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Financial Planning Weekly

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Alternative Assets: A Diversified Approach to Investing

Traditional investments like stocks, bonds, and cash are all well and good, but they don't offer the full range of potential returns and risk profiles that investors are looking for. That's where alternative assets come in.

Alternative assets are investments that do not fall into one of the traditional asset class categories. They can include things like private equity, private debt, infrastructure, real estate, natural resources, and hedge funds.

These assets can offer a number of advantages over traditional investments. They can provide higher returns, lower volatility, and greater diversification when combined with other investments. They can also be used to hedge against risk and achieve specific investment goals.

Here are some of the more popular alternative assets:

- **Private equity**: This is an investment in private companies that are not publicly traded. Private equity funds typically invest in companies that are growing rapidly or that are in turnaround situations. Depending on the fund, the investment can be made at various stages of the company's journey.
- **Private debt**: This is an investment in loans that are not publicly traded. Private debt funds typically lend money to companies that are either unable or unwilling to receive financing from traditional sources. This could be for a myriad of reasons and may see a higher interest cost to the company, or even greater flexibility.
- **Infrastructure**: This is an investment in long-term assets that are essential to the economy such as roads, bridges, and power plants. Infrastructure funds typically invest in assets that generate stable cash flows over many years and may be placed in conjunction with governments.
- **Real estate**: This is an investment in land and buildings. Real estate can be a good way to diversify an investment portfolio and generate income.
- **Natural resources**: This is an investment in commodities, such as oil, gas, and metals. Natural resources can be a good way to hedge against inflation and currency fluctuations.
- **Hedge funds**: This is a type of investment fund that uses a variety of strategies to try and generate profits. The strategies may include short-selling or using leverage, which increases the risks involved in order to generate a potentially higher return.

How to Invest in Alternative Assets

There are a few different ways to invest in alternative assets.

- **Direct:** Such as buying a piece of real estate or investing in a private company. Depending on the asset, this may require a large upfront capital commitment and time spent researching and due diligence.

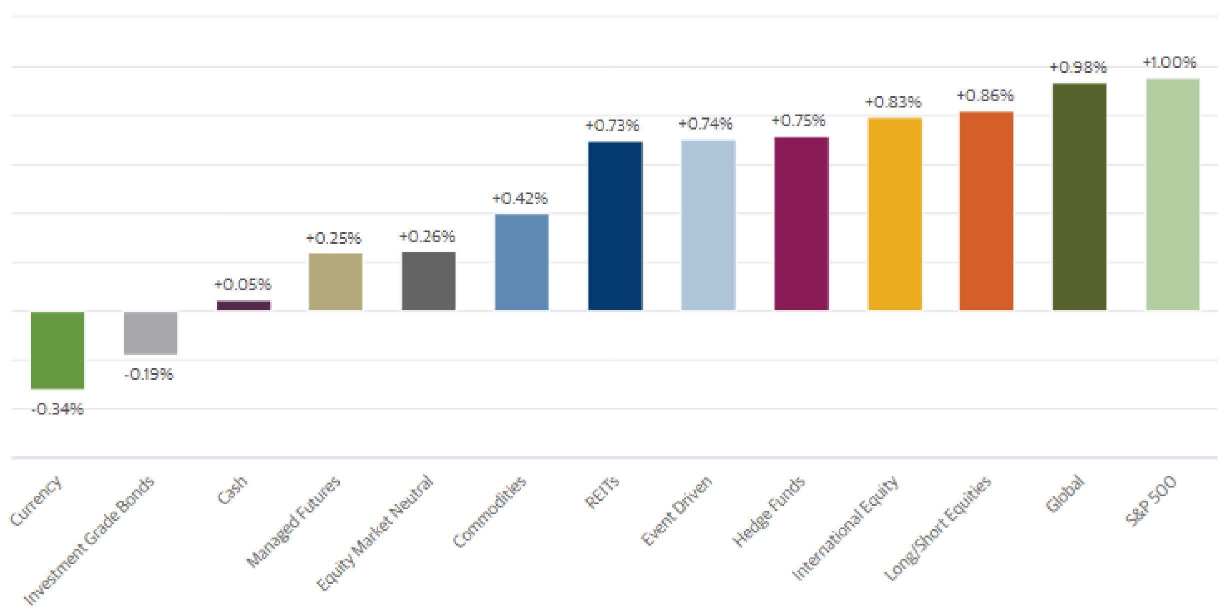
- **Funds:** Such as a managed fund, where you invest through a Product Disclosure Statement (PDS) or other Offer document. The fund manager then invests into various assets according to the investment mandate. Some funds require any investor to be classified as 'Wholesale' or 'Sophisticated' investors.

- **Fund of Funds:** As the name suggests, this is an investment into a fund, that then invests into other funds and may be spread across different themes and assets. Given there is a large variability in returns between the top and bottom quartile funds, this can be a popular approach as you are outsourcing the manager selection and gaining greater diversification.

Correlations to traditional assets

Correlations are a statistical measure of how two variables move in relation to each other. This measure ranges from -1 (perfectly Negatively correlated) to +1 (perfectly Positively correlated). It shows how assets move, either up or down, at the same time as each other. Traditionally, Bonds and Equities have a negative correlation to each other, so in theory if one part of your portfolio was dropping (equities, for example) it would be at least partially off-set by a rise in the bond part of your portfolio. Hence, a diversified portfolio with negatively correlated assets would help to smooth returns. 2022 then came around with higher interest rates, lower equities and substantially lower bond prices. Private market investments, in general, have a lower correlation to traditional asset classes.

Historical Correlation of Various Asset Classes vs. S&P 500® January 2011–December 31, 2022



Source: [Asset Class Correlation Map | Guggenheim Investments]

Performance

The performance of private markets in the last decade has been very strong. Assets under management (AUM) in private markets has reached US$11.7 trillion as of 30 June 2022, growing at an annual rate of nearly 20% since 2017 (source: McKinsey Global Private Markets Review 2023 | McKinsey). This growth has been driven by a number of factors, including:

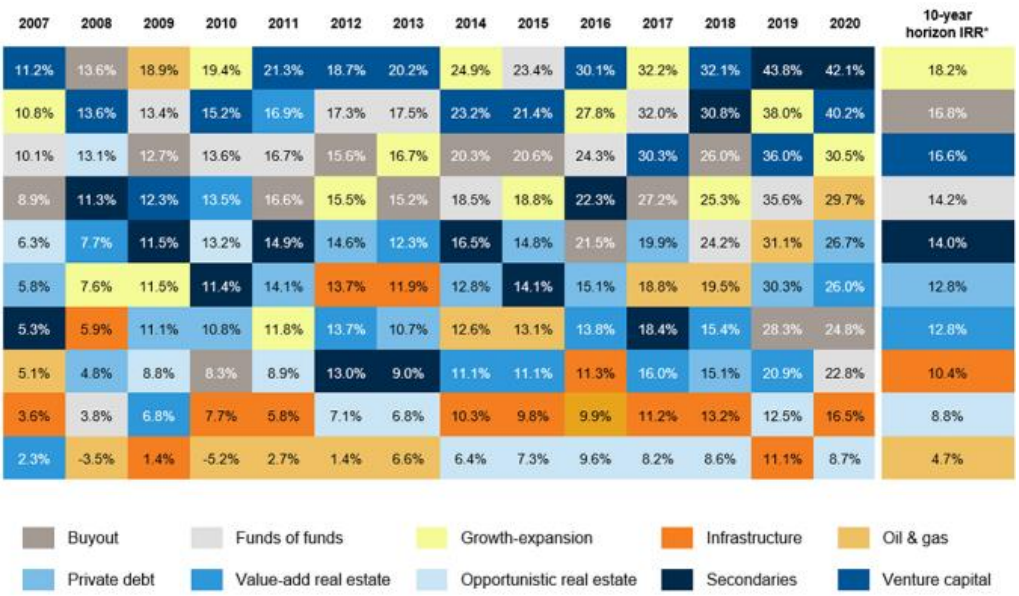
- **Low interest rates:** Low interest rates have made it more attractive for investors to put their money into assets that offer higher returns, such as private markets. During Covid for example, with interest rates at or close to 0%, money was freely available and flowed to Venture capital funds and then onto start-up businesses for expansion. Consequently, the valuations for many of these start-ups went up, delivering big returns for Private equity funds. As interest rates and lending conditions have tightened globally there may be a reversal in these high valuations, time will tell.

- **Demand for diversification:** Investors are increasingly looking to diversify their portfolios beyond traditional assets such as stocks and bonds. Private markets offer a way to do this, as they can provide exposure to a wider range of assets and risks.

- **The rise of mega-funds:** There has been a trend towards the creation of larger private equity funds in recent years. These funds have the ability to invest in larger deals and to take on more risk. The better the performance, the more funds flow and the bigger they get.

The performance of private markets in the next decade is uncertain, and past performance is no indicator for future performance. However, the long-term trend is likely to be continued growth, as investors continue to seek out alternative assets that offer higher returns and diversification benefits.

Private market strategies pooled IRR



Source: The Power Of A Fund-Of-Funds Approach In Private Markets | Russell Investments

Trends

Here are some of the key trends that are likely to shape the performance of private markets in the next decade:

- **The rise of ESG investing:** Investors are increasingly interested in investing in private market assets that meet their environmental, social, and governance (ESG) goals. This is likely to lead to more investment in sustainable infrastructure and real estate projects.

- **The growth of digital assets:** Private markets are also becoming increasingly involved in the investment in digital assets, such as cryptocurrencies and blockchain technology. This is a new and rapidly evolving area.

- **The increasing importance of data:** Data is becoming increasingly valuable in private markets. Investors are using data to identify investment opportunities, to assess risk, and to manage their portfolios. This trend is likely to continue in the years to come.

Overall, the outlook for private markets is positive. The asset class is likely to continue to grow in the next decade, as investors seek out alternative assets that offer higher returns and diversification benefits.

Alex, Anu and the team.

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