Nailing Alternative Investment Portfolio Construction

By Aaron Filbeck, CAIA®, CFA®, CFP®, CIPM, FDP
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Constructing a portfolio is like building a house. Each requires a functional design and a solid footing. For a portfolio, an investment policy statement and policy portfolio act like a home’s architectural drawings and well-built foundation.

Only when these two foundational items are nailed down are you ready to move on to the details that will make a portfolio, or a home, move-in ready.

One of those portfolio finishes may be an allocation to alternative investments. But “alternative investments” cover a lot of options. If alternative investments are part of a client’s policy portfolio, how do you decide what exactly to include in that allocation?

This article describes some of the basics of portfolio construction using alternative investments. It’s important to remember that portfolio construction is a mix of art and science, that every client’s needs are different, and that alternatives vary greatly. Here we explain how advisors can consider all these factors when building a client portfolio.

To a Man With a Hammer, Not Everything Should Be a Nail

There are many different types of alternative investments, each with its own set of risks and potential rewards. It is important to thoroughly research and understand the characteristics of each type of alternative investment before including it in the portfolio. For example, private equity investments involve buying ownership stakes in privately held companies, and hedge funds use a variety of strategies not available in traditional fund formats to generate returns. Real estate investments can provide income potential through rent payments and appreciation, and commodities such as gold or oil can provide a hedge against inflation.

Alternative investments are heterogeneous, and their subcategories are just as diverse. In addition to the type of alternative investments, it is also important to consider the specific investments within each category. Diversification within each asset class can be important to mitigate the risk of any single strategy dominating the portfolio’s risks.

Take real estate as an example: Core real estate, in many ways, is viewed as a fixed income alternative—income-oriented, high principal protection, low risk. On the opposite end of the spectrum, opportunistic real estate comes with great risk of loss of capital, minimal to no income, and a focus on price appreciation. For most alternatives, one characterization does not fit all.

The Foundation

A sturdy home begins with quality plans and a solid foundation. In portfolio construction, one component of the foundation is the investment policy statement. Crafting an investment policy statement is important to any portfolio, but it’s crucial for building out an alternative investment allocation.

Before any allocations are made, it’s important to understand the client’s objectives and constraints, especially regarding liquidity and taxes, because many alternative investment strategies are not as liquid or as tax-friendly as traditional, long-only strategies and their vehicles.

Diversification within each asset class can be important to mitigate the risk of any single strategy dominating the portfolio’s risks.

The investment policy statement is the basis of what we call the client’s policy portfolio. In general, this policy portfolio is meant to be a long-term investment portfolio designed to meet the specific needs and objectives of the client. Policy portfolios are designed to be relatively stable and typically are adjusted infrequently. Many of them use ranges for different asset classes, e.g., 50–70 percent for global equities. Additionally, policy portfolios often are managed using a passive investment approach; they are a starting point for the client and advisor to use to define success at the portfolio level and at the manager level.

Effectively, the advisor has only three means of influencing client return: (1) asset allocation, i.e., the policy portfolio, (2) market timing or tactical allocation, and (3) security or fund selection. Research consistently has shown that asset allocation is the most meaningful decision an advisor can make, because it will drive the majority of future returns.
Therefore, the advisor’s focus should be on adopting the most robust and appropriate policy portfolio for the client. From there, effectively incorporating alternatives into the portfolio can improve overall outcomes.

When using alternative investments, the traditional policy portfolio approach brings about the following two important issues, which an advisor needs to make a client aware of:

**Fluctuations in the alternative allocation.** For clients desiring large allocations to private markets, it’s rare that the stated allocation objective is always met in practice, due to the lumpiness of cash flows during commitment strategies. For example, if the client’s stated objective is 10 percent in private equity, the actual allocation could be 5 percent or 15 percent, depending on market conditions, the rest of the portfolio’s performance, and the net cash-flow distributions from the private-market funds themselves. To mitigate this risk, advisors should ensure that the asset class ranges within the policy portfolio are flexible enough to accommodate a long-term commitment strategy. Additionally, clients should be made aware that the allocation will fluctuate over time within a stated range, with a goal of averaging to the stated objective over the long term.

**Benchmarking the alternative allocation.** The policy portfolio uses passive investments, i.e., indexes, to create the overall allocation, but benchmarking illiquid or more complex alternative strategies is likely to prove difficult because there typically aren’t passive equivalents in the marketplace.

Remember, a good index should be representative and investable at the very least. To mitigate this risk, advisors may need to get creative with how they benchmark alternative investments. The following are three ways to benchmark alternative investments strategies within a portfolio—but none is perfect:

- Total portfolio—compare a strategy relative to the entire portfolio’s performance to determine if it added value
- Absolute return—select an absolute return target, e.g., cash plus 4 percent
- Relative return—like active managers, benchmark the alternative investment to a public index

**TOP-DOWN VS. BOTTOM-UP**

When constructing a portfolio that includes alternative investments, advisors should decide whether they want the inclusion to be a top-down or a bottom-up decision. In other words, are alternative investments an asset-allocation decision or a manager-selection decision? In practice, the decision likely will include a bit of both, but each approach brings about different implementation decisions.

**Top-down decision: asset allocation**

In the top-down decision, the advisor must create an asset allocation that explicitly allocates to alternative investments. An example is an allocation that’s 50 percent global equities, 30 percent global fixed income, and 20 percent alternative investments. The top-down approach, however, raises three potential issues.

First, sectioning off a 20 percent catch-all allocation to alternative investments ignores the heterogeneity of the underlying strategies. Managed futures strategies are very different from private credit, and long-short equity is very different from real estate.

Second, an explicit allocation to alternative investments requires the advisor to try to fill that alternative “bucket,” no matter the market conditions or the manager options. Also, as discussed above, some private-market strategies never actually meet their allocation targets.

Finally, alternative strategies don’t fit neatly into an asset class because many don’t share the same characteristics. Top-down allocation decisions work well for public, long-only assets because they all tend to move together, and the dispersion of outcomes is minimal.

**Bottom-up decision: manager selection**

An alternative approach is to integrate alternative strategies in a bottom-up fashion. In this way, the bottom-up asset allocation decisions focus on building a policy portfolio of investable indexes, but the advisor has the flexibility to deviate from it when an opportunity presents itself. After all, performance dispersion is rampant in alternative investments, far more than in long-only traditional markets (see figure 1).
The manager–selection approach is used by some institutional investors and mitigates some of the drawbacks of a top–down approach, namely that it doesn’t require the advisor to “fill a bucket” when no good opportunities exist. All decisions are made on a relative basis. In other words, an advisor would choose to allocate to a long–short equity or private real estate manager only if the advisor believed the fund manager would add value relative to other options.

There are two potential issues with this approach:

Whipsawed decision–making. Without asset allocation constraints, the temptation to buy and sell strategies based on short–term market whims could be higher. Sometimes, being forced to “fill a bucket” may encourage discipline.

Benchmark risk. Many of the selected strategies likely would deviate from the policy portfolio benchmark in terms of risk or return or both. For benchmark–aware clients, this could cause dissatisfaction when performance deviates from their stated benchmarks.

Best of both: risk–based exposures
The manager–selection approach is probably better than a purely top–down allocation approach. But given performance dispersion, there is a third way to build a portfolio. In the past, I have argued for using a risk–based framework for making allocation decisions (Filbeck 2022). In my view, this approach combines the best of both worlds. It borrows the discipline of a top–down approach and the flexibility of a bottom–up approach.

If anything, good risk–based frameworks can serve as a powerful overlay to either approach, such as the way that factor–based analysis gave us better insights into the investments we own.

WORKING WITHIN BUDGETS
Once the foundation has been laid with an investment philosophy that has been made explicit through an investment policy statement and a policy portfolio, an advisor must determine which alternative investments are available to which clients. This is analogous to working within a home–building budget. For each investment client, this budget depends in large part on (1) the client’s opportunity set and (2) the client’s tolerance for illiquidity as well as other liquidity considerations.

OPPORTUNITY SETS
The opportunity set for a qualified purchaser (QP) is different than for an accredited investor (AI). QPs are required to have portfolios of more than $5 million in assets, so their opportunity sets are much larger and they can access more standard fund structures, e.g., limited partnership structures. AIs are limited because they are required to have a net worth of only $1 million, and some general partners (GPs) do not offer fund structures that are available to these investors.

Regardless of regulatory concerns, some portfolios are too small to warrant an allocation to traditional limited partnership structures due to their minimums. For example, some private equity funds may have minimum investments of $100,000, and others may require several million dollars. It may not be suitable for QP investors with only $6 million in investable assets to allocate to funds with high minimums, even if they qualify in the eyes of the U.S. Securities and Exchange Commission.

Fortunately, democratization allows access to alternative investments in different types of investment vehicles with varying liquidity profiles, as shown in figure 2.

Although not all vehicles are suited for illiquid or long–term focused strategies, some offer the best of both worlds.

LIQUIDITY
From a portfolio construction perspective, an advisor must consider three levels of liquidity when allocating to alternative investments:

Client liquidity tolerance. How much is the client willing and able to lock up and for how long? Ideally, this thought exercise should be evaluated under a stress–test scenario. It is easy to say a client can handle illiquidity when times are good. What will the liquidity need look like after a market drawdown or a major life event? Don’t forget, 20–percent portfolio illiquidity can jump to 40–percent or more in a matter of days or weeks—recall 2008 or 2020—and withdrawals serve to exacerbate that dynamic.

Figure 2
LIQUIDITY SPECTRUM OF FUND VEHICLES

Drawdown Funds
Evergreen Funds
Registered Funds Interval Funds Hedge Funds
REITs BDCs MLPs
Open–End Funds

Less Liquid
More Liquid

Source: Author’s illustrations
markets, through either (1) hedging, i.e., muted downside capture but positive correlation and a beta less than 1.0, or (2) diversification, i.e., positive or differentiated performance through low to negative correlation to other assets.

**Inflation protection.** The strategy protects the portfolio from rising or surprise inflation, either through price appreciation or inflation-linked cash flows.

None of these roles is mutually exclusive; in fact, many strategies fill multiple roles in a portfolio. It’s up to the advisor to select the most appropriate strategies, and examples are shown in table 1.

### #2: WHERE TO USE RISK DRIVERS TO GENERATE RETURN

The second consideration is where these alternative strategies reside within the portfolio. As discussed above, my view is that a risk-based exposure makes the most sense rather than creating a “bucket to fill.”

Using a risk-based framework calls for looking at the primary risk and return driver of each strategy. In other words, for each strategy, ask, “What is the leading risk that drives return?”

Again, categorizations will vary, but for simplicity we can assign strategies among the following four primary risk drivers:

- **Equity.** For these strategies, the primary driver of return is equity risk premia.

### TIME FOR SOME INTERIOR DESIGN

Once the policy portfolio has been constructed, and the liquidility profile has been explored, the investment opportunities should reveal themselves. The art of portfolio construction can now begin.

An advisor must think through the following five key considerations when building out an alternative investment allocation:

- The role of the strategy in the portfolio
- Where the strategy resides
- Sub-strategy diversification
- Vintage year diversification
- Post-commitment strategies

We’ll address each of these in order.

### #1: ROLE IN THE PORTFOLIO

The first, and most important, consideration is the role the particular alternative investment strategy will play in the client’s portfolio. Alternatives are a convenient catch-all, but some strategies act and behave differently than others. Some will have overlapping characteristics, but in general we can categorize every strategy into one of the following four primary roles:

- **Growth.** The strategy plays offense in the portfolio and aims to meaningfully increase the portfolio’s value over time.
- **Income.** The strategy generates an attractive stream of income.
- **Downside protection.** The strategy protects the portfolio during difficult markets, through either (1) hedging, i.e., muted downside capture but positive correlation and a beta less than 1.0, or (2) diversification, i.e., positive or differentiated performance through low to negative correlation to other assets.
- **Inflation protection.** The strategy protects the portfolio from rising or surprise inflation, either through price appreciation or inflation-linked cash flows.

None of these roles is mutually exclusive; in fact, many strategies fill multiple roles in a portfolio. It’s up to the advisor to select the most appropriate strategies, and examples are shown in table 1.

### EXAMPLES OF ALTERNATIVES’ ROLE IN THE PORTFOLIO

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Growth</th>
<th>Income</th>
<th>Downside protection</th>
<th>Inflation protection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyout equity strategies</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long–short equity</td>
<td>X</td>
<td>X (Hedging)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Core real estate</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodities</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct lending</td>
<td>X</td>
<td>X (Hedging)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance-linked securities</td>
<td>X</td>
<td>X (Diversification)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed futures</td>
<td>X</td>
<td></td>
<td>X (Diversification)</td>
<td></td>
</tr>
</tbody>
</table>

Source: Author’s illustration

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Credit. For these strategies, the primary driver of return is credit risk premia.

Real assets. These are strategies with assets that derive value from their physical properties.

Diversifying strategies. These are strategies with assets that lack direct exposure to the other three risk drivers. The manager of a diversifying strategy tactically borrows from the other three risk drivers, and performance is driven primarily by the manager’s skill.

Table 2 shows some examples to illustrate this point. Like consideration #1, the role in the portfolio, some risk strategies will have overlapping exposures. So for simplicity, I’ve categorized them by primary risk driver.

COMBINING #1 AND #2, ROLES AND RISK DRIVERS

We can take things a step further and combine tables 1 and 2 to get table 3, which shows that a risk driver can play different roles. Think of the role as the goal or desired outcome, and think of the risk driver as the tool at the advisor’s disposal for achieving the goal.

Once the roles and risk drivers are known, using a risk-based framework provides clarity. Equity strategies are combined with other equity assets; credit strategies are combined with other credit assets, and so on. Of course, this is an oversimplification. These strategies are complex, illiquid, and carry other considerations. But this approach can be a helpful starting point for both advisors and clients.

This combination of role and risk driver is the sweet spot between the top-down and bottom-up decision-making processes. It recognizes similarities to other asset classes, same as the top-down approach, but it also acknowledges that not all strategies are created equal, like the bottom-up approach.

#3: SUB-STRATEGY DIVERSIFICATION

An important consideration in portfolio construction is sub-strategy diversification. Public, long-only traditional investments allow greater visibility into each strategy’s components, letting an advisor build a diversified allocation within each asset class. In alternative investments, there is no standardized equivalent to the Morningstar Style Box™, so advisors must diversify based on what they can observe. Some of these characteristics might include style, sector, geography, or capital structure. A few examples are described below.

Private equity
Private equity is a broad categorization for an industry with many kinds of strategies. When allocating to private equity strategies, an advisor should consider the following:

Stage. Private equity investments can be made at different stages of a company’s life cycle, e.g., start-up, expansion, or maturity.

Industry. Some GPs are sector specialists, e.g., technology or health care; others are multi-sector.

Geography. Like in the public markets, investing in private equity opportunities in different regions or countries can diversify the portfolio.

Style. Private equity investments can take various forms, e.g., venture capital, growth capital, or buyouts—

### EXAMPLES OF PRIMARY RISK DRIVERS IN ALTERNATIVE INVESTMENTS

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Risk driver</th>
<th>Growth</th>
<th>Income</th>
<th>Downside protection</th>
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<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Core real estate</td>
<td>Real assets</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodities</td>
<td>Credit</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct lending</td>
<td>Credit</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance–linked securities</td>
<td>Diversifying</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed futures</td>
<td>Diversifying</td>
<td>X</td>
<td></td>
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Source: Author’s illustrations

### EXAMPLES OF THE ROLES AND RISK DRIVERS IN A PORTFOLIO

<table>
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<th>Strategy</th>
<th>Risk driver</th>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Author’s illustrations

Table 2

Table 3

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each of which carries its own risk-return profile.

**Strategy.** Each strategy can target value creation from different sources. For example, distressed managers target underperforming businesses and create value by turning around and stabilizing those businesses. In industry roll-up and consolidation, a manager buys a business and uses it to engage in mergers and acquisitions by purchasing smaller companies, benefitting from efficiencies of scale and growing operating leverage.

**Private debt**

Private debt strategies also comprise many strategies within the broader complex. Private debt characteristics include the same characteristics as private equity, plus the following additional characteristics:

**Capital structure.** Some debt strategies focus on senior secured loans and others focus on subordinated or unsecured loans.

**Rate structure.** Some private loans offer fixed rates and others offer floating rates. Additionally, some loans incorporate payment-in-kind yields and other sources of return, such as origination fees.

**Term or maturity.** Some debt strategies focus on shorter-term holding periods, e.g., two to three years, and others may anticipate a loan lasting five to seven years or even 15–25 years in the case of real estate loans.

**Real estate**

Given that real estate’s value is driven by physical characteristics, investors in real estate should consider the following:

**Style.** Like private equity, real estate strategies tend to focus on certain stages and styles of properties, e.g., core, core plus, value-add, and opportunistic.

**Geography and market type.** The opportunity for higher returns also can be driven by the types of markets in which real estate properties exist. Primary, secondary, and tertiary markets have varying degrees of affordability, rental income, and growth opportunities.

**Property type.** Dynamics vary greatly among property types, e.g., office, retail, industrial, multi-family, and hotels. It’s no surprise that dynamics for hotel investments would be different from an industrial or trophy office property.

The unique characteristics of private alternative investment categories go beyond the three examples listed above. The point is that it’s not always enough to have exposure to an “asset class.” Thoughtfully combining strategies within the same category can lead to better outcomes. Many advisors already pursue this exercise in traditional markets—total public equity exposure often is broken into style, factor, size, and geographical exposures—and the same should be done for alternative investments.

The challenge comes with the more flexible and tactical strategies that many hedge funds and liquid alternative mutual funds pursue. For example, managed futures and macro managers may be labeled similarly but pursue their strategies very differently. The key to portfolio construction with these strategies is to combine different managers enough to avoid concentrating risks with one manager but still benefit from the skill the manager adds to the overall portfolio. This can be done by doing either or both of the strategies shown in table 4.

### #4: VINTAGE YEAR DIVERSIFICATION

When investing in private markets using drawdown fund structures, the vintage year of a private fund can be an important factor that determines its future performance. For example, a fund with a vintage year one or two years before an economic downturn may see lower returns, but one a year or two after may see higher returns.

Unlike public markets, it’s difficult to be tactical in private markets, so building a long-term portfolio that invests across vintage years will lead to performance that’s more representative of the broader asset classes. Predicting vintage years is nearly impossible. The best approach is to consistently allocate each year. Going from 0-percent exposure to the target exposure will take time, perhaps years. There are strategies to backfill and increase the exposure more quickly; however, overcommitting in year one is a risk not to be ignored.

Although you can build a diversified vintage year program with new

### Table 4: Combining Flexible Strategies

<table>
<thead>
<tr>
<th>Approach</th>
<th>Example</th>
<th>How to build the portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Combine similar strategies to obtain a desired exposure without taking on significant manager risk.</td>
<td>Three U.S. long–short equity managers</td>
<td>Because these strategies will have similar beta exposures, the focus should be on minimizing the correlation of excess returns by targeting distinct sub-strategies, i.e., sector specialist, growth stocks, capitalization size, etc.</td>
</tr>
<tr>
<td>Combine different strategies to achieve an average return in the long run, with different strategies playing different roles throughout a market cycle.</td>
<td>One managed futures fund One tail-risk fund One macro fund</td>
<td>Because these strategies will have different and varying beta exposures, the focus should be on lowering the correlation of total returns to achieve proper diversification.</td>
</tr>
</tbody>
</table>
commitments, you also can allocate to historical vintage years using the secondary market. In fact, using secondary funds can be a quick way to create a diversified portfolio of vintage years.

5: CASH-FLOW MANAGEMENT AND TIME HORIZONS
After determining a client’s asset allocation and planning a portfolio that meets objectives, the advisor still must manage cash flow. Unlike open-end funds or exchange-traded funds that can be purchased and redeemed daily, many alternative investment strategies use less-liquid structures. Therefore, a meaningful and diversified allocation will take time to build and will be more challenging to unwind.

With drawdown fund structures, there is lag time between capital commitments and capital calls; advisors should ensure they have a strong cash-management program for their clients. It could be months between the time you commit capital to a fund and when that capital is first called and further called in the early years. When a fund manager calls the capital, you may have as few as 10 days to provide your commitment. This requires balancing two tasks: (1) making sure the money is accessible when called but (2) also figuring out what to do with it until it’s called.

Once invested, some strategies may lock up capital for as long as 10–15 years, which means the advisor needs to ensure the total portfolio’s liquidity profile meets the client’s needs. For example, retirees who need regular distributions may not be able to invest a substantial portion into venture capital all at once.

Beyond portfolio construction decisions, one way to manage cash flow for clients is to combine multiple fund vehicles. This approach would explicitly mitigate cash drag on the front end of the investment period and allow periodic redemptions and rebalancing on the back end, all while maintaining long-term exposure to a particular strategy or asset class.

CONCLUSION
Like building a house, portfolio construction starts with a solid foundation. From there, in either case, the design depends on the opportunities and preferences of the client.

Constructing a portfolio of alternative investments requires an advisor to take extra care, because data about alternative investments is less available than data about public investments. Each category of alternative strategies contains overlapping characteristics and economic exposures, but each individual strategy pursues its objectives differently. By combining multiple managers within each category, advisors can layer different exposures appropriately and mitigate manager-specific risks.

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REFERENCE

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