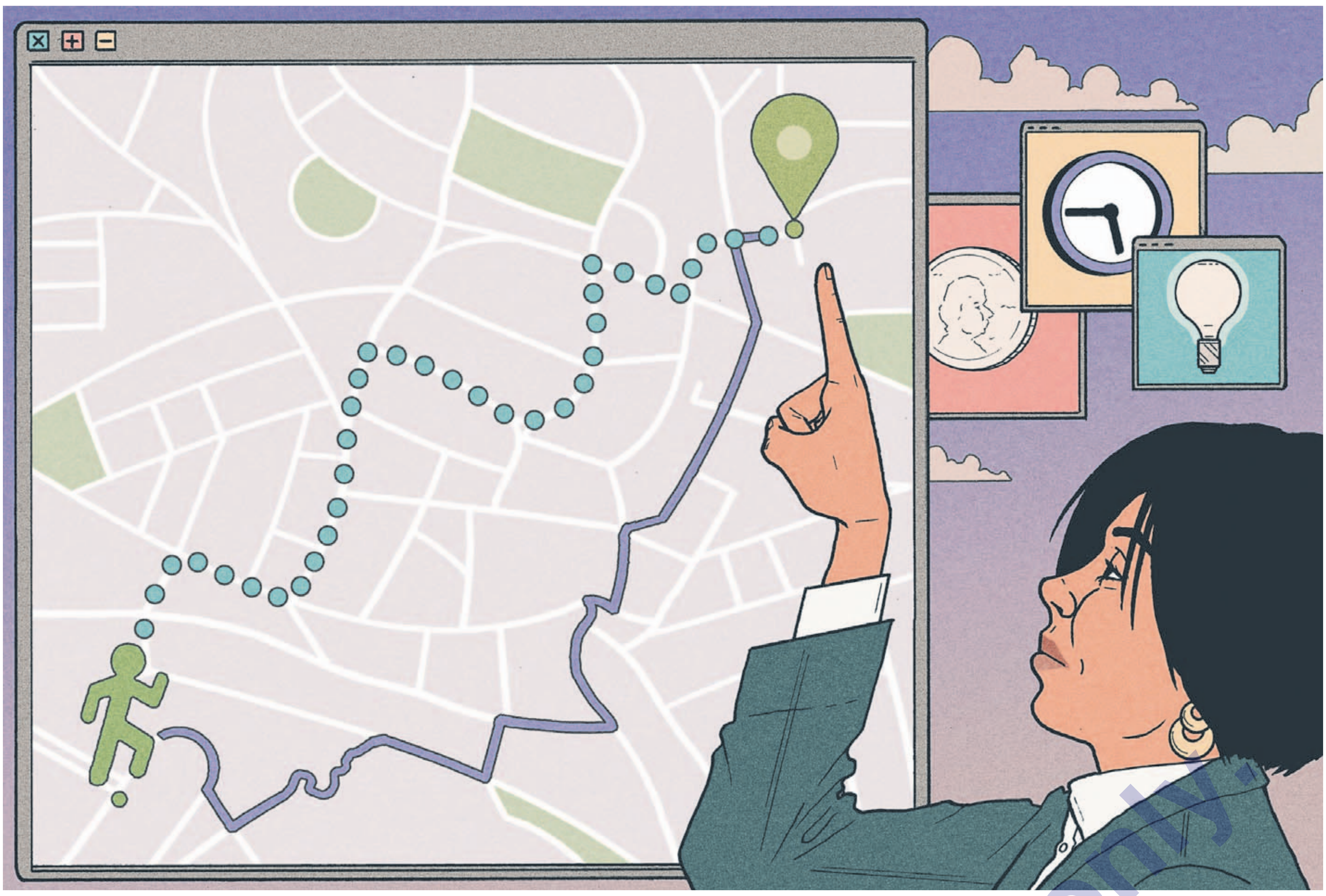

How to Diversify Your Portfolio With Alts

Investors need to figure out the strategy to meet their goals, the kind of alts they are qualified to buy, and which funds are best

By Lewis Braham

Which Alt Is Right for You?

If You Need...	Risk Profile	Alt Type	Publicly Traded Example: Investment / Ticker	3-Year Return
Income	Moderate	Infrastructure	Lazard Global Listed Infrastructure Portfolio / GLIFX	3.1%
	Low	Options Writing	JPMorgan Equity Premium Income / JEPI	N/A
	Moderate	Private Credit	Golub Capital BDC / GBDC	-5.1%
	Moderate	Real Estate	Vanguard Real Estate / VNQ	-1.4
Diversification/Downside Protection	Moderate	Commodities	Vanguard Commodity Strategy / VCMDX	17.2
	Moderate	Long-Short Equity	Invesco S&P 500 Downside Hedged / PHDG	8.7
	Moderate	Macro Trading	iMGP DBi Managed Futures Strategy / DBMF	14.7
	Low	Merger Arbitrage	NexPoint Merger Arbitrage / HMEZX	5.6
Return Enhancement	High	Distressed Debt	N/A*	N/A*
	High	Private Equity	N/A*	N/A*

*High quality, fully liquid funds for investing in private equity and distressed debt are not available. Three-year returns are through Sept. 26 and are annualized. N/A=not applicable
Sources: Morningstar; Bloomberg

With public markets down in 2022, investors' interest in alternative investments, or alts, such as hedge funds and private equity, has spiked.

Alts can perform in a fashion uncorrelated to stocks and bonds, offering diversification and the potential to inject positive performance into a plain-vanilla portfolio during times of market strain. Simple 60%-stock/40%-bond portfolios have suffered a brutal pummeling in 2022, as evidenced by the roughly 20% year-to-date decline of the **Vanguard Balanced Index** fund (ticker: VBIAX), which tracks a 60/40 composite index of the stock and bond markets.

Yet investing in alternatives requires far more research than simply examining a stock fund's fees and returns. For one, investors have to decide whether to invest in "liquid alts," which operate like a traditional mutual or exchange-traded fund, provide daily redemptions, and are more accessible to broad swaths of the investing public. Or, do they invest in private or semiliquid public vehicles that may allow only quarterly—or even less-frequent—redemptions and often require investors to be "accredited"? An accredited investor must have an annual income of at least $200,000 or a net worth of at least $1 million.

Those considering liquid alts should know they have a spotty reputation. Over the past 10 years through June 30, the average liquid alt mutual fund in the Wilshire Liquid Alternative Index has delivered only a 1.7% annualized return versus the Vanguard Balanced Index's 8.2%. The returns "per annum that these [liquid alt] funds have earned are probably less than the fees on average that were paid to their managers," says Andrew Beer, founder and portfolio manager at Dynamic Beta Investments. He believes that most, albeit not all, liquid alts "have no diversification benefits."

Beer should know. He worked as a portfolio manager at legendary hedge fund firm Baupost Group in the 1990s, started three hedge funds himself, and now co-manages two liquid alt ETFs at Dynamic Beta: the **iMGP DBi Managed Futures Strategy** (DBMF) and **iMGP DBi Hedge Strategy** (DBEH). Rather than building a new alts strategy, Beer tries to replicate benchmarks of top-performing managed-futures funds and hedge funds in his ETFs for less. The ETFs' 0.95% and 0.85% expense ratios are less than half what typical private hedge funds charge—2% of assets plus 20% of profits annually. Both ETFs have trounced their liquid alts peers, and the managed-futures one especially has provided strong diversification. It recently was up 33% in 2022.

Beer would be the first to say that there are certain private hedge fund managers—such as Millennium Management, Citadel, and D.E. Shaw—that no liquid alt can match, in part because of their structure. Private funds can invest in illiquid securities that public funds can't. They can also employ significant amounts of leverage to amplify their returns, concentrate their portfolios in just a few companies, and aggressively pursue activist campaigns at companies they're invested in to improve returns. Liquid alts, typically registered with the Securities and Exchange Commission, are limited in what they can do with such strategies.

Alt caveats. Aside from higher fees, the major problem with private alts is access—both getting in and getting out. For instance, Millennium Management has a minimum holding period of five years. There can also be a wide variance in returns between the best and worst private alts. This is especially true in the case of private-equity funds. According to J.P. Morgan Asset Management, annualized returns for private-equity funds ranged from 6.5% to 26.4% in 2005 through 2019. For long/short hedge funds, the five-year annualized returns ranged from 5.2% to 15.5% through June 30, 2021.

Yet private equity and debt seem particularly attractive to high-net-worth investors right now. Tiger 21, an investing networking group, surveys its 1,200 wealthy entrepreneur members about their allocations. In this year's second quarter, they had an average of 27% of their portfolios in private equity, equal to their public-equity weighting and a significant increase over their lowest 8% historical weighting during the 2008 crash. "There's not another cohort of wealth, with perhaps the exception of some of the large family offices, that has such a high concentration," says Michael Sonnenfeldt, Tiger 21's founder.

Assuming you can access a good alt strategy, how do you figure out which ones are right for you? J.P. Morgan has created a useful framework for making that decision. The first question: Are you primarily seeking diversification, income, or investment gains?

To achieve these objectives, J.P. Morgan has identified nine alt categories: core private credit, core real assets, low-vol core equity, subordinated credit, hedge funds, noncore real assets, distressed credit, special situations, and private equity. Core real assets, for instance, are physical assets like real estate or infrastructure that can help achieve income goals (by, say, generating cash from rental income) and/or diversification goals, as they can be an inflation hedge. These could be public or private real estate investment trusts, or REITs, or infrastructure funds such as **Vanguard Real Estate** (VNQ) and **Lazard Global Listed Infrastructure Portfolio** (GLIFX).

Alt choices. Depending on your wealth, age, investment time horizon, and risk profile, you might emphasize one of the alt categories in your portfolio. Very generally, the wealthiest investors with the longest time horizons and highest risk tolerance might emphasize "appreciation driven" alts—private equity and distressed debt (for example, the debt of bankrupt companies undergoing restructuring). Meanwhile, the mass affluent, defined by J.P. Morgan as having $500,000 to $1.5 million in assets, might want more-liquid alt diversification in their equity portfolios.

Special-situation funds such as **NexPoint Merger Arbitrage** (HMEZX), which invests in companies being acquired, and low-volatility core equity funds like **JPMorgan Equity Premium Income** (JEPI), which writes options on stocks to generate income and reduce risk, could be useful diversifiers. And retirees might prize the high income potential of other alts, like private debt.

BlackRock employs an approach similar to J.P. Morgan's for clients' alts allocations. Scott Reeder, head of alternative investments at BlackRock's U.S. Wealth Advisory, sees two goals for alt clients: "One is how to diversify the returns in their portfolios. The other component is around helping clients amplify returns in their portfolio." The latter can be done with private investments—equity, debt, and real estate—that can produce better returns than their public counterparts.

Founder Avy Stein of Cresset Capital, which manages $27 billion for high-net-worth investors, calls private credit a "fabulous asset class" right now: "Private credit provides high-single digit to low-teens kind of returns if done correctly, with largely senior debt risk."

Individuals can tap into this asset class through business development companies, or BDCs—public-market vehicles that can access private-market debt. Many currently yield more than 9%, similar to private-credit alt funds. But unlike the more-glacial price moves of the loans BDCs issue to private borrowers, the publicly traded shares of BDCs like **MidCap Financial Investment** (MFIC), **Golub Capital BDC** (GBDC), and **Ares Capital** (ARCC) can be extraordinarily volatile. That said, the loans inside their portfolios could be just fine, leading to BDCs trading at a premium or discount to their underlying loan portfolios' net asset values. You want to buy at a discount, if possible.

"Within our membership, there's a lot of interest in BDCs," Tiger 21's Sonnenfeldt says, because of the opportunities to buy those that are run by top private lenders at discounts to net asset value, or NAV.

Alt critics. Not everyone thinks private alts are a panacea. Financial advisors Isaiah Douglass of Vincere Wealth Management and Stephen Craffen of Atlas Fiduciary Financial employ private alts for clients but are wary of the industry's claims of stability during downturns like the current one. Both say that prices of private alts often don't reflect economic realities when public markets are down because the private alts' assets can be illiquid.

"Private equity gets to mark [the prices of] their investments every quarter," Douglass says, instead of every day for mutual funds that hold publicly traded securities. "But at the end of the day, these are just businesses that are in the marketplace doing very similar things as publicly traded companies." Craffen, for his part, owns an unusual private-equity alt that provides more-frequent monthly assessments of valuation. Both advisors scrutinize every alt to see whether managers are trustworthy—as should you. ■