The Next Decade of Alternative Investments

By Keith Black, PhD, CAIA®, CFA®, FDP, and Aaron Filbeck, CAIA®, CFA®, CIPM
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A global pandemic. The swiftest bear market in history. Unprecedented fiscal and monetary stimulus. Dizzying volatility. The fear of the unknown is the enemy of capital market stability. Still in its infancy, this new decade has ushered in a storyline we never would have expected or hoped for. How should investment professionals respond to these uninvited circumstances? For the past decade, an investor has benefitted from simply owning public equities and the benefits of diversification have largely been absent. However, after a violent equity drawdown to start 2020, has the promise of diversification struck back?

Alternative investments have never been more polarizing—loved by some, hated by others; and private capital and hedge funds remain a deeply misunderstood set of asset classes and strategies. Despite the divisiveness, alternatives are here to stay and likely will continue to collect assets, albeit at a slower pace than in the previous decade.

A 2020 report by Chartered Alternative Investment Analyst Association (CAIA Association), “The Next Decade of Alternative Investments,” looks at this investment class, its growth potential, and objectives for the future.1

First, to establish context, the report describes the rise, current state, and outlook of alternative investments. From 2003 to 2018, investments in alternatives grew from 6 percent to 12 percent of the global investment market, and CAIA Association expects this growth to continue to as much as 18 percent to 24 percent of global assets by 2025. This expectation is supported by a combination of factors, notably low interest rates, pension funding ratios, the maturation of emerging markets, and a structural shift in capital formation.

Second, against this top-down backdrop, the report examines the growth drivers of underlying industries and asset classes. These assessments and predictions are based on the results of a comprehensive survey of more than 1,000 of CAIA Association’s 11,000+ members, conducted in late 2019, as we prepared the fourth edition of the CAIA Charter Program curriculum. Survey respondents reported that institutional-quality alternative investments such as private equity, private debt, hedge funds, and real assets are likely to experience different levels of investor demand and may encounter different investment-related or structural risks.2

Third, the report concludes with a four-point call to action, which details CAIA Association’s commitment to education, embracing transparency, advocating for diversification, and working to democratize access to alternatives and protect alternatives investors.

ALTERNATIVES IN THE MARKETPLACE

Capital formation has shifted away from public markets in recent years as issuers pursue better alignment with ownership, less onerous and less expensive regulatory requirements, and liberation from the short-term machinations that undergird the stock and bond markets.

Further, the heavily alternative-reliant endowment model, pioneered by the Yale endowment and used by most Canadian public funds, turned 50 years old in 2019. Institutional allocations to alternative investments now approach 30 percent, driven in part by the growing pressure on pension plan sponsors and other fiduciaries to meet outsized plan return assumptions and shrink fast-growing funding gaps.

With such a large portion of the global economy now off limits to retail investors, regulatory bodies are beginning to debate whether to democratize access to this suite of more opaque and complex instruments, making them available to a wider set of investors. The outcome of this debate has the potential to radically alter the alternative investment landscape and investing as we know it.

CAIA Association seeks to provide a balanced, authoritative voice amid this shift in investing. We represent savers, beneficiaries, and the general public, and we are intent on ensuring that financial markets serve the greater good by allocating capital efficiently to the most socially and economically beneficial activities. In our view, fiduciaries should neither blindly endorse nor demonize alternatives.

FUTURE OF INSTITUTIONAL ALTERNATIVES

The growth drivers of underlying industries and asset classes for alternatives are discussed below.

Private equity and venture capital. The relationship between public and private markets is changing. More
private companies offer more investment opportunities, but investors should be aware of dry powder levels in private equity funds (see figure 1).

**Private debt.** Lower interest rates and stricter banking regulations have increased demand for private debt investments. However, more than 80 percent of loans are now covenant-lite, which could suggest significant downside risk and performance dispersion in a market downturn (see figure 2).

**Hedge funds and liquid alternatives.** Many hedge fund strategies have been democratized through liquid alternatives, mutual funds, and UCITS, lowering expenses and increasing access for retail investors. Appetites for hedge funds may accelerate if performance picks up in a sustained market downturn (see figure 3).

**Real assets.** Real assets continue to be an area of interest for investors and already have started to become a larger portion of institutional portfolios. Environmental risks, however, are likely to impact physical assets such as real estate, commodities, and natural resources (see figure 4).

**CALL TO ACTION**
Both public and private pensions are facing massive funding shortfalls, a trajectory that lends itself to potential economic risk and social unrest. Millions of individuals who decades ago would have participated in some type of defined benefit plan have gone from being institutionally dependent to being on their own, without the toolset that would equip them to navigate the investment marketplace.

Alternative investments have established staying power based on their uncorrelated cash flows, risk profiles, and return streams; and they are poised to play a more prominent role in retirement planning as we enter the new decade. As such, they have emerged as at least a partial solution to a significant problem,
i.e., ensuring the financial well-being of future generations of workers.

At the same time, the growing capital commitment to alternative investments comes with its own concerns. Issues of transparency, reporting, education, and the alignment of stakeholder interests need serious reconsideration to incentivize appropriate behavior and to protect investors. Further, plan sponsors and individuals cannot count on alternatives alone to address the funding gap.

The alternative investment industry is obligated to help find solutions to these challenges. Recognizing the seriousness of these circumstances, CAIA Association is leading with a call to action to address these challenges through dialogue and prudent reform based on the following four-point agenda.

COMMIT TO EDUCATION
Try as you might, you will not find an investment professional who is against education; in fact, the word used most often to describe education is “key.” But as the world becomes more complex and as digitization and emerging technologies reshape the ways that capital is invested, industry leaders, regulators, and associations must unite around increasing the sophistication and acumen of the practitioners who are advising clients and allocating capital.

Education can no longer just be key; it must be required. We believe both industry (general partners and limited partners) and regulatory bodies should require higher levels of training about the entire investable universe.

CAIA Association will continue to offer the CAIA credential with a fresh pledge to ensure that the designation remains on the leading edge of alternative investment practice. Our educational experience is designed to prepare an advisor to utilize the full spectrum of asset classes through a deep understanding of interactions and long-term outcomes. We are also committed to dialogue and collaboration among our global membership base, constructive relationships with prominent investment managers in alternative asset classes, and regular roundtables with the largest, most influential asset owners. And, we are marshalling resources to include strategic thought and leadership initiatives.

EMBRACE TRANSPARENCY
Professions begin and end with commitments to ethics and standards, because their work must stand up to scrutiny under the brightest of lights. The alternative investment industry must shed its “wild west” mentality and reputation and embrace a fair, transparent, and virtuous fiduciary culture that allows investors and beneficiaries to meet their long-term goals.

CAIA Association is committed to creating dialogue and building teams that will contribute to the following:

- Improved alignment of interests between general partners (GPs) and limited partners (LPs) to mitigate agency cost; and promotions of better disclosure on cost, standard of care, risks, and ownership structure
- Proportionately appropriate protection of all stakeholders, including employees, to avoid irresponsible or self-serving financing schemes
- Reasonable, consistent, and defensible management and performance fee levels
- Uniform performance presentation standards that address inherent flaws in existing yardsticks such as internal rate of return
- Development of environmental, social, and governance standards in private capital
- Robust financial literacy

ADVOCATE FOR DIVERSIFICATION
Up until the peak in mid-February 2020, public equities had outperformed nearly every asset class since the Global Financial Crisis of 2008–2009; and a precipitous, steady decline in interest rates has led to strong fixed income performance as well. Along with unprecedented global central bank support, these phenomena had rendered anything other than a traditional 60/40 portfolio unnecessary.

Professionals who have entered the industry in the past 10 years are experiencing their first significant correction and may undervalue the importance of a diversified portfolio among weak public markets and stagnant growth. In fact,
this past decade was the first since 1850 without a recession in the United States, only one of two in recorded history without a bear market, and included only one down year—2018—in the U.S. public equity markets.

A careful study of financial history and investment performance, not to mention the swiftest bear market in history, will showcase that the past decade is far from representative; the easy money is behind us, and allocators now need to work harder to meet investor expectations. We believe the merits of diversification are coming back to life in this new environment, and the careful addition and use of alternative investments can mitigate downside risk and enhance upside return potential over the long term.

But alternatives should not be viewed as a panacea or desperation move to improve alpha or close unfunded pension gaps. Too often, the narrative around alternative investments over the past decade has focused on the stars that burn brightly for a year or two before burning out or the disappointment many investors may feel as various categories trail traditional equities. This simplistic approach typically includes performance comparisons to public indexes and endless debates about the extinction of the illiquidity premium versus publicly traded securities.

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**DEocratize but protect**

Changes in capital formation have resulted in large portions of the economy, particularly growth industries, utilizing private markets for longer periods of time. Further, the ability to avoid onerous and costly regulation as well as disruptive activist behavior, and to align themselves more with long-term value creation versus short-term valuation pops, is causing many companies to consider remaining private indefinitely. Regulatory entities around the world are beginning to revisit their dated definitions of eligible or accredited investors, which determine whether an individual can access private capital investments. The conditions often utilize income or net assets as a proxy for sophistication, which excludes many from participating, particularly with the widespread shift from defined benefit to defined contribution retirement plans.

This global debate has begun in earnest in the United States. The Securities and Exchange Commission has submitted a draft revised rule for public comment. At CAIA Association, we see a number of benefits to expanded investor access to the private markets—but only with appropriate conditions and protections. Although higher levels of wealth are likely correlated with more disposable income, they don’t approximate investment sophistication.

We support a mosaic of eligibility conditions that could include the use of a fiduciary professional who is properly trained (e.g. CAIA®, CFA®, CFP®, CIMA®, CPWA®), bound by an ethical code of conduct and the successful completion of a financial literacy test focused on alternative investments. We also support the development and use of simply packaged, easy-to-understand, retail liquid alternative vehicles with standard disclosures. CAIA Association will be publicly vocal in advocating for the right balance of democratization and protection for those who would invest in alternatives.

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ENDNOTES
1. To access the full report, visit https://caia.org/next-decade.
2. To illustrate these dynamics, the report includes two case studies, the first on the shared workspace provider WeWork and the second on the intersection of environmental, social, and governance investing and private capital.
3. A covenant-lite loan has fewer restrictions on the borrower and fewer protections for the lender compared with a traditional loan. Covenant-lite loans tend to be more flexible with regard to the borrower’s collateral and income level payment terms (Investopedia.com).
4. The Undertakings for the Collective Investment in Transferable Securities (UCITS) is a regulatory framework of the European Commission that creates a harmonized regime throughout Europe for the management and sale of mutual funds. UCITS funds can be registered in Europe and sold to investors worldwide using unified regulatory and investor protection requirements. UCITS fund providers who meet the standards are exempt from national regulation in individual European countries.