altera

Navigating Markets & Getting Alternative

SHAPING THE INVESTOR MINDSET

Whether the urbanized cities of New York and London, or the villages of sub-Saharan Africa, our societies are built on the belief that survival and advancement are achievable, but not without hard work and sacrifice. Many fundamental ideas shape this belief, including the notion that there are trade-offs with every decision, and that there are typically more efficient ways to get things done. These types of ideas create a sense of urgency and competition while driving creativity and innovation. These ideas are also underpinned by two key variables: risk and return. Whether in the boardroom or on farmland, individuals are confronted with return-based decisions every day. This is no different in the world of investing and is often magnified by investors' desire for capital appreciation and peace of mind – two goals regularly at odds with each other.

Generally, investors have sought their fortunes in the capital markets and relied on those same markets to supplement their primary income, grow their assets for major expenses, and to save for retirement. As the investment industry has evolved from single stock and bond transactions to pooled funds and other vehicles, the framework for decision making and accounting for risk and return has evolved.

Investment decisions are rooted in an evaluation of risk and return and the consideration of the opportunity cost in choosing one investment instead of another. Many economists and financial practitioners have developed time-tested, statistical concepts and guidelines to address this balancing act, allowing investors to determine the value of an investment and its risk relative to comparable assets and the broader markets. As with most statistical models, these concepts are rooted in assumptions, with the focal point being that investors all have access to perfect information, that is, the same information from which to make decisions and that markets are efficient.

These beliefs have led investors to adopt a mindset that taking higher levels of risk should be rewarded with a higher potential return, and that over time, the values of investments will find their way back to their long-term averages (i.e., mean reversion). Due to the data required to study these mechanics, the focus of historical research has largely been on the publicly available markets (after all, they are "accessible" to investors regardless of size or knowledge). Given the similarities in certain public and private investments, it's natural for investors to apply the same framework to alternative investments. We'll consider how that extension may not be fully applicable.

MARKET BACKDROP

At their core, financial markets are a platform for entities to issue equity or borrow capital, producers to sell yield or hedge against unforeseen changes in their business, investors to make informed transactions, and speculators to take risks and create opportunities for more investment. This platform houses equity, fixed income, and real assets, all of which have an applied value derived from their underlying fundamentals and the dynamics of supply and demand. This is an oversimplified view, but publicly available financial markets have a somewhat predictable format to them. Absent a major collapse (looking at you Global Financial Crisis), investors can use historical, current, and forecasted information to determine how these markets are likely to behave and make investment decisions based on that assessment. However, in a collapse scenario all bets are off, and the low probability may become the norm.

What has the state of the financial markets been in recent years?

For over a decade, investors around the world have been experiencing one of the strongest bull markets in history. This has been particularly meaningful for equity investments; an investment of $1,000 in the S&P 500 Index[1] January 2012 would have grown to approximately $4,625 by January 2022, translating to 16.55% growth per year. This compares nicely to prior 10-year periods which have averaged 9.2% returns.[2]

Over that same period, other asset classes have been positive (U.S. Corporate bonds have returned 5.6% annually over the last 10 years[3]) but equity results have possibly engendered false hope that diversification is not that necessary a tool after all.

What are the overarching themes and approaches that are on investors' minds in this third decade of the 21st century?

Aside from the persistent challenges brought on by the pandemic, we are faced with a system of government that, in recent memory and still today, seems more focused on what may be right for a party and its constituents rather than what can objectively be thought of as good for everyone. This affects behaviors and opinions of companies and investors as well as the common citizen. The possibility exists that a control shift in the House of Representatives may be coming in this year's midterms. This could grind the gears of the machine even more. While there are initiatives, like the Infrastructure Investment and Jobs Act that gained agreement from both sides, it's unlikely to see much traction in the currently polarized legislative chambers. Any personal views aside, markets would likely prefer split control to preserve a policy status quo, particularly as it relates to key areas of impact, like the tax code.

Beyond any tax reforms, there are other precipitating trends that are often discussed. These secular trends include the aging population in the United States, and the effects of climate change, among others. Addressing these issues has been an on-again/off-again focal point, but it's worth mentioning that the Biden administration has emphasized retirement income/senior care and climate change as key areas of focus. With that emphasis, investment opportunities will likely follow.

The trends that are positioned to be influenced by congressional policy decisions are just a few of the topics on investors' minds. Other trends, like sustainable investing (e.g., ESG or impact investing), the cost and effectiveness of actively managed investments, the remaining (albeit trending somewhat higher) low interest rate environment, and the impacts of technology, are all worthy of our attention and could influence the investment strategy one may use.

NAVIGATING THE MARKETS

Is it possible to find the next Amazon or Netflix and make a fortune in the stock market? Absolutely. That possibility exists, and rest assured, many investors are on the hunt for the next big thing that will radically change their fortunes. For most other investors, there is some level of acknowledgement that targeting one, or a small number of stocks with all your assets is a risky proposition for their closely held dollars. This is where the evaluation of risk and return and the assessment of broad macro trends make sense.

Beyond what stocks to pick, or what investment managers to allocate to, investors have a critical decision to make: deciding on the right asset allocation to align with their goals. This is where the balancing act in determining the appropriate level of risk to prospective return is crucial. With the near- to medium-term environment remaining uncertain in some ways, and already prescribed in others (i.e., economic effects of pandemic-related stimulus and supply chain disruptions), market characteristics and return prospects seem to be very much in line with published studies from industry experts. Public fixed income will remain a low volatility option compared to equities but will have uncompelling yields across most sectors, translating to low rates of return and underwhelming income. Focusing on equities, these markets will likely present opportunities for returns, but then the question becomes: if adjusted for the levels of risk they present, should/could this asset class be relied on to achieve investor objectives?

Source: [1]Investing directly in the index is not possible. Funds that track the S&P 500 have variable relative returns depending on if they are actively or passively managed. [2]Per Goldman Sachs, 10-year stock market returns, measured by decade, have averaged 9.2% over the past 140 years while in the 10 years between 2012 and 2022, the average has been 16.55% (www.businessinsider.com/personal-finance/average-stock-market-return#). [3]U.S. Corporate bonds, proxied by ICE BofA 7-10 Year US Corporate Index return from 10/1/10 to 9/30/20; (ICE BofA 7-10 Year US Corporate Index Total Return Index Value (BAMLCC4A0710YTRIV) | FRED | St. Louis Fed).

Taking these views into account, it's important to reinforce that a thoughtfully prepared asset allocation can put Investors on the right track to:

- Invest in assets with favorable historical risk/return characteristics aligning with your personal objectives
- Pair investments with lower correlation of returns to target diversification
- Establish a system to track and measure the effectiveness of each asset class in contributing to your investment plan

Defining a target asset allocation, representative of your personal investment goals, is like planning the courses for a large family dinner and making a shopping list. Once you know how much you need from the butcher, the baker, and other departments, you can move on to evaluating prices and quality of products.

Sticking with the grocery shopping analogy, once the asset allocation is defined, then it's time to think about constructing the portfolio or selecting the groceries. As alluded to previously, there has been a shift away from active management in equity markets. This shift involves using lower cost, passively-managed vehicles to save on fund expenses while capturing the upside performance of equity markets. This is where investors realize the store brand has very similar ingredients as the gourmet brand at half the cost. Until actively managed vehicles can demonstrate persistent outperformance, this shift to passively-managed strategies will likely continue.

Investors are also looking at the benefits of a fixed income allocation and which might be the sectors to raise prospective income yields while not introducing too much risk. This is like a walk through the produce aisle looking at spring mix versus iceberg lettuce (more nutrients and maybe more flavor) and adding things like avocadoes or almonds to enhance the flavor (sources of "good" fat and other nutrients). In the fixed income space, this may mean allocating to U.S. High Yield, with a reduction to core bonds and possibly adding some leveraged loan or emerging market debt exposure. In practice, this is a tradeoff between higher yield and greater correlation to equities.

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In addition to relative cost savings and substitutions for prospectively more portfolio benefit, investors are also looking at the "hot" areas of the market (this would be the limited-edition craft double chocolate cake). Technology is routinely highlighted as a sector to keep an eye on. While in and of itself technology isn't new, there are continuously new ways technology is being used to disrupt established businesses and create investment opportunities along with it. Expect this to continue in the areas of healthcare and sub-sectors of technology like artificial intelligence. Other, perhaps less technology-enabled disruptive businesses, will likely come to market as well, creating more possibilities for investment.

These asset allocation and investment selection decisions are all defined by the landscape and profile of an efficient market platform, where investors are privy to the same levels of information and base decisions on an analysis of risk and return. These decisions have historical applicability to public market investments with observable risk and return data and broadly distributed/available information. These same decisions are extended to the private or alternative investment markets but, to be effective, require analysis of many additional unique factors.

GETTING ALTERNATIVE

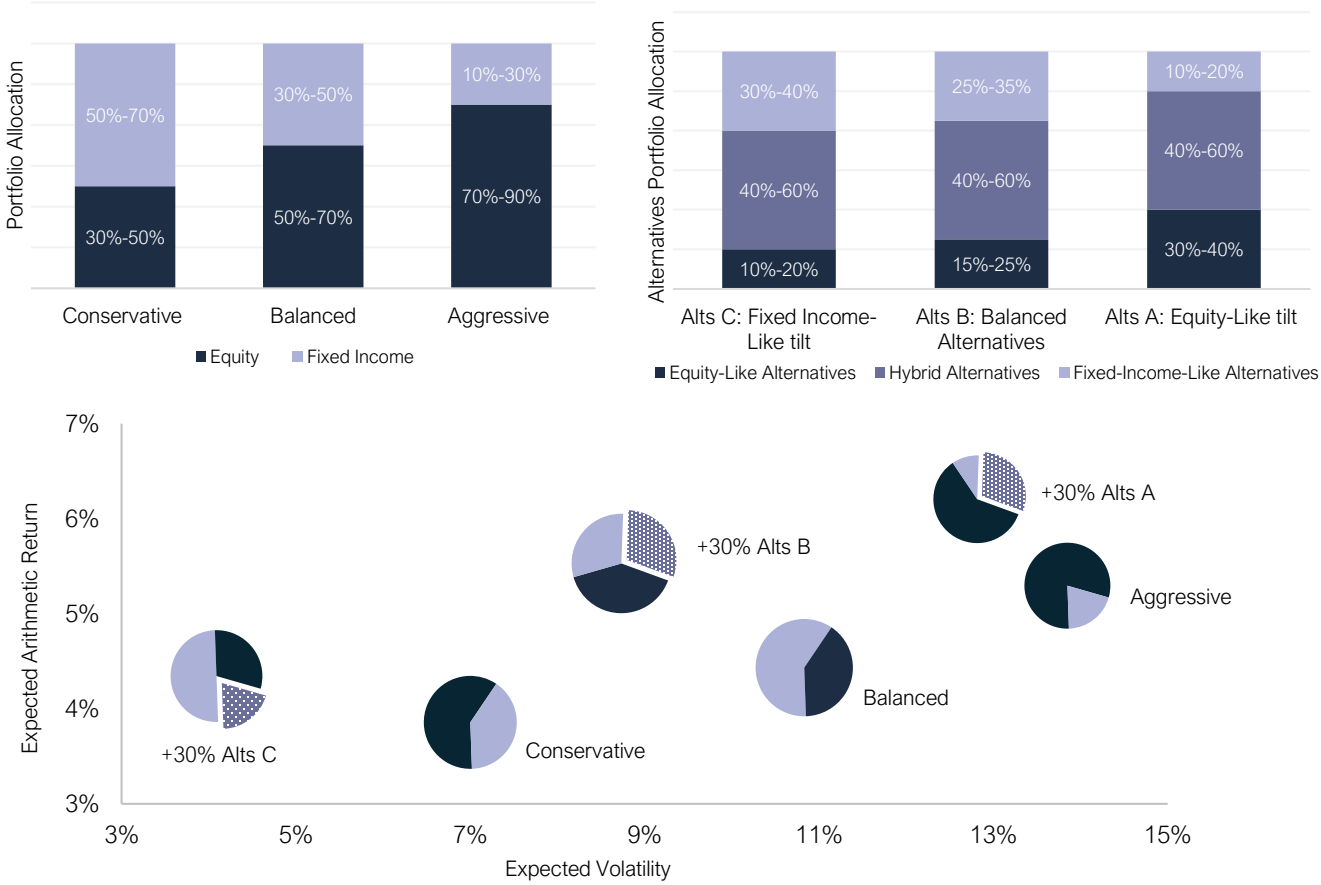
Investing in private markets and alternatives has been a part of portfolio management for many years. Until recently, it had been envisioned as an approach available only to the extremely large and sophisticated pension plans, university endowments, and ultra-high-net-worth investors. The investment approaches and asset classes (hedge funds to private equity and everything in between) that have made alternative investments intriguing, and valuable assets in any diversified portfolio, are now far more accessible to the mainstream investor.

Alternative investments are alternative in many ways, making the name quite appropriate. While categories like hedge funds and real estate funds utilize the public markets, these funds are unencumbered by the regulations that govern mutual funds and ETFs. This allows them to apply large degrees of leverage, use derivatives, and sell securities short – all with the goal of enhancing the risk-adjusted return profile. These strategies, coupled with those in the private credit, private equity, venture capital, and private real assets (including real estate here as well), unlock exposure to private company transactions – a frontier not available through trades on the stock exchanges, or over-the-counter bond markets.

These investments, added to an otherwise diversified portfolio, have positive effects overall. Alternative investments lay claim to being good sources of diversification due to the low correlation of returns with other asset classes. This offers less volatility and similar, if not better, returns to those of public equities, and provides investors a higher yield option than public fixed income. In the context of a diversified portfolio, the addition of a dedicated alternatives allocation can be a game changer, both lowering portfolio risk and increasing expected returns.

Illustrative Case Study: Adding Diversified Alternative Allocations Based on Investors' Risk-Return Objectives

Objectives-based alternative allocations can help improve portfolio outcomes for a range of investors



Source: JP Morgan as of 9/30/20.

This point is represented in the exhibits above. Adding a diversified sleeve of alternative investments to each of these portfolios reduced expected volatility and increased expected returns. As shown, an alternative investments allocation can be a complement to the asset allocation decision, but in deciding whether to make

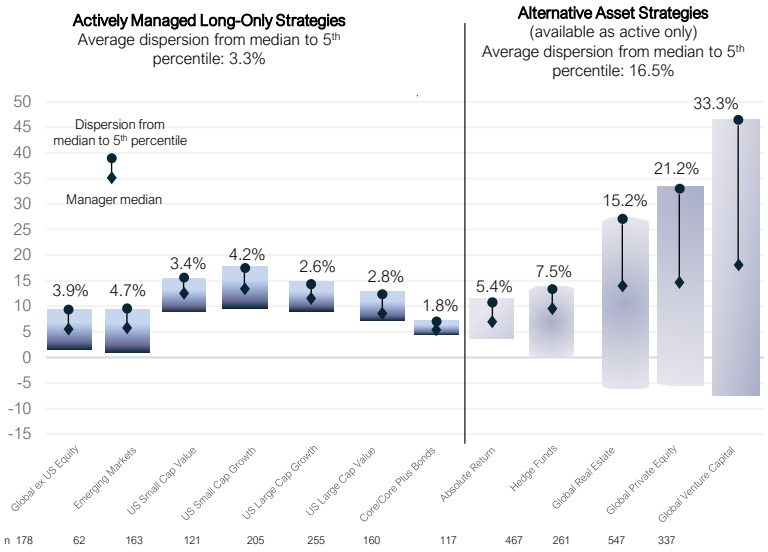
an investment, it is important to better understand the unique attributes of the asset class.

The attributes that make alternative investments attractive also require investors to make several considerations prior to making an allocation decision. Because these investments are substantially, or entirely private, there is information asymmetry across the investor base, coupled with many instances of inefficient operations. This inefficiency presents a situation where certain parts of a market may require more extensive due diligence by investment managers to extract enough knowledge to create investment returns. Along with the information factor, alternative investments have more restrictive liquidity than public markets, with more intricate and complex fee structures. It's in these characteristics that make risk versus return a different equation in alternative investment evaluation and, generally, the equation is not as comprehensive as it may be on the public market side.

This is where a premium is set on due diligence and manager selection. Yes, in the public markets investors are conducting due diligence on the investments and investment managers they select. Yes, that diligence consists of evaluating prior performance, business structure, capabilities, etc., which is similar to the alternative investments space. However, key distinctions between the two is that on the alternative investments side, these investments are private, not regulated in the same way (i.e., exempt from registration generally), and only available if an investor satisfies certain income and/or wealth criteria. These key details magnify the information challenges.

The due diligence process on the alternative investments side is steeped in collecting and examining legal documents, investment memos, sample holdings and performance, organizational manuals, details of key relationships, and many other materials, with the goal of understanding an investment strategy, how the manager will effectively implement that strategy, and what risks and risk mitigants/controls are involved. This process, if done with the proper level of attention and rigor, can translate to identifying and selecting top investment managers and unlocking quite meaningful returns.

Average Annual Manager Returns By Asset Class: *7/1/08- 6/30/18*



Source: Cambridge Associates as of 6/30/18.

Returning to the grocery analogy once more, the asset allocation exercise is critical to alternative investments, but the assessment of managers and corresponding selection is a closer second in alternatives than in the public markets. Allocating to the most favorable asset classes is the ideal first step but being "right" on manager selection is equally critical – if you're going to the butcher, you want to validate you're getting the ribeye versus the skirt steak. There is a much wider dispersion in the returns generated by the best and worst alternative investment managers.

This chart tells us exactly why it's imperative to collect and analyze as much information as possible on any investment manager and fund(s). The spread between being a middle of the road or top performer in each of these alternative categories is greater than in any of the public markets, including the least efficient pockets like Emerging Markets and U.S. Small Cap. Further, the range from the middle to the bottom is 5x wider for

alternative investments on average. This means if you pick an underperforming fund and are focused on capturing alpha, meeting or exceeding benchmark performance, and giving positive news to your investment committee, you are likely much more concerned about what went wrong than in the public markets. But, on the positive side, if you've chosen wisely, and the manager selected is effective, your investment committee will be singing your praise.

This collection of benefits and considerations for alternative investments might create a quandary for some investors. From our perspective, digging into these pros and cons illuminates the possibilities for building optimal investment portfolios and identifying high caliber investment managers and their funds.

Whether considering a public markets-only portfolio, or one that includes alternative investments, there is an extensive assessment to undertake in picking an allocation and choosing managers. This process is comparatively more straightforward on the public market side due to the availability of information from which to make decisions and efficient markets. Despite not having those characteristics, alternative investments present a transformational opportunity for a diversified portfolio. These assets can improve diversification, provide uncorrelated sources of return, lower volatility, generate meaningful income, and perhaps above all, provide support towards achieving investors' goals (think saving for college, purchasing a home, or retiring early). With this compelling proposition, it is important to approach alternative investments with an open and inquisitive mentality. Most alternative investment managers will provide the depth of information investors need, allowing for full evaluations of their capabilities. Be sure to take a critical eye to all the details and evaluate carefully – remember, the choice of managers is just as important an ingredient in alternative investments as choosing the appropriate allocation.

The current and foreseeable market and political environments will provide plenty of challenges, but also plenty of opportunities. Focusing on risk versus return evaluation, understanding how an investment may be impacted by macro events, as well as how different assets in a portfolio interact is a good starting point for any investor.

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Tim Partridge is a Managing Director at Altera and member of the firm's Investment Committee. He has worked in the investment and asset management industry since 2002 and has focused exclusively on private market investing since 2013.

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About Altera

We are a private asset investment firm focused on investing in the lower middle market. We back experienced fund managers and independent sponsors across private equity (buyout, growth equity and venture capital), real assets (real estate and infrastructure) and private credit (senior, junior and opportunistic). We aim to deliver attractive investment opportunities to family offices, high net worth individuals and registered investment advisors.

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