theory are:

$$E(\overline{R}_{pf}) = E(\overline{R}_{M}) \quad and \quad \sigma_{pf} = \sigma_{M}$$

Where: $E(\overline{R}_{pf})$ is the expected return for the portfolio, which depends on the expected return of all the assets returns in the portfolio

σ_{M} is the Variance of the portfolio's return, which depends on the variance of all the assets in the portfolio and the covariance of returns between al pairs of assets in the portfolio

$E(\overline{R}_{M})$ is the market return, expressed by the official market index

σ_{M} variance of the market return

Indexing is a sensible strategy because the security market appears to be remarkably efficient in adjusting the new information. When information arises about individual stocks or about the market as a whole, that information is generally reflected in market prices without delay. But passive management would still be a winning strategy even if markets very inefficient. This is so because winning performance must be a zero – sum. Clearly all stocks have to be held by some of certain investors achieve above – average returns, then it must be the case the other investors are achieving below – average performance. It is clear that all investors cannot be above average.[2]

If the market where portfolio securities are quoted is an efficient market, the only criterion considered for buying them is their relative capitalization. But it is not possible to know if the share's decreasing price is the effect of constitutive factors of securities. Investment passive strategy is considered the most appropriate method for managing a portfolio, in the stock exchange efficiency conditions. The result of choosing this strategy is the elimination of portfolio's specific risk.

Another great advantage of buy and hold strategy is also, the low cost, because broker's commission fees, spreads and other dealing costs become occasional rather than frequent. Passive strategy or buy- and-hold investment strategy means that rather than trading regularly securities are purchased and held for a long time (many years).

3.2. Active investment portfolio strategy

Another portfolio management strategy, opposite of the one, previously presented, is the active portfolio management. In an active portfolio strategy, a manager uses financial and economic indicators along with various other tools to forecast the market and achieve higher gains than a buy- and-hold (passive) portfolio.

Active portfolio management strategy is based on the selection of securities included in the portfolio. Manager will select securities according to their own performance and not according to their affiliation to an index or sector. Active management objective is to achieve higher performance as the benchmark (the stock market's official index).

Accordingly, the return rate obtained by the investment's active management, which involves investing in securities with high return rate and risk is random, being the result of a normal distribution around the average return. (Gaussian function). Managers who adopt this strategy relies on a certain degree of market's inefficiency. They noticed that it could be achieved a higher return rate for very short term, as long as financial asset's price is not steady. Portfolio active management can be applied both on the individual securities, in which case we are talking about "stock selection" (picking) and on various financial assets (from the stock exchange market and from the banking sector), in which case active management is called "active asset allocation". The third form of active management is "market timing", the strategy which is based on expectations of market's return development.

Portfolio managed by an active strategy has fewer titles than the one which is managed by the passive strategy, because requires individual analysis of each title of the portfolio. The active strategy also involves higher costs than the passive one.

4. Alternative investments

Structuring of efficient portfolios implies the existence of a correlation coefficient as lower as it

[1] Reilly, Frank, Brown, C, Keith - Investments Analysis and Portfolio Management (10th Edition), South – Western Cengage Learning, Mason, Ohio, USA, 2012.

[2] Burton G. Malkiel – "Passive Investment Strategies and Efficient Markets" - European Financial Management, Vol. 9. No. 1, 2003, Blackwell Publishing Ltd., 2003.

could be, between the portfolio component assets, so that the fluctuation in profitability or risk of one of them does not influence the financial performance of the other securities in the portfolio. That's why investors are choosing more and more the alternative assets for investing their economies in, aiming to conserve the value or increase the value of their economies. Such alternative assets could be: investments in gold, investments in art objects, investments in various collections (jewelry, machines, wines and stamps), investments in the forex market or, more recently, investments in cryptocurrencies.

One of the methods used for trading alternative assets is represented by contracts for difference (or CFD). Contracts for Difference (CFD) = are complex, derivative financial instruments that operate on the basis of leverage, which does not imply the effective holding of the underlying asset. The underlying asset could be: a commodity, a currency, a stock index, for which a certain fluctuation in the market is anticipated. The investor's aim is to obtain as much gain as possible from the change of the underlying asset price.

Initiating a CFD transaction involves acquiring a long/short position, based on estimates of the price evolution of the underlying asset:

- the anticipation of the increase in the price of the underlying asset leads to the opening of a long position. This financial position means that, in the following period, the investor will could buy the underlying asset at the price fixed in the contract, if on the market the asset's price increases;
- anticipating the decrease in the price of the underlying asset implies the opening of a short position, which will permit to the person who initiated the transaction to sell the underlying asset in the following period at the price stipulated in the contract, given that its market price is falling.

But, the risks of such transactions are high, when the evolution of the market price of the underlying asset is contrary to expectations.

The development of the financial market, as well as the desire of investors to make the greatest and most secure profit, have led to the emergence of a wide range of investments. Alternative investments, in recent times, are showing a growing trend, in terms of quantity and quality, and they are becoming more diversified and at the same time increasingly risky[3].

In 2016 – alternative assets accounted 23% of sovereign funds assets (up 4pp. from 2010[4]) as a result of lower interest rates on banking markets and yields on traditional assets (shares, bonds). Each category of alternative investments has its own advantages and disadvantages, such as the reduced correlation between the profitability of alternative assets and the profitability of financial markets, under the conditions of high financial performance of these investments. But, at the same time, the specific risks of these alternative assets may make them less attractive (the difficulty to determine their real price, their low liquidity or even the high price of alternative assets on the market).

Many types of alternative investments have existed for a long time and are known to investors. Others are relatively new, the alternative investment opportunities continuing to expand in the same time with rising demand. This is how alternative investments such as cryptocurrencies, real estate, art, wine collections, cars, diamonds and jewelry, as well as peer-to-peer loans, have emerged over time.

1. The cryptocurrencies. Investing in cryptocurrencies is based on the same principles as any other type of investment – diversifying the investments for the risks minimizing. This investment diversification can be achieved as time as more and more national entities will enter on the cryptocurrency market, which situation will create a favorable and safe environment for cryptocurrencies in the global economy. The cryptocurrencies provide a high degree of security in terms of how they were created, with Blockchain technology, which enabling users to have the image of all transactions and avoid fraudulent losses. Actually, any intervention by a hacker can be observed in the network of connected computers, which have a copy of the operations performed. The greatest risk of the cryptocurrencies investments remains the strong variation of their price on the market.

2. Art objects. In Romania, the art market has developed very strongly over the last 10 years, which has led to the appearance of the Art Market Index (developed by the Artmark Institute of Art Management, together with Price Waterhouse Coopers) and the TudorArt Index. Internationally, there is the ArtPrice portal, which monitoring public transactions with works of art and publishes the annual returns for the authors with high sales on the specific market.

Made it with inspiration, the investment in artwork can be more cost-effective than other alternative investments. The contemporary art market is more active from an investment point of view, both internationally and in Romania. The "old" art market is the most stable, but positioned far above contemporary art in terms of prices.

The risk factors of the art objects market are:

- the authenticity of the art object
- the real value of the art object (hard to evaluate)
- the emotional involvement of the investor

The specific elements of the art market are: belonging to an important art collection, the provenance of the art object, the mention in the art catalogues or showing in collections and exhibitions. All these specific elements are reflected in the value and the price of the art object.

[3] Conf. dr. Ivan Luchian, conf. dr. Angela Filip – "Abordările conceptuale modern ale investiţiilor alternative", *Paradigme moderne ale economiei şi antreprenoriatului inovativ*. Ediţia a XII-a, 3-4 noiembrie 2017, Chișinău. Chișinău, Republica Moldova: Centrul Editorial-Poligrafic al USM, 2017, pag. 164-170.

[4] According to consulting firm Price Waterhouse Cooper.

Volatility of an art object translates into the intensity of its trading on the market, and from this point of view, such investments are characterized by a low volatility, but which is offset by the fact that, over the time, the investment value will be kept or even will increase.

The trading of art objects is done on the primary market (of art galleries) and the trading through auction houses is increasing. This situation means a benefit from the visibility point of view, greater than the visibility offered by the art galleries and, also, offer the possibility of important gains.

3. Wine collections – are a safe investment, as the price of wine has never experienced sudden collapses on the market, unlike the other traditional assets. At the beginning of the financial crisis, in 2018, all the main sectors of the economy and the capital market suffered considerable losses, but the investments in the wine generated for the investors a profit of 7%, which over time reached even +16% in 12 months.

Accordingly with a study from Mediobanca, investment in wine generated a profit of 160% to 190% in 10 years, surpassing almost all investments in traditional assets, including gold investments and oil investments. In addition, the wine being an absolutely natural product and subject of a large number of factors, (which influence its ageing over time) and being considered a perishable good, the result of these reasons, is that wine isn't subject of any capital gains taxation.

4. Diamonds and the jewels. The investment in jewelry is an opportunity that carries just a few risks and will be a very profitable investment for long term.

The advantages of the investment in jewelry are: a steady increase in long-term value; the jewelry are easy to sell and the demand of jewelry is growing.

a) The steady increase in long-term value

While currencies, cryptocurrencies or shares on the stock exchanges have a volatile value and any increase or decrease of their value is almost impossible to predict, the precious metals from which the jewels are made are stable on the market and aren't devalued. The price of precious metals, too, may decrease for short term, but their value increases in for long term.

b) The jewelry are easy to sell

Even if investments in art objects or in art collections could be profitable for long term, selling them for profit is complicated. Finding a buyer interested in that object and willing to pay the correct price for it can be difficult and may take a long time.

By contrast, gold jewelry and gemstone jewelry are much easier to resell, as the number of people interested in such accessories is high. Also, in situations when it is necessary to sell a jewel and there is no buyer on the market at that time, one of the possible options is to sell the jewel at a pawnshop. The risk of not being able to sell a jewel immediately and with profit may be the result of a declining popularity of a jewelry collection. However, this situation can also be an advantage, because a not very popular jewel can be purchased at a low price and could be sold in the future at a much higher price than the purchase price, as the market trend may change.

c) The demand of jewelry is bigger and bigger

In recent years, the popularity of jewelry, especially gold jewelry, has reached new heights and more and more people are interested in getting jewelry or adding a new model to their collection. As all the signs show that this upward trend of interest for jewelry will continue in the next years, the price of these accessories is possible to increase more and more, like the price of any good for which demand is increasing. In these circumstances, the investment in jewelry is very profitable, both in terms of resale price and in terms of resale opportunity. But, an owner of a gemstone jewelry will never be able to resale the jewelry at the exact market price, because in most cases the person who redeems the jewel will want either its resale or separating gold from the gem and then selling them separately. So that in the price offered for the purchase of the jewelry must also include the future gain of the buyer. But, generally, at least 75 to 80% of the market value at the time of redemption can be obtained, or even less, but if the investment was made at least 1 year before the resale date, it could be obtain a gain over the price registered at the time of the first purchase.

Modern investors prefer alternative investments. In this way, the Rally platform of New York was created for alternative investment. Founded in 2017, Rally platform buys collectibles such as rare cars, sporting items that evoke important moments, old books and so on, and divides these assets into shares which are sells to investors for just $5, making these collectible objects much more affordable. The value of the shares is subject of market fluctuations, the investors being able to sell or buy that shares after a 90-day lockdown period.

The Rally platform facilitates peer-to-peer transactions in a secondary market, where prices can fluctuate over time. But, collectibles are considered risky investments, because the value of some of them can increase greatly over time, and the value of others can quickly depreciate. This situation is generated by the fact that investors lose their desire to own the luxury asset, which they have bought it and will sell it, which will cause the falling of its price. The advantage of such a trading platform, like Rally platform, is that investors can purchase and hold practically a small part of a very valuable asset.

5. Conclusions

Investments in alternative assets offer investors the chance to earn high profits, if they are open to taking high risks. Although traditional financial markets offer a wide range of financial assets, investors' goals of earning as much and as securely as possible make the alternative investment market very attractive. In the latest period, the alternative sources of funding and the

removal of barriers to cross-border investment are intensive promoted. They will stimulate the cross-border market for investing funds, promote the EU market for secured bonds as a source of long-term financing and will provide investors with greater certainty in cross-border securities and receivables transactions.

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