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The Role and Use of Alternative Investments

A Discussion with Stephen Horan, PhD, CFA®, CIPM®, CAIA®, Brian Ullsperger, CIMA®, and Anthony B. Davidow, CIMA®

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The Role and Use of Alternative Investments

A DISCUSSION WITH STEPHEN HORAN, PHD, CFA®, CIPM®, CAIA®, BRIAN ULLSPERGER, CIMA®, AND ANTHONY B. DAVIDOW, CIMA®

For this issue of Investments & Wealth Monitor, *the editorial advisory board wanted to examine the role and use of alternative investments. Over the years,* IWM *has covered the expanding number of alternative investments and examined product innovation. For this article, we asked three of our member experts to respond to questions about some of the challenges and opportunities that alternatives present to advisors and their clients.*

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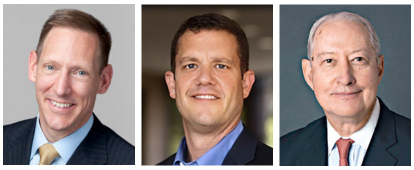

(L-R) Stephen Horan, Brian Ullsperger, Anthony B. Davidow

***IWM*:** How do you define alternative investments?

Horan: There's no universally accepted definition of alternative investments. One approach is to articulate what they are not. That is, they are not publicly traded equity or fixed income instruments—domestic or foreign. That lacks specificity, however, so another approach is to think of them as including private investments (equity, credit, and hybrids), real assets, hedge funds, and even structured products.

The lines between alternative investments and traditional investments have blurred over time as new products have emerged in part because these categories can overlap. Moreover, the underlying investments for hedge funds and structured products can be traditional investments, but the structure in which they reside, or the strategy used to deploy them, is considered alternative.

Ullsperger: We view the alternative bucket of a client's portfolio as a bit of a catch-all. We define alternatives as having low to negative correlation to both traditional long equities and fixed income. In short, they don't neatly fit into an asset class. They could be directional, non-directional, liquid or illiquid, publicly traded or private, and may provide yield or increased opportunity for alpha. Overall, we believe the alts bucket should offer the potential for non-correlated returns that generate higher returns than bonds and a smoother return stream than equities with risk somewhere in between the two. Hence, they smooth out returns of the overall portfolio and improve absolute return while also damping or limiting drawdowns. It's most definitely a grab-bag, catch-all of strategies—like the island of misfit investments. Whatever is in that bucket should have a distinct rhyme and reason for being in the bucket and should perform a function within the alternative allocation.

***IWM*:** What role can alternatives play in a diversified portfolio?

Davidow: Alternative investments represent versatile and valuable tools in building better portfolios. They are particularly well suited to the challenges we face today—lower equity returns, fixed income below historical norms, elevated volatility, and inflation at levels not seen since the early 1980s. But we should be clear that not all alternatives are designed to solve the same problem.

Private equity and private credit historically have delivered an illiquidity premium relative to their public-market equivalents—the excess return that compensates investors for locking up capital for an extended period. They both offer diversification relative to traditional investments and private credit provides an alternative source of income.

Real assets, which include real estate, infrastructure, and natural resources, can provide multiple benefits to a portfolio. Real estate provides growth, income, diversification, and inflation hedging; infrastructure provides growth, diversification, and inflation hedging; and natural resources provide diversification and inflation hedging.

Hedge funds represent a diversified group of strategies serving multiple roles within a portfolio. Equity hedge and event-driven are growth-oriented strategies; relative value is designed to provide steady returns and muted volatility; macro represents defensive, non-correlating strategies such as managed futures; and multi-strategy allocates across the various strategy types.

Alternative investments are particularly valuable tools to address today's challenging environment, and several can play multiple roles within a portfolio.

Ullsperger: Alternatives can be a diversifier, an alpha generator, provide yield, and offer non-correlated returns. Alternatives come in a variety of styles and can be used to accomplish several objectives within the portfolio. Overall, we expect alternatives to generate returns in the mid-single digits (5–7 percent) with decidedly less risk than equities. We also believe alternatives can generate positive returns in any market environment because they may have low or negative correlation to equities, less interest-rate sensitivity, can exploit opportunities created by market dislocation, and may be less sensitive to monetary policy.

***IWM*:** Why is now a good time to allocate to alternatives?

Davidow: Given the challenging environment that we face today, the naïve 60/40 portfolio likely will fall well short of meeting investor needs. Wealth advisors need an expanded toolbox to address the challenges we face and help clients achieve their goals.

Fortunately, many of these once elusive asset classes such as private equity, private credit, and real assets are now available to a broader group of investors at lower minimums and with more-flexible features. Historically, private markets were limited to large institutions and family offices, and most high-net-worth investors had limited options at their disposal. In the past several years, high-net-worth investor demand, product evolution, and a willingness of institutional-quality managers to bring products to the market has changed the investing landscape.

There has never been a better time to consider private markets, and there have never been more high-quality products available to accredited investors.

Horan: The data suggest it's generally bad for both institutional and retail investors to chase returns. Looking past the prospects of potentially low returns in traditional asset classes and the possibility of reaching for higher yields, another reason to consider allocations to alternative investments is that the proportion of investable assets on public exchanges is shrinking relative to private assets. As exchanges place increasing reporting requirements, such as Sarbanes-Oxley and ESG [environmental, social, and governance] reporting standards, growing firms take longer to list on an exchange. As a result, much of the initial returns accrue to investors in the private markets. Moreover, it is increasingly common for listed firms, like Twitter, to consider going private.

Alternative investments also may have the opportunity to generate higher alpha than public securities because the investment markets are less efficient. A reason for that inefficiency, however, is that private markets are more opaque and less liquid than public securities. Moreover, some alternatives, such as commodities and real estate, provide more direct inflation hedges than traditional equity. This protection is especially important for investors experiencing the highest inflation rates in 40 years.

Ullsperger: Alternative strategies have the ability to be more nimble than long-only equity or fixed income strategies. Whether equities, commodities, credit, or currency, alternatives can go long or short, be public or private, liquid or illiquid—and that nimbleness is attractive because managers can put best ideas to work in a variety of attractive and unique opportunities. Long managers and market participation work great during the rising tide. Rough seas create opportunity and alternative strategies have the talent, teams, and tools to take advantage of disruption and dislocation.

***IWM*:** How has product evolution helped democratize access to alternative investments?

Horan: Liquid alternatives, or liquid alts, were introduced after the Global Financial Crisis as mutual funds or exchange-traded funds with daily liquidity. These products were designed to replicate various hedge fund strategies, such as market neutral, event-driven, or macro strategies. But these registered-fund options did not always replicate their less-liquid hedge fund counterparts. Moreover, fickle investors wanting to exit can disrupt many hedge fund replication strategies, and the fees are high. As a result, most have not survived beyond 10 years.

Ullsperger: Interval funds, business development companies, and a host of other structures have provided more mainstream access for advisors to access a whole host of strategies previously exclusive to institutions, family offices, and the ultra-affluent. The tools are in the toolbox. Advisors need to dust it off, then spend some time understanding the tools and how they can (and should) be effectively utilized to meet the unique goals and objectives of the clients they serve.

Davidow: For nearly 50 years, private markets were available only to large institutions and family offices, with high minimums and limited liquidity. The first-generation of private-market funds were structured as limited partnerships and were only available to qualified purchasers (QPs). Feeder funds were the natural response, aggregating multiple investors to provide lower minimums, but unfortunately they were still limited to QPs.

As demand from high-net-worth investors for private-market investments has grown over the years, products needed to adapt to meet their needs, mainly in the form of lower investor eligibility, lower minimums, more flexible features, and favorable tax reporting. Registered funds, including interval and tender-offer funds, are available to accredited investors, at lower minimums, and greater flexibility. Registered funds have grown dramatically since the Global Financial Crisis and now have more than $300 billion in assets under management, with an ever-growing list of sponsors including KKR, Hamilton Lane, PIMCO, etc.[1]

IWM: What are the challenges for advisors? What are the challenges for investors?

Ullsperger: In my opinion, the biggest challenge for advisors is overcoming personal bias. First, during the past 20 years, there has not been much need to expand and explore building a portfolio beyond a 60/40 mix using an equity and bond market proxy. Zero interest rates and accommodating monetary and fiscal policy created an environment that required little work or research beyond rebalancing. Times are changing. A confluence of factors including inflation, rising interest rates, overvalued equities, etc., require more engagement and more sophisticated portfolio strategy. Advisors must re-educate and revisit correlations and complementary strategies to find return, reduce risk, add yield, and generate portfolio-level returns to meet their clients' long-term goals.

Nobel laureate Richard Thaler has said that the mistake is thinking investors are rational. I would argue it is also a mistake to think investors are well-educated and sophisticated. Investors more often are driven by fear or greed, quickly enamored by the latest hot stock or investment fad, and shocked by any market volatility or pullback.

Like any investment, establishing a thesis or expectations about how the tool will impact the portfolio is critical.

The challenge—and the solution—is education. Advisors must educate themselves on the risks, rewards, and value proposition alternatives present. They need to understand the pros and cons, but more so, how does the strategy fit into a portfolio and what problem does it solve for their clients. Lastly, they must develop an effective strategy to overcome misperceptions surrounding alternatives and inspire their clients to action. They must be the student and the teacher for their clients.

IWM: How can advisors better frame the alternative investment discussion?

Ullsperger: Like any investment, establishing a thesis or expectations about how the tool will impact the portfolio is critical. I believe with alternatives it is even more so because alts tend to move independently of the market—both equity and fixed. Being able to tell a story about the strategy, the manager, and the expected risk and return allows the client to buy into why they should add it to the portfolio. We spend time talking about the alternative bucket, each strategy in that bucket, and why we don't want everything to move in lock-step with the S&P 500. No strategy is a silver bullet, outside of asset allocation. Having a story about how each strategy contributes to return, risk mitigation, and yield in an up or down market helps investors with the rhyme and the reason to invest beyond an index. If the goal is to earn the return of the S&P 500, buy the S&P. The goal for most clients is a comfortable retirement, cash flow, and peace of mind. Explaining how alternatives help achieve those goals will go a long way toward keeping clients engaged and invested over time.

Davidow: We all need to recognize the challenge for investors to understand our unique terminology and confusing jargon. We need to do a better job framing the discussion in terms of the role each investment plays in the portfolio. There are four primary goals of each portfolio: growth, income, defense, and inflation hedging.

1. The growth in the portfolio will come primarily from the equity and equity-like allocations including U.S. and non-U.S., equity hedge, event-driven, infrastructure, and private equity.
2. The income will primarily come from fixed income (treasuries, corporate bonds, and high yield), plus real estate and private credit.
3. The defensive portion of the portfolio would include cash, commodities (gold), macro, multi-strategy, and natural resources.
4. Inflation hedging would include certain commodities, TIPS [Treasury Inflation-Protected Securities], real estate, infrastructure, and natural resources.

The value of framing the discussion in this manner is two-fold. First, it establishes realistic expectations regarding the role of each investment in a portfolio. It also moves the discussion away from outperforming the market in rising markets.

Horan: Pursuing these goals also can be framed in the context of an illiquidity premium. If investors have a long-term time horizon with few liquidity requirements, they can earn an expected return for giving up liquidity in the interim. Private-market companies must offer investors a premium on the order of 3 percent to 5 percent per year for them to tie up capital for seven to 12 years. Private-equity fund managers need to place constraints on investor exits and the ability to make capital calls to deploy over the long time horizons demanded in private markets.

IWM: How can advisors effectively incorporate alternative investments?

Davidow: Before allocating to alternatives, we should revisit our process—establishing goals and objectives, developing a strategic allocation, writing an investment policy statement, selecting the appropriate manager and structure, and monitoring the results over time. Alternative investments need to be carefully integrated into the process that you currently use.

However, there are a few unique asset allocation considerations for advisors to consider before allocating capital.

- Goals: What are the investor's specific goals? Do the alternatives being considered increase the probability of achieving those goals?
- Sophistication: Does the investor understand the role of the various alternative investments in their portfolio? Does the investor understand the structural trade-offs, including fees, leverage, and liquidity?
- Investor eligibility: What type of fund is the investor eligible to invest in (traditional QP fund, feeder fund, or registered fund)?[2] What are the structural trade-offs?
- Time horizon: What is the investor's time horizon? Private markets should be viewed as a long-term investment (7–12 years).
- Allocation: What is the appropriate amount of capital to allocate? Is it all drawn down upfront?
- Liquidity: What are the fund's liquidity features? Does it align with the investor's time horizon?
- Fees: What are the underlying fund fees? Do the fees create too high of a burden to overcome?

Horan: Investors also should consider how their alternative investments are taxed. A portion of private equity, for example, can be characterized as operating income, which can be taxed relatively heavily. And direct private-equity investment returns are reported on a K-1, which is often provided late or revised.

Ullsperger: Education. Education. Education. There is no one way to correctly implement alternatives just as there is no one perfect allocation. For advisors to effectively incorporate alternatives, they need to understand why they are adding alternatives, what impact they anticipate alternatives having (improve return, reduce risk, etc.), how to incorporate alternatives in an allocation, and which strategies and structures to use. Advisors need to discuss, debate, and decide on the merits of the investment—fully commit—in order to communicate, with conviction, the rhyme and the reason for alternatives to be part of their clients' portfolios.

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ENDNOTES

1. For a complete description, see Anthony B. Davidow, "Private Markets: Asset Allocation and Portfolio Construction," *Investments & Wealth Monitor* 37, no. 4 (July/August 2022): 20–25.
2. Tony Davidow, *Goals-Based Investing: A Visionary Framework for Wealth Management* (New York, McGraw-Hill, 2021): 149–170.

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