ALTERNATIVE INVESTMENTS

Considerations for Portfolio Construction

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Investors have improved access to alternative investments today, and studies show that they can enhance portfolio performance. This piece reviews the growing asset class and provides guidance for portfolio construction.

SIZE AND GROWTH OF ALTERNATIVES

Alternative investments (Alts) as an asset class, encompassing strategies that fall outside traditional equity and fixed-income solutions, continue to gain importance for investor portfolios. This is driven by the potential for improved portfolio performance and better access to the asset class.

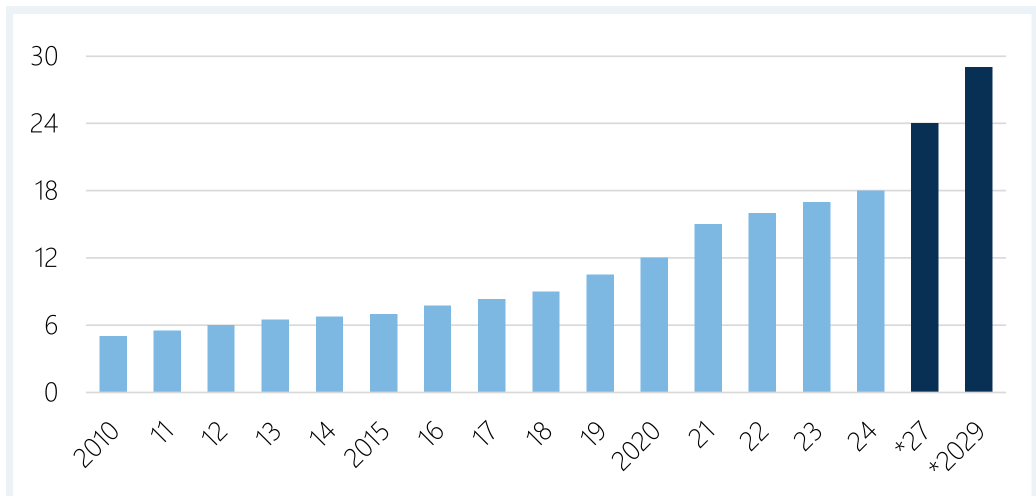
The demonstrated success of alternatives has led to significant growth, with estimates showing over $17 trillion in assets under management today compared to $7 trillion a decade ago. Projections show alternatives growing by about 11% per year to a size of over $29 trillion by 2029.

Greater access to the asset class for investors is an important feature today, with asset managers focused on "democratizing" alternatives to expand the pool of potential investors. There has been meaningful growth in offerings with smaller minimum investments, greater transparency, and lower fees, which allow investors to capture more of the value added, along with the illiquidity premium inherent in private vehicles. Another attraction today is the availability of funds that are not partnerships, providing 1099s instead of K-1s (simplifying tax reporting).

These newer offerings often allow investors to access markets typically reserved for illiquid funds, such as private equity or direct lending, but in vehicles that offer the potential for liquidity on a quarterly basis.

In addition to the increased availability of private capital, the cost and complexity of being a public company is a major factor for the growth of private markets. Today, many growth companies, led by technology-focused

Figure 1: Alternatives Seeing Significant Growth, 11% CAGR Growth Forecast Through '29



Source: Janney ISG, iCapital, Hedge Fund Research, and Preqin

firms, are waiting longer and becoming much larger before going public. The number of publicly listed U.S. stocks has fallen from a peak of 8,000 to less than 6,000 today, while the median age at a company's initial public offering has gone from five years in 1999 to 11 years today. High-growth, technology-related firms are a major source of potential returns for private markets.

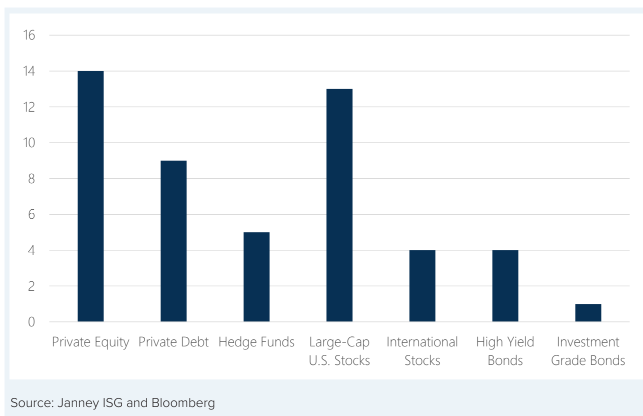
ALTERNATIVES SUB-ASSET CLASSES

Alternatives have a broad range of sub-asset classes, including private or non-public equity and debt, venture capital, real assets (real estate, infrastructure, and natural resources), and hedge funds, which employ a variety of proprietary investment strategies. Please see Page 6 for a description of these investment vehicles.

HISTORICAL AND PROJECTED RETURNS

Alternatives continue to gain attention, and investor fund flows are increasing because of the potential for attractive returns. Over the last decade, private equity has averaged about a 14% per year return, private debt 9%, with hedge funds at 5%. This compares to about 13% for large-cap U.S. stocks, 4% for international stocks, 4% for non-investment grade U.S. bonds, and 1% for U.S. investment grade bonds. Portfolio diversification benefits offered by Alts is another important feature discussed below.

Figure 2: Alternatives Show Strong Historical Returns (% Total Return over Last Decade)

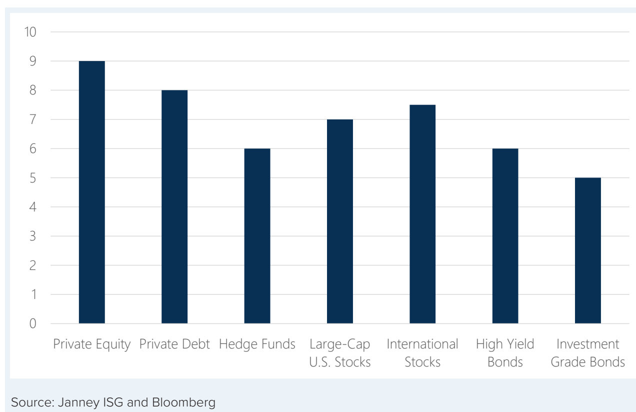


Source: Janney ISG and Bloomberg

Private equity (about $6 trillion in assets) is the largest asset class within alternatives, has grown significantly, and is forecasted to have the highest future growth rate of alternatives. Private debt (about $2 trillion in assets) is expected to see the second-highest growth rate. Hedge funds (over $4 trillion in assets) remain an important alternative asset class.

Investors continue to be drawn to the potentially attractive returns private equity and debt are expected to show in the future. Consensus estimates for long-term capital market assumptions show private equity is expected to see the highest returns of all asset classes over the next decade, with an assumed return of 9%. Private debt is expected to see the next highest return at 8%. This compares to about 7% for Large-Cap U.S. stocks, 5% for U.S. investment-grade bonds, and 6% for non-investment-grade U.S. bonds.

Figure 3: Consensus Estimates Expect Further Healthy Alternatives Returns (% Total Return Projected for Next Decade)



Source: Janney ISG and Bloomberg

CRITICAL INVESTMENT CONSIDERATIONS AND RISKS OF ALTERNATIVES

The potential excess returns from Alts derive from the need to compensate investors for illiquidity due to long lockup periods, high investment minimums, and limited reporting.

While the value of alternative investment funds may fluctuate less than investments in public companies, illiquidity is the prime risk investors need to understand. Alternatives are meant to be long-term investments, and investors need to be comfortable with the idea of having cash locked up for extended periods.

In addition, the lack of transparency adds to the complexity and risk. Information is not available to everyone because these are private companies— unlike public companies that are required to provide significant investor information. Alternative investments are not regulated as strictly as public companies, so additional due diligence is required to understand the opportunity and risk before investing.

Manager selection is a major driver of return outcomes for alternatives. While private equity showed an average return of 14% over the last decade, top-quartile funds averaged 23%, while bottom-quartile funds returned only 2%. There are similarly wide outcome dispersions for other alternative asset classes.

Another important consideration is determining what asset class to displace when adding alternatives to a portfolio. This is driven by the correlation, or relationship, that alternatives have with other major asset classes.

IMPORTANCE OF CORRELATION

Correlation measures how closely the price movement of two assets is related. A correlation of one means both assets move up or down by the same percentage. A correlation of negative one means they move opposite one another, while a correlation of zero means there is no relationship between their price movement.

Correlation is the key attribute for portfolio diversification and improving potential returns while reducing risk. Ideally, a well-diversified portfolio combines assets that are not highly correlated to each other. Pairing assets with low correlations can improve anticipated returns while reducing expected portfolio volatility.

A key observation is that alternatives have a correlation of less than one with other major assets, providing the potential to improve portfolio performance. The table below (Figure 4) lists representative correlations among the various major asset classes.

OBSERVATIONS FROM CORRELATION MATRIX

1. Private equity has its highest correlation with stocks (0.96–0.61), hedge funds (0.62), private debt (0.58), high-yield bonds (0.55), and real estate (0.48).
2. Private debt has its highest correlation with high-yield bonds (0.66), private equity (0.58), hedge funds (0.55), stocks (0.55–0.49), and real estate (0.37).
3. Hedge funds have their highest correlation with stocks (0.71–0.66), high-yield bonds (0.63), private equity (0.62), private debt (0.55), and commodities (0.40).
4. Commodities have their highest correlation with international (0.42) and emerging market stocks (0.42).
5. Real Estate has its highest correlation with stocks (0.57–0.45), high-yield bonds (0.49), private equity (0.48), hedge funds (0.45), and private debt (0.37).
6. It's important to note that these correlations change or drift over time.

With these correlations in mind and considering a traditional 60% stock/40% bond portfolio, we would classify private equity, hedge funds, and real estate as part of the equity weighting and private debt as part of the bond weighting.

ADDING ALTERNATIVES CAN LEAD TO BETTER PORTFOLIO PERFORMANCE

Three traditional portfolio allocations that pair stocks with bonds to improve potential returns for any level of risk include the standard 60% stocks/40% bonds, the more defensive 40% stocks/60% bonds, and the more aggressive 80% stocks/20% bonds. Using historical data from the last 30 years shows that adding alternatives to these traditional portfolios led to better performance—higher returns with lower volatility.

Figure 5 (on page 5) shows that infusing 30% Alts into any of these portfolios led to better performance. The 60%/40% portfolio reallocated to 40%/30%/30% stocks/bonds/alts raised the return from 8.7% to 9.1% while reducing the annualized volatility from 9.7% to 7.9%. In the case of 80% stocks/20% Alts, shifting to 50% stocks/20% bonds/30% Alts allocation benefits from a lower degree of annualized volatility while producing a similar return.

Figure 4: Representative Correlations Among Various Major Asset Classes

Asset Class	1	2	3	4	5	6	7	8	9	10	11	12
1. Large Cap Stocks	1.00											
2. Small Cap Stocks	0.90	1.00										
3. Developed International Stocks	0.81	0.76	1.00									
4. Emerging Market Stocks	0.70	0.67	0.79	1.00								
5. Investment-Grade Bonds	0.28	0.23	0.26	0.24	1.00							
6. High-Yield Bonds	0.68	0.67	0.64	0.62	0.49	1.00						
7. Cash Equivalents (US Treasuries)	(0.03)	(0.06)	(0.02)	(0.02)	0.14	(0.03)	1.00					
8. Real Estate	0.57	0.57	0.50	0.45	0.27	0.49	(0.03)	1.00				
9. Hedge Funds	0.71	0.70	0.68	0.66	0.26	0.63	(0.01)	0.45	1.00			
10. Commodities	0.34	0.35	0.42	0.42	0.06	0.37	(0.00)	0.25	0.40	1.00		
11. Private Equity	0.75	0.96	0.66	0.61	0.18	0.55	(0.07)	0.48	0.62	0.29	1.00	
12. Private Debt	0.55	0.55	0.49	0.50	0.17	0.66	(0.08)	0.37	0.55	0.33	0.58	1.00

Source: Janney ISG, Horizon Actuarial Services, Morningstar

GUIDANCE ON PORTFOLIO ALLOCATION

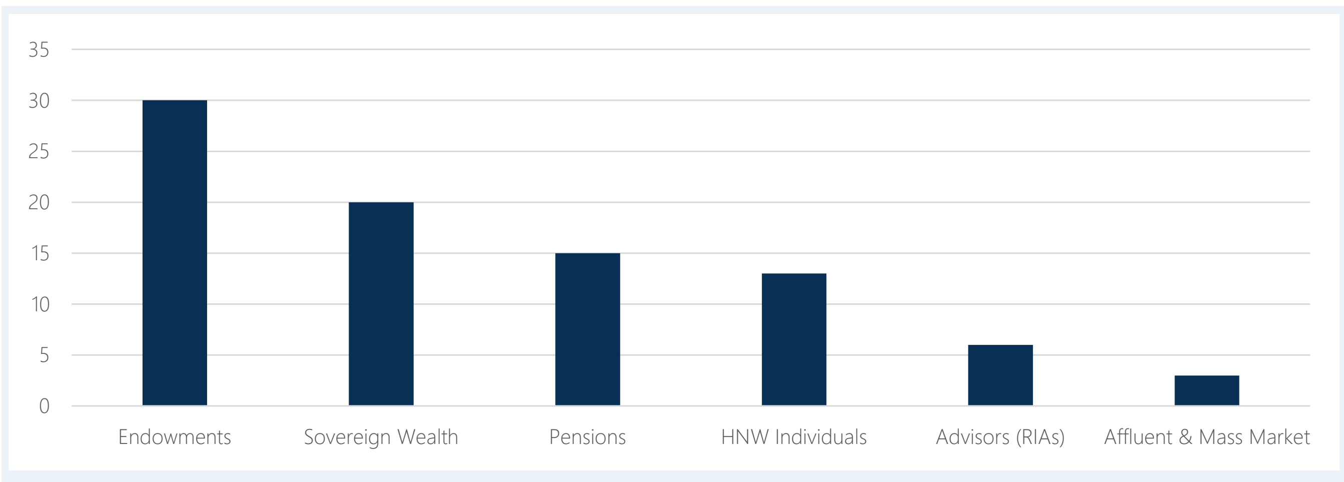
The percentage of alternative assets to include in your portfolio depends on several factors, including your financial goals, risk tolerance, investment horizon, and existing portfolio composition. We view 5-10% of a portfolio as a starting point for an alternatives allocation. A percentage much lower than this would have minimal impact on portfolio performance.

Endowments and sovereign wealth funds, which have very long-time horizons for their portfolios, allocate 20–30% to alternatives (Figure 6). Investors comfortable with lower liquidity and have an extended time horizon for their portfolio could benefit from a 20-30% allocation and the potential for enhanced portfolio performance that alternatives can offer.

Figure 5: Alternatives Can Improve Portfolio Risk and Return Annualized Volatility and Returns, 1Q90–2Q24

Source: Janney ISG, Rhodium Group/Clean Investment Monitor (CIM)

Figure 6: Allocation to Alternatives in Private Wealth Lags Institutional Use (% Allocation to Alternatives by Investor Type)



Source: Janney ISG and iCapital

Description of Various Alternative Investment Categories

Private Equity: Private Equity (PE) has two main segments: Venture Capital and Buyout.

- Venture Capital can range from the most nascent seed investing (sometimes pre-company or even pre-product) through mezzanine financing or preparing for an IPO. The predominant venture capital strategy is to plant many seeds at a fairly low cost and hope the few winners' seismic ROIs more than cover the losers that never get off the ground.
- Buyout firms employ significant leverage to acquire whole companies or segments to assist or replace management of (usually) distressed or inefficient companies through restructuring. They will also acquire with the intent to liquidate the capital assets when they deem the sum of the parts more valuable than the whole, either due to labor inefficiencies or mismanagement (also referred to as "corporate raiding"). Buyout firms may also simply identify undervalued companies and seek to optimize them or facilitate capital markets transactions (M&A, IPO, etc.) to earn significant profits without undergoing drastic wholesale changes.

Part of PE's higher return comes from the "illiquidity premium" derived from their multiyear lockup periods. Of the major sub-classes of Alts, Private Equity has the highest correlation to Public Equity. Alpha is also more sustainable in PE. Name-brand players generally outperform lesser names because of their elite human capital and access to the best opportunities. However, managers have been unable to rely on financial engineering to the same degree they did in the 2010s when rates were near zero. Alpha, going forward, will come more from operational improvements. Retail investors can access PE through feeder funds.

Private Credit: Private placements of debt are typically done through banks and other high-finance firms that offer them to qualified institutional buyer ("QIB") clients. Issuers of private debt tend to be smaller, often unrated, and have limited access to capital markets. They seek to borrow smaller amounts than would be feasible through public issuance, so the situation can be a win-win: lower reporting/filing costs for borrowers and higher yield for lenders. The Private Debt market grew tenfold in the 2010s as the hunt for yield intensified in the ultra-low rate environment. However, as inflation and rates spiked post-pandemic, fixed-rate coupons on pre-pandemic issued Private Debt became uncompetitive with new issuance and caused prices to fall on the former. Private Credit spreads remain notably wider than public peers but are tighter than historical averages.

Like in Public Credit markets, credit risk in the private space becomes a concern when spreads tighten to the point that managers can't compete on pricing, so they try to win deals by softening terms, increasing leverage, and/or offering loose covenants. At that point, generally at the top of the cycle, both credit quality and upside erode. There has been some evidence of deterioration in the past year, but it has been somewhat overstated in the press. It also remains true that the best managers have the strongest pipelines, while smaller shops are more likely to get squeezed as more dollars chase more deals. The best-in-class have the luxury of nearly always requiring rigorous diligence and covenants because they will always be in demand.

Real Estate: Real Estate offers significant control and upside, which appeals to active investors who believe they can create alpha through development/redevelopment. Performance can be difficult to measure since properties are not commodities or direct substitutes, and time lags artificially dampen volatility. REITs can be a great way for passive investors to access Real Estate markets and gain exposure without dealing with physically managing property. Macro factors, such as rising rates or falling prices, can overpower even superior managers. For example, even best-in-class funds from the vintage year 2005 have underperformed even the weakest performers from the vintage year 2010 for economic reasons entirely beyond manager control. Still, every pullback creates opportunity, and plenty of managers are presently (selectively) bullish on Real Estate given the pullback over the last two years.

Hedge Funds: Hedge Funds (HF) each have unique proprietary strategies but fall into broader sub-groups:

- Market-Neutral strategies attempt to identify winners and losers within sub-sectors by tailoring long and short positions (i.e., long Home Depot, short Lowe's, etc.) to net out sector/market movements and/or beta. Doing so theoretically preserves alpha and performance even during downturns, which are no fault of the manager. In fact, when market neutrality is properly executed, alpha might be even more apparent during a downturn.
- Event-Driven identifies known or expected market catalysts (e.g., mergers, spinoffs, lawsuits) that are believed not to be fully or properly priced in due to uncertainty or time.
- Relative Value seeks mispricings between convertible bonds and their equities, parent/subprices, or other incongruence.
- Global Macro employs directional or thematic investing plays around the world, often using sophisticated futures.

Like other active strategies, Hedge Funds tend to outperform in bear markets and high-volatility environments when there is more alpha to be had rather than in bull markets when it's harder to outperform the passives net of fees. A common theme among hedge funds is their significant use of leverage and rigid fee structures. Some (underperforming) hedge funds' fee structures have recently been challenged, but the traditional models are generally holding.

DISCLAIMER

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