Morgan Stanley

INVESTMENT MANAGEMENT

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

**ALTERNATIVES** | AUGUST 2024

## 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 "democratization" of alternatives—the introduction and evolution of client-friendly vehicles—many individual investors now have access to these strategies.
4. Financial Advisors should know the value proposition alternative investments in order understand how allocating to them may help strengthen client portfolios.


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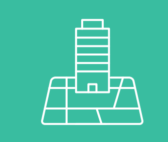
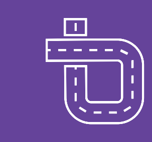
## Overview of the Alternative Investment Landscape

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 inefficiencies, 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 and originate privately held 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 various loans or assets, for example, 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.

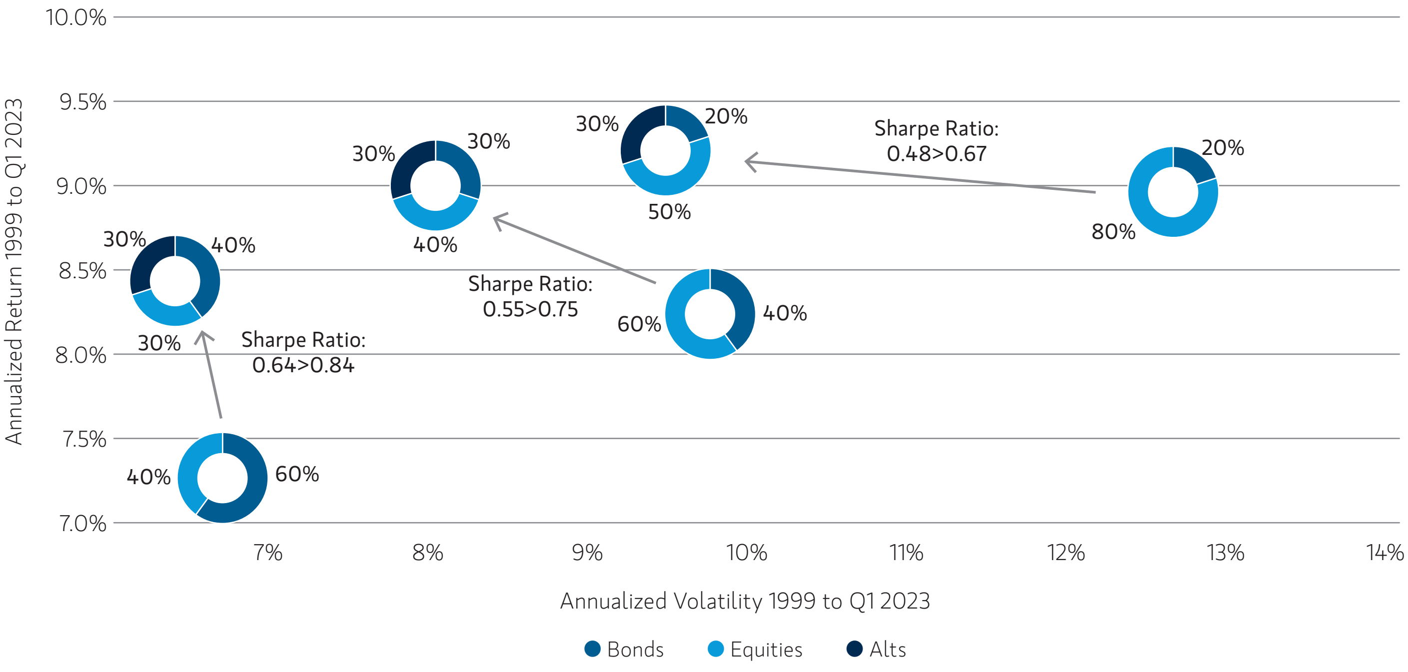
**PRIVATE EQUITY** strategies are primarily differentiated by where they focus in terms of company lifecycle stage—early, middle and late. These

[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.

**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.

strategies have traditionally offered a considerable illiquidity premium to investors, with their risk/return profiles linked to the 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 latest strategy segment as measured by AUM. Buyout investors 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 ENCOMPASSES REAL ESTATE AND INFRASTRUCTURE,** are tangible, physical assets whose value stems from their physical use. Private real estate strategies are 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 involved 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

For many years, the investment community has embraced the 60/40 portfolio as the industry standard. This model, modeling 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 allocation offered some degree of diversification due to the low correlation between stocks and bonds. This model, however, experienced a significant downturn in 2022, when both asset classes decreased 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 portfolios. Until fairly recently, only institutions and ultra-high net worth individuals who meet eligibility requirements as defined by Qualified Purchaser (QP) status[3] (could partake.

Fortunately, asset managers have been focused on "democratizing" alternatives. There has been meaningful growth in offerings made at lower minimums, with greater transparency and more timely tax reporting. As a result, financial advisors now have access to an expanded set of tools. In short, alternative investments give financial advisors more ways to potentially help their clients. Indeed, advisor allocations to alternative investments are expected to steadily increase from 4% reported in 2022 to an anticipated 4.5% in 2024.[4]

## What the Democratization of Alternative Investments Means for Financial Advisors

Three primary factors have driven the democratization of alternatives:

1. **MARKET ENVIRONMENT:** The current market environment necessitates a more comprehensive and sophisticated toolkit to best address the investable opportunity set
2. **PRODUCT INNOVATION:** Improvements in product structures have introduced more investor-friendly structures for accessing alternative investments
3. **ACCESS TO INSTITUTIONAL MANAGERS:** While institutional and ultra-high net worth investors have significantly increased their allocations to alternative investments over the past twenty years, the usage rate among individual investors remains relatively lower. To address this opportunity gap, institutional managers have responded with the creation of alternative investment 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 provide access to private markets that are tailored for sophisticated individual investors—with lower minimums and, often, 1099 tax reporting. These vehicles and other asset classes that were previously difficult for these investors to attain. And importantly, these strategies have the potential to act as important portfolio diversifiers with returns that are uncorrelated to traditional markets, lower volatility and often offering an illiquidity premium.

Investors can access these strategies through registered funds, which offer many of the protections associated with SEC registration while still allowing investment in illiquid assets like private markets. These funds, including tender offer funds and interval funds, are structured as continuously offered closed-end funds registered with the SEC under the 1940 Act. They are typically available to Accredited Investors, defined as people who have earned income of more than $200,000 (or $300,000 together with a spouse) in each of the last two years and reasonably expect to earn the same for the current year. Other vehicles for accessing private markets include Business Development Companies (BDCs) and non-traded REITs (NTRs) both of which tend to be available to Accredited Investors. BDCs, both public and private, offer access to private credit while NTRs provide entry to private real estate.

## Conclusion

In conclusion, the democratization of alternative investments marks a significant milestone in the industry. These new products offer a compelling opportunity for both financial advisors and individual investors. The ability to access previously exclusive asset classes allows for enhanced portfolio diversification and the potential for higher returns with reduced volatility. As investors navigate an increasingly complex and often volatile investment landscape, these alternative investment options may prove to be powerful tools to both the advisor and the client provided that potential risks and benefits are fully understood.

[3] An individual or family business that owns $5M USD or more in investments; A trust sponsored and managed by other qualified purchasers; An individual or entity that invests at least $25M USD, either for their own accounts or on others' behalf)

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

## Risk Considerations

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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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Alternative investment funds are often unregulated, are not subject to the same regulatory requirements as mutual funds and are not required to provide periodic pricing or valuation information to investors. The investment strategies described in the preceding pages may not be suitable for your specific circumstances; accordingly, you should consult your own tax, legal or other advisors, at both the outset of any transaction and on an ongoing basis, to determine such suitability.

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