ADVISORS ASSET MANAGEMENT

Alternative assets: An important source of return and diversification

Most individual investors are highly invested in more liquid asset classes, typically beyond their immediate liquidity needs. By moving beyond the traditional asset mix of more liquid public stocks and bonds, incorporating less-liquid alternatives has the potential to improve returns, increase diversification and enhance the overall portfolio risk profile.

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What are alternative assets?

The alternatives label can be a catchall for a wide range of assets. But broadly, it can be split into three main groups.

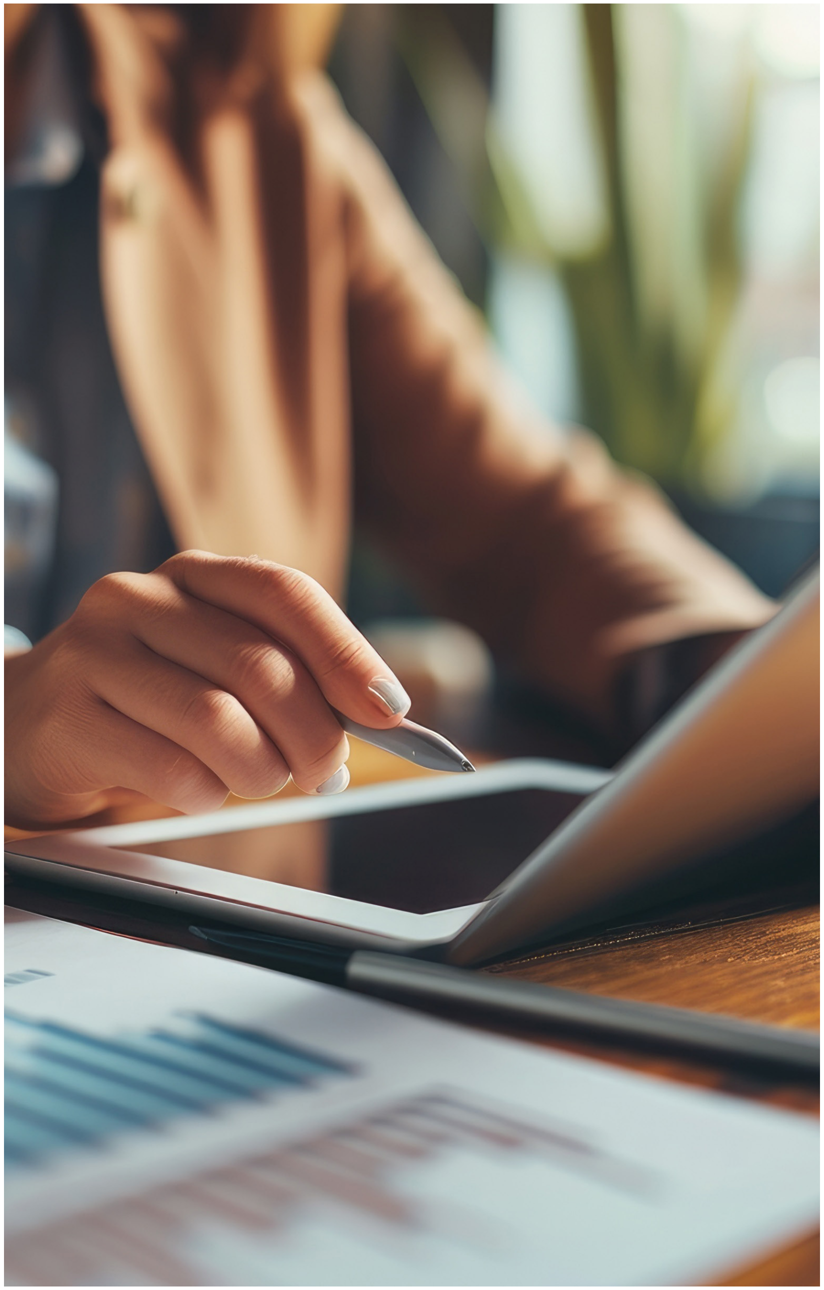
1 **Private assets**
These are the most long established and popular strategies. These include private equity, private debt, real estate, infrastructure and natural resources. Within each of these is a range of styles and themes. And in the case of debt, varying credit quality offerings.

2 **Liquid alternatives**
These are mainly hedge funds and commodity strategies that use publicly traded assets as their building blocks.

3 **Idiosyncratic investments**
Art, collectables, and digital assets are also alternatives. But for now, these are a small part of the overall mix and tend to be tailored to individual investor requests.

A key difference between public assets and most alternative assets is that traditional assets trade on exchanges or in over-the-counter markets, while many alternative assets are private and do not.

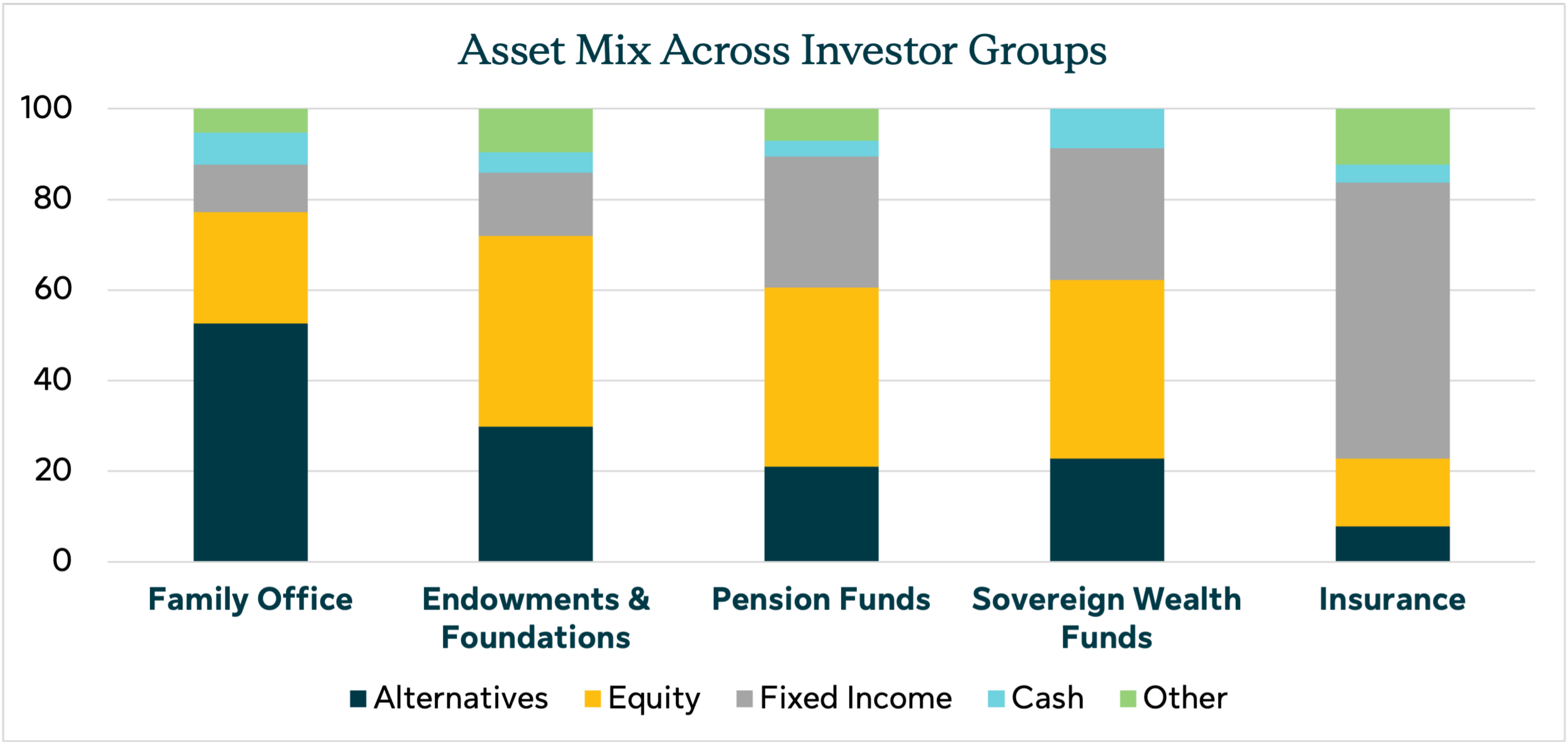
Private asset investments are typically originated by experienced specialty asset managers who analyze, structure and oversee the assets through the investment cycle. Their goal is to deliver a return advantage over comparable public assets through active management.



Who owns alternative assets?

Some of the largest investors in alternatives are endowments, foundations, pension funds, sovereign wealth funds, insurance companies and family offices. Endowments were some of the earliest adopters and average around 30% of assets allocated to alternatives. However, there is significant variation. Yale University, for instance, has over 75% of its endowment invested in alternatives. Other institutions like pension funds and sovereign wealth funds have 25% on average invested in alternatives, while global family offices have 54% (*Source: Preqin, Goldman Sachs Global Investment Research*).

Ultimately the asset mix decision is a function of investor return targets, time horizon and risk appetite. This is also informed by estimating future obligations and cash flow needs.



Source: Preqin, Goldman Sachs Global Investment Research

What drives the return advantage?

Historically, private asset classes have on average delivered a return advantage over comparable public assets. Some of this premium is compensation for the lower liquidity, but it also stems from the greater degree of customization required in private transactions, as well as the "complexity premium" associated with structuring these deals.

For example, in the case of debt, one of the big differences between public and private debt is that the terms and conditions of public debt are determined by the underwriting banks, who set those terms based on market demand and supply. However, in private debt transactions the deal terms are often customized to what individual companies need with appropriate covenants and downside protection for investors. These direct relationships allow greater communication, which during times of business stress can lead to more cooperation and better outcomes to preserve value. The additional customization and underwriting required often helps generate higher yields for investors.

The same applies in the case of private equity, including real estate and infrastructure. The opportunity to actively manage assets through their holding period can significantly enhance value.

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What has the return advantage been?

As private assets have grown, so too has the research on performance. As expected, the return advantage varies across asset classes based on risk. Manager skill also matters as there has been a significant difference between upper and lower tier performance.

Some of the most comprehensive data on the aggregate return advantage comes from two studies: one on private equity and the other on private debt. The private equity study[1] covered 1,800 U.S. funds, mainly venture capital and buyout funds, over 30 years. The average annual return premium, over a public market equivalent, was around 3.5%.

The private debt study[2] focused on 448 global funds and was also over 30 years. It reported an average annual return premium, over a public market equivalent, of 1% but with a wide range. Importantly, the top quartile funds achieved a return advantage of over 3%.

Some key conclusions from this research are that the return advantage has been compelling, that manager style and skill is important, and that the variation around the average is wider the riskier the asset class.

Therefore, understanding the manager's strategy, process, and track record are important. Some managers may have strategies that aim for a competitive return but with less volatility. Others may have strategies that perform well across most business cycles but excel during high inflation periods.

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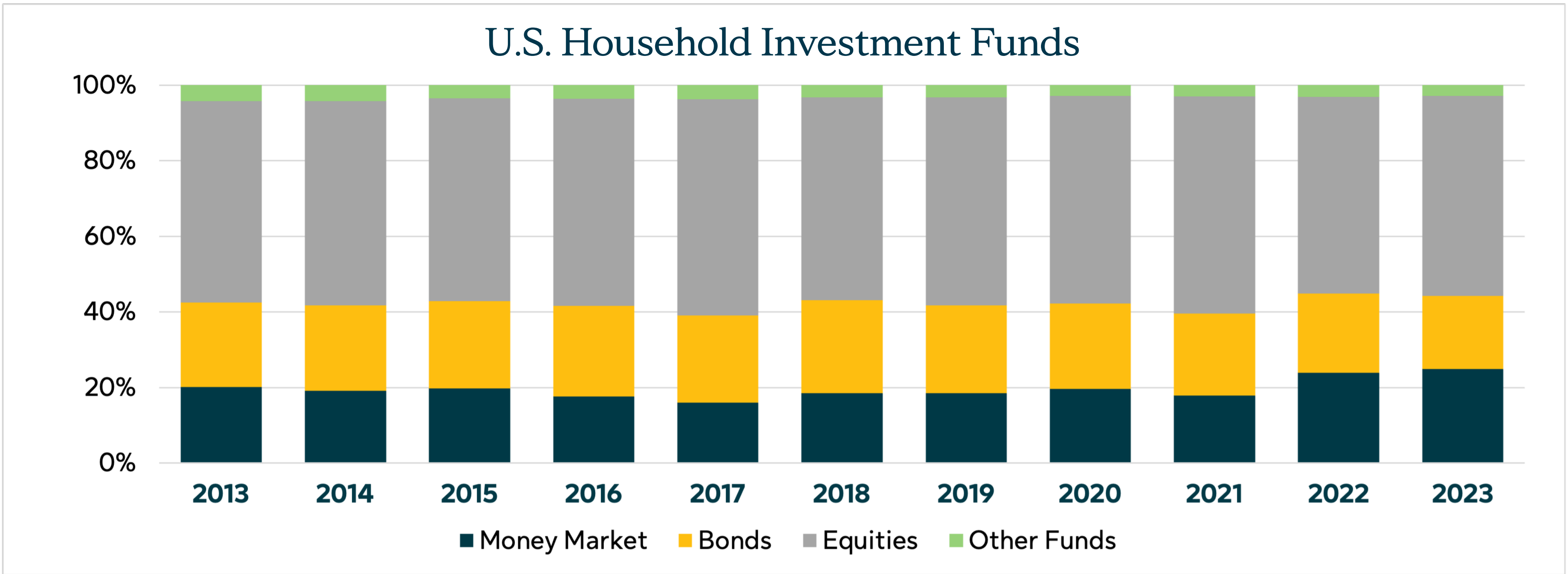
Do investors have unneeded liquidity?

Many individual investors have excess liquidity in their portfolio that they neither need for managing expenses nor utilize for frequent restructuring of their portfolios.

The chart below of U.S. household investment funds shows a relatively consistent mix of equities and bonds over time. Even cash balances have been relatively stable with the only noticeable uptick during 2022 and 2023 when rates rose quickly.

This consistent mix suggests that many individual investors are not tactically trading and probably do not need as much liquidity as they initially expect. Therefore, they may be better off switching a portion of their public assets to private markets, where they can trade unneeded excess liquidity for the extra premium that historically has been available from investing in private assets.

This practice mirrors trends among institutional investors like pension plans and insurance companies who seek to tightly manage their liquidity requirements while capitalizing on the illiquidity premiums wherever possible.



Source: OCED Statistics, US Households' assets and liabilities dataset

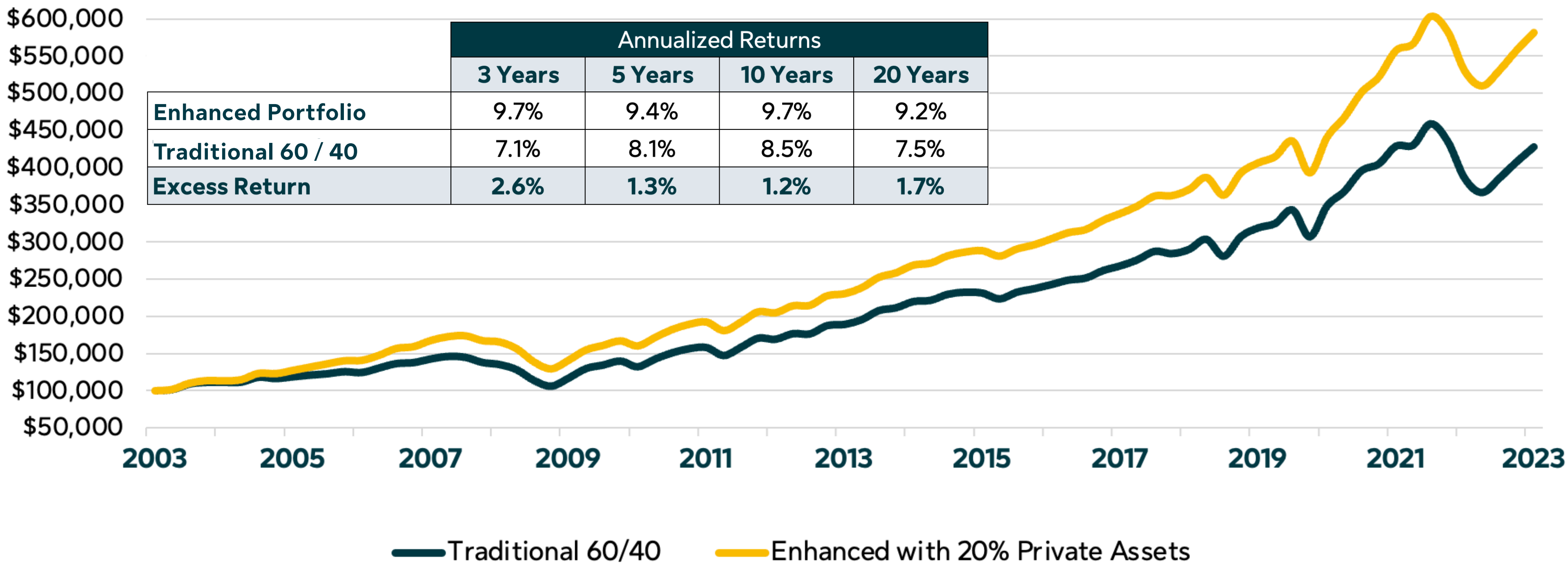
What does a traditional public portfolio look like with private assets?

The model below shows the performance of $100,000 invested in a traditional public portfolio of 60% equity and 40% bonds. The enhanced portfolio adjusts the traditional portfolio to include a 20% allocation to private assets[3]. Over 20 years, the traditional portfolio has grown by 7.5% a year while the enhanced portfolio has grown by 9.2%.

This results in the traditional portfolio growing to approximately $430,000 while the enhanced portfolio grows to over $580,000.

Traditional Public Portfolio and Enhanced with Private Assets

	Annualized Returns			
	3 Years	5 Years	10 Years	20 Years
Enhanced Portfolio	9.7%	9.4%	9.7%	9.2%
Traditional 60 / 40	7.1%	8.1%	8.5%	7.5%
Excess Return	**2.6%**	**1.3%**	**1.2%**	**1.7%**



Source: Aladdin, Cliffwater, Pitchbook & NCREIF. Historical results are based on 20 years of quarterly data through June 2023. **Past performance does not guarantee future results.** The modeled traditional portfolio is 60% S&P 500 and 40% Bloomberg US Aggregate Bond Index. The modeled enhanced portfolio is 48% S&P 500, 32% Bloomberg US Aggregate Bond Index, 10% Private Equity, 5% Private Debt, 2.5% Real Estate and 2.5% Infrastructure. The private asset performance is from PitchBook Benchmarks as of Q2 2023. The model rebalances public asset weightings each quarter. While private assets are rebalanced every five years based on estimated median fund maturities. See important disclosures for additional information.

What is the right portfolio allocation to private assets?

Across some surveys[4], it looks like individual investors have allocated 3% on average to private assets. This is gradually rising as they can now participate more freely in what was once only available to institutional investors. As a result, the question becomes ***what is the right target?***

In our modelling of median investor profiles and varied cash flow needs, we estimate that private asset classes could reasonably range from 10 to 30% of an investor's portfolio. We have also seen similar ranges in other surveys and research[5].

As we stressed earlier, the private asset target and decision is a function of investor return goals, time horizon, risk appetite and cash flow needs. Financial professionals can help with this type of analysis.

Key takeaways

Alternatives or private assets can help **improve returns and increase diversification** beyond the traditional 60/40 public portfolio.

While private assets have been popular with institutional investors for decades, **that opportunity is now available to individual investors.**

Historically, private asset classes have delivered a return advantage over public assets. While some of that premium is compensation for the inability to quickly trade the asset, most of the extra return is from the asset manager's ability to **actively make improvements to the assets.**

Many individual investors probably **do not need as much liquidity as they initially expect.** Therefore, they may be better off switching a portion of their public assets for the extra premium that historically has been available from investing in private assets.

Asset manager skill is critical, and the variation around the average is wider the riskier the asset class.

About the SLC Management group of companies

SLC Management is a global institutional asset manager of Sun Life that offers institutional investors traditional, alternative and yield-oriented investment solutions across public and private fixed income markets, as well as global real estate equity and debt and infrastructure. We help our clients optimize their asset allocation profile and meet their long-term income and capital appreciation objectives by leveraging our insights and deep capabilities in fixed income, alternatives and real assets through our specialty managers including SLC Fixed Income, BGO, Crescent Capital Group, and InfraRed Capital Partners. Through Advisors Asset Management, our independent U.S. retail distribution firm, we can extend our alternatives solutions to high net worth investors.

As of December 31, 2023, SLC Management has assets under management of **US$283 billion/C$374 billion.** As of December 31, 2023, the brokerage and advised business at AAM represents approximately US$41.4 billion in assets. (Assets under supervision represent US$5.4 billion in UIT assets. The firm has US$32.1 billion in assets under administration that represents the non-proprietary assets for which AAM provides various levels of service, but not management. The firm's US$3.9 billion in assets under management represents AAM's proprietary separately managed account, mutual fund and ETF assets.) For more information, visit **www.slcmanagement.com**.

For more information visit **www.aamlive.com** or contact a financial professional to discuss potential opportunities in today's environment.

Disclosure

Sources

1. Kaplan, Steven N., and Antoinette Schoar. Private equity performance: Returns, persistence, and capital flows, The journal of finance 60.4 (2005): 1791-1823.
2. Pascal Böni & Sophie Manigart (2022) Private Debt Fund Returns, Persistence, and Market Conditions, Financial Analysts Journal, 78:4, 121-144.
3. Historical results are based on 20 years of quarterly data through June 2023. The modeled traditional portfolio is 60% S&P 500 and 40% Bloomberg US Aggregate Bond Index. The modeled enhanced portfolio is 48% S&P 500, 32% Bloomberg US Aggregate Bond Index, 10% Private Equity, 5% Private Debt, 2.5% Real Estate and 2.5% Infrastructure. The private asset performance is from PitchBook Benchmarks as of Q2 2023. The model rebalances public asset weightings each quarter. While private assets are rebalanced every five years based on estimated median fund maturities.
4. Cerulli Associates
5. Alternatives: Do you want to invest? Here's how to start, JP Morgan Private Bank, November 2023.

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RISKS:

Alternative investments offer the potential for diversification, higher returns, and protection against inflation, however they come with their own set of risks and challenges.

Past performance is not a guarantee of future results. All investments are subject to risk, including the loss of the principal amount invested. There is no guarantee of downside protection and losses may occur, including the loss of the entire principal amount invested.

Diversification will not guarantee profitability or protection against loss.

Alternative investments may lack transparency as to share price, valuation and portfolio holdings. Complex tax structures often result in delayed tax reporting. Compared to mutual funds, private funds are subject to less regulation and often charge higher fees.

Bonds that are rated below investment grade are sometimes referred to as "high yield bonds" or "junk bonds." Below investment grade securities have predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. They may also be illiquid and difficult to value.

An investor may not have access to their investment for an extended period of time.

Market risk is prevalent since many of the companies invested in are unproven, which can lead to significant losses. Default risk is also higher with less established companies.

Additional risks include limited operating history, uncertain distributions, inconsistent valuation of a portfolio, changing interest rates, leveraging of assets, reliance on the investment advisor, potential conflicts of interest, payment of substantial fees to the investment advisor and the dealer manager, potential illiquidity, and liquidation at more or less than the original amount invested. Performance may be volatile, and the NAV may fluctuate.

DEFINITIONS:

Correlation is a statistical measure of how two variables move in relation to each other with coefficients ranging from +1 to -1. A correlation coefficient of +1 implies that as one variable moves, the other will move in exact lockstep. Alternatively, a correlation coefficient of -1 implies that if one variable moves, the other moves in the same amount in the opposite direction. If the correlation is 0, the movements of the variables are completely random.

The **Bloomberg US Aggregate Bond Index** is an unmanaged, broad-based index composed of US dollar denominated, investment grade, fixed rate taxable bonds with at least $250 million par amount outstanding and at least one year to final maturity.

S&P 500 Index is an unmanaged market capitalization weighted index used to measure 500 companies chosen for market size, liquidity and industry grouping, among other factors.
The Morningstar LSTA US Leveraged Loan 100 Index is designed to measure the performance of the 100 largest facilities in the US leveraged loan market. Index constituents are market-value weighted, subject to a single loan facility weight cap of 2%.

Cliffwater Direct Lending Index (CDLI) seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain Eligibility Criteria. The CDLI is an asset-weighted index that is calculated on a quarterly basis using financial statements and other information contained in the U.S. Securities and Exchange Commission ("SEC") filings of all eligible BDCs.

National Council of Real Estate Investment Fiduciaries (NCREIF) Fund Index – Open End Diversified Core Equity is a capitalization-weighted index of gross-of-fee investment returns of 38 open-end commingled funds marketed as a being a diversified core investment strategy, primarily investing in private equity real estate.

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