Improving portfolio risk/return profiles with private market alternatives

While individual investors have historically focused on publicly traded stocks and bonds, there has been growing interest in private market alternative investments – such as private credit, real estate and infrastructure – *and for good reason.*

IN PARTNERSHIP WITH *SLC MANAGEMENT*

When added to the typical 60/40 equity/fixed income portfolio, alternative asset classes have the potential to enhance returns, improve portfolio diversification, and provide downside protection. Alternatives benefit from several factors that may help improve a portfolio's long-term performance:

1

Improved relative returns

Alternatives have typically generated higher returns relative to public assets. This additional return potential is primarily driven by the compensation for lower liquidity in private markets (the illiquidity premium), as well as the additional value derived from the customization, due diligence information advantage, control, and speed of execution available in private markets.

2

Diversification benefits

In terms of the number of issuers, the size of private markets dwarfs that of public markets, providing investors access to companies and sectors that are not available through traditional investments. 2022, a year that saw both stocks and bonds post negative returns, highlighted the importance of adding investments less correlated to these two traditional asset classes.

3

Downside protection

Many alternatives have covenants or collateral that can provide investors an additional layer of security in tougher market conditions. Private markets are generally less susceptible to volatility driven by macroeconomic shifts and geopolitical events. Additionally, private assets often provide a more stable investor experience as valuations can be less volatile than their public market equivalents.

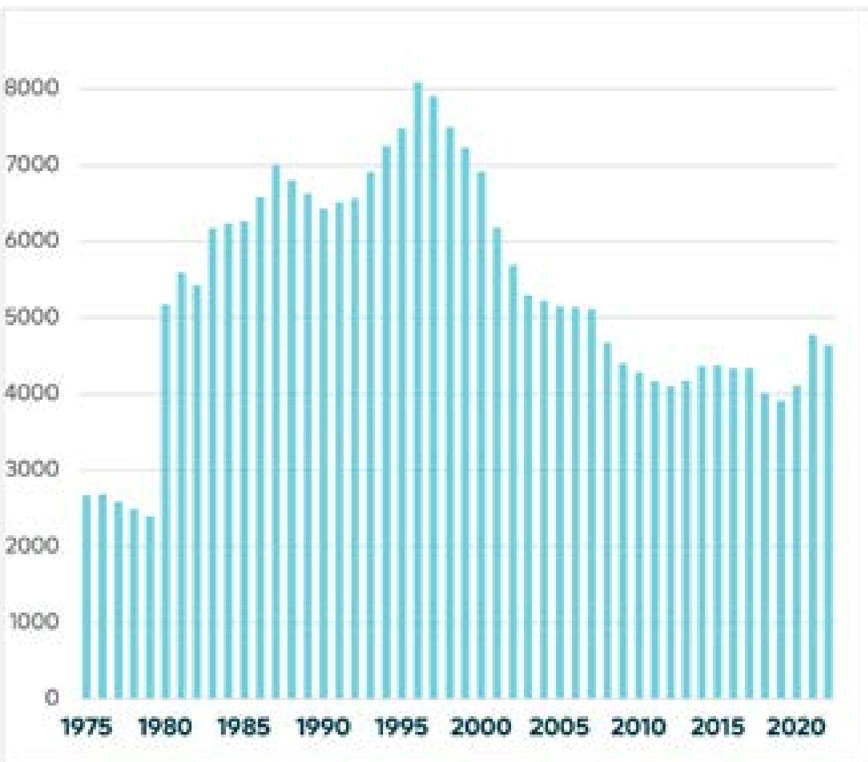
Understanding the opportunity set

Interest in private markets intensified after the 2008-2009 Global Financial Crisis (GFC), resulting in assets under management growing to about four times what they were in 2010. Assets are forecasted to continue growing at a consistent rate over the next several years.

This growth has been driven by the prospects of increased opportunities and diversification. For instance, the number of U.S. public companies has shrunk from over 8,000 listed companies in the mid 1990's to about 4,600 today.

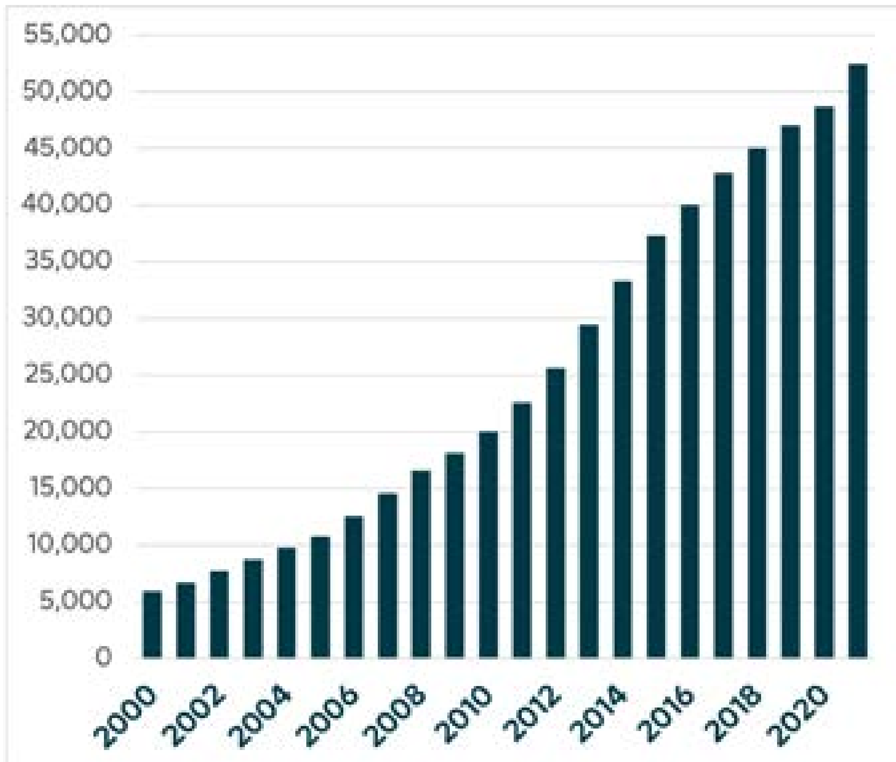
Over that same period, the number of private companies with Private Equity and Venture Capital investors grew from 5,000 to over 52,000. Therefore, based on the total number of equity-backed companies, 92% are private. This underscores the expanding opportunities in private markets versus the more concentrated options in public markets.

Number of U.S. Listed Companies



Source: World Bank, World Federation of Exchanges database

Number of Private Companies



Source: PitchBook: Quantitative Perspectives US Market Insights Q3 2022

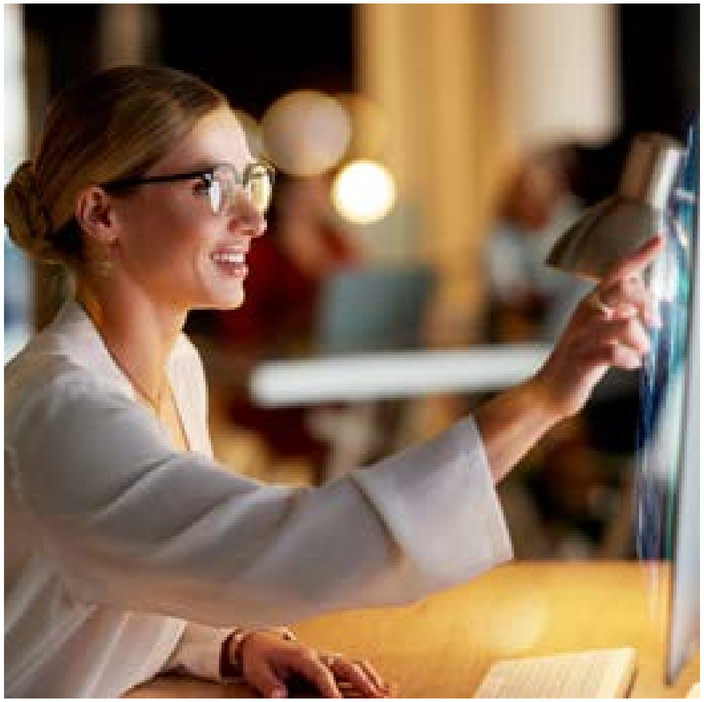
Institutional investors have long utilized alternatives within their portfolios

U.S. pensions and endowments, which on average invest roughly one-quarter of their portfolios in alternatives (source: Wall Street Journal, 2023), point to higher return potential and portfolio diversification as key reasons for their allocations. Today, there is significant opportunity for individual investors to allocate to similar asset classes and potentially benefit from the same characteristics.

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).

Over the past 20 years during periods of low and stable inflation, stocks and bonds displayed low-to-negative correlations. However, with the recent shift to more volatile inflation, stocks and bonds have largely moved in the same direction, which was especially evident in 2022 when U.S. equity markets suffered their worst year since 2008 and bond markets posted their worst performance on record. Against that backdrop, many investors are seeking better ways to diversify their portfolios and generate more stable returns.

Furthermore, because alternative investments are issued in the private markets or in lower-traffic areas of the public markets, they oftentimes come with better negotiated downside protection features such as more advantageous structures and covenant packages. Given ongoing economic and geopolitical risks, this is an important part of the value proposition of investing in alternatives.



"Today, there is significant opportunity for individual investors to allocate to similar asset classes and benefit from the same characteristics."

Alternatives delivered solid returns over the last decade.

	Public Equities	IG Public Bonds	Direct Lending	Real Estate
Public Equities	1.0			
IG Public Bonds	0.1	1.0		
Direct Lending	0.4	-0.1	1.0	
Real Estate	0.2	-0.1	0.4	1.0

Alternatives typically have lower correlations to traditional stocks and bonds.

Sources: Aladdin, Morningstar, Cliffwater, Pitchbook, National Council of Real Estate Investment Fiduciaries, 2022. Proxy benchmarks used: Bloomberg US Aggregate Bond Index (IG public bonds), S&P 500 Index (public equity), Morningstar LSAT Leverage Loan Index (bank loans), Cliffwater Direct Lending Index (direct lending), NCREIF Fund Index – Open End Diversified Core Equity (real estate), MSCI EAFE Index (international equities), and Bloomberg US Corporate High Yield Index (high yield bonds). **Past performance does not guarantee future results.** It is not possible to invest directly in an index. 10 year period ending 9/30/2023.

Attractive risk/return profiles in alternatives

In addition to the drivers of return already discussed, such as the illiquidity premium and the structuring premium associated with private assets, many alternative asset classes have also benefitted as interest rates have moved away from the "lower-for-longer" rate environment that characterized the last decade. Many alternatives produce a steady income stream as a significant component of total returns and we have seen alternatives such as private credit, infrastructure and real estate benefit from the changing rate environment.

Historically, many alternative asset classes have also experienced lower price volatility relative to public assets. Many investors value the benefit of more stable valuations during periods of extreme volatility in public markets. It is worth remembering though that much of the lower volatility is attributable to the lack of observable market values in private assets and often does not reflect the true mark-to-market volatility.

Alternative investments have attractive long-term risk/return profiles, driven by strong returns and low realized volatility.

Sources: Aladdin, Cliffwater, National Council of Real Estate Investment Fiduciaries, as of September 30, 2023. Proxy benchmarks used: S&P 500 Index (Public Equities), Bloomberg US Aggregate Bond Index (IG Public Bonds), Cliffwater Direct Lending Index (Direct Lending), NCREIF Fund Index – Open End Diversified Core Equity (Real Estate). Historical volatility measured by the historical standard deviation of the asset class on a monthly return basis since the inception date of its corresponding benchmark. **Past performance does not guarantee future results.**

CASE STUDY

Improving returns and reducing overall volatility by adding alternatives

To demonstrate the benefit of adding alternatives to a traditional 60/40 equity/fixed income portfolio, the following illustrative case study shows the impact on overall portfolio risk and return at different allocation levels – the alternatives bucket consisting of a combination of private credit and real estate.

Trading excess liquidity for higher returns

Liquidity describes how easily an asset can be converted to cash without affecting its market price. For investors facing the potential for unforeseen expenses necessitating the sale of current investment holdings, having a portion of their portfolios held in highly liquid assets is important. However, investors can sometimes overestimate the amount of liquidity they need. This comes at a cost in terms of the additional compensation that investors forgo by missing out on the illiquidity premium. The illiquidity premium has contributed to the meaningful historical outperformance of private assets over their public counterparts.

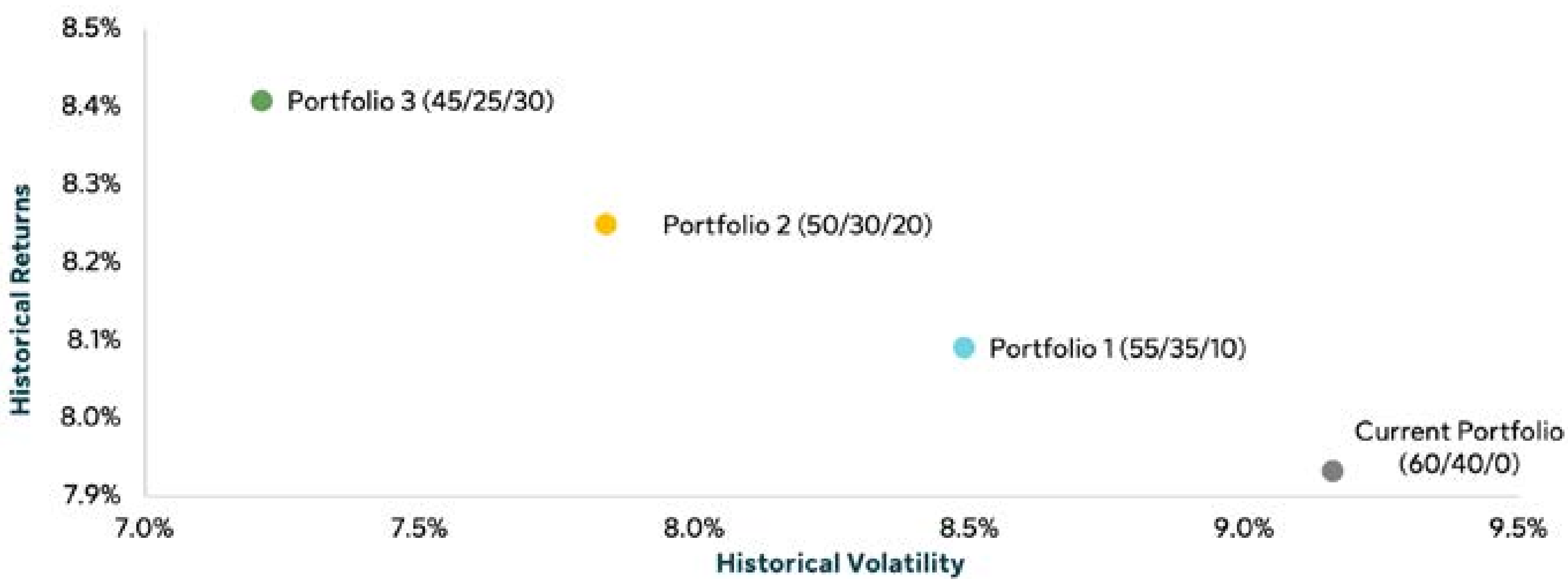
CASE STUDY

In illustrative Portfolio 1, we reduce the allocation to bonds and equities by 5% each and initiate a 10% allocation to alternatives. In Portfolio 2, we take another 5% out of both equities and bonds and initiate a 20% allocation to alternatives. In Portfolio 3, we take an additional 5% out of equities and bonds and initiate a 30% allocation to alternatives.

As we increased the allocation to alternatives, the overall return of the portfolio increased. In addition, because of the relatively low correlation of alternatives to public equity and bonds, the portfolio's overall volatility was reduced as well.

	Equities	Bonds	Alternatives
Starting Portfolio	60.0%	40.0%	0.0%
Portfolio 1	55.0%	35.0%	10.0%
Portfolio 2	50.0%	30.0%	20.0%
Portfolio 3	45.0%	25.0%	30.0%

Higher allocations to alternatives has led to enhanced risk-adjusted returns



Source: Equities: S&P 500 Index, Bonds: Bloomberg US Aggregate Bond Index, Commercial Real Estate: NCREIF ODCE Index, Private Credit: Cliffwater Direct Lending Index. Year end 2013 to year end 2023 (10 Years).
Past performance does not guarantee future results.

Key takeaways

Alternative asset classes have historically displayed relatively low correlation to traditional stocks and bonds. As a result, adding an allocation to alternatives can result in **more stable portfolio returns** over time.

Many alternatives come with enhanced downside protection features such as more advantageous structures and covenant packages. With economic and geopolitical risks that exist today, this **built-in downside protection** can be important in dampening overall portfolio volatility.

Investors in alternatives are typically compensated with higher potential returns for the additional value they provide private borrowers. This is often expressed in terms of an illiquidity premium as well as compensation for the **customization, complexity and speed of execution** available in private markets.

While lower liquidity is a tradeoff with alternatives, investors can sometimes overestimate the amount of liquidity they need and should consider **harnessing the illiquidity premium** offered by adding a component of private market alternatives to their portfolios.

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] Prequin Special Report: The Future of Alternatives in 2027

[2] World Bank, World Federation of Exchanges database.

[3] PitchBook: Quantitative Perspectives US Market Insights Q3 2022.

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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%.

MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets*, excluding the US & Canada.

The **Bloomberg US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of a nationally recognized statistical rating organization (NRSRO) is Ba1/BB+/BB+ or below.

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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