A Framework for Approaching Illiquid Alternatives

By Sarah Abernathy, CFA®, CAIA®
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Illiquid alternatives have long been a staple in institutional and ultra-high-net-worth portfolios, gaining fame as a core piece of what has come to be known as the endowment model. Today, the continued evolution of these products means that they are becoming accessible to a broader swath of investors. From hedge funds to private markets, illiquid alternatives can be a valuable instrument in today’s portfolio construction toolkit.

Despite their manifold attractions, allocating to illiquid alternatives is no straightforward task. This article aims to lay the groundwork for that undertaking. As a first step, the basics of private placement vehicle mechanics are reviewed, because they are much different from exchange-traded vehicles or even separately managed accounts. Though the industry has yet to develop a common framework for defining “alternatives,” we next offer some high-level categorization and discussion to get our arms around the space.

With this foundational understanding, we turn to implementation—just how should these things be put into a portfolio? This task is both an art and a science, as with many things in wealth management. Finally, we discuss some of the key considerations to address before embarking on an illiquid alternatives program. Though far from an exhaustive list, these are top-of-mind issues with which any illiquid alternatives investor must be comfortable.

VEHICLE MECHANICS
Private placement vehicles remain a key avenue for access to illiquid securities. Many hedge funds are structured as evergreen funds with periodic investment and redemption windows, but private-market vehicles traditionally are structured as limited partnerships. Investors always should thoroughly read and understand offering documents from private placements, but a basic understanding of their general structure is a useful place to start.

Structure. In the partnership arrangement, the manager of the fund is the general partner (GP), and investors that commit capital are the limited partners (LPs). The GP invests the fund’s capital, manages ongoing investments, and executes exit from and harvesting of those investments. The LPs are passive investors who contribute capital to and receive payouts from the fund.

Eligibility. Because these investments are not listed, they have unique regulatory constraints and have been allowed certain exceptions from standard governing rules, such as the 1940 Investment Company Act. Probably the most relevant are rules governing who can invest. An investor must be either a qualified purchaser (QP) or accredited investor (AI) as defined by the U.S. Securities and Exchange Commission (SEC) to participate in private investments. The most applied portion of the SEC’s definition of QPs is that they must have at least $5 million in investable assets excluding a primary residence if they are individuals, or at least $25 million in investable assets if they are a company. AIs are either an individual with gross income exceeding $200,000 in each of the prior two years or joint income with a spouse or partner exceeding $300,000 for those years with a reasonable expectation of those income levels continuing, or a net worth of more than $1 million excluding primary residence individually or with a spouse. Some investment professionals also may qualify outside of these requirements. Most traditional private-market funds require QP status; however, the AI level of eligibility is becoming increasingly common among the growing universe of semi-liquid private-market vehicles coming to market.

Investment mechanics. In traditional structures, investors commit an amount upfront via a “capital commitment.” The GP then periodically draws down that commitment or issues a “capital call” during the fund’s investment period. Fund managers typically draw down 70 percent or more of an investor’s committed capital in the first three years of the fund’s life, and it is not uncommon for less than 100 percent of an investor’s commitment to be drawn down during the life of the fund. The fund manager then invests in or lends to target companies with the called capital and will return investor capital later, along with growth in or income from that capital, as positions are exited. This structure results in the J-curve effect, where returns are...
negative in the first several years of the fund’s life as capital calls exceed distributions from exits. Private credit funds tend to have a less dramatic J-curve effect given income generated earlier in the life-cycle of the fund.

With this background in mind, the next step is to consider the vast universe of illiquid alternative types.

ILLIQUID ALTERNATIVE OPTIONS
Hedge funds, private equity, private credit, and private real estate are broad categories that encompass numerous sub-styles. Despite this overgeneralization, they can be thought of as aiming to serve at least one of three purposes within a portfolio, as shown in figure 1: risk reduction, income and growth, or return enhancement. Hedge fund styles exist to fill all three buckets, but private-market vehicles tend to have an ideal fit in one or two of these categories.

Hedge funds can be designed to achieve a potential range of outcomes. Risk-reducing hedge funds are designed to protect against drawdowns. Balanced risk–return hedge funds seek to reduce overall portfolio volatility and add potential excess return. Return-enhancing hedge funds’ goal is to use active management and specialized resources to access unique sources of alpha.

HEDGE FUNDS
Hedge funds invest opportunistically using long and short positions, derivatives, and options across various assets in the pursuit of return streams that differ from traditional stocks and bonds. Although hedge funds generally hold liquid publicly traded securities, they also tend to offer unusual risk and return characteristics because of strategies employed, such as short sales or trading strategies. Despite the exchange-traded nature of the underlying holdings, traditional hedge funds are structured as private placement vehicles or vehicles with limited liquidity, and investors should view them as long-term, illiquid investments.

The CAIA education program suggests four broad categories that can be used to describe hedge fund strategies (see table 1). It notes that macro and managed futures funds may be highly diversifying to a portfolio of traditional stocks and bonds. Event–driven and relative–value funds are subject to the greatest losses during large downturns in traditional asset classes. Equity–hedge strategies are expected to have less risk than equity markets but may maintain a high correlation with public equities if they are net long. Substyles within each category differ further in terms of risk and return profiles and primary outcomes.
In aggregate, hedge funds primarily are attractive because of their ability to hedge investment risks or look for idiosyncratic sources of alpha. As a result, many hedge fund styles have exhibited low correlation to traditional asset classes over time, making them good diversifiers in a portfolio of liquid stocks and bonds.

**PRIVATE MARKETS**

In the United States, there is a much larger universe of private companies than public companies. Private-market participants invest in those companies that have not gone public or that cannot access more liquid markets in an efficient way.

Hamilton Lane reports that roughly 17,000 private businesses in the United States had revenues of more than $100 million at the end of 2020, compared to 2,800 public companies of the same size (Hamilton Lane 2021). Additionally, data from the St. Louis Fed and Hamilton Lane suggests that the number of companies going public is in a downward trend. As shown in figure 2, the total number of listed companies peaked at around 8,000 in the mid-1990s and declined steadily to around 4,800 at the end of 2020.

In addition, the timing of when companies go public is lengthening. Evidence of this is seen in the size of initial public offerings (IPOs) when companies decide to list. According to McKinsey and Company, between 2001 and 2010, 15 percent of IPOs filed were less than $50 million, but that number was only 5 percent for the decade that followed (McKinsey and Company 2021), suggesting that companies are experiencing more of their high-growth phases while private.

Private markets allow investors to access this larger universe of potentially faster-growing companies through equity and debt investments. However, this access comes at the cost of liquidity. Though secondary markets exist for some private-market interests to be bought or sold, overall, private markets are much less liquid than their public counterparts. Still, studies have shown that this illiquidity earns a premium. For investors with the time horizon, patience, and risk appetite to handle it, the illiquidity premium is a key component of private markets’ value proposition.

Private-market investments cover a diverse landscape of asset classes, vehicle types, and investment objectives. Next, we briefly describe three common private-market investment styles: private equity, private credit, and private real estate.

**PRIVATE EQUITY**

Private equity is symbolic of the reputation for innovation and high returns that the term “illiquid alternatives” generally evokes. Private equities are much less efficient than their public counterparts because of their lack of transparency and tradability. This discrepancy offers an opportunity for skilled fund managers to research and negotiate attractive deals to help these private companies grow and improve their operations. Conversely, the longer-term nature of these deals is attractive to private companies, because they allow them to pursue aggressive growth plans, restructurings, acquisitions, or other strategies that are sometimes difficult to do as a public company. Typical private equities are shown in table 2.

![Figure 2](PUBLICLY LISTED STOCKS ON THE DECLINE)

Source: St. Louis Fed, Hamilton Lane, Envestnet

<table>
<thead>
<tr>
<th>Figure 2</th>
<th>PUBLICLY LISTED STOCKS ON THE DECLINE</th>
</tr>
</thead>
<tbody>
<tr>
<td>![Graph](Figure 2)</td>
<td>![Diagram](PUBLICLY LISTED STOCKS ON THE DECLINE)</td>
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<tr>
<td>18,000</td>
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</tr>
<tr>
<td>14,000</td>
<td>12,000</td>
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<td>10,000</td>
<td>8,000</td>
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<td>6,000</td>
<td>4,000</td>
</tr>
<tr>
<td>2,000</td>
<td>0</td>
</tr>
<tr>
<td>1975</td>
<td>Listed companies</td>
</tr>
<tr>
<td>1996</td>
<td>Private companies</td>
</tr>
<tr>
<td>2020</td>
<td></td>
</tr>
</tbody>
</table>

Source: CFA Institute, Envestnet

<table>
<thead>
<tr>
<th>Table 2</th>
<th>PRIVATE EQUITY SEEKS CAPITAL GROWTH</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategies</td>
<td>Description</td>
</tr>
<tr>
<td>Buyout/Leveraged Buyout</td>
<td>Used as an exit strategy for existing company management or to acquire and turn around a generally mature firm. Typically involves leverage to maximize equity return.</td>
</tr>
<tr>
<td>Growth Equity</td>
<td>Invests in companies in various stages of their life cycles with the intent to grow the business. Venture capital is a specific instance focused on high-risk companies in the early concept or development stages.</td>
</tr>
</tbody>
</table>

Although the private market is much larger and less efficient than the public one, public and private equity valuations are affected similarly by macro and market factors, even though these relationships may be disguised by stale pricing in the private sphere. Net cash flows from private equity funds also show a positive correlation with public equity markets, because funds typically harvest investments through IPOs or mergers and acquisitions, both of which ebb and flow with the overall market environment. As a result, private equity investments are best viewed as return...
PRIVATE CREDIT

Private credit funds have been on the rise since the financial crisis because consolidation within the banking industry and shrinking balance sheets among those still standing have left many private companies with less access to traditional forms of credit. Traditional private credit funds generally own higher-yielding corporate debt held within a private “lock-up” fund partnership structure. They tend to have fewer holdings than public fixed income funds as well. Unlike public-market bond issues, almost all private-market debt issues are secured, meaning they are backed by assets that are identified to be sold to repay investors in the event of a default. The core business of traditional private credit lenders has been to provide first-lien term loans to middle-market companies backed by private equity sponsors, referred to as “sponsored loans.” However, the business is evolving, and it now includes strategies designed for capital growth.

These strategies run a gamut of risk profiles. Less-risky strategies include traditional direct lending to mature private companies through sponsored senior debt issuance. This strategy strives for consistent returns while providing protections due to their place in the capital structure. Though issued to below-investment-grade companies, portfolios of these loans tend to exhibit few losses, with recovery rates similar to or better than those on public high-yield debt and floating-rate loans.

Return-focused strategies include distressed debt funds and funds that focus on capital appreciation through warrants. In the case of distressed debt, the idiosyncratic risk of the company itself often dwarfs macro risks such as interest-rate levels or changes in spreads. Some providers categorize these return-seeking strategies as private equity given the return profiles or to simplify categorization of alternatives. Strategies that do not fall in these categories are either opportunistic and invest across the credit spectrum as market opportunities permit, or niche/specialty finance strategies, such as aviation finance or healthcare royalties. These strategy types are unique and require specialized assessment.

NCREIF has categorized three styles of real estate, each adding more risk than the last. Thus, private real estate can serve as an income and/or capital appreciation asset within a portfolio.

PRIVATE REAL ESTATE

Private real estate funds may hold the equity and/or debt interests in various types of real property. These funds generally are set up as private equity real estate funds in a limited partnership arrangement with defined lifespans and capital call periods.

Private real estate aims to provide diversification, inflation hedging, and improved risk-adjusted returns, making it an attractive addition to diversified portfolios. However, because of the indivisibility and high unit costs of the underlying asset, private real estate is the most illiquid of the private asset classes discussed here. The National Council of Real Estate Investment Fiduciaries (NCREIF) has categorized three styles of real estate, each adding more risk than the last (see table 4). Thus, private real estate can serve as an income and/or capital appreciation asset within a portfolio.
A NEW PIECE IN THE ASSET ALLOCATION PUZZLE

Whether dead or alive, the ubiquitous 60/40 portfolio has served as a general framework for the average investor around which most of the investment profession was reasonably comfortable. No such allocation exists within the alternatives realm for several reasons. Illiquid alternatives are ill-defined. Even within frameworks such as the one laid out above, a wide range of strategies and approaches with different expected outcomes makes generalizations difficult. Data on private securities is likewise less robust than data on public ones, resulting in less standardization of modeling frameworks across practitioners.

However, the nuanced nature of illiquid alternatives does not preclude their thoughtful inclusion in diversified portfolios. Instead, they become additional pieces in the puzzle that is total portfolio asset allocation. Just as in assembling a puzzle, it helps to first organize the pieces and then work on combining them into a whole.

ORGANIZING THE PIECES

Helpful context for organizing the puzzle pieces comes from evaluating risk and return expectations for the asset classes that will be used in the total portfolio.

ASSET CLASS RETURN EXPECTATIONS

Alternatives have higher forecasted return and similiar or lower forecasted risk than many liquid counterparts.

As noted, the experience for each category of illiquid alternatives will depend very much on where investors land in choices of substyles within the broad categories. Nevertheless, an understanding of expectations at the broad style level is a step in the direction of understanding how these pieces may work together.

Figure 3 lays out risk and return expectations for both public- and private-market asset classes based on QRG Capital Management’s (QRG) forward-looking expectations. As shown here, private asset classes are expected to add value either from a return or risk perspective relative to their public counterparts.

For example, relative to public equity asset classes, private equity is expected to perform better with less risk. Private credit is expected to perform better than all public fixed income asset classes, though with similar or higher risk. Private real estate is expected to lie between private credit and private equity from a return perspective but with lower overall risk, which is intuitive given the blend of growth and income that is expected from private real estate securities. In sync with their risk-reducing pedigree, hedge funds are expected to have the lowest risk of all private asset classes, but also the lowest returns.

Beyond the risk and return characteristics of private asset classes, their potential diversification benefit is evident in their correlation profiles with other asset classes. Private asset classes have correlations generally close to or below 0.5 with all major public asset classes (see table 5). Hedge fund correlations with liquid securities are the highest on a relative basis, which generally reflects their investment in assets tied to publicly traded securities. Private credit, private equity, and private real estate offer low correlations across most asset classes.

Risk and return expectations, as well as correlations, point to a case for including alternatives in a diversified portfolio. As noted above, their roles in the portfolio can be thought about as serving other broader functions as well, in addition to their ability to add diversification. Private equity works as a possible return enhancer, private credit offers income and potentially capital appreciation, private real estate offers income and growth, and hedge funds run the gamut. With this context in mind, we turn to assembling the puzzle pieces into an overall asset allocation.

ASSEMBLING THE PUZZLE

To include illiquid alternatives in an overall asset allocation framework that includes both liquid and illiquid securities, Envestnet relies on a framework developed by QRG that is both an art and a science. Three main steps are completed to develop our asset allocation framework for including illiquid alternatives.

STEP ONE: CREATE OPTIMIZED LIQUID ASSET CLASS PORTFOLIOS

Envestnet relies on a variation of mean-variance optimization and our own forward-looking capital market assumptions to develop optimal weights in liquid asset classes for portfolios across the risk spectrum. This process results in our “asset class portfolios,” which span the efficient frontier and allocate to a diversified mixture of domestic and

Figure 3


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international equities and fixed income. The asset class portfolios serve as the bedrock for model management across the Envestnet platform and within Envestnet’s own portfolio management capabilities. Accordingly, they serve as the starting point for allocating to illiquid alternatives as well.

**STEP TWO: MACRO FACTOR MODELING AND ACTIVE RISK RANGES**

A key potential benefit of adding illiquid alternatives to the multi-asset portfolio is access to the illiquidity premium (Hibbert et al. 2009). Illiquidity is a compensated risk, meaning exposure to it in a portfolio should generate excess return. To capture the potential to harvest this excess return, Envestnet seeks to add exposure to the illiquidity premium to the optimized liquid portfolios using illiquid alternatives.

To accomplish this, macro factor modeling is done on both the liquid asset classes included in the asset class portfolios and on the illiquid asset classes of private equity, private real estate, and private credit. To develop this modeling, QRG expanded upon a method known as “Flexible Indeterminate Factor-based Asset Allocation” (Blyth et al. 2016).

This approach offers a quantitative factor exposure framework to which we can add informed judgment on factor exposures of illiquid asset classes that are less easily modeled.

An important caveat is our treatment of hedge funds within this framework. In our view, when combining hedge funds and private markets within a single portfolio, hedge funds should be used primarily to dampen risk and private asset classes should be used primarily to capture macro factor premia, including the illiquidity premium. In this way, hedge funds may offer additional diversification and risk management, and private asset classes may enhance returns. This is of course not the only way to approach hedge funds—as discussed above, they can serve a multitude of functions. However, they tend to have the lowest exposure to the illiquidity premium but offer the best downside protection. As a result, we allocate to them using a fixed percentage of fixed income in each allocation and focus product selection on risk-reducing styles such as hedged equity and managed futures.

Table 6 shows an example of our modeling. The first column shows the exposures of the optimal 60/40 liquid portfolio determined in step one to the macro factors listed, which importantly include the liquidity factor (which paradoxically measures exposure to illiquidity in this model). To increase exposure to the

### Table 5: Alternatives’ Low Correlations Offer Potential Diversification Benefits

<table>
<thead>
<tr>
<th></th>
<th>U.S. Large-Cap Equity</th>
<th>U.S. Small-Cap Equity</th>
<th>Intl. Developed Equity</th>
<th>EM Equity</th>
<th>Intmld. Long Bond</th>
<th>Intl. Bond</th>
<th>High-Yield Bond</th>
<th>Hedge Funds</th>
<th>Private Equity</th>
<th>Private Credit</th>
<th>Private Real Estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Large-Cap Equity</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>U.S. Small-Cap Equity</td>
<td>0.86</td>
<td>1.00</td>
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<tr>
<td>International Developed Equity</td>
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<td>0.59</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Emerging Market Equity</td>
<td>0.64</td>
<td>0.64</td>
<td>0.68</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Intermediate Bond</td>
<td>0.16</td>
<td>0.04</td>
<td>0.14</td>
<td>0.13</td>
<td>1.00</td>
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<tr>
<td>Long Bond</td>
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<td>0.03</td>
<td>0.12</td>
<td>0.12</td>
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<tr>
<td>International Bond</td>
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<td>0.10</td>
<td>0.55</td>
<td>0.43</td>
<td>1.00</td>
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<tr>
<td>High-Yield Bond</td>
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<td>0.57</td>
<td>0.48</td>
<td>0.54</td>
<td>0.32</td>
<td>0.35</td>
<td>0.04</td>
<td>1.00</td>
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<tr>
<td>Hedge Funds</td>
<td>0.63</td>
<td>0.59</td>
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<td>0.51</td>
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<td>Private Equity</td>
<td>0.26</td>
<td>0.25</td>
<td>0.23</td>
<td>0.20</td>
<td>0.04</td>
<td>0.04</td>
<td>0.02</td>
<td>0.17</td>
<td>0.21</td>
<td>1.00</td>
<td></td>
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<tr>
<td>Private Credit</td>
<td>0.16</td>
<td>0.14</td>
<td>0.16</td>
<td>0.14</td>
<td>0.05</td>
<td>0.05</td>
<td>0.02</td>
<td>0.17</td>
<td>0.17</td>
<td>0.14</td>
<td>1.00</td>
</tr>
<tr>
<td>Private Real Estate</td>
<td>0.04</td>
<td>0.04</td>
<td>0.03</td>
<td>0.02</td>
<td>0.02</td>
<td>0.00</td>
<td>0.03</td>
<td>-0.01</td>
<td>0.05</td>
<td>0.05</td>
<td>0.03</td>
</tr>
</tbody>
</table>

Source: QRG Capital Management

### Table 6: Optimization Enhances Exposure to Illiquidity Premium

<table>
<thead>
<tr>
<th></th>
<th>Optimal Liquid 60/40</th>
<th>Addition of 25% Illiquid Alts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>0.60</td>
<td>0.55</td>
</tr>
<tr>
<td>Real Rate (TIPS)</td>
<td>0.43</td>
<td>0.31</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.42</td>
<td>0.29</td>
</tr>
<tr>
<td>Credit</td>
<td>0.05</td>
<td>0.16</td>
</tr>
<tr>
<td>Commodity</td>
<td>0.00</td>
<td>0.01</td>
</tr>
<tr>
<td>Currency</td>
<td>-0.03</td>
<td>-0.02</td>
</tr>
<tr>
<td>Liquidity</td>
<td>0.00</td>
<td>0.08</td>
</tr>
<tr>
<td>Active Risk</td>
<td></td>
<td>1.75%</td>
</tr>
</tbody>
</table>

Source: QRG Capital Management, as of October 30, 2022
illiquidity premium, we allow the optimization to allocate to illiquid asset classes within certain constraints to arrive at the final optimal portfolio including illiquid alternatives.

In Table 6, the addition of a 25-percent allocation to illiquid alternatives resulted in a meaningful increase to the illiquidity premium. Notice that this does not occur in a vacuum, because other exposures were altered as well. The process becomes a give and take, and we monitor changing exposures to ensure we are comfortable with changes in other exposures that come along with seeking the illiquidity premium.

**STEP THREE: DETERMINE APPROPRIATE ACTIVE RISK EXPOSURE TO IDENTIFY ALLOCATION TO ILLIQUID ALTERNATIVES**

Step three is about the art of choosing which level of active risk relative to the original liquid asset class portfolio is ideal, given client circumstances. The level of active risk correlates to the overall allocation to illiquid alternatives.

For example, you’ll notice in Table 6 that the active risk of the portfolio that includes illiquid alternatives at 25 percent relative to the original 60/40 portfolio is 1.75 percent. But it is feasible that an investor that was identified originally as one who should invest in a 60/40 portfolio would be willing to take on more or less risk, and thus choose a higher or lower tracking error target.

The question of how much active risk is one for the investor to answer. Numerous inputs go into this decision, such as the investor’s time horizon and risk tolerance, as well as the portfolio’s liquidity requirements and overall objectives. To give some guidance, our approach has been to use as the base case what we expect to be acceptable active risk for the average investor across the risk spectrum for different risk tolerances, and then suggest a range of allocations around that base case. For example, on the more conservative end of the spectrum, the forecasted tracking error for our base case allocation to illiquid alternatives is approximately 1 percent. At the most aggressive allocation, the base case assumes a forward-looking tracking error estimate of around 3 percent.

Figure 4 shows our recommended allocation ranges for investors at different points on the risk spectrum. Funding for these allocations is taken proportionately from equity and fixed income in the original liquid-optimized portfolio.

**GETTING STARTED**

With an understanding of the puzzle pieces and how to put them together, investors are ready to build an illiquid alternatives program. However, moving from the relatively straightforward world of publicly traded securities to the much opaquer universe of illiquid alternatives requires more than just a bigger purse and puzzle-solving skills. Before making an allocation to illiquid alternatives, investors must think through many nuances that come along with investing outside the public sphere. Foremost among them are considerations surrounding time horizon, liquidity management, commitment pacing, and manager selection.

**TIME HORIZON**

Illiquid investments have at least one thing in common—they require a long-term investment horizon. Investors should be prepared for assets to remain tied up for several years, up to a decade or more, depending on the strategy and type of vehicle pursued; the time frame may vary based on strategy and manager. Figure 5 highlights the typical life cycle of a private-market fund and illustrates the patience and commitment that investors require to allocate fully to private markets.

As a result, the CFA Institute recommends that investors with less than a 15-year investment horizon avoid investments in private asset classes entirely. Although hedge fund strategies tend to have shorter lockups than private-market vehicles and offer some greater liquidity due to periodic redemption windows, they also should be viewed as long-term, illiquid investments.

**LIQUIDITY MANAGEMENT**

Investors also must consider how to manage liquidity to fund ongoing commitments. Some hedge fund allocations can be funded all at once during monthly or quarterly investment acceptance periods. However, given the life cycle of private-market vehicles, it may take multiple years for investors to fund these allocations fully. It also is desirable to plan an allocation to private markets over multiple years to help diversify the market environments in

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**ILLIQUID ALTERNATIVES ALLOCATION CAN BE GUIDED BY OPTIMAL LIQUID ALLOCATION**

<table>
<thead>
<tr>
<th>Conservative</th>
<th>Balanced</th>
<th>Aggressive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low TE Tolerance</td>
<td>Moderate TE Tolerance</td>
<td>High TE Tolerance</td>
</tr>
<tr>
<td>10%–30%</td>
<td>12%–35%</td>
<td>15%–40%</td>
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</tbody>
</table>

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which private-market investments are made, known as “vintage year diversification.” Spreading the target allocation over a specified number of years is a simple heuristic approach, with the number of years defined by the client’s time horizon.

In the interim, investors face a choice of where to hold assets yet to be invested. On one hand, the capital to be committed could be invested in liquid asset classes with similar risk profiles. For example, private equity allocations could be invested in public equities, private credit in public debt, and private real estate in public real estate vehicles, ensuring a similar factor profile and market exposures for the overall portfolio while investors wait for capital to be called or a funding window to open. However, the trade-off is the risk of adverse market conditions that could result in a loss of capital and the subsequent inability of the investor to meet capital calls. This risk is especially acute in down markets where the value of liquid assets may fall at a time when private-market distributions slow and capital calls increase. In down markets, fund managers may hold off exiting positions due to unfavorable valuations, and at the same time call capital because attractive opportunities become available.

On the other hand, capital yet to be called could be held in relatively safe government or credit securities that are readily saleable or even cash, which would limit the downside risk to this capital. However, it comes at a high opportunity cost in the form of missed capital appreciation opportunities through the cash-drug effect. Holding committed capital in these less-risky vehicles also would likely distort the total portfolio’s asset allocation targets, potentially to a large degree.

The ideal placement of the committed but not yet called capital, from aggressively to conservatively invested, will vary for each investor, but likely lies somewhere between the two extremes. An investor’s risk tolerance as well as access to other sources of liquidity outside the private-market portfolio to meet capital calls will help inform the choice.

The illiquidity of hedge funds and private-market strategies can lead to hurdles when rebalancing a portfolio as well, at least on paper. These positions cannot be easily rebalanced because they cannot be easily sold or incrementally bought. This may lead to the over- or underweighting of illiquid asset classes relative to traditional allocations because of the denominator effect, which occurs because although public-market securities are repriced daily, private-market securities are valued much less frequently. Over time, they may appear to make up a larger portion of the overall allocation because of the lagged adjustment to valuations. However, the full extent of the proportional change likely is overstated. Although it takes longer to reflect in private markets, valuation of
these securities is similarly affected by market trends.

**PACING THE ALLOCATION**

Traditional illiquid alternatives are structured as self-liquidating private placements—capital is returned to investors over time, and funds are closed eventually. As a result, private-market exposure will decline without ongoing commitments to new funds.

Figure 6 illustrates this cycle in terms of a hypothetical cash-flow scenario. As the fund ramps up and begins to invest called capital, exposure to private markets increases. However, as capital calls wind down largely by the fourth year of the fund, distributions begin to pick up. Over time, distributions cease, and the fund is closed. As mentioned earlier, the cycle of early capital calls and later distributions is known as the J-curve. Allocating to new funds over time becomes an important activity if the investor desires to maintain the illiquid alternative allocation as part of the strategic asset allocation. Otherwise, exposure to private markets eventually will be zero as shown in figure 6.

Determining when and how to make those ongoing commitments requires a projection of future cash flows, such as capital calls and distributions, as well as anticipated capital growth from current investments. Unfortunately, cash flows from illiquid private-market vehicles are uncertain at both the beginning and end of their life cycles. The timing and size of distributions are affected by manager performance as well as the cyclicality of the market, as is capital growth. The timing of capital calls typically is at its quickest pace in the early stages of the investment cycle, but it may vary by fund type. Historical data across multiple cycles can be used as a starting point to model projected calls, distributions, and growth from different vehicles, but scenario testing should be done given the different experiences investors should expect in different market environments.

With these projections in mind, commitment pacing plans can then be developed to help manage net cash flows throughout this time so that target allocations are always in view. Over time, this can lead to a self-funding private-market allocation. As investments are exited through sale, distributions can be used to fund new commitments, as can income from private debt or real estate investments.

Another key takeaway from figure 6 is the level of market exposure achieved over time. At the start of the fund’s life, market exposure is very low, because no capital has been called and no investments have been made. Over time, exposure picks up, but it may take many years to peak. As capital calls wind down and distributions pick up, the overall portfolio exposure to private markets declines. Because of the offsetting nature of the cash flows, investment exposure generally never reaches the full target.

To overcome this net cash-flow drag on reaching the overall target allocation, investors may adopt an overcommitment strategy, if it fits within their liquidity and risk tolerance. This strategy involves making commitments to illiquid alternatives that are greater than the targeted asset allocation, such as committing 15 percent of capital to such vehicles instead of the policy allocation of 10 percent. An overcommitment strategy can be developed based on cash-flow forecasts to address the phenomenon shown in figure 6, where the allocation is never fully funded because of the cycle of drawdowns and distributions.

**DIVERSIFICATION AND MANAGER SELECTION**

Manager selections and diversification is a crucial undertaking for a successful illiquid alternatives program. The dispersion of performance within and across illiquid alternative categories and vintage years for private-market vehicles is much wider than for traditional asset classes. Therefore, it is important to take into consideration that the return and risk of the median manager in many illiquid alternative categories may not be representative of the average investor’s experience.

In addition to the wide dispersion of returns across illiquid investments, illiquid alternative managers tend to exhibit higher performance persistence than managers of traditional liquid strategies. Top-performing managers tend to have follow-on funds that remain top-performing relative to peers. Because of this persistence tendency,
fund sourcing is important, because historically successful managers typically have higher demand for their vehicles. Investors with smaller pools of capital that may be forced to make smaller allocations to alternatives will face greater competition for access to these top managers.

As in liquid securities, diversification can help reduce the risk of choosing an underperforming strategy. Investors should diversify their illiquid alternatives by category and manager to address the wide dispersion in performance outcomes. As noted, diversifying private-market investments by vintage year can help with cash-flow management, but investing in vehicles launched in different years also reduces the dependency on any particular market environment, smooths returns, and reduces tail risks.

Smaller allocations are better suited to diversified multi-strategy options, but larger allocations may have the flexibility to consider multiple single strategies. A maximum allocation to any single strategy of 3 percent of total portfolio assets should help lessen this concentration risk. Multi-strategy or fund-of-funds vehicles are another means to diversify exposure to single strategies or managers.

Investors should diversify across managers and vehicles and also have in place a thorough manager due diligence framework to choose among available strategies. The nuances and idiosyncrasies of illiquid alternatives require rigorous review and assessment to properly address and inform risk-taking.

CONCLUSION
Investors are faced with a host of questions and considerations when opening the box on illiquid alternative investments. The mechanics of access materially are different than investing in public markets. The vastness of the universe also adds complexity because “alternatives” cover a wide-ranging array of securities, but some defining structure around the space aids in understanding. Putting it all together in a robust asset allocation poses a further challenge, because these investments introduce unique risks and returns to a portfolio. After evaluating the universe and deciding upon an asset allocation, investors are well-advised to have a clear understanding of an assortment of qualitative considerations before actual implementation begins.

As in liquid securities, diversification can help reduce the risk of choosing an underperforming strategy.

Despite the heftiness of these tasks, they are well worth the effort, because illiquid alternatives have the potential to increase returns, generate income, reduce risk, and diversify traditionally allocated portfolios. When thoughtfully completed in tandem, these comprehensive tasks will lead to a purpose-driven alternatives allocation that can enhance traditionally allocated portfolios.

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ENDNOTES

1. An important point is that at least part of these correlation profiles may stem from stale pricing that plagues the data on private asset classes. Valuations within private asset classes occur less frequently than in public markets, and this stale pricing creates artificially low correlations and overall volatility for the asset classes. The regression here refers to a linear ordinary least squares regression of a manager’s current net returns against current performance of the manager’s benchmark.


REFERENCES


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