An Introduction to Alternatives in Multi-Asset Class Portfolios

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As institutional investors increasingly look for opportunities to increase returns and diversify their portfolios, assets outside of traditional publicly-traded bonds and stocks, such as private equity and/or real assets, have come into focus. These investments are often referred to as alternatives (or alts). For investors with the appropriate risk tolerance level, alternatives may provide diversification and enhanced returns for portfolios for endowments and foundations, pensions and a wide universe of other institutional investors.

With that in mind, it is important to note that as many investors use portions of those returns to fund the objectives of their organization, it is an essential and sometimes delicate balancing act to find the right mix of investments to generate a target return, support the organization's spending policy or benefit payments while avoiding a drawdown on their overall portfolio's assets. As one of many ways to potentially support those goals, let's take a look at some basics on alternatives.

Our Definition, Preferences and Process

At PFM, we view alternative investments as fitting into one of four basic categories: Private Equity, Private Debt, Real Assets and Diversified Strategies. Specifically, Private Equity, Private Debt, and Real Assets are particularly attractive because we see these as strategic allocation areas within the broader alternatives universe.

In each bucket/investment category, we utilize a core and satellite portfolio construction methodology where our core managers provide more consistent alpha exposure within their respective broad categories. Meanwhile, satellite managers typically invest in market niches and will have exposures with lower correlations to the core manager, but will also come with higher alpha expectations. Using our rigorous research process, we weigh/allocate within these categories to create an optimal alternatives portfolio to augment the more traditionally managed part of the portfolio. We believe in customization, so our approach is tailored to the needs of each client.

The Benefits

One benefit of investing in alternatives is the potential to generate returns above typical market indices and benchmarks. In addition, these investments may reduce volatility through lower correlations to the public portion of the portfolio, and thus provide greater diversification for a client's portfolio.

That said, one must understand that alternatives are not a "silver bullet" for funding woes or sub-par returns. Because they are generally less liquid, the inclusion of these vehicles in a portfolio could also create a cash crunch for funds that do not adequately plan for future drawdowns or turmoil within public market allocations.

Negatives and Other Details That Must Be Considered

It is important to note that the dispersion of the top and bottom quartile managers (in terms of performance) can be considerably more significant than in public markets. These investments also tend to be more complex and require substantially more resources to identify, evaluate and monitor. Access can also be a challenge because, as noted before, investing with top-performing managers is crucial for long-term performance.

Other considerations for investors are that these funds aren't always accepting nor seeking new/additional capital, and the longer time commitment periods increases illiquidity risk and opportunity cost. As part of the due diligence process, it is important to evaluate the potential returns relative to those risk factors.

How Do We Decide Where to Invest?

When selecting strategies, we use what we define as a top-down approach to determine an area of focus. It starts with a broad assessment and analysis of both the current, and what we perceive to be, the potential future economic environment. This intense effort allows us to narrow down attractive ideas and opportunities for both the medium- and long-term. As part of this process, we conduct a thorough comparison of public market investment options. We do this with the understanding that there needs to be some compensation for the opportunity cost, illiquidity and business risk being taken.

Once we target categories for investment, we use a bottom-up process to source managers. In short, we do not subscribe to the traditional research funnel, but instead, sift through the available alternative investment universe to select possible managers. We then combine this process with our internal research and database to narrow down manager options and come to a viable selection.

For institutions considering alternatives and those interested in a more in-depth discussion on the subject, please listen to our recent podcast on alternative investments, which features Floyd Simpson and Kathleen Walters, senior managing consultants with PFM.

To learn more or discuss in greater detail, please contact us:

Floyd Simpson III, CFA, CFP | Senior Managing Consultant
simpsonf@pfm.com | 215.557.1435

Kathleen Walters, CFA | Senior Managing Consultant
waltersk@pfm.com | 414.847.5585

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