

A blurred photograph of a busy city street at dusk or dawn. Several people in business suits are walking, their figures blurred to convey a sense of motion. In the background, modern buildings with lit windows are visible. A yellow banner is overlaid on the lower half of the image.

# **ALTERNATIVE INVESTMENTS IN THE MODERN PORTFOLIO**



# Alternative Investments

Although younger or inexperienced investors bemoan the past year as unprecedented, the past few years have marked an outcome of predictable, cyclical processes. Securities, policies, and economic infrastructure may change as time passes, but human psychology doesn't, and this is the driving force behind investors' lost confidence following recent performance.

## Nothing New Under the Sun

While investors and managers with more than a few years in differing markets under their belts remember, a history lesson reinforces the déjà vu feel of capital markets today. In June 2000, think tank giant The Brookings Institute pointed to a fundamentally changing economy and low inflation as indicators of a **New Economy**. The new economy promised a national capacity to "sustain a higher growth rate without suffering from higher inflation," and Brookings urged the Federal Reserve to become more dovish in reaction to the new paradigm.<sup>1</sup>

Two years later, the stock market traded nearly 80% lower than when Brookings printed their report, and the promise of a new era didn't bear fruit.

At the tail end of the pandemic, institutional and retail investors felt similar euphoria. Outsized valuations and cheap debt created a bull run in the stock market as unprofitable companies with shaky financials saw swelling market capitalizations.

But, like the Dot-Com Crash, circumstances that appear too good to be true often are. Post-pandemic realignment saw three distinct, interrelated factors converging to wreak havoc on many portfolios: inflation, recession fears, and the monetary policy enacted mainly in reaction to the latter two.

## A Tough Break

Driven by denial or inexperience, many investors lost as much or more than the rewards they reaped during the pandemic. Stocks struggled mightily, and fixed-income assets like corporate bonds and Treasuries couldn't match inflation. Inflation quickly became 2022 and 2023's mainstay maxim as the pandemic-induced haze diminished, and we woke up with an economic hangover.<sup>2</sup>

Disrupted supply chains, renewed consumer spending, and the aftereffects of loose monetary policies combined with geopolitical turbulence created a perfect storm that spiked national inflation to 9.1%, the fastest month-over-month rise since 1981.

Furthermore, popular alternatives to these portfolio mainstays fared little better.

Housing markets saw a substantial supply and demand slinky effect as supply chains caught up with booming demand. The new builds began in earnest, but just in time to see rate hikes bring the 30-year mortgage averages from a multi-decade low of 2.66% to nearly 7% in a few short months.<sup>3</sup> Residentials lay empty and dormant, dashing flippers' dreams, while the multi-year federal eviction moratorium expired in August 2022 and gave cash-flow-focused renter investors anxiety.

Crypto crashed, currencies couldn't keep up with inflation, and hedge funds fared little better as even the wealthiest and accredited investor classes struggled to reorient on an abrupt economic swivel.

## Stocks, Bonds, Cash

On their own, the assets comprising a traditional portfolio got crushed in recent years. Concerningly, the 60/40 portfolio paradigm (60% stocks, 40% bonds) fell apart as the two opposing asset classes became increasingly correlated, moving in lockstep – and preventing bonds' protective power in a down equity market.

<sup>1</sup> The Internet and the New Economy, The Brookings Institute. June 2000. [Link.](#)

<sup>2</sup> US Inflation Hits New Four-Decade High of 9.1%, Wall Street Journal. July 13th, 2022. [Link.](#)

<sup>3</sup> 30-Year Fixed Mortgage Average in the United States (MORTGAGE30US), FRED. January 2023. [Link.](#)

Feeling the pressure, private companies shied away from public listing en masse. The annual IPO rate fell by 82% from the previous year, signaling a widespread lack of confidence in public prospects from private executives and the investment banking firms that underwrite and bring them to market.<sup>4</sup>

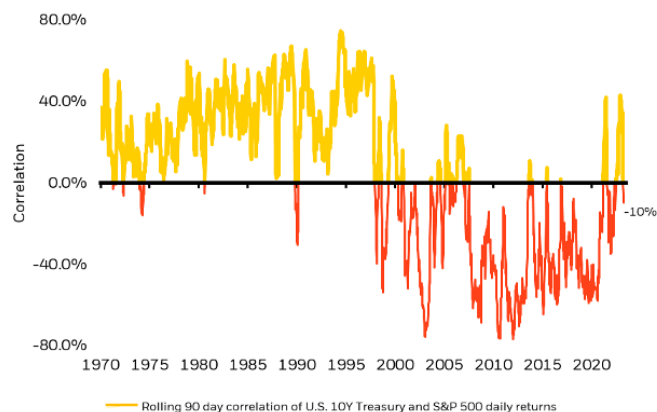
As rising yields created deep discount pricing, active bond traders also suffered throughout the year. US Treasury indices lost a net 12.5% over the year, while the former pandemic favorite high-yield junk bond performed slightly better at an 11.2% loss.<sup>5</sup> Even fixed-income investors, content with clipping coupons, contended with inflation wiping out already-tight yield margins.

Cash, of course, was a lost cause in 2022. Ray Dalio's prescient January 2020 prognostication that "cash is trash" held throughout 2022. Although Dalio maligned cash positions as a lost opportunity amid swelling global valuations pre-pandemic and affirmed the thesis throughout 2021, currency proved an equally poor defensive position in 2022.

## Traditional Investing and Portfolio Management

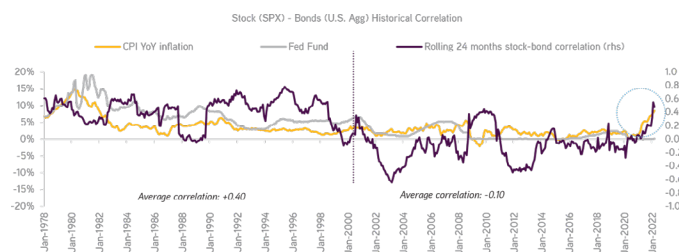
It's little wonder that, with all three asset class mainstays suffering, the traditional portfolio fared poorly in 2022. But its future prognostication is little better, leaving investors and analysts alike tolling the death knell for the 60/40 traditional portfolio.

Long heralded as the pinnacle of prudent investing, the 60/40 (or 70/30) portfolio's balanced mix of stocks and bonds walks the line between speculative growth prospects and defensive fixed income. But the concept is an output of the 1950s' modern portfolio theory in an era before globalized markets and ongoing financial engineering that skew the statistical expectations of the 60/40 model.



The core thesis supporting a 60/40 portfolio is an inverse correlation: if stocks fall, bonds rise to compensate and buoy the losses. However, that fundamental truth is no longer guaranteed. Understanding the lagging performance of the portfolio is critical because many individual investors, and even professional managers, continue to view the concept as a "safe" play to offset the perceived excess risk in today's market.

Bottom line: stocks and bonds are increasingly correlated. Without overexplaining the factors contributing to the statistical divergence, the bond-based ballast keeping a portfolio afloat during bear markets isn't viable. Bond market values fell in lockstep with equities in 2022, and this correlation compounds alongside inflation. These factors create a disaster for the 60/40 portfolio in today's environment.



Faced with a fundamental realignment, sophisticated investors and professional managers are realigning portfolios through alternative investing: equities and fixed-income assets that compensate for 60/40's lost benefits and complete a well-rounded, risk-adjusted portfolio in today's market.

<sup>4</sup> The 2022 IPO Market: A Dearth of Volume and Names, Barron's. December 2022. [Link.](#)

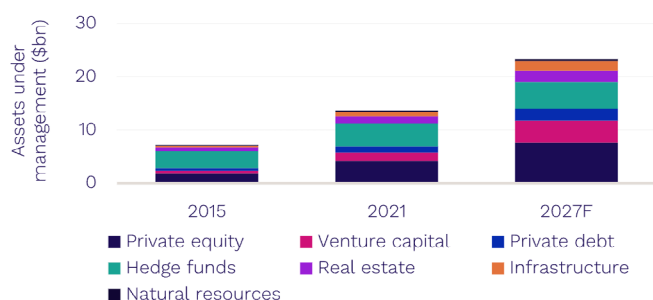
<sup>5</sup> Market Review 2022, JP Morgan Asset Management. January 2023. [Link.](#)

## Alternative Investments

Alternative investments offer an endless array of selections to suit most investors' income status, risk tolerance, and strategic preference. The title alternative investments underscore the simplicity of the concept as the entire class consists of investment options outside of stocks, bonds, cash, and some derivatives. At the same time, the name belies the complexity of the entire field.

## Alternative Investment Outlook

Although the sector saw rising popularity in recent years primarily due to digital innovations to streamline information and investing processes, their growth and exposure rates began growing exponentially in 2020.



Source: Preqin Pro. Data as of October 2022

Expert analysts estimate that the global alternative investment AUM pool will grow to \$23.3T in the next four years – nearly doubling in size since 2021.<sup>6</sup>

Furthermore, alternatives' growth isn't just a function of the Fed's money printing or a proportionate rise in global equities and net investment AUM. No longer relegated to the highest of HNWI's, management funds and firms are recommending a partial outlay in alternatives to most clients to reorient performance in the wake of today's unique circumstances and flagging 60/40 allocation performance.

Global investment firm KKR & Co, recognizing both the headwinds in traditional investing even if markets stabilize, asserts that a 40/30/30 stocks/bonds/alternatives portfolio is far superior irrespective of market conditions. Even if this allocation is market-agnostic, KKR emphasizes that this proportion is critical in today's

environment.<sup>7</sup> KKR also emphasizes the growing importance of specific classes like private credit when determining the structure of the 30% total.

## Benefits

The benefits of individual alternatives within the broad class vary but tend to have three fundamental commonalities to draw investors:

## Diversification

Unlike stocks and bonds, many alternative asset classes aren't correlated with the market, either positively or inversely. By detaching performance entirely from the guide rails of equity and bond markets, investors are free to consider investments on their own merits rather than judge them against public peers' projected performance.

## Reduced Volatility

Volatility varies by individual asset class, but generally, alternatives tend to see less valuation whipsaw. Lessened volatility serves to stabilize investors' net worth and wealth management strategies. While partially due to illiquidity, a downside we'll address shortly, the most popular alternatives in volatile markets remain steady as a function of systems and processes emphasizing structure, predictability, and a more significant potential for long-term appreciation that shrugs off short-term instability.

## Enhanced Returns

In private equity and venture capital, investors get special access to the "ground floor" of a promising company or project and can often structure terms that bias the investors. In debt-based alternative allocations, similar term structuring advantages and borrower-specific risk generate much higher fixed-income rates than the public debt markets. In both cases, alternative assets enhance a portfolio's rate of return because alternative investment firms and facilitators attract the best human capital and expertise. Leveraging that, alternative investment firms do

<sup>6</sup> The Future of Alternatives in 2027, Preqin. October 2022. [Link.](#)

<sup>7</sup> Regime Change: The Benefits of Private Credit in the "Traditional" Portfolio, KKR & Co. December 2023. [Link.](#)



exhaustive due diligence and detailed negotiations to ensure the best options for clients' circumstances and risk profiles.

## Risks

All investments carry risk. While many alternatives protect against systematic risk, each alternative asset class has systemic risks. Alternative investing firms typically warn clients about:

## Liquidity

Since regulations restrict alternative investments to an elite class of investors, the asset market is smaller. This and other investment-specific variables mean that alternative assets are illiquid and cannot be sold as quickly or easily as public investments. Therefore, investors should refrain from investing substantial sums in an alternative investment if they expect to need the funds soon. Alternative assets also tend to have long-term investment horizons with predefined closures like an exit event in venture capital or principal repayment in real estate credit investing. Potential buyers rarely join investments like these in the middle of a planned timeline, making a quick cashing out difficult.

Some foresee liquidity being less problematic in the future. Just like Web 2.0 advances made the alternatives market more readily available, the ongoing transition to Web 3.0 may increase liquidity. Blockchain and related distributed ledger technology mean that holdings can be broken into near-infinite slices (tokenization) and create a larger market to trade alternatives. This tokenization could also increase access to alternatives like real estate or private credit funds, further driving growth.<sup>8</sup>

## Denominator Effect

Illiquidity contributes to the Denominator Effect when a portfolio has both alternative and traditional assets. Assuming a defined proportion of each, as in KKR's recommended 40/30/30 split, pricing disparities between alternative and public assets can skew the balance. Since the market constantly affirms public

equities pricing, volatility can drive the value of that proportion up or down substantially while the alternative investment's pricing lags. Therefore, if aligning strictly with a proportional allocation, portfolio managers may prematurely buy or sell the public side of a portfolio to realign the distribution and cause further problems down the road.

## Leverage

Many investments, like real estate projects and credit funds, often assume third-party debt. Increased leverage coupled with illiquidity means that the assets are increasingly sensitive to interest rate hikes and external factors. Venture capital is also susceptible to overleveraging an investment, as term sheets typically dictate lenders' priority repayment. If a startup goes under, the remaining cash and assets go to creditors first and investors second.

## Sector Risk

Individual assets have unique risks that may surprise investors unfamiliar with alternatives. Investors must understand the nuanced factors that influence the specific investment or have a valued and trusted relationship with their fund management teams. Suppose an investor doesn't understand the nuance of international shipping but is overweight infrastructure credit funds. In that case, he may be surprised when shipping lanes close and cause steel prices to spike – increasing the risk of project delays and cash flow interruptions.

## Cornerstones of Alternative Investing

The field of alternatives is expansive. Investors have nearly unlimited products to pick from and can find options no matter their risk profile or strategic preferences. Tech enthusiasts can flock to crypto, old-world sophisticates can invest in fine art and vintage wines, and aggressive investors can go all-in on speculative derivative assets through hedge funds. All come with advantages and unique risks, but three core alternative investments remain the most popular and drive much of the growth in the alternative space: real estate, private equity, and private credit.

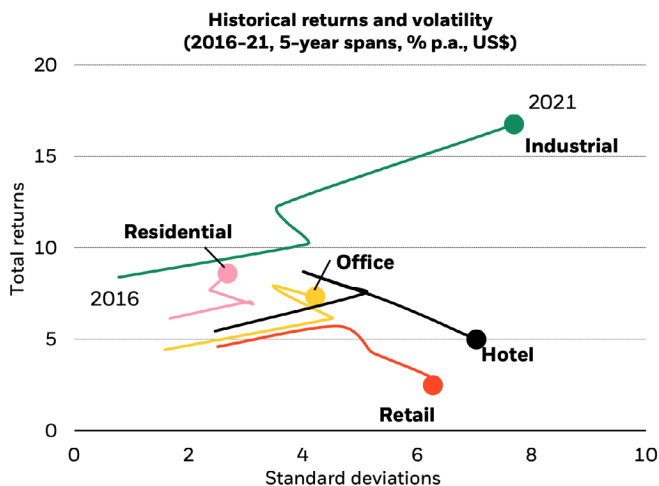
<sup>8</sup> From Tailwinds to Turbulence, Boston Consulting Group. May 2022. [Link.](#)

## Real Estate

Real estate is one of the most widespread alternative investments, as it scales more than many and isn't restricted to accredited investors – anyone with the cash for a down payment can invest in a rental property or flip a home. However, fund managers and accredited investors get to invest in a range and scope of real estate products denied to others.

Real estate investments prioritize either capital gains through property value increases or recurring, reliable, fixed-income-style cash flow through rental or leasing management. Both hold for standard real estate investments. But whereas an individual retail investor can buy and flip a home or rent out a duplex, accredited investors can do the same at scale and invest in different real estate sectors.

Sector diversification in real estate investing is critical for a balanced portfolio, especially as conditions today damage residential prospects and office complex investing. Sectors were once correlated mainly with one another but have diverged substantially since 2016.<sup>9</sup> The five core sectors returned between 5 – 10% and had similar volatility; today, industrial investments outperform all others. Because industrial-style investments and projects require so much capital compared to residential, they mainly favor wealthier clients and funds specializing in real estate credit management.



No matter the sector, investors on both ends of the risk spectrum can find a viable investment through capital appreciation projects or emphasizing cash flow.

Both have benefits in today's macroeconomic environment.

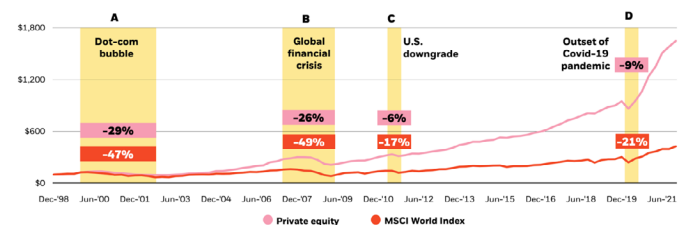
Property values, as a market whole, inevitably trend upwards over time. Assuming an investor's comfortable with capital lockup for a more extended period, they're all but guaranteed to generate a return by funding new builds or buying existing properties. Today's supply chain crunch means that new build prospects are uncertain. Demand continues to rise, but inflation and interest rate hikes make new property developments less attractive and drive the value of existing properties and investments higher.

Cash flow and fixed-income investors also benefit from inflation. Investors ensure that cash flow matches inflation as they pass costs downward by investing in a wide swath of leased properties, especially those with short lease terms like residential areas. On the riskier end of fixed-income real estate, lenders funding new builds or improvements can take advantage of interest rate hikes through floating-rate loans.

## Private Equity

For two decades' worth of financial crises, private equity outperformed the global public market over time, but the difference is stark during troubled periods.

The same skittishness scaring investment banks from underwriting new IPOs in 2022 creates an opportunity for alternative investments in private equity. Private companies still need access to fresh capital, and the high costs of debt may preclude some firms from financing. Inflation and costly debt also give investors an improved bargaining position to demand downside protection and preferred terms. Private equity issues, therefore, are an ideal capital structuring plan for today's conditions.



<sup>9</sup> 2023 Private Markets Outlook: A New Era for Investors, BlackRock Alternatives, January 2023. [Link.](#)



Because private equity targets more established firms than venture capital, there are increased opportunities to negotiate for special dividends, as retained earnings don't solely fuel constant growth. The prospect of this cash flow serves as a cyclical, reinforcing mechanism. To solicit private equity, a company must demonstrate sound financials and potential for returns. Those fundamentally good enough are better positioned to weather the next few years than early-stage growth startups who use every cent available to expand and bring a product to market.

As always, private equity fund managers must be thorough in due diligence before investing in any company, and careful consideration should ensure investors' downside protection through liquidation preference or similar measures. Private equity valuations are more appropriate than most public stocks, and today may be an ideal time to expand private equity holdings.

## ■ Private Credit

Somewhat ignored over the past decade because of cheap debt, private credit is the fastest-growing alternative asset class. It is ideal for investors prioritizing capital preservation and consistent, reliable periodic income. The simple title private credit, like alternative investments, obscures the scope and diversity of investment opportunities. One firm's origination head observed, "there is so much diversity in this asset class, which means investors will have plenty to do regardless of market conditions. If you think about benign markets, you can invest in direct lending. If you think about challenging markets, you have distressed debt and others. [There are] 26 strategies within private credit, which allows this asset class to be relevant in any market condition."<sup>10</sup>

Although many options exist, ideal private credit investments rely on diligent fund managers to expertly navigate negotiations and skew the term balance in favor of protecting the principal and benefiting investors. In today's environment, investors interested in private credit should prioritize:

- Rate structure: floating rates benefit investors if rate hikes continue as expected, providing

an offset for inflation. While a balanced private credit portfolio also includes long-term fixed-rate debt structuring, short-term direct lending should include floating rate provisions

- Liquidity compensation: private credit is one of the most illiquid investments, as portions of a debt load are challenging to offload and sometimes unauthorized under term agreements. Therefore, investors have a right to demand greater returns for their risk. That cost of capital increase is an illiquidity premium, and the suppressed real estate market decreasing liquidity means that the premia should rise.
- Default risk: since private credit borrowers cannot, by definition, solicit debt from public markets, they may have an inherent and outsized risk of default. And, similar to public junk bonds, investors should collect an increased yield premium in exchange for assuming more default risk. With so many economic factors converging and threatening firms on a shaky foundation, fund managers' due diligence must be exhaustive when considering lending options.

No matter the strategy, conditions today favor lenders. Although corporate bonds and Treasuries coupon rates fall well below inflation, most private credit investments should match or beat it, depending on risk tolerance. For the hungriest, opportunistic credit helps bridge struggling companies that cannot maintain their current capital structure in exchange for substantial compensation. Unlike many other credit investments, distressed debt trades relatively quickly on secondary markets.<sup>11</sup>

Risk-averse investors can chase improved yield through investment in mid-market lending. Many mid-market segmented firms aren't financially troubled or fundamentally unsound – their relatively small size makes them less attractive for large, institutional lenders. This unwillingness puts mid-market lenders in an ideal position to demand better deal terms in exchange for capital. This leverage makes mid-market credit investing ideal for market turbulence, as history shows they've outperformed large-cap markets during downturns based on deal negotiation.

<sup>10</sup> Private Debt Outlook 2023, Pitchbook. December 2022. [Link](#).

<sup>11</sup> Ibid.

Private credit is one of the most flexible and beneficial broad-spectrum alternative investments today. Because there are so many subclasses of private credit, investors of all types can find preferred funds and lending options. Typically, firms offering private credit investments are also industry experts with decades of experience and a deep bench of contacts. This expertise means managers are fluent in the complexities and esoterica of deal term sheets and have the practical context to spot deals and red flags alike.

## ■ Conclusion

Even if analysts and experts calling for the end of the 60/40 portfolio paradigm are incorrect, that allocation into public equities and bonds underperforms in today's shaky economy. To offset and manage those losses and generate returns despite falling equity valuations and rising yields, intelligent investors are turning to alternative investments.

Alternative investments like real estate, private credit, and private equity tend to be uncorrelated with public markets, so stock volatility doesn't immediately translate to alternative asset instability. Alternatives are also less prone to market-wide shocks, including interest rate hikes and inflation that will doubtless continue for the foreseeable future. Many directly compensate for or offset inflation, and economic conditions put investors with sufficient dry powder in a better bargaining position.

Finally, quality human capital undergirds the best alternative investment options. Because alternatives are less transparent and much more complex than stocks and bonds, alternative asset fund and firm managers are experts in their specific subsector with years of practical experience in opening, managing, and exiting investments. Due diligence, a part of any investment, is especially critical when considering capital-intensive investments, and managers must be up to the task. Investors must also be thorough in due diligence, but because of opacity and complexity, they must carefully vet the gateway to alternative investments – quality, proven, and responsible fund management.





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