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360 Perspectives

Alternative Assets and the roles they play in portfolios

Wealth Management Chief Investment Office

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What are Alternative Assets?

To say financial markets has been challenging would be an understatement. The highest inflation in decades has led central banks to raise interest rates at an unprecedented pace, clouding prospects for global equity and bond markets. However, the investment landscape are not limited only to publicly traded stocks and bonds. There is also an entire universe of assets that fall within the private and alternative assets realm that can offer valuable diversification benefits much needed in today's investing climate.

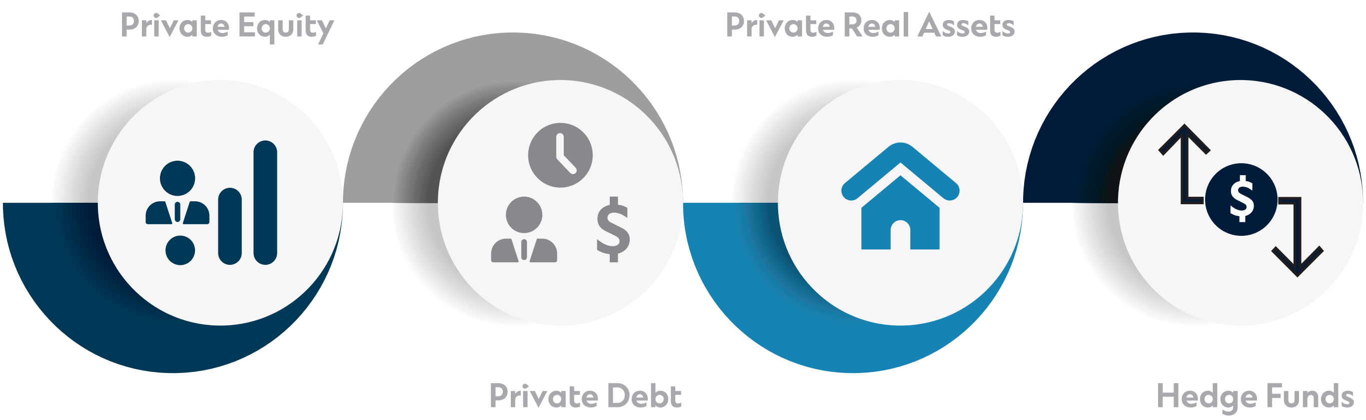
Alternative Assets are investments that fall outside of the traditional asset classes of stocks, bonds or cash. They include investments in liquid and private assets such as Private Debt, Private Equity and Private Estate or investment strategies that use non-traditional approaches, such as long/short or global macro strategies.

Specifically, **Private Equity** is the investment of capital in private companies in exchange for equity or ownership. It differs from public equity investments in that the stake in the company is not publicly traded.

Private Debt is the provision of debt to companies directly from investors rather than banks or public markets. The debts are typically secured loans, but their terms are tailor-made between the borrower and a single or small group of lenders.

Private Real Assets is an asset class that covers investments in physical assets, which can include residential housing, commercial real estate, infrastructure, commodities and natural resources.

Lastly, **Hedge Funds** are loosely regulated private pooled investment vehicles that can employ derivatives and leverage, make investments in less liquid assets and take short positions. As an asset class, it comprises of a wide range of strategies, including Equity Hedge, Event-driven, Global Macro and Relative Value.



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Comparison between Traditional and Alternative asset classes

Traditional Assets		Alternative Assets
Publicly traded and liquid investments	VS.	Typically not publicly traded and less illiquid
Investors allowed to buy and sell as they wish	VS.	Usually involve long-term lock-ups
Highly regulated	VS.	Less regulated and transparent, can vary according to strategy
Numerous and passive owners	VS.	Smaller number and more active owners
Correlated with market movements	VS.	Generally less correlated to public markets
Some assets can offer low risk-adjusted returns	VS.	Historically offer high risk-adjusted returns
Low investment amounts allowed	VS.	Higher minimum investment requirements
Open to general public	VS.	Generally only open to more sophisticated investors

Source: Standard Chartered

Benefits of Alternative Assets

Amid the backdrop of elevated cross-asset correlation and volatility, Alternative assets are becoming increasingly relevant and sought after.

The lessons of 2022, which saw the 60 / 40 stock and bond portfolio lose value for only the fourth time in 150 years, will likely encourage investors to continue seeking out alternative, less correlated sources of returns. Alternative assets, in contrast, declined less. Liquid Alternatives were down 5.3%, while an index of Private Equity (Buyout) declined by 2.3% in 2022.

Alternative assets offer various benefits to investment portfolios during times when traditional asset classes are simultaneously losing value. One such benefit is the ability to enhance the returns of a traditional portfolio. The enhancement to returns comes from their exposure to a differentiated set of strategies, manager expertise, a broader universe of investments as well as compensation for illiquidity and complexity risk.

An allocation to Alternative assets can offer diversification benefits. A traditional portfolio consisting of only public equities and bonds can be strongly correlated to economic and market conditions. A small allocation to Alternative assets, which typically offer less correlated returns to traditional assets, can expand one's options and yield diversification benefits.

Some Alternative assets also bear unique characteristics that allow them to be more resilient to economic cycles, inflationary pressure, and tighter monetary policies. For example, Global Macro Hedge fund strategies can offer lower beta and correlation compared to traditional strategies and limit portfolio losses during equity market drawdowns. Relative Value strategies have also historically exhibited resilience in different growth, inflation and interest rate regimes, thus making them useful portfolio diversifiers. Meanwhile, some private assets such as private credit or real assets deliver a large part of their returns from stable cash flows and are often less correlated with traditional asset classes over a longer period, thereby offering diversification and some protection against inflation and market volatility.

Benefits of Alternative assets

Provide diversification

Investor can lower their overall portfolio risk by investing in assets that have a lower correlation to traditional stocks and bonds

Enhance returns

Alternative assets can potentially provide higher returns than traditional investments given additional sources of returns (eg. illiquidity, complexity, skill premia)

Protection against inflation

Some Alternative assets can provide a hedge against inflation, with cash flows repricing higher as inflation increases

Potential to lower volatility

Some Alternative assets may be less volatile than traditional assets (eg. farmland, infrastructure) and can provide steady, predictable returns

Access to unique opportunities

Alternative assets can provide unique opportunities, (eg. early stage companies, art work, collectible) which may not be correlated to the broader financial markets

Source: Standard Chartered

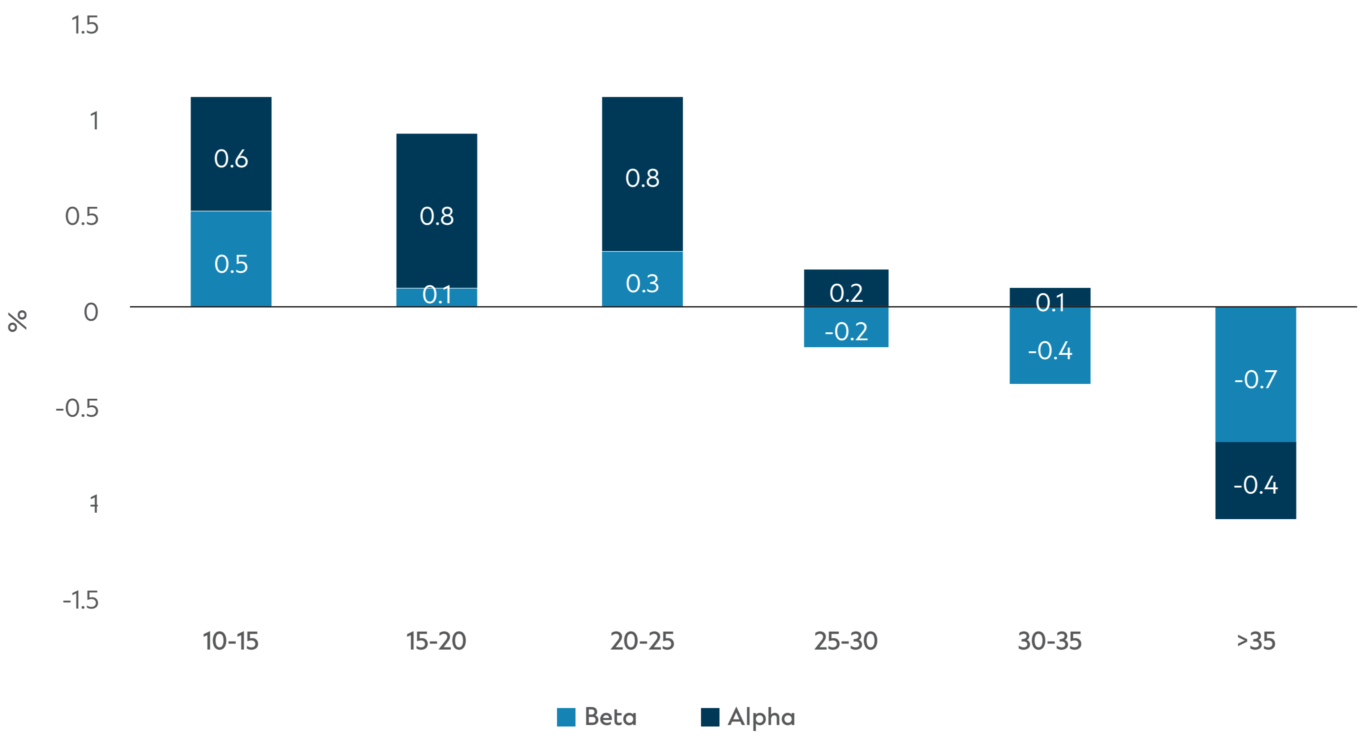
The roles Alternative Assets play in a portfolio

Liquid Alternatives strategies valued for their flexibility

The roles that Alternative assets play in the portfolio differ by asset class and strategy. For instance, Liquid alternatives have high degree of flexibility and diversity in terms of strategies. Managers can take long or short views and are typically unconstrained by benchmarks and asset classes, with an aim to generate absolute returns. Managers can also hedge market risks through the use of derivatives and short-selling, resulting in less correlated returns. An allocation to liquid alternatives strategies in a traditional portfolio can thus help to improve diversification and improve the portfolio risk-return over the long-term.

The importance of manager skill to capture alpha i.e. excess returns over benchmark during good and bad times

Average hedge funds strategy returns by VIX level, 1990 – present



Source: HFRI, CBOE, MSCI, FactSet, J.P.Morgan Asset Management

Private assets provide a wide opportunity set

Private Equity can offer investors a differentiated source of returns and the potential to generate alpha through superior manager selection. Moreover, it has an expanded set of opportunities to choose from given the universe of public companies has largely contracted over the past few decades.

While high growth, innovative companies can generally be found in both the public and private markets, those in the earliest, highest growth phase, are almost exclusively privately funded. This approach allows investors to capitalise on potential megatrends such as an ageing population, ESG and Fintech. By and large, private equity has generally achieved returns above public equities over the long run, unlevered real estate returned somewhere between stock and bond returns, and private debt has typically outperformed high yield bond returns.

The enhancement to returns comes from the asset class's exposure to a differentiated set of strategies and manager expertise, as well as compensation for illiquidity and complexity risk. Depending on investors' portfolio, private equity can be viewed as an "equity replacement" within a foundation allocation or a source of "opportunistic returns", complementing core portfolios.

Private Debt often serves as a reliable source of income while proving to be more resilient than traditional fixed income. It offers several advantages relative to High Yield (HY) bonds and bank loans, in our view: higher yield and more limited mark-to-market volatility, generally higher returns and some protection against pre-payment. Private Debt also tend to comprise floating rate loans, which can make them attractive in a rising rate environment.

Private debt borrowers come a wider variety of industries and are typically mid-sized companies, differentiating from traditional public markets. Lenders also the flexibility to set preferred lending terms and have a greater influence when it comes to negotiating and structuring loans, which is also contributor to its lower volatility and resilience relative to public debt.

We would consider Private debt strategies as a yield enhancer within a broader fixed income allocation or as a diversifier within an overall growth portfolio.

Private Real Assets, meanwhile, capture both the characteristics of Private Equity (ie. capital appreciation) and Private Debt (ie. income) and can potentially serve as source of protection against inflation. Private Estate and Infrastructure deliver a large part of their returns from stable cash flows and are often less correlated with traditional asset classes over a longer period. These assets, thus, have relatively low correlation with public markets, offering diversification and drawdown mitigation benefits.

In addition to income potential, investing in real assets can offer some inflation hedge characteristics, as these asset classes often enjoy strong pricing power or explicit long-term contracts to pass the impact of rising prices to customers. For example, most infrastructure asset contracts have concession agreements to pass through the impact of higher prices to end consumers. Property developers can also increase the price of their properties due to higher input costs or increase rents during periods of robust demand and/or low supply.

Investors can consider this strategy as a potential yield or return enhancer to diversify allocations within a traditional portfolio.

Expected roles of each sub-strategy in investment portfolios

	Role of each strategy in traditional portfolio			
	Diversification against traditional assets	Income	Capital growth	Inflation hedge
Private Equity	LOW	LOW	HIGH	LOW
Private Debt	MEDIUM	HIGH	LOW	LOW
Real Assets	HIGH	MEDIUM	MEDIUM	HIGH
Liquid Alternatives	MEDIUM	LOW	HIGH	LOW

Source: Standard Chartered

Potential risks

While Alternative Assets are a growing area of interest for investors, they can come with their own, unique risks.

Manager selection

Manager selection is a critically important step. Alternative Assets are often complex and there can be significant performance dispersion across managers within the same investment strategy. Meanwhile, costs can also be high compared to public market investments.

Liquidity

Liquidity is also a risk. Some Alternative Assets involve investments in illiquid assets such as private equity and real estate which may take months or even years to sell. There could also be lock-up periods or redemption caps during which investors may not be able to withdraw their funds. Given exposure to securities that are not traded, some Alternative Assets could be subject to valuation risks, which utilize pricing information and valuations furnished to it by third parties, including appraisal firms and pricing services.

Transparency

Some Alternative Assets may also offer less transparency than traditional assets. Historical data may be limited, or strategies may employ complexity that is not always well-understood by investors. Benchmark indices that provide investors with information on an asset class's risk and returns may also suffer from 'survivorship bias', with failed managers no longer included, resulting in arguably inflated performance.

Leverage

Last but not least, Alternative assets may employ leverage. For example, the acquisition of debt securities may be financed in substantial part by borrowing, which increases exposure to loss. The use of leverage can also magnify losses for investors.

Conclusion

In our assessment, Alternative Assets provide investors with numerous benefits and should be an essential part of a diversified portfolio. During times of elevated cross-asset correlation in traditional assets, they can provide valuable diversification benefits. That said, the nature of risks presented by Alternative assets can be somewhat different to those of more traditional assets and hence require more careful assessment of the risk/reward trade-off.

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