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Why Alternative Investments—and Why Now?

By Anthony B. Davidow, CIMA®

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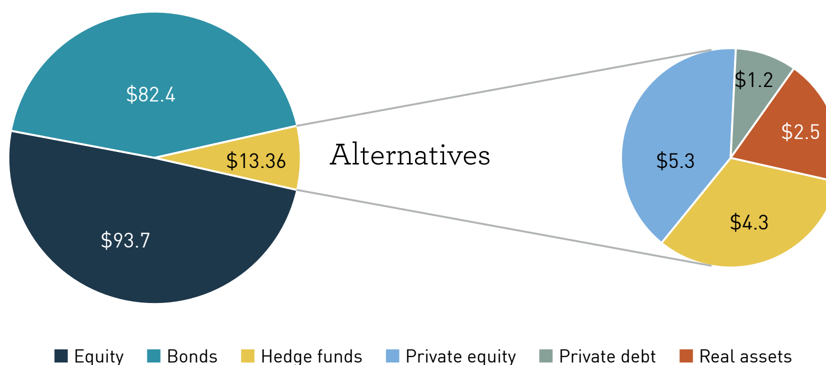
Emphasizing inefficiently priced asset classes with interesting active management opportunities increases the odds of investment success. Intelligent acceptance of illiquidity and a value orientation constitute a sensible, conservative approach to portfolio management.
—David Swensen (2009)

Figure 1

GLOBAL INVESTABLE MARKET AS OF DECEMBER 31, 2021 ($ TRILLIONS)



Source: Preqin, Bank of International Settlements, World Bank, Franklin Templeton Capital Market Insights Group, World, World Bank, World Development Indicators, Financial Sector, Capital Markets, Market Capitalization of Listed Companies, Current Prices, USD (trillion)

Legendary investor David Swensen, former chief investment officer of the Yale Endowment, pioneered portfolio management by allocating significant portions—as much as 70–80 percent—of the endowment's portfolio to alternative investments. He believed that the "intelligent acceptance of illiquidity" could generate substantial returns over time.

Swensen left a successful career on Wall Street to join Yale in 1985. Under his stewardship, he transformed the Ivy League school's endowment from plain vanilla stocks and bonds to what has become known as the "endowment model."

With Swensen at its helm, Yale's endowment grew from $1.3 billion to $31.2 billion. But perhaps his greatest legacy are the people he trained, including Princeton investment head Andrew Golden, MIT's Seth Alexander, and Penn's Peter Ammon. These former staffers now run some of the best-performing endowments at several of America's top colleges and philanthropic organizations.[1]

Of course, endowments such as Yale's have a staff of investment professionals, gain unique access to private markets, negotiate favorable terms, and have a scale advantage relative to high-net-worth (HNW) investors. Endowments also benefit from well-heeled alumni who make donations over time. Based on the success of the Yale Endowment, many institutions and family offices have followed Swensen's lead in allocating significant capital to alternative investments seeking higher returns.

Until recently, many of these investments were not broadly available to HNW investors. In the past few years, a confluence of events has helped to democratize alternative investments:

- Today's market environment demands a more robust and sophisticated toolbox.
- Product innovation helped usher in more investor-friendly structures to access alternative investments.
- Access to institutional managers has been critical for the quality of the products.

We will cover these issues in greater detail below.

DEFINING ALTERNATIVE INVESTMENTS

Alternative investments represent a relatively small portion of the global investable market, with private equity and hedge funds representing the largest percentage of the alternative pie (see figure 1). However, with slightly more than $13 trillion in assets under management, it is a large and growing portion of the overall pie. The vast majority of the assets under management (AUM) is currently with institutions and family offices, but HNW demand is beginning to change the underlying composition.

The industry uses the term "alternative investments" loosely, often referring to any investment that is not considered mainstream as an alternative investment. Therefore, new investments and structures

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such as cryptocurrencies, non-fungible tokens, and special purpose acquisition companies are sometimes grouped together with well-established asset classes such as private equity and real estate. This only adds to the confusion about how they should be used with clients. Let us begin by separating alternative asset classes, strategies, and structures.

Asset classes. Alternative asset classes include private equity, private credit, and real assets. Private equity can be further divided into venture capital, growth equity, and buyouts; private credit can be divided into direct lending, mezzanine, and distressed; and real assets can be divided into real estate, infrastructure, and natural resources.

Strategies. Alternative strategies include equity-hedge, event-driven, relative value, macro, and multi-strategy. They can be further divided into sub-strategies such as long–short, merger arbitrage, market-neutral, managed futures, and activist, among others. These strategies generally are available via a hedge fund limited partnership structure.

Structures. Alternative structures include hedge funds, qualified purchaser (QP) funds, feeder funds, registered funds, and liquid alternatives (mutual funds and exchange-traded funds). Registered funds include interval funds, tender-offer funds, non-traded real estate investment trusts (NTRs), and private business development companies (BDCs).

We also will delve into private markets and hedge funds, and how advisors can use them effectively, as well as structural trade-offs and the various ways of accessing these unique investments.

THE APPEAL OF ALTERNATIVE INVESTMENTS

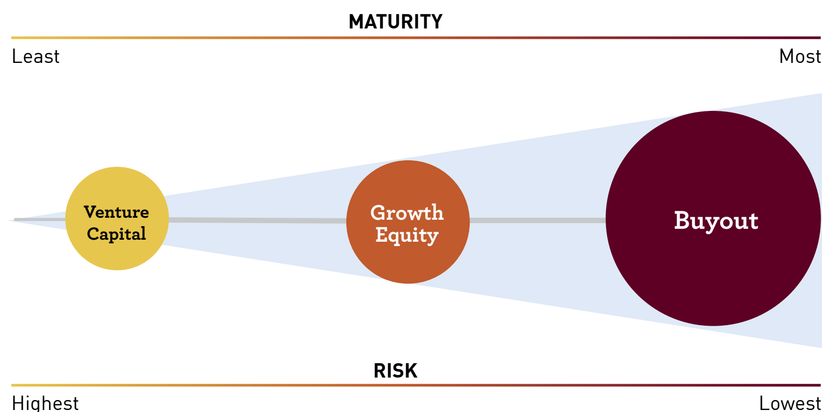
PRIVATE EQUITY

One of private equity's greatest appeals is the opportunity it provides to invest in early-stage companies and reap benefits as they go public or get acquired by other companies. Investors who got in with Google, Facebook, Tesla, or Airbnb in the early days received extraordinary returns when these companies went public via initial public offerings.

Private equity, however, represents a range of opportunities across various stages of development (see figure 2). On one end of the spectrum, we find venture capital: early-stage companies that still are developing their products or services. At the other end of the spectrum, we find buyout: cash-flow-positive companies that may benefit from reorganizing or selling certain assets. Growth equity represents companies that are growing and have a path to profitability but need additional capital to execute their plans.

Figure 2

PRIVATE EQUITY: A RANGE OF OPPORTUNITIES ACROSS STAGES OF DEVELOPMENT



Private equity has been able to deliver a significant illiquidity premium—the excess return received for locking up capital for an extended period—because private equity managers are given ample time to unlock value. This long-term mindset is an important part of the value of private equity. By comparison, investors often view mutual fund results over shorter intervals and are tempted to sell a fund that underperforms.

PRIVATE CREDIT

With global yields at low levels, investors increasingly are seeking alternative yield sources, and private credit has become an attractive source of return. Private credit historically has offered attractive risk-adjusted results. Direct lending has been the fastest growing segment of this market. Investing in the debt of private companies is another way investors can gain exposure to private companies, potentially with less risk involved than a private equity company. Like public company debt, private credit may offer investors an attractive income stream.

Typically, private credit has low correlation to other, more traditional fixed income, because the debt is not traded and subject to the volatility of the public markets. The debt is often floating rate, so investor income rises with overall interest rates—an attractive feature in a rising-rate environment.

REAL ASSETS

Real assets are tangible, physical assets with value derived from their physical use. This is a distinct feature that differentiates real assets from financial assets, such as stocks and bonds, which derive benefit from ownership claims to underlying assets with prices that reflect the forces of supply and demand. By contrast, real assets often are key inputs for economic activities with intrinsic value in and of themselves. Buildings, bridges, and farmland have utility even if they are not being traded. In fact, a large portion of a nation's wealth and economic capacity is tied to its stock of real assets.

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Real estate historically has been a source of income, often generating yields well in excess of traditional fixed income options. Advisors typically are familiar with publicly traded real estate investment trusts (REITs) and their ability to provide growth and income. However, there are big differences between private and public real estate, with private real estate representing a vast and diverse opportunity set.

Infrastructure has several distinct features that make it a differentiated asset class. Infrastructure projects generally are large fixed, long-term assets providing essential services to a society or business sector. Consequently, they are less sensitive to the business cycle than public equities and fixed income. Infrastructure assets generate cash flows that often are linked directly or indirectly to inflation, providing a potential hedge. Infrastructure can provide incremental returns given the need to build and modernize our airports, bridges, highways, and broadband.

Natural resources include energy, agriculture, timber, and minerals and mining. Natural resources provide the opportunity for higher returns, serve as a hedge for rising inflation, and provide valuable diversification benefits. They benefit from limitations in their availability, and their valuations fluctuate based on supply and demand.

HEDGE FUNDS

Hedge funds can be broadly divided into equity-hedge, event-driven, relative value, macro, and multi-strategy (see figure 3). Each of these strategies can be divided into sub-strategies including market-neutral, activist, global macro, managed futures, and merger arbitrage, among others. Although hedge funds are grouped together, they employ different approaches and serve different roles in portfolios.

Equity-hedge and event-driven provide equity-beta with reduced volatility.

Relative value is designed to take advantage of mispricings in the market, deliver steady returns, and mute volatility. Macro strategies are defensive and historically earn their stripes during market dislocations, and multi-strategy allocates across the strategies in an opportunistic fashion.

ADVISORS NEED A NEW TOOLBOX

For many years, advisors embraced the 60/40 portfolio as the market proxy. The 60/40 portfolio was modeled after institutional allocations and was easy to explain to investors. The expectations were that the 60 percent allocated to equities would deliver the growth in the portfolio and the 40-percent allocation to fixed income would provide income and stability. Because stocks and bonds exhibited low correlation to one another, investors received some degree of diversification.

Unfortunately, the 60/40 portfolio was down dramatically in 2022, with the largest declines seen in decades (>16 percent), and both stocks and bonds down by double-digits. When interest rates started to climb, stocks

Figure 3

HEDGE FUND SPECTRUM

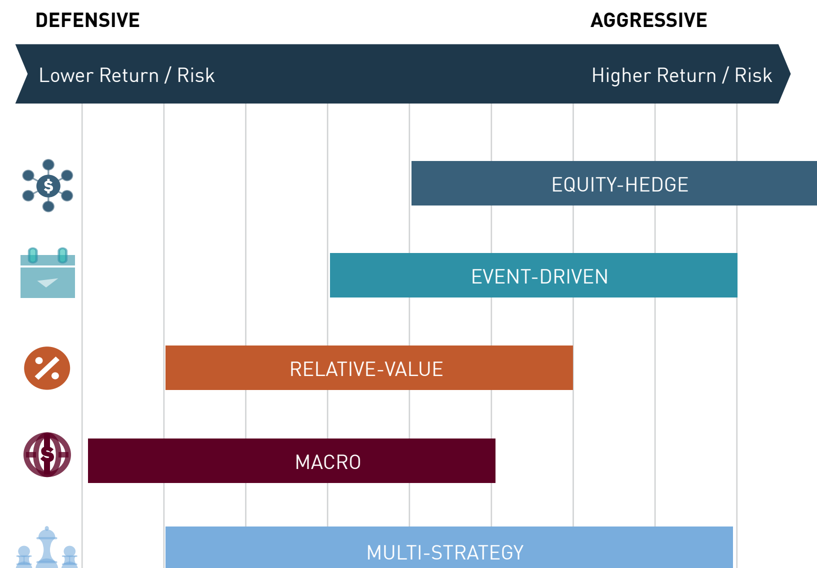

Table 1

ANNUALIZED CAPITAL MARKET EXPECTATIONS

Asset Class	Expected Return	Standard Deviation
U.S. Equity	7.9%	16.0%
EAFE	8.9%	16.5%
Emerging Markets	9.3%	19.8%
Global REITs	8.0%	19.2%
Global Infrastructure	7.2%	16.2%
U.S. Government Bond	3.9%	4.6%
U.S. Investment Grade	5.6%	6.4%
U.S. High Yield	6.6%	9.1%
Commodities	5.3%	16.2%

Source: 2023 Capital Market Expectations, Franklin Templeton Investment Solutions, September 30, 2022
Similar capital market expectations are being reported by other firms

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INVESTOR ELIGIBILITY

Qualified purchaser (QP). Investors who have $5 million or more in investable assets not including a primary residence. Only 1.5 million people in the United States qualify as QP investors.

Accredited investor (AI). Investors who have an annual income of at least $200,000 (or $300,000 in combination with a spouse) in each of the past two years, with a reasonable expectation of reaching the same income level in the current year. Alternatively, this status can be achieved with a household net worth of $1 million or more, excluding the value of a primary residence.

dropped—which was expected; however, bonds also declined significantly, which was not expected. Instead of one allocation offsetting the other, both dropped for the first time in decades.[2]

Given the current market environment, capital market expectations (CMEs) are projecting lower returns during the next 10 years (see table 1). U.S. equity returns were robust during the bull market (2009–2020), but the S&P 500 returns are projected to be below their long-run average in the next 10 years (7 percent versus 10.3 percent).

As noted in table 1, traditional equity returns are expected to be below their historical averages, and private equity remains an appealing option based on its historical illiquidity premium. Coupled with the challenge that advisors have found in sourcing income for their clients, bouts of volatility, elevated correlations across most traditional asset classes, and inflation at levels not seen in decades, advisors will need to expand their toolbox beyond the naïve 60/40 portfolio (Davidow 2022).

Fortunately, advisors now have an expanded toolbox at their disposal, with a broader set of alternative solutions available to more clients at lower minimums. These investments are uniquely suited for this challenging environment. Product innovation, and a willingness of institutional managers to develop products geared to HNW investors, has helped democratize alternative investments.

Private equity. Private equity historically has delivered an illiquidity premium of 300–500 basis points compared to its public market equivalent (S&P 500) over time. The illiquidity premium is the excess return for locking up capital for an extended period of time (7–12 years).

Private credit. Private credit historically also has delivered an illiquidity premium versus its public market equivalent, and it has delivered higher income than traditional fixed income options.

Real assets. Real assets represent a diverse set of strategies (real estate, infrastructure, and natural resources) that can provide enhanced return, increased income, diversification, and inflation hedging.

Hedge funds. Hedge funds are diverse strategies that can exploit market mispricing, take advantage of being long attractive companies and sectors, and short those that are overvalued.

These once-elusive investments are now being made available to a broader group of investors, at lower minimums and with more flexible options. We will cover product innovation, and the structural trade-offs, below.

DEMOCRATIZING ALTERNATIVE INVESTMENTS

An exciting development during the past couple of decades has been the democratization of alternative investments, bringing these once exclusive investments to a growing group of investors. It has been fueled by a flurry of new products geared toward HNW investors and a willingness of alternative managers to enter the wealth management market.

The first generation of alternative investment funds provided institutions and family offices access to these unique opportunities via a limited partnership structure, which had been available only to HNW investors, at very high minimums ($1 million–$5 million). They are sometimes referred to as QP funds based on their investor eligibility.

Traditional alternative investment structures provided limited liquidity to investors, to allow fund managers to execute strategy without having to meet frequent redemption requests. Large institutions and family offices, with both the willingness and ability to tie up capital for extended periods of time, made big allocations to the private markets and often were handsomely rewarded for doing so.

However, these funds were not designed for HNW investors who often require lower minimums and more flexible liquidity. Also, many HNW investors don't meet the investor eligibility criteria (see sidebar). As HNW investor demand for alternative investments has grown, managers have begun to design structures that better align with the needs of investors.

After the 2000 tech-wreck, investors wanted access to strategies designed to limit downside volatility, at lower minimums, with lower fees and greater transparency. The market's response was liquid alternatives, mutual fund versions of hedge fund strategies. Liquid alternatives have delivered mixed results. Although they provide long-short exposure in a more liquid and transparent structure, these strategies are limited in their use of leverage and must meet diversification requirements.

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Table 2

STRUCTURAL CONSIDERATIONS

		REGISTERED FUNDS		
	Mutual Funds, Liquid Alternatives	Interval Funds	Tender-Offer Funds	Traditional Private Market Funds
Eligibility	All	Broad, though varies by fund and distributor	Broad, though varies by fund and distributor	Qualified Purchasers
Investments	Public	Public and Private Investments	Public and Private Investments	Private Investments
Continuous Offering	Yes	Yes	Yes	No
Daily Valuations	Yes	Yes	Yes	No
Minimum Investment	$1,000–$5,000	$2,500–$25,000	$2,500–$25,000	$1M–$10M
1099 Tax Treatment	Yes	Yes	Yes	K-1
Capital Calls	No	No	No	Yes
Cash Drag	Yes	Yes, but to a lesser extent	Yes, but to a lesser extent	No
Liquidity Provisions	Daily	Quarterly	Quarterly, at board discretion	10+ Year Lockup

Tender-offer and non-traded REITs typically offer quarterly liquidity at board discretion, while interval fund quarterly liquidity provisions are mandatory.

Source: Interval Fund Tracker 2021. Investment Company Institute, Interval Funds: Operational Challenges and the Industry's Way Forward, p.7 (accessed January 17, 2022)

Registered funds serve as a hybrid solution providing many of the protections of registering with the Securities and Exchange Commission (SEC), as well as the ability to invest in illiquid investments such as private markets at lower minimums and with greater flexibility. Registered funds include interval funds and tender-offer funds among other vehicles. They are structured as continuously offered closed-end funds and registered with the SEC under the Investment Company Act of 1940. Registered funds typically are available to accredited investors, with some available to sub-accredited investors.

BDCs and NTRs are other vehicles available to access private markets. BDCs, which can be public or private, can be used to access private credit; and NTRs, which are different than publicly traded REITs, can be used to access private real estate.

After the Global Financial Crisis, interval and tender-offer funds became the preferred vehicle for HNW investors to access private markets. However, their growth has not been at the expense of the traditional private market structure, which continues to thrive today because of the increased allocation by institutions and family offices. There are structural trade-offs that advisors need to weigh before allocating (see table 2). Although registered funds offer more liquidity, they may experience cash drag to meet the liquidity requirements.

DUE DILIGENCE AND FUND EVALUATION

As with any investment, an advisor must understand and evaluate the many dimensions of a fund before making any recommendation. Because of the specialized nature of conducting due diligence on alternative investments, advisors may rely on due diligence conducted by their firms or a third-party provider.

Advisors need to consider several key factors, often referred to as the four Ps, but there are nuances with alternative investments:

Performance. Has the fund manager generated attractive returns across different economic cycles? Does it have experience managing alternative funds? What are the comparable absolute and relative returns? How much risk has the manager taken to generate its results?

Philosophy. Does the fund manager have a specific philosophy that it has used over time? Does it make economic sense given the current market environment?

Process. How are investment ideas generated, vetted, and executed? Who makes decisions? What resources are devoted to research and are they sufficient? Is the process consistently applied? What is the compensation philosophy?

People. Does the fund have a dedicated and experienced team of professionals? What are their professional qualifications? Have they worked together in managing comparable funds? Has there been a senior management turnover? What is the depth and consistency of the investment team?

Beyond the investment considerations, advisors also should evaluate several structural issues:

- What type of fund is being considered (limited partnership, registered fund, or liquid alternative)?
- What is the investor eligibility for each fund (QP, AI, or non-accredited)?
- What is the minimum investment?
- What are the liquidity features?
- Does the fund exhibit cash drag?
- Does the fund have capital calls?
- What is the tax reporting (K-1 versus 1099)?
- What is the total fee (investment management, performance fee, acquired fund fee, etc.)?

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In addition to investment due diligence, advisors also should conduct operational due diligence (ODD) focusing on internal controls, finance and accounting, information technology and cybersecurity, and the use of independent auditors and pricing services. ODD can help in identifying lax internal controls or inadequate checks and balances.

As with any traditional due diligence effort, advisors also should conduct ongoing due diligence to ensure that the fund is managing capital consistent with its stated approach. Advisors should leverage due diligence conducted by headquarters, institutional consultants, and third-party providers.

ASSET ALLOCATION PROCESS

Let's revisit the asset allocation process used for allocating capital and consider the appropriateness of including alternative investments (see figure 4).

Establish goals and objectives. What is the investor trying to accomplish with its capital? There may be multiple goals to be solved for, across multiple account types (personal, retirement, trusts, etc.).

Determine the risk profile. What is the investor's risk appetite? There may be a need for education about alternative investments. Unfamiliar investments often feel riskier than they may be.

Determine the time horizon. What is the timeframe to achieve the specific goal? Time horizon in particular is an important consideration due to the long-term nature of many alternatives. An investor, or an account, with a short-term need for liquidity may not be a good candidate for private markets.

Determine eligibility. What is the investor's eligibility for a particular fund? It is important to determine in advance which funds an investor, or account type, can invest in based on the accreditation threshold and the minimum investment amount.

Determine the target allocation. What is the targeted amount of capital to allocate to alternatives broadly and the amount per fund? Traditional private market funds have capital calls, which would require funding over time.

PORTFOLIO CONSTRUCTION

Portfolio construction is assembling the portfolio to achieve a specific outcome. We like to focus on the role that various investments play so we can evaluate their effectiveness (see figure 5). We consider adding private equity for growth, private credit for income, macro for defense, and real estate for inflation hedging.

By defining role(s) for each investment, we can then determine if they are fulfilling their roles in the portfolio and move client expectations away from evaluating each investment relative to the S&P 500 or some other arbitrary benchmark.

This framework also makes it easier to think about where to source the allocation. Private equity should come from the growth bucket, private credit from income, macro from defensive, and

Figure 4
ASSET ALLOCATION PROCESS

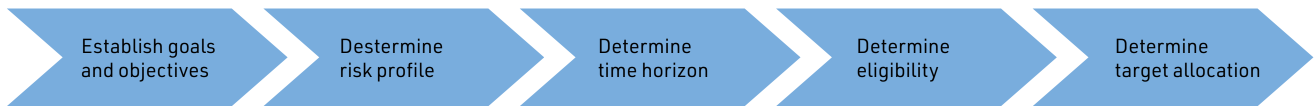
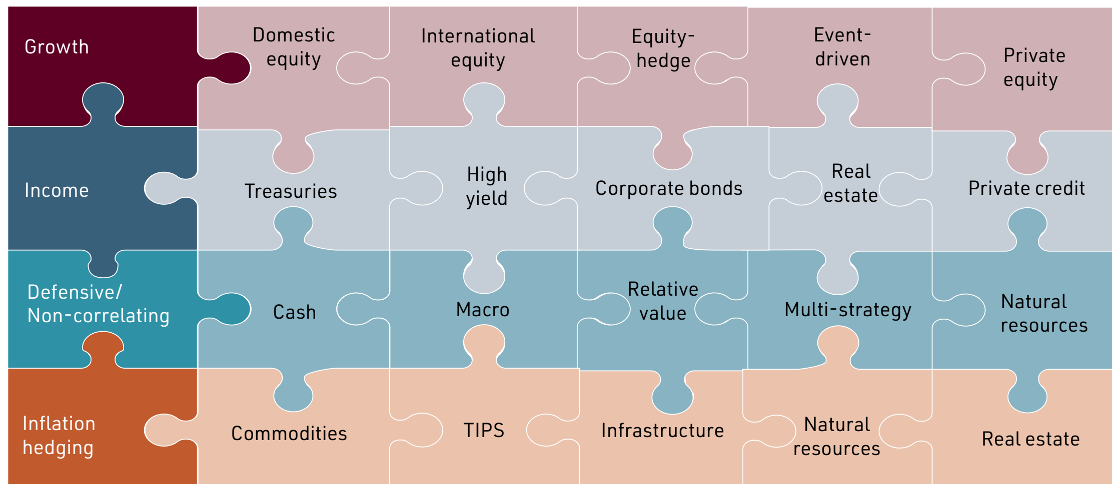


Figure 5
THE ROLE ASSET CLASSES PLAY IN A PORTFOLIO



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natural resources from inflation hedging. Certain investments such as real estate fulfill multiple roles within a portfolio.

One of the challenges with aligning asset allocation and portfolio construction is making sure that the manager or fund stays true to its stated discipline. We do not want our value manager buying growth stocks, and we generally want our alternative managers staying in their lane. We want managers to adhere to their disciplines so we can evaluate the overall risk and return profile of the portfolio. We want to avoid taking on unintended bets due to style drift.

Of course, certain hedge fund managers' skill and edge come from the freedom afforded them in seeking opportunities and exploiting market mispricings over time. So, some degree of freedom may be acceptable.

CONCLUSION

The current market environment presents several challenges for advisors and investors that require a different set of tools. Fortunately, through product innovation and a willingness of institutional-quality managers to launch products geared toward the wealth management community, advisors now have more and better tools at their disposal.

Because these strategies are relatively new to the wealth management community, and because they are more complex than traditional options, advisors will need to educate themselves regarding the benefits and features of these versatile tools. As noted, there are structural trade-offs with liquid alternatives and registered funds. Once educated, advisors will then need to take the lead in educating investors regarding the role and use of alternative investments.

Wealth advisors should evaluate these new investments, considering the structural trade-offs, to help investors achieve their long-term goals and objectives. Whereas asset allocation models are becoming commoditized, alternative investments require specialized due diligence and fund evaluation to determine how to use these tools appropriately. Alternative investments provide an opportunity for advisors to enhance their value proposition and avoid the commoditization trap.

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ENDNOTES

1. See S. Adams, "Yale Endowment Chief David Swensen Leaves Legacy of Top College Investment Leaders," *Forbes* (May 6, 2021), https://www.forbes.com/sites/susanadams/2021/05/06/yale-endowment-chief-david-swensen-leaves-legacy-of-top-college-investment-leaders.
2. See B. McMillan. "Does The 60/40 Portfolio Still Make Sense?" *Forbes* (July 15, 2022), https://www.forbes.com/sites/bradmcmillan/2022/07/15/does-the-6040-portfolio-still-make-sense.

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