Script

“Would you sign this deal? You give me €100,000. I promise to make you more money — eventually. You can’t take it back for ten years, I don’t tell you how I invest it, and if it works, you’ll actually pay me extra.

Most of us would probably say no, right? But this is basically what investors agree to when they put their money into alternative assets. They accept less control, less transparency, and long lock-up periods — because the potential returns can be really high.

And with that, welcome to Chapter 20: **Alternative Assets.**

So, what are alternative assets? In short, they’re investments outside traditional markets like stocks, bonds, and cash. They give investors more ways to diversify and access opportunities beyond public markets.

There are four main categories:

Hedge funds use flexible trading strategies — they can short-sell, use leverage, and hedge to make money even when markets fall.

Private equity focuses on buying entire companies, improving them, and selling them later for a profit — so it’s about active ownership and long-term value creation.

Real assets include tangible things like real estate, natural resources, and commodities. They’re often used to hedge inflation or add stability.

And **structured products** combine normal securities with derivatives to create tailored payoffs — for example, protecting against losses while still participating in gains.

So all these assets go beyond traditional investing — they’re more complex, less liquid, but can offer higher potential returns and better diversification.”

“So how are alternative assets different from traditional ones?

Let’s start with **transparency**. Traditional investments like mutual funds are highly regulated — they have to publish what they hold and how they perform. Alternative funds, on the other hand, are private and only report limited information to their investors. You don’t really see what’s happening behind the scenes.

Next is **who can invest**. Traditional markets are open to everyone. But alternatives are only available to **accredited investors** — meaning you need a net worth of at least **one million euros excluding your home**, or a high, stable income. The idea is that you should be financially experienced enough to understand the risks.

When it comes to **investment strategies**, traditional funds usually follow fixed rules — for example, a bond fund must hold bonds. Alternative funds are much more **flexible**. They can use short-selling, leverage, or derivatives and invest across different asset classes.

The next big one is **liquidity**. Stocks and bonds can be sold instantly. But in alternatives, money is locked up — sometimes for years. That's why investors earn a **liquidity premium**, meaning they expect a higher return to compensate for not being able to exit early.

Then we have the **investment horizon**. Traditional funds are open-ended — you can buy and sell anytime. Alternatives are **closed-ended** — they usually run for around **10 years**, after which the assets must be sold.

And finally, **fees**. Mutual funds charge maybe 0.5 to 1.25% per year. Alternative funds often charge the famous **'2 and 20'** — 2% management fee plus 20% of profits. So they're more expensive, but investors accept that because managers are more actively involved.

We'll get back to this **fee structure** later, because it's actually a really interesting part

"Now that we've seen the bigger picture of alternative assets, our main focus today will be on **private equity**, which is basically the business of buying, improving, and selling companies.

Private equity isn't just one thing — it includes **three main categories**, depending on the company's stage and strategy.

First, we have **angel investors**, who are wealthy individuals investing their own money at a very early stage, often right after the founders.

Then comes **venture capital**, which involves professional funds investing in startups with strong growth potential.

And finally, **leveraged buyouts**, where private equity firms buy mature companies using a lot of debt to improve and later sell them.

So we'll go through each one, starting with angel investors."

"Angel investors are wealthy individuals or families who provide the very first external capital to a startup — usually right after the founders have invested their own money. So they're often the first outsiders to take a risk on a business idea.

Because most startups are small and risky, angels usually invest relatively small amounts — around **50 to 100 thousand dollars** — but they expect very high returns from the few that succeed.

Many angels don't work alone; they invest through **angel networks**, which connect them with startups and help improve the screening and due diligence process.

The funding process usually has three steps:
First, startups **apply and get screened** based on size, region, and industry fit.
Then comes the **pitch**, where founders present their idea, and angels decide if it's worth looking into.
And finally, there's **due diligence**, where they check the business plan and potential before investing.

Because early-stage startups don't have positive cash flows yet, they can't be valued with models like DCF. Instead, angels **work backward** — they estimate what the company could be worth at exit and calculate how much ownership they need today to reach their target return. We'll also come back to this later when we look at **valuation challenges**, since this idea of working backward from an exit value is a common approach in private equity.

Since most startups fail, only a few investments end up covering all the losses — that's why angels aim for extremely high potential returns."

"Now let's move on to **venture capital**, which takes things one step further than angel investing.

Venture capital refers to **professionally managed funds** that invest in **high-growth startups** — companies with strong potential but also high risk. Unlike angels, these investors use other people's money, not their own.

There are two main types:
Independent VC funds like *Sequoia* or *Kleiner Perkins*, which raise money from institutions, and **corporate VC arms**, such as *Google Ventures* or *Intel Capital*, where big firms invest in startups that are somehow connected to their own business.

The goal is to provide both **capital and expertise**, helping startups grow until they can **exit** — usually through an IPO or being acquired by another firm.

Venture capital funds are structured as **limited partnerships**. That means:

- The **general partners (GPs)** run the fund, find startups, do due diligence, and manage investments.
- The **limited partners (LPs)** are the investors — often pension funds or endowments — they provide the money but don't get involved in decisions.

Let's now look at how this process works over time — how funding actually moves through the stages of a startup."

"Here you can see the **startup investment stages**. It starts with **seed capital**, which is the first VC money — used to build a prototype, refine the business model, or build the founding team.

Then comes **early-stage funding** — rounds A and B — which help launch the product, expand the team, and enter the market.

Finally, **late-stage VC** — rounds C and D — is used to scale operations and prepare for exit through an IPO or acquisition.

In the beginning, cash flows are negative because the startup is still developing and not profitable — that's why this curve is called the **J-curve**. Only later, once the firm grows, cash flows turn positive."

“Now if we zoom out and look at the **VC fund life cycle**, we can see how the money flows across the 10-year fund period.

It starts with **fundraising**, where the GPs collect commitments from LPs — this is called the *vintage year*.

Then comes **sourcing and due diligence**, where they identify startups and assess their business model, team, and product.

Next is **investment and monitoring** — funds are released **in stages**, not all at once. Whether a startup gets more money depends on how well it performs.

And finally, **exit and harvest** — once a startup goes public or gets acquired, profits are returned to LPs and GPs. The ones that fail are simply written off.”

“To show how common VC backing actually is — which of these companies do you think *did not* start with venture capital?
Spotify, Airbnb, Google, Amazon, Samsung, or Dyson?”

“So as you can see, most of the world’s biggest tech firms were backed by venture capital early on. It plays a massive role in shaping innovation and bringing startups to scale.”

“Finally, let’s talk about **leveraged buyouts**, or LBOs — this is what most people think of when they hear ‘private equity’.

In a leveraged buyout, a PE firm buys an **underperforming but stable company**, improves its operations or management, and then sells it later for a profit.

The word *‘leveraged’* refers to the fact that **most of the purchase is financed with debt** — usually around **60 to 90%**. Only a small portion comes from the PE firm’s own money.

Now, the key part here is that the **debt is placed on the company itself**, not on the PE fund. That means the company is the one responsible for paying interest and repaying the loans. So the company’s **future cash flows** need to be strong enough to cover that.

Because the equity part is so small, even a small improvement in the firm’s value can lead to a **huge increase in return on equity** — that’s called the **leverage effect**. But it also works the other way around: if the company performs worse, losses are also amplified. So, high potential, but very high risk.

After about 5 to 7 years, the fund exits the investment. The most common **exit strategy** is selling to a **strategic buyer**, which is another company — that happens in about **38%** of cases.
Another option is a **secondary buyout** — selling to another private equity firm, which accounts for around **24%**.
In some cases, the company goes public again through an **IPO**, or, in smaller cases, management might buy it out themselves. Of course, some end in **bankruptcy**, because not every LBO works out.”

“Now let’s talk about **valuation in private equity**, and more importantly, why it’s so difficult to do.

Unlike public companies, private equity investments don’t have **market prices**, because they aren’t traded daily. You can’t just look up a stock price to see what something’s worth.

Valuations are also **infrequent** — they’re usually updated only after major events like a new funding round, an acquisition, or an IPO. That means values can stay unchanged for months or even years.

On top of that, valuations are **subjective**, because they’re often done internally by the fund managers, or general partners. And let’s be honest — when the same people who earn performance fees also value the investment, there’s a certain bias risk.

Another big issue is **illiquidity** — capital is tied up for 7 to 10 years, and these positions can’t just be sold if market conditions change.

And because prices are updated so rarely, you get **smoothed returns** — they look way more stable than they really are, simply because volatility is hidden between valuation points.”

“So how do fund managers actually estimate value in these illiquid markets?

Traditional models like **DCF or CAPM** rarely work here — startups and private companies usually don’t have reliable forecasts or steady cash flows.

So instead, fund managers — especially in venture capital or angel investing — use a **target ownership approach**. They basically ask: *How much of this company do I need to own today to reach my target return when I exit?*

One simple way to calculate this is with the **Capital Multiplier Method**. The formula is:

Terminal ownership share = (Initial investment × Capital multiplier) / Forecast terminal value

Here, the **capital multiplier** represents how many times the investor wants to multiply their money — for example, 5× or 10×.
The **terminal value** is what the firm is expected to be worth at exit, say in an IPO or acquisition.

If the investor expects dilution — meaning new funding rounds will reduce their ownership later — they need a higher initial ownership share now to reach the same return.

Of course, this method has major **limitations** — it’s based on forecasts and assumptions, which means it’s uncertain and imprecise. And since there’s **no active market** to verify these valuations, they’re mostly educated guesses.”

“So now that we’ve talked about valuation, the next question is — **can we actually trust reported returns in private equity?**

Let’s start with a small thought experiment.

Imagine a professor calculating the **average grade** of a class, but only including the students who made it to the final exam. Everyone who failed earlier or dropped out isn’t counted.

What happens to the class average? It obviously looks **higher than it really is**, right?

That’s exactly what happens in private equity — it’s called **survivorship bias**.”

“**Survivorship bias** means that **unsuccessful funds** — the ones that performed poorly — **stop reporting** and disappear from the database, leaving only the successful ones.

This creates a few big problems:

- Databases **overrepresent strong performers**, because the losers are gone.
- As a result, **average returns look 2 to 4% higher** than they actually are.
- And finally, it makes funds look **less risky** than they truly are, because failures aren’t counted.”

“To visualize this, imagine another example:
Your university only adds students to its **alumni list** once they’ve landed an impressive job. The ones still job hunting aren’t included.

How would that affect how outsiders view your university? It would look a lot more successful than it really is. And that’s exactly what happens in PE performance databases — they only show the success stories.”

“There’s another type of distortion called **backfill bias**.

This happens when **funds only start reporting their results after** they’ve already had **strong early performance**. That means the **bad early years** are missing from the record.

The result is that **historical data looks too good** — weaker periods are excluded, and average returns appear around **5% higher** than in reality.

So when we look at reported returns, we have to be careful — because both survivorship bias and backfill bias give a **false impression of consistent success**.”

So now that we’ve seen how performance can be biased, the question is — who actually benefits from these potentially inflated numbers?
This brings us to the fee structure — how fund managers get paid.

Alternative investments typically use performance-based fees to align manager and investor interests.
There are two main types of fees:

First, **the management fee**, which is usually around 1–2% of the assets under management. This covers the fund's basic operating costs — things like salaries, research, and admin. Then there's **the incentive or performance fee**, which rewards managers for doing well — usually 20% of the profits that go beyond a certain agreed benchmark.

Basically, if the fund performs better than expected, managers get a slice of those excess gains.

Here's the logic behind it — managers only earn that 20% incentive if returns exceed the benchmark.
If performance stays below the benchmark, they get nothing extra.
But once performance goes above it, the manager earns 20% of the excess profits.

We can think of this like a **call option**.
In this analogy, the benchmark return acts as the **strike price**, and the slope of 0.20 represents the manager's 20% share of returns above that threshold.
So the better the performance, the higher their payout — but there's no downside risk for the manager if returns are poor.

Now let's look at how profits are shared between the investors, called LPs, and the fund managers, called GPs.
This process is known as the **waterfall distribution**, and it determines who gets paid first and how much.

Here's the typical order:

1. First, capital is returned to LPs — they get back what they initially invested.
2. Then comes the **preferred return**, or **hurdle rate**, usually around 8%. That means LPs must earn 8% before the GP gets any performance fee.
3. After that, there's a **catch-up clause**, where GPs temporarily receive a higher share (around 80%) until they've caught up to their agreed profit split.
4. Then we move to the **final split**, where profits are shared — typically **80% to LPs** and **20% to GPs**.
5. And finally, there's the **clawback clause** — if the fund later performs worse and the GP was overpaid, the LPs can reclaim part of that earlier payout.

This structure is meant to make sure GPs are rewarded only after investors have earned their fair share first.

"So to wrap everything up, let's quickly go through the main takeaways from today's chapter.

First, alternative assets help investors diversify beyond traditional markets like stocks and bonds — but this comes at the cost of less transparency and liquidity.

Second, a big part of private equity is *active value creation*: investors don't just wait for markets to move — they actively improve companies through governance and restructuring.

Third, since these investments are illiquid and come with high fees, the required rate of return needs to be high enough to compensate for that.

Fourth, performance measurement is tricky. Illiquidity and reporting biases make it difficult to know whether returns actually reflect skill or just noise.

And finally, the bottom line: alternatives *can* add value — but only for investors who understand their structure, risks, and how to interpret reported performance."