Alternative Investments and Their Roles in Multi-Asset Class Portfolios

By Stephen Beck, CFA®, Darby Nielson, CFA®, and Sumit Sharma, CFA®
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Alternative investments can be generally defined as assets distinct from traditional portfolio holdings that include stocks, bonds, and cash. However, a broad and diverse range of asset types and investment strategies fall within the alternatives classification, including hedge fund strategies, private equity, private credit, real assets, and digital assets. Some hedge funds, for example, are non-traditional investment strategies based on traditional asset classes, such as stocks and bonds. Although individual categories of alternatives have distinct characteristics and can play unique roles in a portfolio, investors have generally allocated to alternatives when seeking to enhance returns, manage risk, or improve diversification.

Institutional investors have sought exposure to alternatives for decades for these reasons, and many hold significant allocations. In fact, based on a Fidelity survey of institutional investors, including pension funds, endowments, and foundations, more than 90 percent of respondents allocate to liquid and/or illiquid alternatives. On average, pension funds reported a 22 percent allocation to alternatives, and endowments and foundations reported an average allocation of 32 percent, with the size of the allocation generally increasing based on the fund asset level. Adoption of alternatives among financial advisors and individual investors, on the other hand, has generally been more limited.

For many years, alternative investment strategies were largely available only to institutional investors. This lack of access to alternatives has been one of the major roadblocks to their widespread adoption. But asset managers have accelerated their efforts to develop and offer innovative investment vehicle structures that can grant a broader spectrum of investors access to alternatives—some in the form of mutual funds and exchange-traded funds (ETFs). Here we address some of the following perceptions of alternatives that may be additional barriers to their widespread adoption.

Some investors hold the view that alternatives are too complex and point to a shortage of available research as a barrier for allocating to them. In this article, we highlight and define the key categories of alternatives to shed more light on these strategies. Another perception of alternatives is that they are challenging to access and cumbersome to own, but these hurdles may be resolved by the structure of the alternative investment strategy. We explore some examples of investment vehicle structures available for investors to gain access to alternatives.

### KEY TAKEAWAYS

- Alternative investment strategies were at one time largely available only to institutional investors, but asset managers have accelerated their efforts to develop innovative investment vehicle structures, some in the form of mutual funds and exchange-traded funds, that provide broader access to the potential return, risk, and diversification benefits of alternatives.
- We studied the historical investment characteristics of 16 traditional and alternative investment categories from 2005 through 2021, and we ranked them based on three key metrics: annualized returns, performance amid poor public equity market returns, and diversification benefits.
- Among the alternatives we studied, private equity, private credit, and private real estate (a real asset) demonstrated higher returns than most other asset categories over the period; the returns of private equity, direct lending (within private credit), private real estate, and hedge fund strategies held up relatively well amid poor public equity performance; and hedge fund strategies, private real estate, and late-stage venture capital (within private equity) offered enhanced portfolio diversification.
- In a multi-asset class context, we found that expanding the investment opportunity set to include alternative investments may enhance risk-adjusted returns relative to a universe composed only of traditional asset classes.
Further, investors hold varied views of the risk and return profile of alternatives. We review historical return and risk attributes of several distinct alternatives categories to illustrate their investment characteristics.

With a more comprehensive understanding of the range of alternatives and their key attributes, investors and advisors may be better equipped to determine which, if any, may be appropriate for their portfolios.

OVERVIEW OF THE ALTERNATIVE INVESTMENT LANDSCAPE
Categories of alternatives generally include hedge fund strategies, private equity, private credit, real assets, and digital assets, each with several subcategories. Though it is not an exhaustive list, below is an overview of the alternative investment landscape.

HEDGE FUND STRATEGIES
Hedge fund and hedge-fund-like strategies are non-traditional investment strategies that use a range of different approaches to managing securities, many with the goal of generating returns that are uncorrelated to traditional asset markets. Hedge fund strategies often invest in public equities and bonds, but they also may hold private assets or derivatives, such as options, swaps, and futures contracts, to provide the underlying investment exposures. Derivatives typically have embedded leverage that may amplify returns, both positive and negative. Hedge fund strategies may have different risk profiles than traditional investments, with varying levels of exposure to the equity market, as well as a range of systematic and idiosyncratic risks obtained through leverage, shorting, and potentially concentrated positions. Below are some examples of different types of hedge strategies.

Equity hedge. These strategies, such as market neutral hedge funds, seek returns that are not tied to an underlying market index. Instead, these strategies typically strive to deliver a modest, positive return regardless of market cycles and shorter-term dynamics.

Relative value. These hedge fund strategies involve buying a security perceived as undervalued and selling short a similar security perceived as overvalued to take advantage of temporary differences in price.

Convertible arbitrage. This is a relative value strategy that involves the purchase of convertible securities, often bonds that can be converted to stocks, and the simultaneous short of the same company's stock, seeking to take advantage of mispricing opportunities.

Hedge fund strategies often invest in public equities and bonds, but they also may hold private assets or derivatives, such as options, swaps, and futures contracts, to provide the underlying investment exposures.

Options-based. These strategies use options seeking to hedge downside risk, enhance income, or take advantage of mispricing of volatility across asset markets and the capital structure.

Event-driven. These hedge fund strategies seek to exploit mispricing that can occur in advance of or following corporate events, such as mergers, acquisitions, bankruptcies, and earnings calls.

Macro. Macro strategies use analysis of macroeconomic trends, business cycles, and market regimes to identify divergences between market expectations. These strategies often invest in asset classes as opposed to individual stocks or bonds.

PRIVATE EQUITY
In general, private equity is the investment in companies that are not traded in public markets; to do so, investors can make direct investments in a private company or invest in a private equity fund. Unlike traditional public equity, private equity investors typically need to hold an investment for multiple years to gain value before exiting positions. Below are some of the different types of investments in private equity.

Buyouts. Most private equity activity is in the form of buyouts—the acquisition of majority stakes or full ownership positions in companies. Other private equity investments may reflect lesser ownership stakes but involve important governance and management rights. Private equity investments can occur at any time during a company's life cycle, from start-ups to established revenue-generating companies.

Venture capital. Venture capital is a form of private equity that typically involves acquiring a minority stake in start-up companies with high growth potential.

Growth equity. Growth equity often is described as taking a significant equity interest with governance/management rights in more mature companies with the potential for accelerating earnings growth. With these rights to affect change at a company, the private equity fund manager works actively to add value by growing sales, making strategic acquisitions, and increasing operating efficiencies, which is distinct from the role of a traditional public equity fund manager.

Secondary investments. A growing proportion of the market, secondary investments involve the buying and selling of existing interests in private equity funds.

PRIVATE CREDIT
Like private equity, private credit generally refers to investments that are
originated or negotiated privately, are not traded on public markets, and often are composed of higher-yielding securities. Different subsets of private credit are described below.

**Direct lending.** Investors lend money directly to private companies. The borrowers are typically small and mid-sized private companies, and the lenders may be institutions or asset management firms.

**Distressed debt.** This refers to debt issued by companies that have defaulted, are undergoing bankruptcy, or are facing other near-term business complications.

**Collateralized loan obligations.** These are securitized assets made up of various types of loans—generally lower-rated but senior secured corporate loans—that are bundled together and sold to investors in different tranches.

**Mezzanine debt.** This subset of private credit falls between senior debt and equity in the capital structure. Mezzanine debt often contains embedded equity warrants that may be converted to equity ownership under specified circumstances.

**Opportunistic credit.** This encompasses a range of fixed income investments that may include private investments, structured securities, or public corporate debt.

**REAL ASSETS**

Real assets encompass a diverse range of assets from private real estate to fine art and collectibles. Private real estate investments involve ownership stakes in commercial properties or land in a variety of sectors, such as office buildings, retail, industrial, and multi-unit housing. Private real estate debt strategies offer exposure to loans on such properties.

Private real estate equity strategies fall within four main categories that reflect their risk and return characteristics, as described below.

**Core.** Core strategies generally provide exposure to well-leased buildings in sought-after markets. These properties tend to have quality tenants with long-term leases and therefore returns are driven by both current income and capital appreciation.

**Core plus.** These funds invest in quality properties in good locations where modest capital improvements or increased occupancy rates can enhance total return.

**Value-add.** These strategies may offer exposure to less-desirable properties that require capital improvement or have low occupancy levels and thus tend to have higher risk and return profiles.

**Opportunistic.** Opportunistic funds include challenged properties that may be vacant or very early in the development phase. Returns are generally driven by capital appreciation, and these strategies tend to be more suitable for investors with a higher tolerance for risk.

Commodities also are classified within real assets and include basic goods, raw materials, and natural resources, such as oil, natural gas, precious metals, and agricultural products. Infrastructure represents physical structures, facilities, and other assets that enable the storage or transport of goods, services, energy, and information, such as bridges, highways, pipelines, and data centers.

**DIGITAL ASSETS**

**Cryptocurrencies.** These are digital assets, such as bitcoin, that are designed to work as mediums of exchange that are stored on a decentralized ledger known as a blockchain. Investors and traders can buy and sell these assets on exchanges similar to other public securities markets.

**Stablecoins.** These are a class of digital assets designed to offer price stability backed by a reserve asset. They are tokenized forms of fiat currency.

**Central bank digital currencies.** These digital assets are government-led initiatives attempting to create natively digital fiat currency on a blockchain network.

**Non-fungible tokens.** NFTs are individually unique digital assets; unlike fungible cryptocurrencies, they cannot be traded or exchanged at equivalency. NFTs can be used to represent natively digital or real-world items, such as art, collectibles, and real estate.

**ALTERNATIVE INVESTMENT VEHICLE STRUCTURES SPAN THE LIQUIDITY SPECTRUM**

The liquidity of alternative strategies, like any investment, has two dimensions—the liquidity of the underlying assets in which the strategy invests and the liquidity terms of the vehicle
structure itself. Because the investment vehicles for alternative strategies typically are not traded on public markets like their traditional counterparts, e.g., a mutual fund or ETF, alternative investments often cannot be readily converted to cash and thus have lower levels of liquidity. However, it is important to note that an illiquid investment vehicle structure, such as a limited partnership hedge fund with an extended lock-up period, may still invest in highly liquid stocks or bonds.

From an asset class perspective, shown in figure 1, examples of some of the most liquid assets are large-cap equities or Treasuries, which typically can be easily traded and converted to cash. Meanwhile, ownership stakes in private companies via equity or debt, which are considered alternative asset classes, are more difficult to trade without a public market. Other examples of illiquid asset classes would include private real estate or fine art. As seen in public markets, the liquidity of any asset can vary based on market conditions; for example, during periods of market stress, it can be more difficult to trade high-yield bonds or even public equities.

The second dimension of liquidity, shown in figure 2, is determined by the investment vehicle structure and can range from highly liquid to highly illiquid. Liquid alternatives are alternative investment strategies structured as mutual funds, ETFs, and collective investment trusts (CITs) that offer daily pricing and liquidity. These liquid alternative vehicles may invest in a range of asset classes, including public and private markets. Many are hedge-fund-like strategies that seek returns that are uncorrelated with public markets, to provide investors with sources of diversification beyond traditional asset classes.

On the other end of the liquidity spectrum, investors may gain access to illiquid alternatives through direct investments or in a private vehicle structure, such as a limited partnership. These vehicles may be available only to investors that meet certain net worth, asset, and/or income minimums and can be highly illiquid, with lock-up periods of longer than five years that limit investors’ access to their capital.

Between these two ends of the liquidity spectrum are several investment structures, such as non-traded business development companies, interval funds, and non-traded real estate investment trusts (REITs). These vehicles tend to have at least some lock-up or gate provisions that limit liquidity, but shares generally can be redeemed at defined intervals, such as monthly or quarterly, often with caps on redemptions.

Although institutional investors tend to invest in illiquid alternative investments, many increasingly via direct investment due to their scale, financial advisors tend to invest to a greater degree in liquid alternatives on behalf of their clients. Surveyed advisors cited operational efficiencies, lower costs, and daily liquidity as benefits of investing in mutual fund and ETF structures. One in five financial advisors surveyed on behalf of Fidelity in...
2021 reported that illiquid alternative investments are not available through their firms; however, we anticipate that the proliferation of the vehicle structures highlighted above will continue to improve access to different types of alternative investments over time.5

Importantly, investors should consider whether liquidity may come at a cost. If illiquid assets are offered in liquid vehicle structures, there may be trade-offs over time between greater liquidity and the underlying exposures investors are seeking when allocating to alternatives.

WHY OWN ALTERNATIVES?
Investors generally have allocated to alternatives seeking to enhance returns, manage risk, or improve diversification beyond what afforded by traditional asset classes. To explore the roles that individual categories of alternatives can play in multi-asset class portfolios, we analyzed historical return, risk, and correlation statistics of 16 traditional and alternative investment categories, representing alternatives with the following: hedge fund strategies, private equity, private credit, and real assets from 2005 through 2021. Table 1 summarizes our key findings, and figures 3 and 4, as well as table 2, provide more details.

It is important to note that alternative investment strategies generally have a much shorter historical track record than their more traditional counterparts, and thus much less data than we typically evaluate when approaching strategic asset allocation decisions. The track records for bitcoin and other digital assets, in particular, are so short that we have excluded them from our quantitative analysis.

Our analysis begins in 2005 because that is the earliest we could obtain high-quality data for direct lending—the largest category of private credit. However, we conducted analysis on the other asset categories back to 2001 to assess the impact of the bursting of the dot-com bubble. We found that private equity returns appear more attractive starting in 2005, because the years 2001 and 2002 were meaningfully negative for the asset category—late-stage venture capital in particular. Including these earlier years in our analysis, we found that the private equity categories still led the others based on annualized returns; however, both ranked lower in years when the U.S. large-cap equity market performed poorly, which would reduce its attractiveness on our lesser downside measure summarized in table 1.

Based on our analysis beginning in 2005, the returns of private equity, as represented by late-stage venture capital and buyout datasets, were superior to all other traditional and alternative investment categories over the period studied, as shown in figure 3. Importantly, private equity outperformed U.S. small-cap and large-cap equities, illustrating the return premium investors expect when they sacrifice liquidity by owning private versus public equities.

More recently, private companies have been waiting longer before initial public offerings and now make up a significant proportion of the global economy. With many companies going public at steep valuations and the larger number of private companies, investors continue to seek potential opportunities in private equity highlighted here.

Private credit, represented by direct lending and distressed debt, and private real estate also boasted strong returns relative to many other asset categories over the period studied. Note that many investors look to private credit and real assets, specifically private real estate, to enhance portfolio yields—a component of total return. Meanwhile, commodities—another real asset category—have demonstrated strong returns episodically, such as during periods of unexpectedly higher inflation, as we have seen recently.

Acknowledging that some investors might argue that private equity and

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**EVALUATING POTENTIAL BENEFITS OF ALTERNATIVE INVESTMENTS, 2005–2021**

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Return Enhancement</th>
<th>Lesser Downside Amid Poor U.S. Equity Performance</th>
<th>Diversification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge Fund Strategies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Macro</td>
<td>-</td>
<td>+</td>
<td>++</td>
</tr>
<tr>
<td>Market Neutral</td>
<td>-</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Private Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buyout</td>
<td>++</td>
<td>++</td>
<td>--</td>
</tr>
<tr>
<td>Late Stage Venture Capital</td>
<td>++</td>
<td>++</td>
<td>+</td>
</tr>
<tr>
<td>Private Credit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct Lending</td>
<td>++</td>
<td>++</td>
<td>--</td>
</tr>
<tr>
<td>Distressed Debt</td>
<td>+</td>
<td>-</td>
<td>--</td>
</tr>
<tr>
<td>Real Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Real Estate</td>
<td>+</td>
<td>+</td>
<td>++</td>
</tr>
</tbody>
</table>

++ Top Quartile  ·  Second Quartile  ·  Third Quartile  ·  Bottom Quartile

Past performance is no guarantee of future results. Table 1 reflects how the representative alternative investment categories ranked among the 16 representative traditional and alternative categories, by quartile, from 2005 through 2021. Return enhancement: Asset categories ranked based on annualized returns. Lesser downside amid poor U.S. equity performance: Asset categories ranked based on average annual returns in the worst four years of returns of the Russell 1000 Index from 2005 through 2021. Diversification: Asset categories ranked based on the lowest average correlations with the other 15 asset categories. See figures 3 and 4, as well as table 2, for the analysis of all 16 asset categories based on these metrics. See appendix for index/asset category definitions.

Sources: Bloomberg Finance L.P., Morningstar, Burgess, Cliffwater LLC, Fidelity Investments, as of December 31, 2021.
private credit returns may be attributable to their exposure to public markets, we sought to isolate the residual returns that may be a result of the illiquidity premium or other factors. By examining the returns of these alternative asset classes and their relationships with their public market counterparts, we found that these private asset categories exhibited positive historical returns after controlling for exposure to public markets.  

We also would note that to analyze the returns of traditional asset classes, we use publicly available indexes, which aggregate the returns of, for instance, stocks and bonds, and are not directly investable or inclusive of fees. Correspondingly, we used a direct lending index that is also gross of fees, because it captures the returns of the underlying loans in the index. However, the hedge fund, private equity, distressed debt, and private real estate datasets capture the returns of funds that hold underlying asset classes and are net of fees. Therefore, fees have been applied to the returns of six of the seven alternative investment categories, and the returns of these categories may be understated relative to those of direct lending and the traditional asset classes in our study.

We also conducted analysis to account for typical fees for the traditional asset categories and direct lending, and the results presented here did not change materially. Fees for direct lending and other alternatives are generally higher than most traditional asset classes, but they may be offset by leverage, which is often used in direct lending and other alternative investment categories included in our study.

To explore the potential risk management benefits of alternative investments, we examined performance in years when public equity returns were poor. We studied the four worst return years for public equities from 2005 through 2021, with average declines of 10.0 percent

### ANNUALIZED RETURNS, 2005–2021

<table>
<thead>
<tr>
<th>Alternative Investment Category</th>
<th>Annualized Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Late-Stage Venture Capital</td>
<td>19.9%</td>
</tr>
<tr>
<td>Buoyt</td>
<td>15.6%</td>
</tr>
<tr>
<td>U.S. Large Cap</td>
<td>10.7%</td>
</tr>
<tr>
<td>Direct Lending</td>
<td>9.5%</td>
</tr>
<tr>
<td>REITs</td>
<td>9.2%</td>
</tr>
<tr>
<td>U.S. Small Cap</td>
<td>9.0%</td>
</tr>
<tr>
<td>Distressed Debt</td>
<td>8.4%</td>
</tr>
<tr>
<td>Private Real Estate</td>
<td>8.3%</td>
</tr>
<tr>
<td>Emerging-Market Equity</td>
<td>7.5%</td>
</tr>
<tr>
<td>High-Yield Bonds</td>
<td>7.0%</td>
</tr>
<tr>
<td>Treasuries</td>
<td>6.3%</td>
</tr>
<tr>
<td>Developed-Market Equity</td>
<td>5.4%</td>
</tr>
<tr>
<td>Investment-Grade Bonds</td>
<td>5.0%</td>
</tr>
<tr>
<td>TIPS</td>
<td>4.3%</td>
</tr>
<tr>
<td>Macro Hedge Fund Strategies</td>
<td>3.5%</td>
</tr>
<tr>
<td>Market Neutral Hedge Fund Strategies</td>
<td>2.7%</td>
</tr>
</tbody>
</table>

Sources: Bloomberg Finance L.P., Morningstar, Burgiss, Cliffwater LLC, Fidelity Investments, as of December 31, 2021.

### AVERAGE ANNUAL RETURNS IN THE FOUR WORST RETURN YEARS FOR THE RUSSELL 1000 INDEX, 2005–2021

<table>
<thead>
<tr>
<th>Traditional Asset Category</th>
<th>Average Annual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasuries</td>
<td>12.7%</td>
</tr>
<tr>
<td>Late-Stage Venture Capital</td>
<td>10.4%</td>
</tr>
<tr>
<td>Direct Lending</td>
<td>4.2%</td>
</tr>
<tr>
<td>Buoyt</td>
<td>2.4%</td>
</tr>
<tr>
<td>Private Real Estate</td>
<td>2.1%</td>
</tr>
<tr>
<td>TIPS</td>
<td>2.1%</td>
</tr>
<tr>
<td>Investment-Grade Bonds</td>
<td>0.6%</td>
</tr>
<tr>
<td>Macro Hedge Fund Strategies</td>
<td>-1.2%</td>
</tr>
<tr>
<td>Market Neutral Hedge Fund Strategies</td>
<td>-1.2%</td>
</tr>
<tr>
<td>High-Yield Bonds</td>
<td>-7.2%</td>
</tr>
<tr>
<td>REITs</td>
<td>-7.7%</td>
</tr>
<tr>
<td>Distressed Debt</td>
<td>-8.7%</td>
</tr>
<tr>
<td>U.S. Large Cap</td>
<td>-10.0%</td>
</tr>
<tr>
<td>U.S. Small Cap</td>
<td>-13.3%</td>
</tr>
<tr>
<td>Developed-Market Equity</td>
<td>-17.5%</td>
</tr>
<tr>
<td>Emerging-Market Equity</td>
<td>-25.3%</td>
</tr>
</tbody>
</table>

Sources: Bloomberg Finance L.P., Morningstar, Burgiss, Cliffwater LLC, Fidelity Investments, as of December 31, 2021.

Figures 3 and 4: Past performance is no guarantee of future results.

Traditional asset categories: U.S. large-cap equity—Russell 1000 Index; U.S. small-cap equity—Russell 2000 Index; developed-market equity—MSCI EAFE Index; emerging-market equity—MSCI Emerging Market Index; Treasuries—Bloomberg US Long Treasury Index; Treasury Inflation-Protected Securities (TIPS)—Bloomberg US Treasury Inflation Linked Bond Index; investment-grade bonds—Bloomberg US Credit Index; high-yield bonds—ICE BofA US High Yield Index; REITs—FTSE NAREIT All Equity REIT Index. Alternative categories: Hedge fund strategies—HFRI Macro Total Index and HFRI EH Equity Market Neutral Index; private equity—buyout and late-stage venture capital reflect annual return data from Burgiss; private credit—direct lending represented by the Cliffwater Direct Lending Index; distressed debt reflects annual return data from Burgiss; real assets—private real estate reflects annual return data from Burgiss. Burgiss Data used in this research reflects returns of U.S. private capital funds and funds of funds. See appendix for index/asset category details.
A NOTE ABOUT EVALUATING THE RISK OF ALTERNATIVES

Due to the nature of private markets, the returns of some illiquid alternatives can appear “smoother” or less volatile, which can underestimate the risks of these asset classes relative to others with similar characteristics.

For example, appraisal-based valuations that often are used in categories such as private real estate tend to change slowly over time and can lead to stale pricing. This can cause serial correlation, in which one period’s return is highly correlated with the previous period. This statistical issue poses problems when measuring volatility.

To identify the asset classes with artificially “smooth” returns, we can test for serial correlation and apply statistical modeling techniques to ensure the data is comparable to other asset returns. For those categories where we observed meaningful serial correlation (buyout, late-stage venture capital, real estate, and direct lending), we used modeled “unsmoothed” return data in our correlation and efficient-frontier analysis to reflect the volatility of these categories more accurately.*

* Unsmoothed returns for buyout, late-stage venture capital, and real estate calculated as follows: We estimated the relationships between these private alternatives and public asset classes at a low frequency (annual), accounting for any lagged influences that may be present due to the lack of liquidity. We then applied the estimated relationships to higher frequency or unlagged public asset returns, obtaining an estimate of what the volatility of the private asset could have been if trading in private alternatives were more frequent. Unsmoothed returns for the Cliffwater Direct Lending Index, a publicly available index with infrequent (quarterly) pricing, were provided by the index provider.
hedge fund strategies, private real estate, and late-stage venture capital had among the lowest average correlations with the other asset categories, as shown in table 2.

Based on the potential risk, return, and diversification benefits of the alternative asset categories we’ve outlined, investors may improve investment outcomes by incorporating them into multi-asset class portfolios. Our study so far has largely focused on each asset class independent of others. However, by constructing efficient frontiers—or sets of portfolios that vary their asset allocations to optimize expected return for a given level of risk—we can illustrate how including alternatives may enhance risk-adjusted returns.

Using our historical return data, we created two efficient frontiers with constraints that we believe are appropriate for a diversified portfolio.7 The maroon line in figure 5 represents a baseline efficient frontier that includes nine traditional asset classes (defined in the appendix). The teal line represents a portfolio that also may include seven alternative investment datasets that represent hedge fund strategies, private equity, private credit, and real assets (also defined in the appendix). As the asset mix is expanded to include alternatives, the efficient frontier moves up and to the left in figure 5, reflecting a higher level of return for the same unit of risk. By broadening the investment opportunity, this second set of portfolios boasted the stronger historical risk-adjusted returns of the two frontiers. This improved efficiency is the result of including additional asset categories with diversification benefits or higher historical returns at an equal or lower expected level of risk. This result also may reflect the compensation investors expect for bearing illiquidity and/or tail risk—the risk of outsized negative return.

**LOOKING AHEAD**

We have highlighted some of the potential risk–and–return merits of alternative investments, and why investors—more traditionally large institutions—have sought exposure to them. But the availability of these strategies in more varied and accessible vehicle structures has increased over the years and has enabled more investors to pursue their potential benefits.

The types of alternative investment strategies and vehicle structures investors might consider will depend on their investment objectives, time horizons, and risk tolerances. Furthermore, some categories of alternatives have a wide dispersion of returns among managers and strategies, so the performance an investor experiences in a single strategy may differ from the representative data sets shown in this article. The broad range of investment outcomes of some alternative investment strategies.
INDEX DEFINITIONS

**Bloomberg U.S. Credit Index** is a market value-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more.

**Bloomberg U.S. Long Treasury Index** measures the performance of U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury with a maturity greater than 10 years.

**Bloomberg U.S. Treasury Inflation-Protected Securities (TIPS) Index (Series-L)** is a market value-weighted index that measures the performance of inflation-protected securities issued by the U.S. Treasury.

**Cliffwater Direct Lending Index** is an asset-weighted index of more than 8,000 directly originated middle market loans totaling $223 billion. The CDLI assists investors to better understand asset class characteristics and to benchmark manager performance.

**ICE BofA U.S. High Yield Index** is a market capitalization-weighted index of U.S. dollar-denominated, below-investment-grade corporate debt publicly issued in the U.S. market.

**The FTSE NAREIT All Equity REITs Index** is a free-float-adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.

**HFRI Macro Total Index**: Investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long- and short-term holding periods. Although some strategies employ relative value techniques, macro strategies are distinct from relative value strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, although both macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to equity hedge, in which the fundamental characteristics on the company are the most significant are integral to investment thesis. In order to be considered for inclusion in the HFRI Monthly Indices, a hedge fund manager must submit a complete set of information to the HFR Database. Additionally, all HFRI constituents are required to report in U.S. dollars monthly, net of all fees, performance, and assets under management. Constituent funds must have either $50 million assets under management or at least $10 million USD assets under management on the last reported month prior to the index rebalance and have been actively trading for at least 12 months.

**HFRI EH Equity Market Neutral Index**: Equity market neutral strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between select securities for purchase and sale. These can include both factor-based and statistical arbitrage/trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical arbitrage/trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies that may occur as a function of expected mean reversion inherent in security prices; high-frequency techniques may be employed and trading strategies also may be employed on the basis of technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely, or accurately discounted into current security prices. Equity market neutral strategies typically maintain characteristic net equity market exposure no greater than 10-percent long or short.

**The MSCI Europe, Australasia, Far East Index (EAFE)** is a market capitalization-weighted index designed to measure the investable equity market performance for global investors in developed markets, excluding the United States and Canada.

**MSCI Emerging-Markets (EM) Index** is a market capitalization-weighted index designed to measure the investable equity market performance for global investors in emerging markets.

**The Russell 1000 Index** is a market capitalization-weighted index designed to measure the performance of the large-cap segment of the U.S. equity market.

**The Russell 2000 Index** is a market capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity market. It includes approximately 2,000 of the smallest securities in the Russell 3000 Index.
underscores the importance of manager research and suggests investors may consider diversified exposure to alternatives, such as funds of funds, multi-strategy solutions, or in the case of real estate, REITs in place of ownership in a single building.

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ENDNOTES

1. Results from Fidelity’s 2021 Institutional Innovation Study. Survey of 500 Institutions (42 percent Defined Benefit Plans, 16 percent Insurance, 15 percent Defined Contribution Plans, 11 percent Endowments and Foundations, 7 percent Family Office, 6 percent Private Bank, 4 percent Other (Multi-employer Pension and Sovereign Wealth Funds)). Allocation percentages may include both liquid and illiquid alternatives. Investor definitions of alternative investments may vary, and thus survey results may reflect different interpretations among respondents.

2. See endnote 1.

3. Results from the 2021 Fidelity Advisor Insights survey, an online blind survey fielded from October 2021 to November 2021. Participants included 2,759 advisors who manage or advise upon client assets either individually or as a team, and work primarily with individual investors. The study was conducted by an independent firm not affiliated with Fidelity Investments. Allocation percentages may include both liquid and illiquid alternatives. Investor definitions of alternative investments may vary, and thus survey results may reflect different interpretations among respondents.

4. Results from the 2021 Fidelity Advisor Alternative Investment Survey, an online blind survey fielded in April 2021. Participants included 204 advisors who personally manage or advise at least $30 million in client assets.

5. Results from the 2021 Fidelity Financial Advisor Community—Investment Decision-Making Study, an online blind survey fielded in July 2021. Participants included 406 advisors who manage or advise upon client assets either individually or as a team, and work primarily with individual investors. The study was conducted by an independent firm not affiliated with Fidelity Investments.

6. In conducting linear regression analysis, returns of large-cap U.S. equities and high-yield bonds were used as independent variables, and returns of buyout, late-stage venture capital, direct lending, and distressed debt were used as dependent variables. The alpha (intercept) from these regressions was interpreted as a measure of excess return due at least in part to illiquidity. For example, regression analysis involving buyout and large-cap U.S. equities, yearly returns of buyout (dependent variable) were regressed against yearly returns of large-cap U.S. equities (independent variable). The representative datasets for each asset category are defined above.

7. Efficient frontier analysis constrained by the following minimum and maximum allocations: Russell 1000 Index (Min: 0 percent; Max: 60 percent); Russell 2000 Index (Min: 0 percent; Max: 15 percent); MSCI EAFE Index (Min: 0 percent; Max: 30 percent); MSCI Emerging—Markets Index (Min: 0 percent; Max 15 percent); Bloomberg US Long Treasury Index (Min: 0 percent; Max: 15 percent); Bloomberg US Treasury Inflation Linked Bond Index (Min: 0 percent; Max: 15 percent); Bloomberg US Credit Index (Min: 0 percent; Max: 50 percent); ICE BofA US High Yield Index (Min: 0 percent; Max: 15 percent); FTSE NAREIT All Equity REITs Index (Min: 0 percent; Max: 15 percent); all alternatives categories (Min: 0 percent; Max 15 percent).

APPENDIX: METHODOLOGY DETAILS

Details underlying the information shown in figures 3–5 and tables 1 and 2 are given below.

Traditional asset categories: U.S. large-cap equity—Russell 1000 Index; U.S. small-cap equity—Russell 2000 Index; developed market equity—MSCI EAFE Index; emerging market equity—MSCI Emerging—Market Index; Treasuries—Bloomberg U.S. Long Treasury Index; Treasury Inflation—Protected Securities—Bloomberg US Treasury Inflation Linked Bond Index; investment-grade bonds—Bloomberg US Credit Index; high-yield credit—ICE BofA US High Yield Index; REITs—FTSE NAREIT All Equity REITs Index.

Alternative categories: Hedge fund strategies—HFRI Macro Total Index and HFRI EH Equity Market Neutral Index; private equity—buyout and late-stage venture capital reflect annual return data from Burgiss; private credit—direct lending represented by the Cliffwater Direct Lending Index; distressed debt reflects annual return data from Burgiss; real assets—private real estate reflects annual return data from Burgiss. Burgiss calculation details: Results are posted with every quarter-end publication date. The results reflect those of U.S. private capital funds and funds of funds and are net of fees and carried interest. Vintage is assigned based on the year of initial cash—flow date. Pooled results are calculated based on the composite transaction (cash flow and valuation) activity of the underlying funds. Roll-forward valuations are used to calculate results whenever reported valuations are not available.

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Investing involves risk, including risk of loss. Alternative investment strategies may not be suitable for all investors and are not intended to be a complete investment program. Alternatives may be relatively illiquid; it may be difficult to determine the current market value of the asset; and there may be limited historical risk and return data. Costs of purchase and sale may be relatively high. A high degree of investment analysis may be required before investing.

Investing in digital assets, such as bitcoin, is speculative and may involve a high degree of risk. Digital assets can become illiquid at any time and are only for those investors willing to risk losing some or all their investment and who have the experience and ability to evaluate the risks and merits of an investment in bitcoin.

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