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Alternative Investments: Increased Accessibility for Investors and What Investors Need to Know

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KEY TAKEAWAYS

1. Alternative investment strategies may potentially improve performance of and add diversification to 60/40 portfolios.
2. These strategies are no longer the exclusive domain of institutions and wealthy individuals.
3. With the introduction and evolution of client-friendly vehicles, many individual investors now have access to these strategies.
4. Professional investors should know the value proposition of alternative investments in order understand how allocating to them may help strengthen client portfolios.

Overview of the Alternative Investment Landscape

The term “alternative investments” is broad and, in our view, not particularly descriptive or useful. It encompasses all strategies that cannot be accessed through traditional equity and fixed income solutions. These strategies have the potential to address many of the challenges that investors face today—the need for enhanced income, inflation protection, diversification, and stability amid volatile markets.

At the highest level, alternative investments can be categorized into the following strategy types: hedge funds, private credit, private equity, real estate and infrastructure.

DISPLAY 1

Overview of the Alternative Investment Landscape

HEDGE FUNDS	PRIVATE CREDIT	PRIVATE EQUITY	REAL ESTATE	INFRASTRUCTURE
Investment vehicles with access to a wide range of underlying strategies and often characterized by "shorts"	Privately held loans issued to public and private companies	Equity investments in privately held companies	Equity investments and loans to privately held real estate properties	Equity investments and loans to public and private infrastructure facilities and services

HEDGE FUNDS employ a wide range of strategies, each with their own unique risk and return characteristics. As such, they can serve different roles in a portfolio: isolating alpha, enhancing returns, mitigating or hedging risk, and providing diversification.

Generally speaking, hedge funds can be classified into five categories: Equity Hedge, Event Driven, Relative Value, Macro and Multi-Strategy. Each of these categories can be further divided into sub-strategies.

Equity Hedge and Event Driven strategies offer equity beta with the opportunity for reduced volatility by providing exposure to equities while seeking to diminish portfolio risk through hedging strategies. Through the simultaneous buying and selling of securities to take advantage of pricing in efficiencies, relative value strategies seek to capitalize on price discrepancies in the market, delivering consistent return with muted volatility. Macro strategies are defensive in nature, historically proving their worth during market dislocations. These strategies bet on broad macroeconomic trends using futures, options and spot markets, providing potential diversification benefits during times of market stress. Lastly, multi-strategy hedge funds allocate capital across strategies in an opportunistic manner, aiming to deliver uncorrelated returns and reduce portfolio risk.

PRIVATE CREDIT investing is a form of lending capital outside the traditional banking system whereby lenders work with borrowers to negotiate private loans, typically held to maturity, that are not traded on the public market. Because these loans are not traded, investors are compensated with an illiquidity premium—the additional return generated from committing capital over an extended period and providing managers time to unlock value.

The private credit market has grown exponentially since the global financial crisis, both in terms of breadth and depth. Private credit AUM has more than quadrupled from $262.2 billion globally[1] in 2009 to $1.6 trillion today.[2] Generally speaking, private credit strategies can be categorized as follows: direct lending, specialty lending and distressed lending. Direct lending strategies provide credit primarily to middle market, non-investment grade companies who are seeking loans from non-bank lenders, and they focus on income generation. Specialty lending encompasses a wide range of products that are typically backed by different types of assets, including real estate. These strategies tend to focus on the highest possible total return. Distressed lending involves acquiring stakes in stressed companies at significant discounts with the intention of generating profit post company turnaround. Like specialty lending strategies, distressed strategies are focused on generating the highest possible total return.

Private credit historically has exhibited a low correlation with other, more traditional, fixed income since the debt is not traded and is not subject to public market volatility. The debt is often floating-rate, meaning investor income increases with overall interest rates—a desirable feature.

PRIVATE EQUITY strategies are primarily differentiated by where they focus in terms of company lifecycle stage—early, middle and late. These strategies have traditionally offered a considerable illiquidity premium to investors, with their risk/return profiles linked to the

[1] Preqin, as of October 31, 2023.

[2] Preqin, all private credit funds with a vintage year between 2000 and 2023, as of October 31, 2023.

likelihood of them achieving growth/improvement targets. Private equity strategies can be thought of in three main categories: buyout, growth capital and venture capital. Buyout represents the largest strategy segment as measured by AUM. Buyout investors take complete or majority ownership and control of mature companies through equity and debt. Growth capital strategies are characterized by minority or non-controlling stake in companies with growth potential. Investors usually take a passive approach, retaining the same management team, and typically use lower levels of leverage than buyout transactions. Finally, venture capital strategies involve investments made in start-up companies and early-stage businesses that are believed to have significant growth potential. As a company grows, additional financing is provided in the form of "rounds."

REAL ASSETS, which encompass real estate and infrastructure, are tangible, physical assets whose value stems from their physical use. Private real estate strategies are focused on equity investments and loans to privately held real estate properties. They are classified as Core, Core-Plus, Value Add and Opportunistic. Strategies are categorized according to the level of risk related to characteristics such as location, quality of property and percentage leased. Primary property types include residential, commercial and industrial. Historically, these strategies have served as an income source, often generating yields significantly surpassing traditional fixed income options.

Private infrastructure strategies involve equity investments and loans to privately held infrastructure facilities and services. There are generally considered to be two broad categories of strategies: economic (e.g., toll roads, airports, water treatment and electricity) and social (e.g., schools, hospitals, correctional facilities). Like real estate, strategies can be classified as Core, Core-Plus, Value Add and Opportunistic.

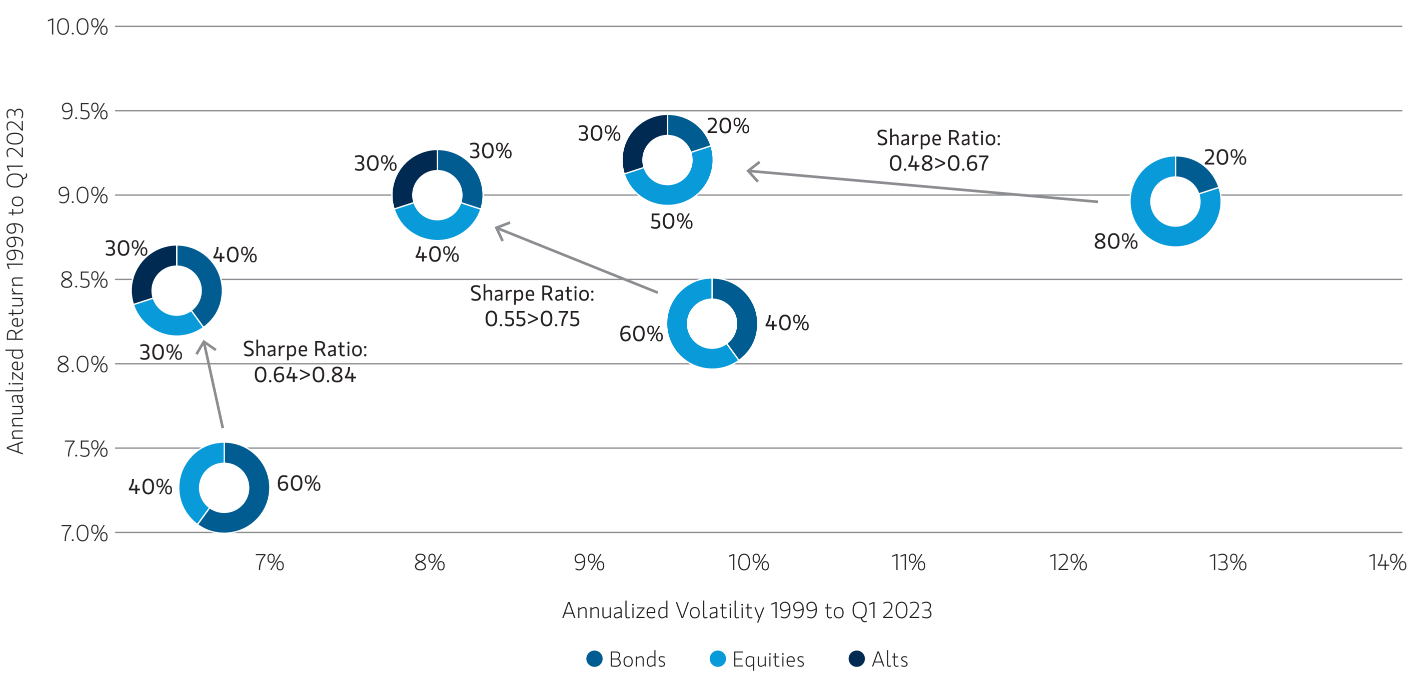
Why Now? Advisors Need an Updated Toolkit

This model, which mirrored many institutional allocations, was simple to communicate to investors. The expectation was that equities, comprising 60% of the portfolio, would drive growth while fixed income, making up the remaining 40%, would offer stability and income. This balance offered a degree of diversification because of the low correlation between stocks and bonds. However, this model experienced significant under performance in 2022, when both asset classes declined simultaneously for the first time in decades. With advisors facing challenges in finding income sources for their clients and increased correlations across most traditional asset classes, there is a pressing need to expand beyond the traditional 60/40 portfolio.

Studies have shown time and again that allocating to alternative investment strategies has the potential to improve the risk/reward profile of balanced

DISPLAY 2

Portfolio Diversification: Adding Alternatives to a 60/40 Portfolio



Source: The 60/40 Portfolio Needs an Alts Infusion | CFA Institute Enterprising Investor, Charles De Andrade, CAIA and Soren Godbersen, December 21, 2023.

portfolios. Until fairly recently, only institutions and ultra-high net worth individuals who meet eligibility requirements could partake.

Fortunately, asset managers have been focused on broadening the access to alternatives. There has been meaningful growth in offerings made at lower minimums, with greater transparency and more timely tax reporting. As a result, professional investors now have access to an expanded set of tools. Indeed, advisor allocations to alternative investments are expected to steadily increase from 4% reported in 2022 to an anticipated 4.5% in 2024.[3]

What Does the Broadening Access to Alternative Investments Mean for Professional Investors?

Two primary factors have driven the democratization of alternatives:

1. **MARKET ENVIRONMENT:** professional investors need a comprehensive and sophisticated toolkit to best address the investable opportunity set for their clients
2. **PRODUCT INNOVATION:** Managers have responded to investor demand by launching vehicles with lower minimums, targeting sophisticated individual investors who can tolerate non-daily liquidity.

Taken together, these factors have contributed to a proliferation of alternative investment vehicles that are increasingly looking to provide access to private markets with investor-friendly terms such as lower minimums, simplified processing of subscriptions and, in some cases, redemption terms. Investors can access these strategies through newly regulated fund vehicles, such as SICAV Part IIs, ELTIFs and LTAFs, which offer many of the protections associated with public registration while still allowing investment in illiquid assets like private markets. Depending on the vehicle structure certain products can be distributed not only to professional investors, but also retail investors. Importantly, these strategies have the potential to act as portfolio diversifiers with returns that are uncorrelated to traditional markets, lower volatility and often offering an illiquidity premium.

Conclusion

In conclusion, the broadening access to alternative investments marks a significant milestone in the industry. Access to previously exclusive asset classes allows for enhanced portfolio diversification and the potential for higher returns with reduced volatility. As we navigate an increasingly complex and often volatile investment landscape, alternative investment strategies may prove to be powerful tools for both advisors and clients, provided that potential risks and benefits are fully understood.

[3] Source: The Cerulli Report—U.S. Alternative Investments 2022: Delivering Alternative Capabilities to Retail Investors. As of December 31, 2022.

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Diversification does not protect you against a loss in a particular market; however it allows you to spread that risk across various asset classes. Past performance is no guarantee of future results.

Alternative investments are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for long-term investors willing to forego liquidity and put capital at risk for an indefinite period of time. Alternative investments are typically highly illiquid—there is no secondary market for private funds, and there may be restrictions on redemptions or assigning or otherwise transferring investments into private funds. Alternative investment funds often engage in leverage and other speculative practices that may increase volatility and risk of loss. Alternative investments typically have higher fees and expenses than other investment vehicles, and such fees and expenses will lower returns achieved by investors.

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