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Embracing Complexity and Illiquidity: The Power of Alternatives in Today's Environment

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Embracing Complexity and Illiquidity

THE POWER OF ALTERNATIVES IN TODAY'S ENVIRONMENT

By Steve Dean, CFA®, and Lance Lehman, CFP®, CIMA®, CPWA®

Despite the increase in access for retail investors to alternative investment products in recent years, many advisors continue to avoid them—often at the expense of improving the risk characteristics and performance of clients' portfolios.

In recent issues of the *Investments & Wealth Monitor*, several articles (Abernathy 2023; Beck et al. 2023; Davidow 2023; Filbeck 2023) expertly examined the characteristics of alternatives, illustrating the historical benefits afforded to investors by including alternatives as part of a well-diversified portfolio.

Investors can't buy past returns or participate in past characteristics, but the historical perspective provides an instructive backdrop for considering the pros and cons of alternatives relative to other investment vehicles, including public stocks and bonds.

Although asset class timing is usually a fool's errand, we recognize the importance of the entry point of any investment, especially for advisors who may be considering alternatives for the first time. This article seeks to strengthen the foundation for the ongoing and selective support of alternative investments from the historical and theoretical perspective while also examining alternatives within today's market environment of stubbornly high inflation, "higher for longer" interest rates, and slowing economic activity.[1]

KEY TAKEAWAYS

Embrace complexity. There often are rewards for managers who can understand the return and risk potential of the investments when information is limited or unstructured.

Alternative investments are not homogeneous. Thoughtful categorization allows for clearer assessment and communication of opportunities and risks.

Private real assets can help in inflationary periods. Private real estate and infrastructure historically have exhibited strong performance in periods of rising prices.

Private credit fills a void. Corporate borrowers have turned to private loans as tighter regulations and challenges at regional banks have reduced traditional bank lending.

Downside protection. Private equity historically has fared better than public stocks in periods of economic and market weakness.

Reining in behavioral biases. Low correlation with public markets can smooth the ride in down markets such as 2022 and, combined with the forced constraints from limited liquidity, can help investors avoid poor investment timing decisions.

Education is key. A thoughtful presentation of the benefits of alternatives in the context of limited liquidity can help offset an aversion to illiquidity.

CHALLENGES AND BENEFITS OF COMPLEXITY

First, a cautionary tale: Investors have limited abilities to unpack a given topic, especially one relatively foreign and new. Indeed, one of the sources of the potential for superior performance and risk mitigation from alternatives is the complexity of the underlying investments. There often are rewards for managers who can understand the return and risk potential of the investments when information is limited or unstructured. Advisors stand to do themselves and their clients an excellent service by breaking down this complexity, approaching each category of alternatives independently with clear definitions and characteristics when discussing them with clients. Simply put, alternatives are not a monolithic group but are best considered separately. Viewing alternatives as a homogeneous group ignores each subcategory's different drivers, characteristics, risks, and benefits.

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To that end, alternative investments data and analytics provider Burgiss[2] provides a valuable framework for categorizing the broad, most established alternative asset classes of private equity, private debt, and private real assets, as shown in table 1.

Private equity consists of investments in the equity or ownership of private, non-publicly held companies. After extensive due diligence, private equity firms typically specialize in investing in companies that they believe have significant growth potential. Public companies also can be acquired and taken private by these investment firms. Historically, private equity has provided net returns that exceed public equity markets.[3]

Private debt, or private credit, comprises portfolios of private loans to businesses or individuals that seek non-bank financing due to their higher risk and specialized areas of expertise. Relative to traditional lending, private debt benefits from above-average yields. Private debt often finances buyouts, expansion capital, or acquisitions. More than 80 percent of private loans (by value) use a floating rate, benchmarked to a reference index; the London Interbank Office Rate was the most common in 2020 and 2021. As a function of this floating rate characteristic, private debt returns are an excellent inflation hedge and less impacted by duration, i.e., interest rate sensitivity, than their public counterparts.[4]

Private real assets typically include private real estate investments in office properties, industrial, residential (single and multi-family), health care, retail, storage, hotels, infrastructure, land, and natural resources. Private real estate investment trusts (REITs) provide a potential tax advantage for investors because REIT earnings are taxed only once.

Hedge funds often are considered to be alternative investments. Hedge funds generally fall into one of five main strategy categories: equity-hedge,

Table 1

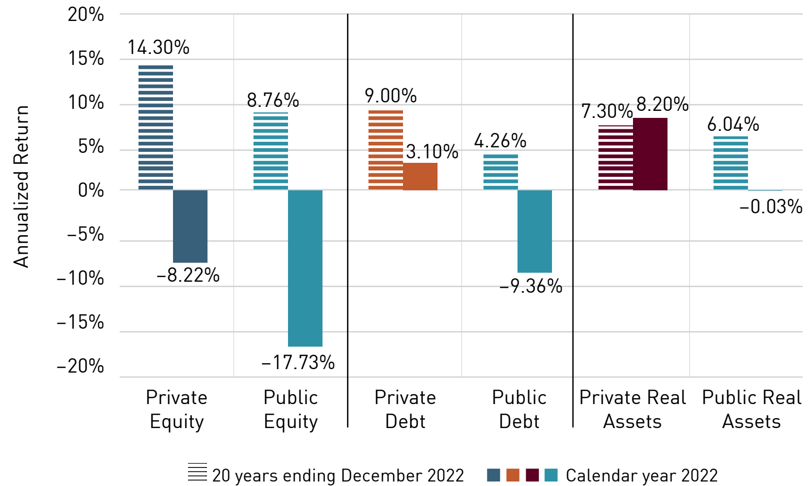
PRIVATE EQUITY, PRIVATE DEBT, AND PRIVATE REAL ASSETS CATEGORIES

Private Equity	Private Debt	Private Real Assets
Venture Capital	Senior	Real Estate
Expansion Capital	Mezzanine	Natural Resources
Buyout	Distressed	Infrastructure

Source: Burgiss

Figure 1

ALTERNATIVE VS. PUBLIC-MARKET INVESTMENTS



Sources: Burgiss (Private Equity, Private Debt, Private Real Assets), MSCI (Public Equity – MSCI World Index), Bloomberg Barclays (Public Debt – Barclays Global Aggregate), State Street (Public Real Assets – Real Assets Custom Blended Index). Past performance is no guarantee of future results.

event-driven, macro, multi-strategy, and relative value—each with different capabilities and objectives of risk reduction and return enhancement. They employ various actively managed strategies seeking to provide positive absolute returns in all market environments. Because they often derive their strategies from stocks and bonds, hedge funds tend to be more positively correlated to the public markets than private equity, private debt, or private real assets. Although not as broad a spread as alternative investments, the dispersion of returns across hedge fund strategies is significant, making hedge fund manager selection a determining factor.

In recent years, lesser-known but growing categories of private-market alternatives include collectibles, digital assets, fine art, wine, and reinsurance. Like private equity, private debt, and private real assets, these lesser-known assets have shown low or negative correlations with traditional assets, including stocks and bonds, but over relatively limited time periods. With more historical data illustrating their correlations through various market conditions, such assets may prove to be potential candidates for portfolio diversification.

HISTORICAL RESULTS AND TODAY'S ENVIRONMENT

With this established categorization framework, investors can examine the subcategories' strengths and weaknesses against the current and projected environment.

Historical results for the primary alternative investment categories show the return advantage of alternative investments. Although the longer-term results are compelling, an equally important attribute is the relative performance advantage of alternatives over public

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markets in poor-performing years such as 2022 (see figure 1). This downside protection afforded by alternatives can be extremely helpful in keeping investors relatively calm and resolute during challenging market environments and thus more likely to stay the course of their investment strategy.

One concern of many advisors and clients is that the current market environment, with higher interest rates, inflation, and a slowing economy, could present challenges for some alternative investments.

Although the current cycle of interest rate increases may have peaked, the higher level of rates may need to persist for longer than the Federal Reserve appreciates, given the massive increase in the money supply from pre-pandemic levels to today and the Fed's late reaction to the resulting inflationary pressures. As Friedman (1970) shared:

> *Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.*

Although the money supply has started to contract and inflation has eased recently, price increases remain well above the Fed's 2-percent long-term target.[5] Those higher rates are designed to slow economic activity, with the risk that the slowing becomes a recession. High interest rates, high inflation, and slow growth present a challenging backdrop for most risk assets, and alternative investment behavior in prior periods of market stress can be instructive.

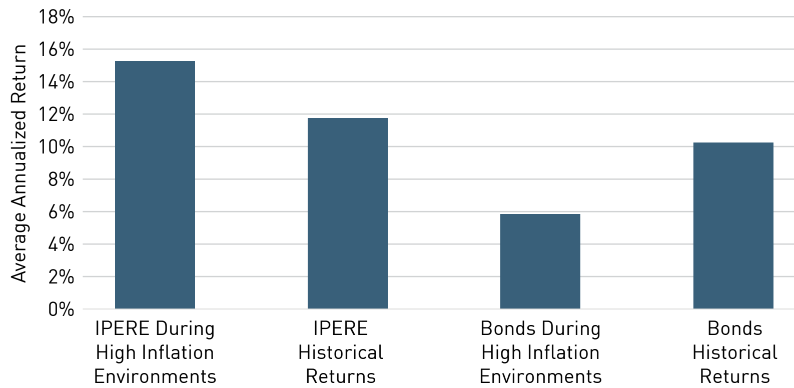
Historically, real estate has provided a hedge against high inflation. Private real estate in particular has held up well in inflationary environments. Figure 2 shows that the performance of institutional private real estate (IPERE) in high inflation periods has topped its long-term average and far outpaced public fixed income investments.

Still, the current period also is characterized by declining property values, especially in certain segments. The specific alternative real estate investment category likely will influence performance more than usual in the near term. In most markets globally, low inventory and ongoing strong demand for industrial properties and multi-family housing are expected to support those sectors. In contrast, office buildings and retail properties continue to face oversupplied conditions.[6]

Infrastructure investments are another category that, historically, has held up well in inflationary environments (see figure 3). Infrastructure needs in areas such as digital support networks, clean energy projects, roads, and airports are seen globally. The development projects for many of these areas often are funded through long-term contracts, helping to insulate them from economic cycles, and they have costs and prices linked to the consumer price index built into their plans, which can make them a hedge against the effects of inflation. Still, they rely on government contracting, which adds political risk elements, as do rising labor and materials costs.[7]

Figure 2

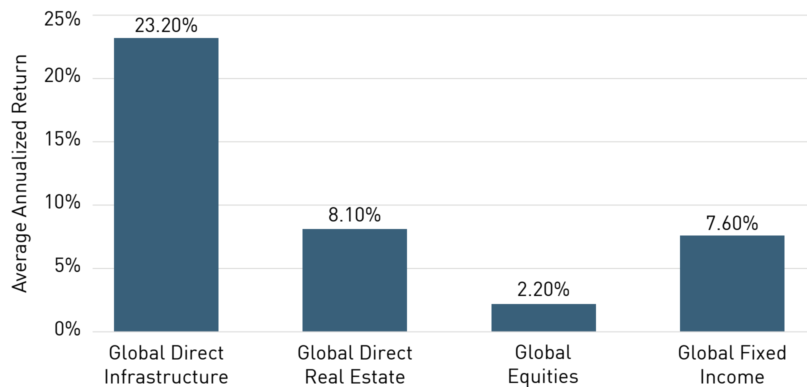
IPERE PERFORMANCE DURING HIGH INFLATION ENVIRONMENTS



Source: Bluerock, NCREIF, Bloomberg, U.S. Bureau of Labor Statistics. A high inflation environment is defined as quarters when the Consumer Price Index (CPI) increased 100 basis points or more; NCREIF Property Index (NPI) and Bloomberg Aggregate Bond Index tallied, averaged, and annualized for those quarters. Analysis since Bloomberg Aggregate Bond Index inception (January 1980) through December 2020. Past performance is no guarantee of future results.

Figure 3

RETURNS IN LOW GROWTH/ HIGH INFLATION ENVIRONMENTS



Source: BlackRock, Bloomberg, Barclays (Global Fixed Income), MSCI (Global Equities), GREFI (Global Direct Real Estate), EDHEC (Infrastructure: All equity); as of June 30, 2022 (data since 2000). You cannot invest directly in an unmanaged index. High growth periods are when U.S. GDP > 2.5 percent and high inflation periods are when U.S. CPI > 2.5 percent. Past performance is no guarantee of future results.

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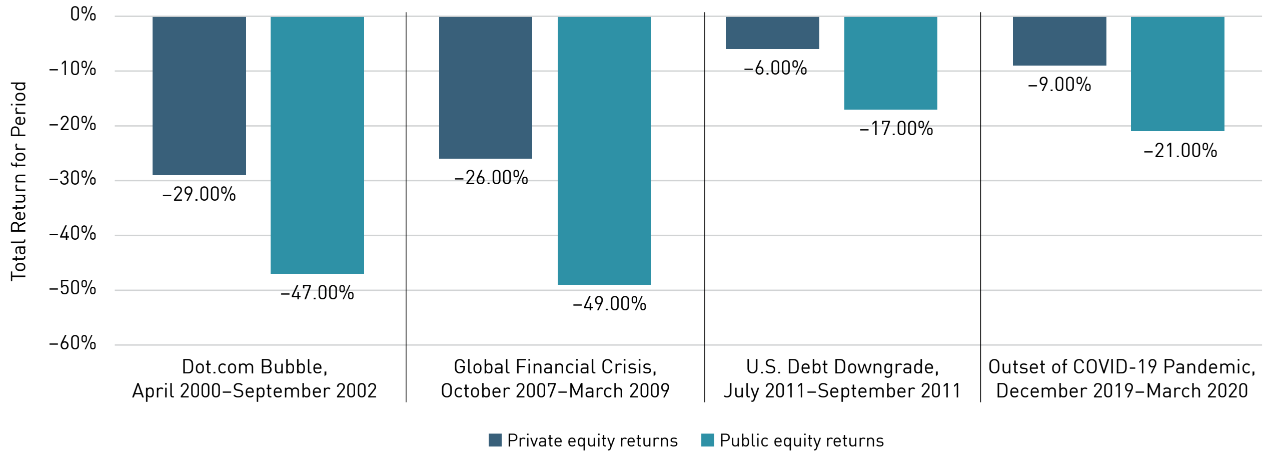
Figure 4

PRIVATE AND PUBLIC EQUITY RETURNS IN DIFFICULT MARKETS



Source: BlackRock, Private equity: Burgiss, and MSCI World total return index for public equities. Private equity data sourced from Burgiss covers vintages 1999–2019 as of December 31, 2021. Private equity strategies include: Buyout, VC (Late), VC (Generalist), and Expansion Capital. All dollar figures are USD. Index performance returns do not reflect any management fees, transaction costs, or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance is no guarantee of future results.

Recent challenges in the banking markets, notably smaller regional banks, i.e., Silicon Valley Bank and First Republic, have led to tighter lending from traditional bank sources. Private credit has grown to fill the void left by shrinking bank loans. Although this shift has been building for some time, the current environment may further increase the volume of profitable opportunities for private lenders. Offsetting that positive trend is the slowdown in economic growth that may cause increases in loan defaults, especially in specific industry sectors.

Private equity has seen a sharp slowdown in deal activity in the past year, and valuations have started to reset lower during the past several quarters. In 2022, the number of deals fell by 15 percent, and the value of those deals fell 26 percent from the extreme 2021 levels.[8] As shown in figure 1, private equity performance held up well in relative terms in 2022 and historically has fared better than public equity in market drawdowns (see figure 4). In challenging times, investors tend to favor the more prominent private equity managers with deep experience navigating dislocations in ways that allow them to find opportunities that set up a stronger performance for upcoming vintages of investments.[9]

BEHAVIORAL ADVANTAGE OF ILLIQUIDITY

The near-term environment contains both risks and opportunities for alternative investments. Advisors, however, also should review longer-term risk/reward characteristics and fundamental reasons for including them in a well-diversified portfolio when discussing these investments with their clients. One vitally important part of the discussion is proactively and thoroughly reviewing the illiquid nature of alternatives—whether that exposure is achieved through quarterly liquid interval funds or other less-liquid options. A best practice here is for advisors to explicitly define alternative investments' characteristics, specifically their illiquidity, within a client's investment policy statement (Filbeck 2023).

Illiquidity too often is cast as something to be avoided by many advisors and likely even more investors. However, cognitive and behavioral biases often influence advisors' and investors' understanding and acceptance of this crucial aspect of alternative investments. Illiquidity is not something to be feared or considered a disadvantage by investors. Instead, illiquidity often is the source of alternative investments' relative performance advantage compared to public markets (hence the term "illiquidity premium"). In fact, many investors' liquidity needs likely are far less than they perceive. Indeed, the insight by endowments and foundations that led to relatively high allocations to alternative investments (the endowment model) was that their time horizons should be considered infinite. In other words, endowments and foundations realized they didn't need as much liquidity as public investments afforded. The advisor's role is to educate investors on their true liquidity needs.

Illiquidity is not something to be feared or considered a disadvantage by investors. Instead, illiquidity often is the source of alternative investments' relative performance advantage compared to public markets.

Research has shown that investors often are poor stewards of their own money, not for lack of intellect but because investors are susceptible to behavioral

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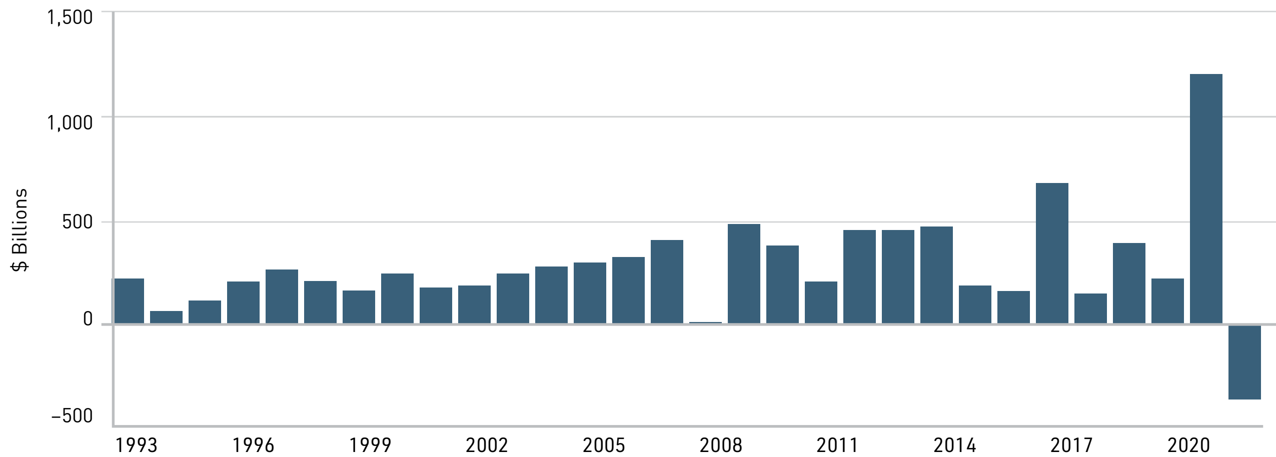
Figure 5

ANNUAL LONG-TERM U.S. FUND FLOWS



Source: Morningstar Direct Asset Flows, data as of December 31, 2022

errors.[10] The primary reason is that evolution molded the human brain into an exceptional risk avoidance calculator, and it arguably is the most successful mechanism for identifying and avoiding risk. Although it has been great for humanity's survival, it is ill-suited for long-term investing success.

So the illiquid nature of alternative investments can play a valuable role in helping advisors and investors overcome status quo bias and buttress against loss aversion (Kahneman and Tversky 1979).

Cognitive biases show themselves as either information-processing or emotional biases. Information-processing biases are statistical, quantitative errors of judgment that are relatively simple to reconcile with new data or correct information. However, emotional biases often are more challenging to address due to their foundation in conscious and unconscious attitudes and feelings rather than quantifiable facts and figures.[11]

Investors often succumb to their cognitive biases, resulting in suboptimal investment decisions, typically at the most inopportune time. For example, the fear of missing out (FOMO) can lead to buying stocks near or at the peak of a bull market or panic selling at or near the trough of a bear market. One needs to look no further than fund flows to see this self-sabotage appear. Per Morningstar, U.S. funds shed $370 billion in 2022 (see figure 5), suffering their first calendar year of outflows since Morningstar started tracking such data in 1993.[12]

Emotional biases often are more challenging to address due to their foundation in conscious and unconscious attitudes and feelings, not quantifiable facts and figures.

An investor suffering from status quo bias can be challenging for an advisor. An investor with status quo bias may favor holding onto an existing portfolio of public, liquid securities despite the utility that alternative investments can provide in decreasing risk, increasing return potential, or both. Alternative investments, properly presented, can help investors overcome this bias and allocate a modest portion of an overall investment portfolio to alternatives. The illiquid nature of alternatives, and their smoother return patterns, can help investors avoid the destructive buy-at-the-top or sell-at-the-bottom tendencies that stem from loss-aversion behavior.

For all these reasons, the illiquidity premium can be an advisor's and investor's friend.

Education is paramount for advisors and investors alike. The risk and return patterns highlighted here illustrate the potential benefits that an alternative allocation brings to the overall portfolio. Still, the aversion to illiquidity may be hard to overcome. For many, it distills to a framing bias in which the focus on the illiquidity of private investments obscures the fact that the more significant portion of a well-diversified portfolio consists of highly liquid public assets. Highlighting that the lion's share (75–90 percent) of a well-diversified portfolio allocation is in liquid public securities before pointing out that a much smaller portion (10–25 percent) is allotted to illiquid alternatives may help overcome an investor's reluctance to embrace an allocation to this important category of investments.

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CONCLUSION

The increasing accessibility of alternative investments opens a range of tools to improve the potential returns and risks in our clients' portfolios. Still, this is a new and challenging category for many advisors and clients, with unique features and terminology that can be intimidating. Mastering that complexity can start with effective categorization that helps avoid lumping the range of alternative investments into a single group. Each alternative category has its own risk, return, and liquidity characteristics that can be assessed historically and in the context of today's environment. Far from being a negative trait, the complexity and illiquidity of alternative investments can provide a source of improved investment outcomes. Complexity often brings inefficiencies in valuations that can provide opportunities to buy undervalued assets. Illiquidity may provide a premium for taking on that risk and, perhaps more importantly, constrain investors from acting on harmful emotional biases during challenging market environments.

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