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***Your* Active Wealth**
Podcast

The New Alternative World of Investing

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Featuring:

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VO [00:00:01] Is your wealth strategy supporting your long-term goals? Welcome to *Your Active Wealth* with BNY Mellon Wealth Management, where we offer insights that can help you move closer to your goals. We'll tackle timely topics through the lens of the five pillars that comprise our Active Wealth framework, Invest, Spend, Manage, Borrow and Protect, and provide guidance on navigating the unpredictable, to help you build and sustain wealth.

Alicia [00:00:35] Hi everyone and welcome back to *Your Active Wealth*, where we discuss topics to help you build and sustain wealth. I'm your host, Alicia Levine, and today we're discussing a very timely topic; why we need to invest in alternative assets such as private equity and real estate. So, look, let's face it, we've had a tough start to the year. Equities and bonds are both down year to date, and equities have had the toughest start to the year in about a century. Volatility has been extreme, with about 89% of all trading days, year to date, having at least a 1% volatility swing within the day. Very unusual. But the thing is, we do expect these conditions to continue for the next few months until the path of inflation is much more clear and how the Fed will bring inflation down to deal with the fact that it's at a 40 year high. It's in critical times like these that investors have to diversify beyond traditional stocks and bonds to include alternatives and other assets in their portfolios. So I'm very excited today to invite my colleague Joanna Berg. She's senior alternative investments strategist at BNY Mellon, and she's going to help us understand the benefits and the uses of alternatives in an overall portfolio allocation. Joanna, thanks for joining me today.

Joanna [00:01:57] Hi, Alicia. Thanks so much for having me.

Alicia [00:01:59] So I'm really excited for this conversation because I think it's really an important one given the kind of market we're in. And it's at times like this that we get to talk to our clients about diversifying with alternatives. So can you just explain to us what are alts and why are they so critical to have in your portfolio in the current environment?

Joanna [00:02:18] Alternative investments is such a broad term, and it includes a variety of investment strategies across the liquidity and risk return spectrums. On a high level, alts are split into hedge fund strategies and private market strategies. When we think about hedge funds, these could be long shot equity, absolute return, relative value, event driven or distressed or global macro. So different strategies to take advantage of different trends in the market, different parts of the market cycle, and really looking for those idiosyncratic sources of return that have low correlation with the public markets and also deliver that with lower volatility.

On the private market side, this includes private equity, real estate, infrastructure, private debt and on a very high level and I'm sure we'll get into this in a little bit, private market strategies, through less liquid structures, really look to provide that illiquidity premium or higher returns than the public markets through the complexity and the control of the investments that these funds have. And we add the alternatives to portfolios to serve a particular goal. And this could be, as you just talked about to reduce the volatility in portfolios. Hedge funds can reduce drawdowns by taking both sides of the market in long, short strategies. It could be the goal to provide higher sources of return than public markets. Again, this is through that illiquidity premium through private market strategies. The goal could be to hedge against inflation. This is on top of everyone's minds. A lot of alternative assets have inherent or built-in inflation hedges such as infrastructure and real estate. It can also be to provide higher current income. The private debt sector has grown immensely over the last decade and has become an integral part of investment portfolios in the low-rate environment that we have seen over the last decade. And as we look at the markets now, we're seeing cyclical and secular changes and trends in the market that make it even more important to have these types of strategies in investors' portfolios.

Alicia [00:04:36] So can you unpack some of those secular changes that you're talking about? Because I think we talk about regime change a little bit, going from that low inflationary world to maybe a higher inflationary world. And can you talk about how those trends increase the importance of having alts in the traditional portfolio allocation?

Joanna [00:04:56] Absolutely right. So that easy monetary policy that we've seen has really made that 60/40 portfolio much harder to deliver the same type of returns that it has over the past few decades. We've been in a low bond yield environment that has essentially eroded the ability of fixed income to act as a buffer against equity volatility. And at the same time, we've seen capital flowing into the private markets to get those higher returns and higher yields.

We've seen a significant growth in the private debt markets with private debt lending essentially replacing banks in the lower middle market space, offering attractive yields to investors in the lower yield environment than we've been in. The structural changes in the banking sector, bank consolidation in the early 2000s, further fueled by the GFC, banks have essentially exited the small and mid-cap lending space, paving the way for these private lenders to replace them. And as a result of the complexity of these privately negotiated loans, the current yield that investors get from these private loans has made private debt an increasingly bigger part of investors' portfolios. And these changes are here to stay. And we have now seen the private debt industry go through a few market cycles and has proven itself to be a fairly resilient asset class with really low defaults and high recovery rates.

On the private equity side, we have seen big changes in the structures of the equity markets. There are now more private companies than public. Companies are staying private for longer. They're delaying their public offerings. And this has essentially led to most of the value creation occurring in the private stages of a company's life.

And we have seen this play out in the performance of private equity. If we look at the last 20 years, private equity markets have outperformed various public market indices by anywhere from 400 to 700 basis points, and that's just for the index returns. In private markets, and this is a crucial point, the dispersion in returns, so top to bottom quartile performers, is significantly wider than what we see in the more efficient public markets. So comprehensive due diligence, such as the process that our manager research group conducts on potential fund managers for our clients is really imperative to identify those top quartile performers.

Alicia [00:07:33] Definitely. I had a question about leverage and specifically when you were talking about direct lending. Is it necessary to put leverage on these funds to get those kinds of returns? Or are you comfortable doing it without leverage, get maybe a lower return, but it feels a little bit safer in a more difficult macro environment? What do you say to that?

Joanna [00:07:55] So I think it really varies across the different strategies. So when you think about the private debt market, what we've seen there is with loans that tend to be more senior in the capital structure that are secured by cash flows or by assets, we see some levels of leverage added to those strategies. But as you go down the capital structure and up the risk profile, so you know second-lien or just junior debt, those strategies generally do not utilize leverage. On the private equity side, when we think about venture capital, that is a much riskier strategy than typical private equity. There is no leverage utilized in that end of the market. And then the lower and middle market private equity buyout and growth equity – those strategies, and that's the part of the market that our private equity business invests in, that part of the market utilizes much lower levels of leverage than, say, the upper end or the large mega buyouts. The lower and the sort of small and mid-cap private equity end of the market relies more on generating returns by improving the operations of companies by really adding the value add.

Alicia [00:9:22] So Joanna, what would you say to equity investors today who maybe would think something along the lines like, look, since the end of the global financial crisis, we've had equity returns on average of 13 to 15% annually. Yes, we're going through a difficult market right here. But why should I take on different asset classes and move away from the asset class that I'm comfortable with? What say you to those investors?

Joanna [00:9:50] That's a great question. And this is a question that we get all the time. There's a couple of ways to answer this. It's different today. We have a much more challenging investment environment. We're seeing a lot of cyclical changes taking over. You mentioned those at the very beginning. Inflation, right, felt essentially in every part of the economy now, that is increasing rates and rapidly, and we're seeing the geopolitical tensions creating volatility. And when we think about all the liquidity that has flushed in the system over the last decade or so, elevating those asset valuations, it's really made it harder for some of the fundamental investors to find opportunities, and it's really affected some of the hedge funds. But the volatility that we're experiencing now, which has become far more

frequent, the geopolitical tensions, the rising inflation, the rising rates, all of this is leading to higher dispersion. More bifurcation across securities, more dislocations in the markets, which in turn sets a much better environment for fundamental investors in hedge funds in long/short equity who can find those opportunities and take advantage of these opportunities.

And we knew this was coming. When we look at our capital markets assumptions, we've been calling for a far more challenging return environment and the increasing importance of alts within a well diversified portfolio. When we look at the expected equity returns and these are projected to be under 6% annually over the next ten years, bonds can't perform in a rising rate environment as we have seen with the negative performance so far this year. So again, I think investors need other sources of return to continue that historical return of the 60/40 portfolio and to also absorb the market shocks.

Alicia [00:11:41] So would you take the alternative piece from the bond portion or the equity portion? Where would you fund this allocation from?

Joanna [00:11:49] Well, you can fund it from both, depending on the type of strategy that you're looking to invest in, think that would be your funding source. I think the way we think about private equity or more beta driven long-short equity hedge funds that tend to return higher returns are more volatile, are more equity like, that would come from the equity allocation. And more lower volatility funds such as absolute return or relative value hedge funds, these are hedge funds that generally run low net exposure to the markets, have very low volatility, lower correlation, lower beta. Those could be funded from the fixed income side. And then we've also seen portfolios funding the direct lending allocation from fixed income and especially investors who can certainly take on a little bit of illiquidity.

Alicia [00:12:55] So let's talk about the liquidity issue, because that's actually one of my favorite conversations that we have with clients and with foundations. And typically, investors tend to equate illiquidity with higher risk, which I find fascinating actually, because as you watch equity markets sell off 2% every day, you do wonder why liquidity is less risk. But can you talk to us about the illiquidity premium and why, in fact, it may not be more risky?

Joanna [00:13:26] You touched upon a really, really great point. People talk about illiquidity as a risk, a source of risk. But when you really think about it and you unpack your typical private equity fund, you have portfolio managers who are looking to invest into companies and take control oftentimes and hold on to those companies for a few years. They identify the investment thesis. They want to carry that out, improve the companies, and they need a few years to do that. But in order to do that, they have to have these illiquid structures. And with those illiquid structures, they don't have to worry about investor redemptions or quarterly earnings. They can drive their value add through the control that they have. They also have control over the timing of disposition of those investments. So right now, you have a private equity manager looking to realize an investment. It may not be the best time to do it. They can hold on to it. They are not forced to realize an investment right now. They can wait it out. They can wait for a better market opportunity. And so because of that freedom and that flexibility that allows the private equity portfolio managers to execute on their investment thesis and drive those returns, this is really where that illiquidity premium comes from.

When you think about how private equity valuations are marked, they're not marked-to-market on a daily basis, they're marked on a quarterly basis. And so we don't see that interim volatility reflected in those valuations. The valuations are based on company fundamentals. If there is a big drawdown in the markets, you might see a bit of a down tick and those valuations when the quarter ends. But again, these valuations are based on the fundamentals rather than some of the technicals and some of the other forces that sometimes drive the market volatility. So illiquidity, it can really provide that extra return. And again, I think it's important to keep in mind that these investments could make up 10%, let's say, 15% of a client's portfolio when we're talking about the private equity, illiquid markets. So we think a lot of investors can certainly take on that level of illiquidity to increase their returns on their portfolios.

Alicia [00:16:04] I love this discussion on illiquidity because it becomes very obvious in markets such as the one that we're in in the beginning of 2022 where the equity market is so volatile and it's very clear that actually illiquidity gives managers the gift of time. And so, with long-term capital, you're not forced to make decisions that are not pertinent to the actual investment, and as you point out, for other structural reasons. So I think that's a really important conversation with investors. One of the things I get asked all the time is what should I do about inflation? What should we do for inflation protection? So can you tell us specifically which alternative investments are best to hedge against inflation?

Joanna [00:16:53] We have been getting those questions just as often and frequent this year as I'm sure you have. And when we look at our alts platform and the different types of strategies, there are certain investments that have inherent or built in inflation hedges and that have historically provided some protection against inflation in investor portfolios. So here we're talking about traditional infrastructure such as toll roads, utilities, nontraditional infrastructures. So here I've got cell towers, renewable energy, real estate, and then also asset-based lending. These all can provide some inflation hedging.

So when we take real estate, for example, historically all the different sectors have provided some level of hedging against inflation. When you think about real estate leases, long-term leases such as for office and industrial assets, these tend to include annual adjustments which are generally connected to inflation. On the shorter end of the lease spectrum, so think hotels, self-storage apartments, these tend to be daily, monthly or annually, which means the rents reset often and they keep up with that rising inflation. And so to execute on these themes, investors can invest in real estate across different risk return spectrums from core real estate through evergreen structures that we have available for our clients or to more the value add and opportunistic strategies that take on a little bit more risk, more private equity like returns. On the traditional infrastructure side, so toll roads, utilities, airports, most infrastructure assets have an explicit link to inflation through regulations with revenue contracts that are often tied to inflation indicators such as CPI. Again, providing that inflation protection through those step ups. Nontraditional infrastructure, so renewable energy, cell towers. These are hard assets that tend to rise in value with inflation. And within the renewable energy space, the demand for these assets has been so strong that development has remained attractive even as the costs rise for construction. At the same time, production cost for wind and solar energy have fallen due to economies of scale and technology improvements. And lastly, and I think this is probably the last asset class that clients think about when there is inflation is asset based lending and direct lending. Think about inflation eroding fixed income returns. Direct lending is actually mostly floating rate and coupons reset with rising rates. And so the current income will rise as well. When you think about asset-based lending, so loans backed by things such as equipment, these have physical assets that will rise with inflation. We talked about it with the illiquidity of these structures. These are not marked on a daily basis, which provide a little bit of that ballast that we have seen eroded in fixed income this year.

Alicia [00:20:14] What about the other word that we hear a lot, the possibility of recession? Is there any concern out there that private equity returns could be lower in a recessionary environment or scenario because the companies get lower multiples? I mean, similar to what happens in the public markets and becomes more difficult to exit investments via an initial public offering?

Joanna [00:20:37] And that's a great question. And this has been on top of investors minds. I want to stress that private equity is a long-term investment. So the longer-term nature and the flexibility that we talked about of the private equity asset class. Right now, we're in an environment where we could be going into a recession. But this is also an environment where buyers into this type of market environment are buying at lower multiples. We've also looked at vintage performance over time to determine the performance of private equity funds across different market environments and found that recessionary and post recessionary vintages tended to outperform other vintages. And this really stems from the ability to invest at lower entry multiples, ability to identify attractive companies whose valuations may have been depressed along with the market, and to really drive the value add component through the benefit of sector expertise and seasoned operating partners, that's common in the private equity model. So also during these periods, there tends to be far less competition or deals in these periods. And in terms of the exits, we're talking about 3- to 5-year holding periods. You have to think about the longer-term nature of the investment and focus more on the entry point that we have right now.

Alicia [00:22:08] So I want to pick up something you said which is fascinating, which is that the vintages that started during recessionary times actually outperform. True in private equity and of course, true in public markets as well. During recessions you tend to pick up very strong companies at very low multiples that outperform over time. So there is a mirror image here about sort of timing on when to invest. One of the things that I would love for you to be able to explain to our listeners. Could you just explain a little bit about the time lag from when you commit to sort of when you start getting returns?

Joanna [00:22:46] So your typical private equity fund commits capital over, let's say, 4 to 5 years as they see opportunities. They're not investing all the capital that they raised from investors all in one year. They take their time. They want to find the right investment opportunities, but also to diversify across the different years given that this is a longer-term hold. What we really like to recommend to our clients when we build private equity portfolios, we like to think about adding secondary private equity, secondary investment. secondaries are essentially funds that require

private equity investments from other investors. And these investments are fairly mature. Meaning they're a few years into the investment period and the portfolio companies are essentially closer to being realized. what this means is that investors into these private equity secondary funds can see cash flows back to them sometimes even in the first year. When you compare that to your typical private equity fund, the first distributions, the cash flows back to the investors, really don't begin until year 4 or 5, when those initial investments made in those first years are being realized, given that 3-, 4- or 5-year holding period. By adding these private equity secondaries to a private equity portfolio to build that private equity allocation, this essentially shortens the duration of the investments. It reduces that J-curve effect in private equity, which is essentially the period in the first few years where the client pays in the capital but generally does not see any capital coming back nor any returns. Through these secondaries, you're backfilling vintage exposures, meaning you're getting exposure to investments that have been made, let's say, if we think about it today, 2015 to 2020, whereas the primary private equity investments invest in a go forward basis. The two strategies really complement one another and the secondaries really add those earlier cash flows and kind of ease that period for clients who are starting with essentially no allocations to private equity.

Alicia [00:25:17] That's a great solution to the J-curve issue, particularly for investors who are new to the asset class. So that's a great option, I think. Joanna, this has been a fascinating conversation and actually really well timed given what's going on in markets. And we really need to talk about non correlated assets in volatile and inflationary times as this. So thank you so much for joining me.

Joanna [00:25:41] My pleasure. Thank you so much for having me, Alicia.

Alicia [00:25:44] So this conversation is really an important reminder to all investors that the traditional 60/40 portfolio may not fit current market conditions and alternatives can help balance a well-diversified portfolio. We encourage everyone to talk to your wealth advisor to ensure that your portfolio is built to weather all market conditions, including the one we're in now. When it comes to withstanding the impact of today's volatility, inflation and rising rates, alternatives check all the boxes. Thank you for listening today and see you next time on the next episode of *Your Active Wealth*.

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