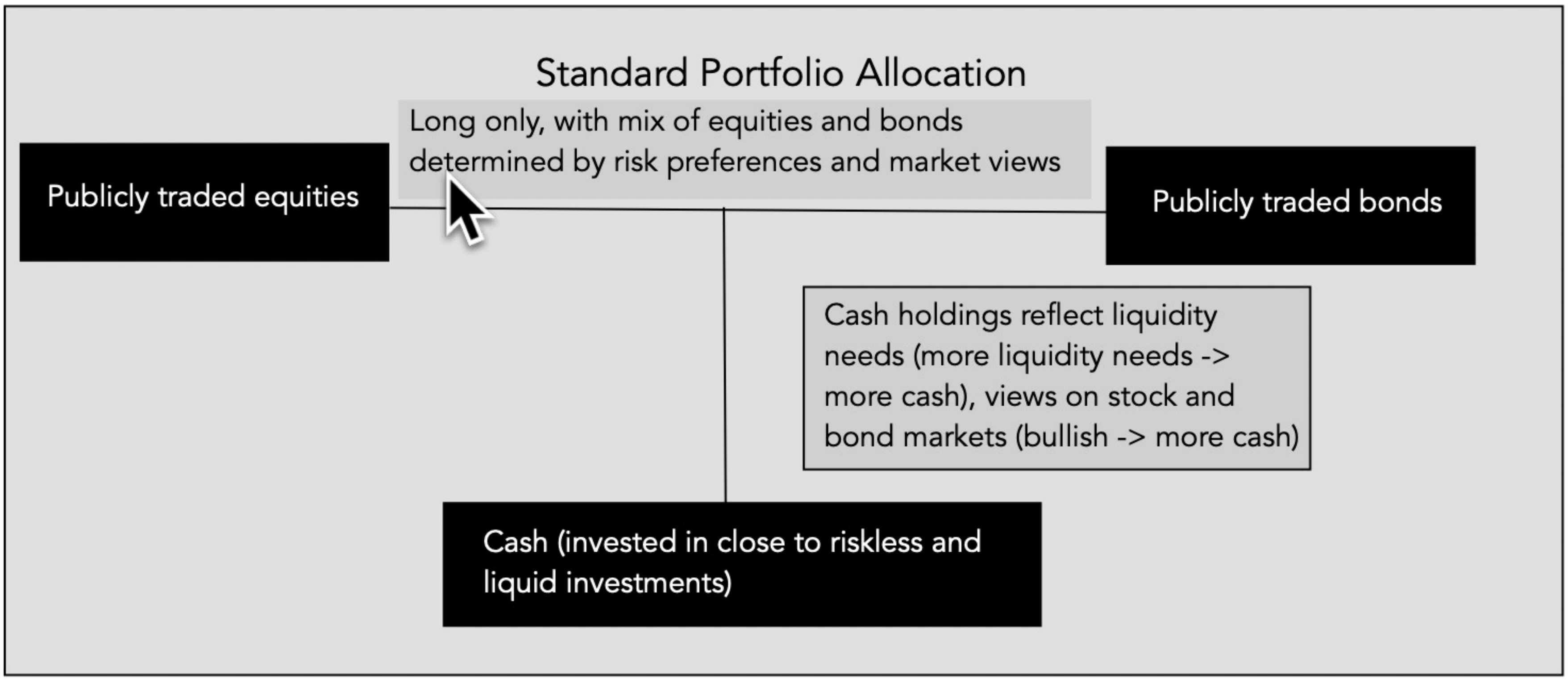
ALTERNATIVE INVESTING: THE PROMISE AND (UNCERTAIN) PAYOFF!

VC, PE and Crypto

THE PUSH FOR ALTERNATIVES

- It is true that **most investing lessons are directed at those who invest in stocks and bonds**, and mostly with long-only strategies.
- It is also true that in the process**, we are ignoring vast swaths of the investment universe**, from other asset classes (real estate, collectibles, cryptos) to private holdings (VC, PE) to strategies that short stocks or use derivatives (hedge funds).
- In the last two decades, **alternative investments have entered the mainstream**, first with choices directed at institutional investors, but more recently, in offerings for individual investors.
- Without giving too much away, the sales pitch for adding alternative investments to a portfolio composed primarily of stocks and bonds is that the melding **will create a better risk-return tradeoff**, albeit with two different rationales.
  - The first is that they have **low correlations with financial assets** (stocks and bonds), allowing for classic diversification benefits and
  - the second is some of these alternative asset groupings (VC, PE and hedge funds, in particular) have the **potential to earn excess returns or alphas**.

THE STANDARD PORTFOLIO SETUP



THE MISSING PIECES..

- This **general framework allows for variants**, accommodating different view on markets (from those who believe that markets are efficient to stock pickers and market timers) as well as investors with very different time horizons and risk levels, but those variants revolve around
  - The mix of stocks, bonds and cash to hold
  - How to pick the individual stocks and bonds to invest in..
- However, there are clearly large segments of investing that are left out of this mix from **private businesses** (since they are not listed and traded) to **short selling** (where you can have negative portfolio weights not just on individual investments but on entire markets) to **asset classes that are not traded**.
- In fact, the best way to structure the alternative investing universe if by looking at alternative through the lens of these missing pieces.

1. THE LONG SHORT DIVIDE

- Many institutional investors, including most mutual, pension and endowment funds, are restricted from taking short position on investments, with exceptions sometimes carved out for hedging. For close to a century, at least in the United States, **hedge funds have been given the freedom to short traded assets**.
- While they do not always use the power to short to benefit, it is undeniable that **having that power allows an investor to create return distributions (in terms of expected returns, volatility and other distributional parameters) that ae different from those faced by long-only investors**. Within the hedge fund universe, there are diverse strategies that not only augment long-only strategies (value, growth) but also invest across multiple markets (stocks, bonds and convertibles) and geographies.
- The **opening up of derivatives markets** has allowed some investors to create **investment positions and or structured products** that use options, futures, swaps and forwards to create cash flow and return profiles that diverge from stock and bond market returns.

2. THE PUBLIC-PRIVATE DIVIDE

- While much of our attention is spent on publicly traded stocks and bonds, there is a large segment of the economy that is composed of private businesses that are not listed or traded. Many of these **businesses are owned and funded by their owners**, but a significant proportion do need outside equity capital, and historically, there have been two providers:
  - For young private businesses, and especially those that aspire to become bigger and eventually go public, it is **venture capital** that fills the void, covering a spectrum from ideal companies (with angel financing) to growth capital (for young businesses).
  - For more established private businesses, some of which need capital to grow and some of which have owners who want to cash out, the capital has come from **private equity inves**tors.
- On the debt front, the public debt and bank debt market is supplemented by **private credit**, where investors pool funds to lend to private businesses that need them, with negotiated rates and terms

3. UNTRADED ASSETS/INVESTMENTS

- Real estate: For much of the twentieth century, real estate remained outside the purview of public markets, with a segmented investor base and illiquid investments, requiring localized knowledge. That started to change with the creation of real estate investment trusts, in the 1970s, and in the 1980s with the advent of **mortgage-backed securities** in various forms. That said, real estate punches well below its weight, in market value terms, in public markets.
- Collectibles: The collectible asset class spans a wide array of investment, most of which generate little or no cash flows, but derive their pricing from scarcity and enduring demand. The first and perhaps the longest standing collectible is **gold**, a draw for investors during crises or when they lose faith in fiat currencies and governments. The second is **art**, ranging from paintings from the Middle Ages to digital art (non-fungible tokens or NFTs), that presumably offers owners not just financial returns but emotional dividends. At the risk of raising the ire of crypto-enthusiasts, I would argue that **much of the crypto space** (and especially bitcoin) also fall into this grouping, with a combination of scarcity and trading demand determining pricing.

THE SALES PITCH FOR ALTERNATIVES

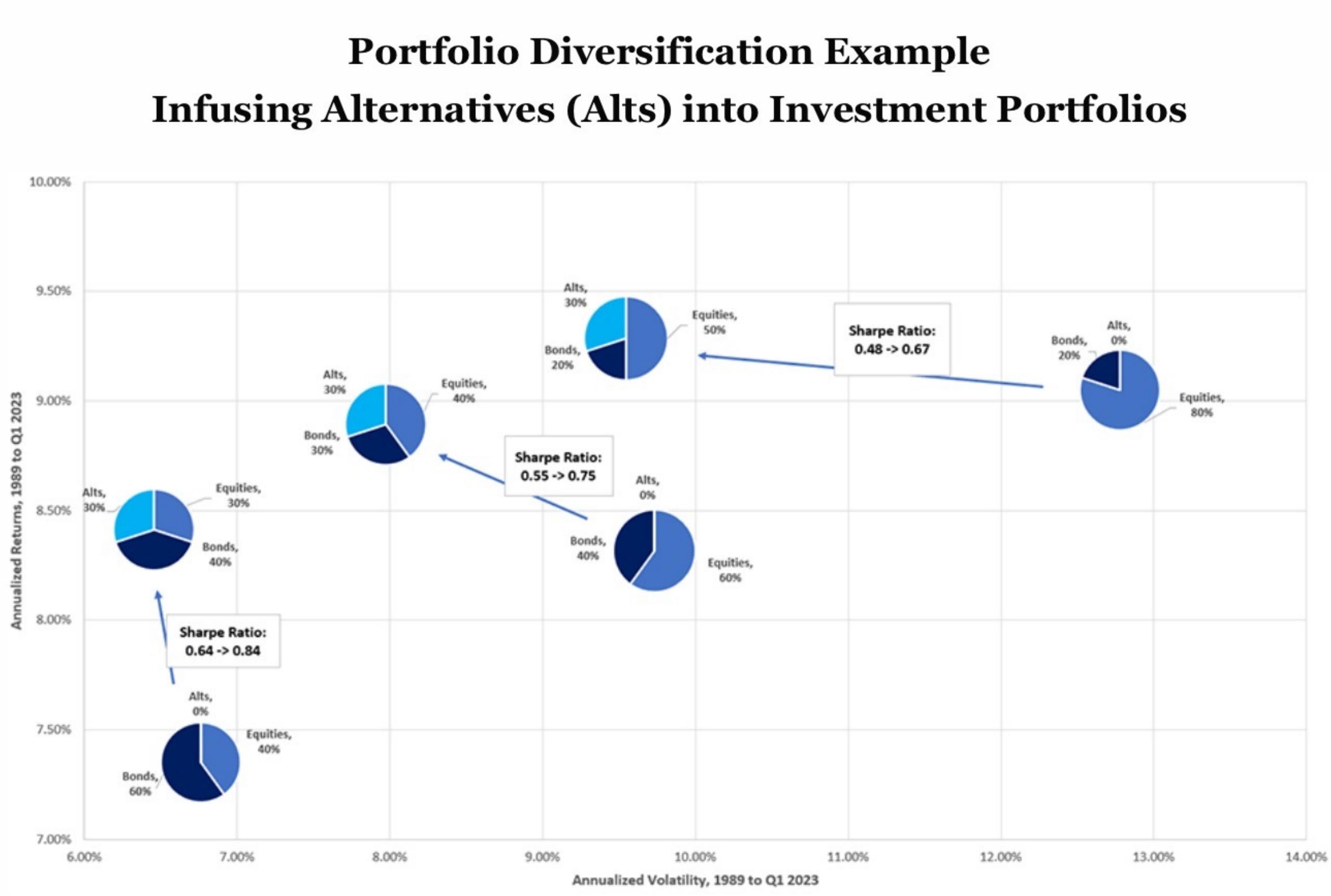
- The strongest pitch for adding alternative investments to a portfolio dominated by publicly traded stocks and bonds comes from a basic building block for portfolio theory, which is that **adding investments that have low correlation to the existing holdings** in a portfolio can create better risk/return tradeoffs for investors.
- That pitch has been supplemented in the last two decades with arguments that alternative investments also offer a greater chance of finding market mistakes and inefficiencies, partly because they can be **easier to find in these markets** and partly because of **superior management skills on the part of alternative investment managers**, particularly hedge funds and private equity.

ALTERNATIVE ASSETS: HISTORICAL CORRELATIONS

	Positive	Negative
High	0.7-1.0	(0.7)-(1.0)
Moderate	0.4-0.7	(0.4)-(0.7)
Low	0.0-0.4	(0.0)-(0.4)

	Investment Grade Bonds	Cash	Commodities	Currencies	Equity Market Neutral	Event Driven	Global	Hedge Funds	International Equity	Long/Short Equity	Managed Futures	REITs	S&P 500®
Investment Grade Bonds	1.00												
Cash	0.12	1.00											
Commodities	(0.18)	(0.12)	1.00										
Currencies	(0.47)	(0.06)	(0.23)	1.00									
Equity Market Neutral	0.20	(0.12)	0.26	(0.52)	1.00								
Event Driven	0.17	(0.01)	0.60	(0.26)	0.34	1.00							
Global	0.40	0.00	0.44	(0.46)	0.31	0.79	1.00						
Hedge Funds	0.14	(0.02)	0.60	(0.25)	0.45	0.88	0.75	1.00					
International Equity	0.41	0.00	0.45	(0.57)	0.37	0.76	0.94	0.73	1.00				
Long/Short Equity	0.30	0.06	0.46	(0.40)	0.46	0.80	0.87	0.86	0.84	1.00			
Managed Futures	(0.16)	(0.04)	0.04	0.25	0.05	0.02	(0.08)	0.34	(0.12)	0.05	1.00		
REITs	0.58	(0.05)	0.25	(0.31)	0.27	0.63	0.78	0.61	0.71	0.66	0.03	1.00	
S&P 500®	0.37	0.00	0.40	(0.39)	0.26	0.75	0.98	0.72	0.86	0.84	(0.05)	0.78	1.00

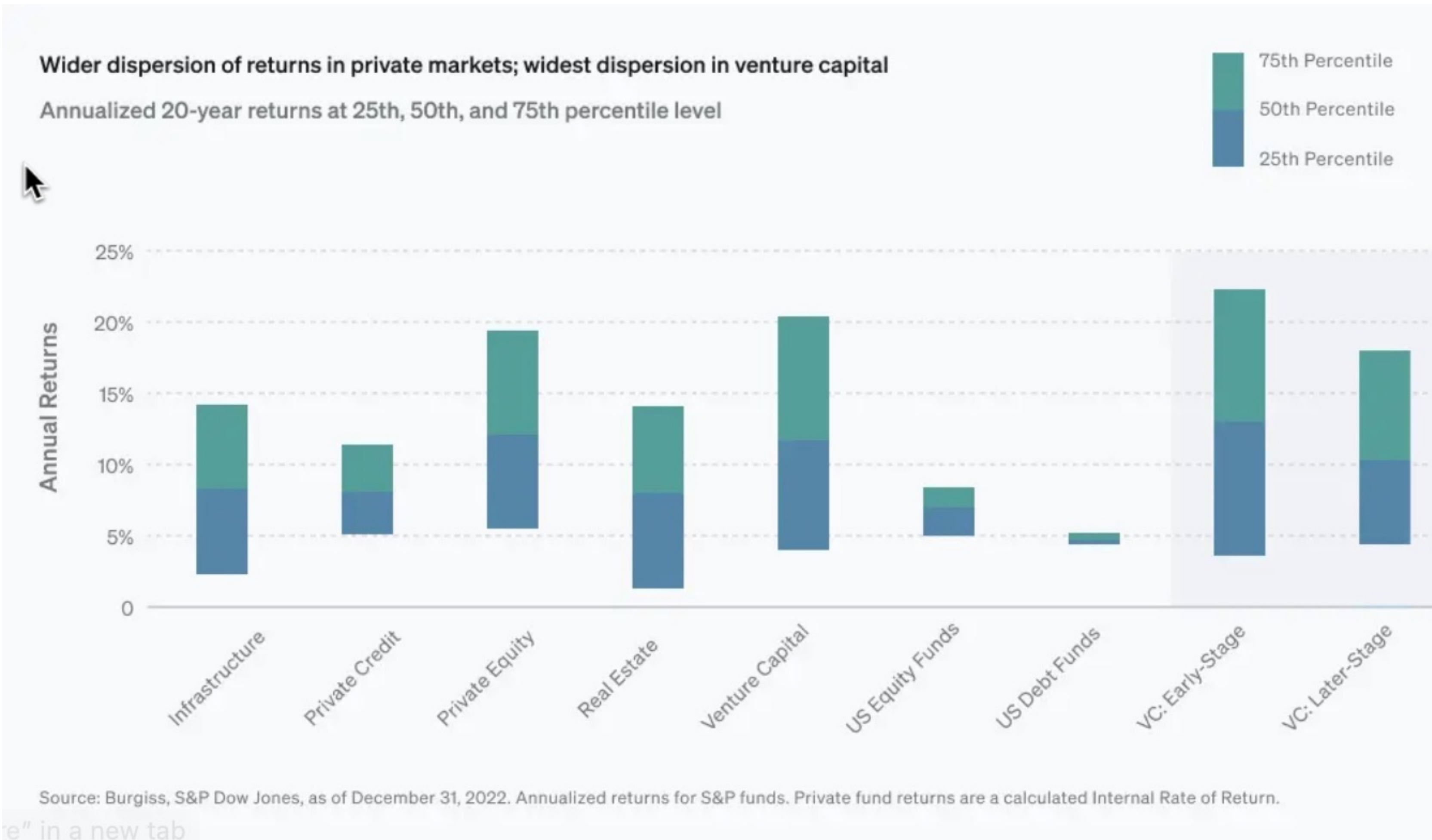
AND THE PAYOFF (AT LEAST ON PAPER)



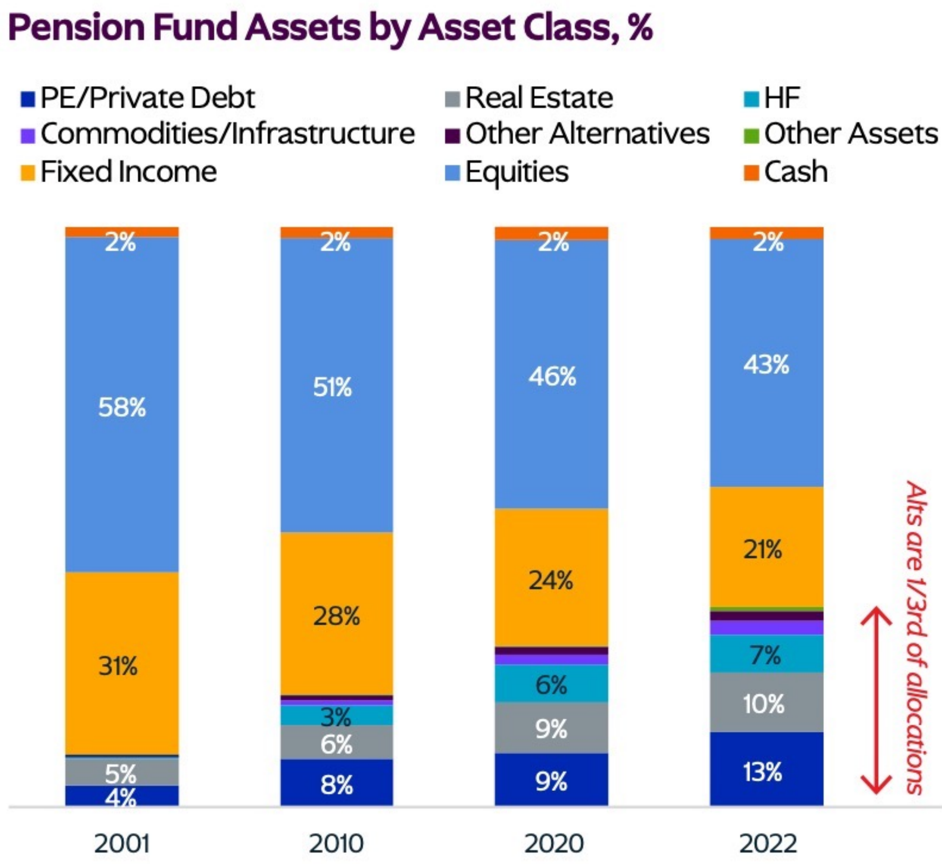
THE ALPHA ARGUMENT

- The **correlation-based argument for adding alternative investments to a portfolio is neither new nor controversial**, since it is built on core portfolio theory arguments for diversification.
- For some advocates of alternative investments, though, that captures only a portion of the advantage of adding alternative investments.
  - They argue that the investment classes from alternative investments draw on, which include non-traded real estate, collectibles and private businesses (young and old), **are also the classes where market mistakes are more likely to persist**, and
  - that alternative asset managers have the **localized knowledge and intellectual capacity to find and take advantage of these mistakes.** The payoff from doing so takes the form of "excess returns" which will supplement the benefits that flow from just diversification.

HEDGE FUND, PE AND VC ALPHAS!

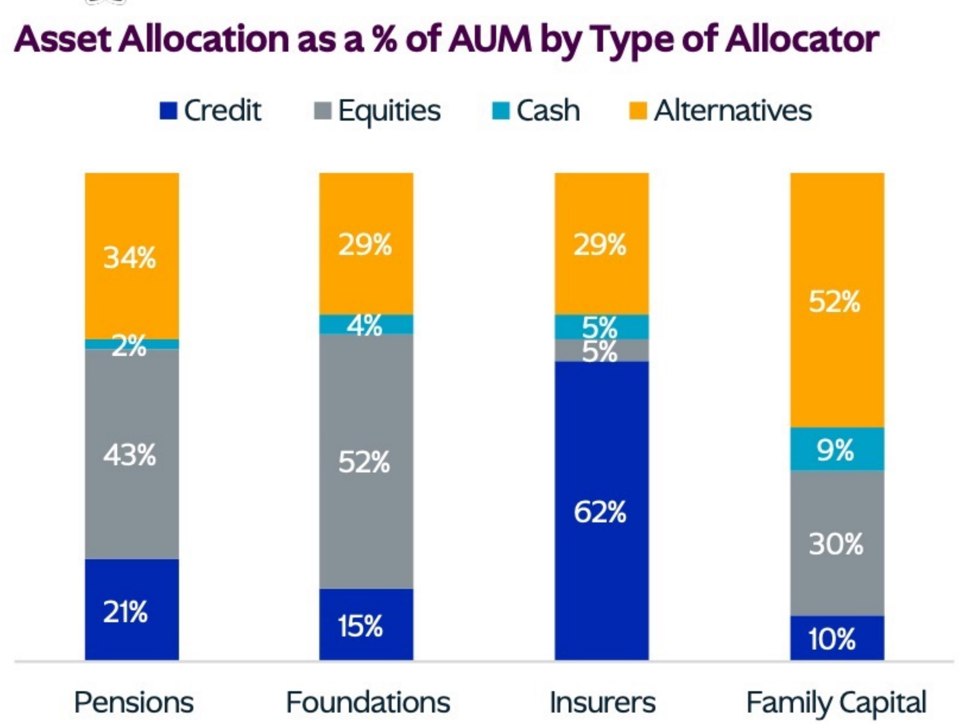


THE RISE OF ALTERNATIVES...



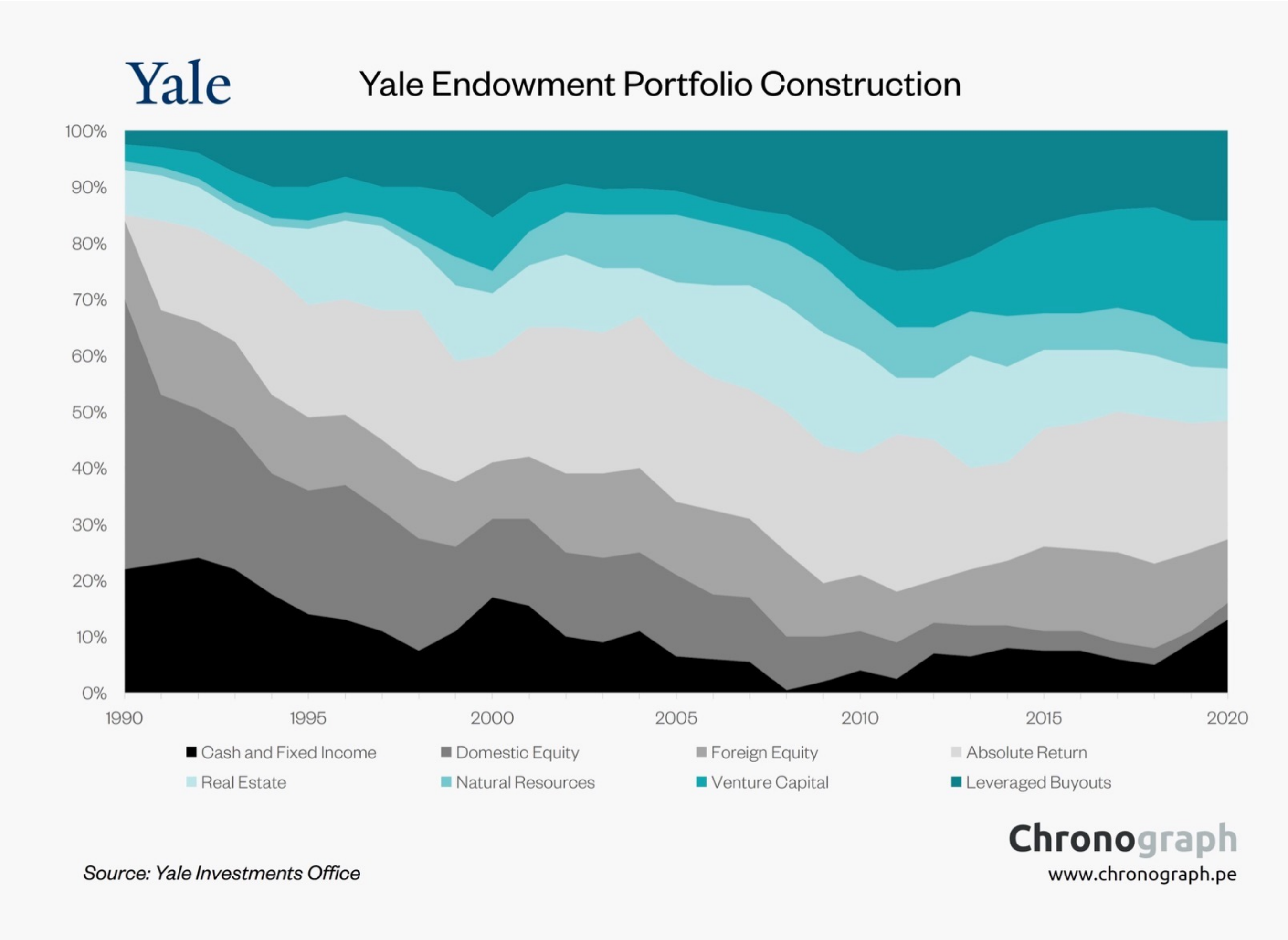
Data as at December 31, 2022. Source: Public plans data.

AND BY FUND GROUP…



Alternatives include Private Equity, Private Credit, VC/Growth, Hedge Funds, Real Estate, Infrastructure, and operating businesses for Family Offices. Insurers as at 2023. Remaining allocators as at 2022. Source: Public plans data, CommonFund, KKR 2024 Insurance Survey, and KKR 2023 Family Capital Survey.

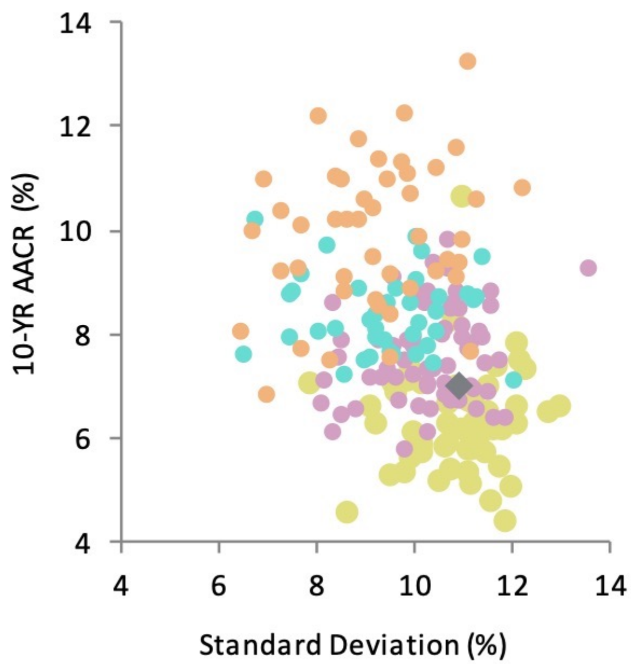
WITH EARLY ADOPTERS CELEBRATED… DAVID SWENSEN AT YALE!



THE PAYOFF IN PRACTICE? ENDOWMENT FUNDS…

FIGURE 26 10-YR STANDARD DEVIATION AND SHARPE RATIO

Periods Ended June 30, 2022

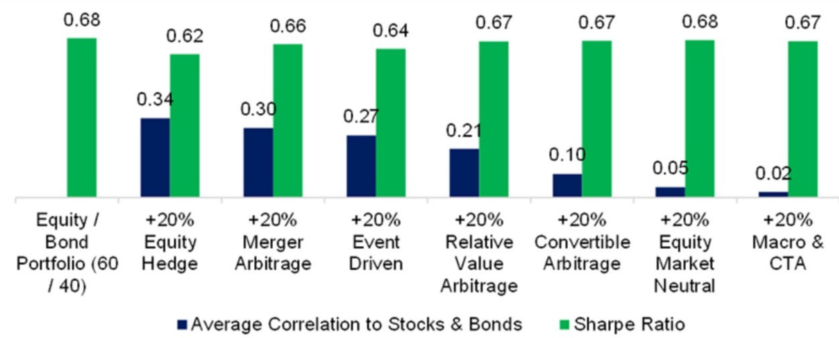


	AACR	Standard Deviation	Sharpe Ratio	*n*
All Endowment Median	7.7	10.2	0.74	*212*
Median by PI Allocation				
Less Than 10%	6.3	11.1	0.54	*60*
10%–20%	7.4	10.5	0.70	*66*
20%–30%	8.4	9.4	0.83	*40*
More Than 30%	10.1	9.2	1.02	*46*
70/30 Benchmark	7.0	10.9	0.62	

Sources: Endowment data as reported to Cambridge Associates LLC. Index data are provided by Bloomberg Index Services Limited and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

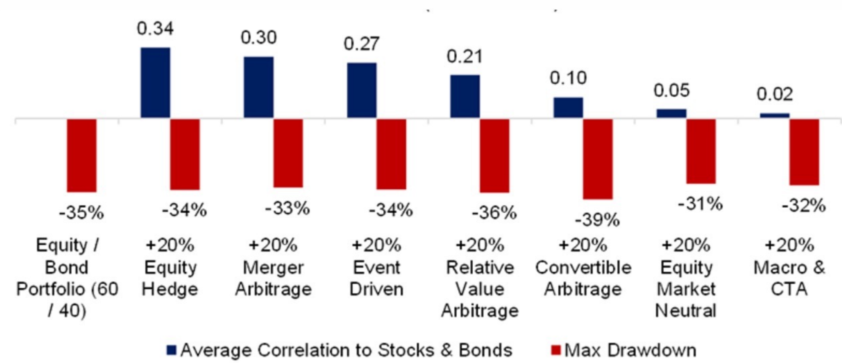
A CLOSER LOOK!

60/40 Portfolio Plus 20% Alternative Allocation: Sharpe Ratios, 2003 to 2022



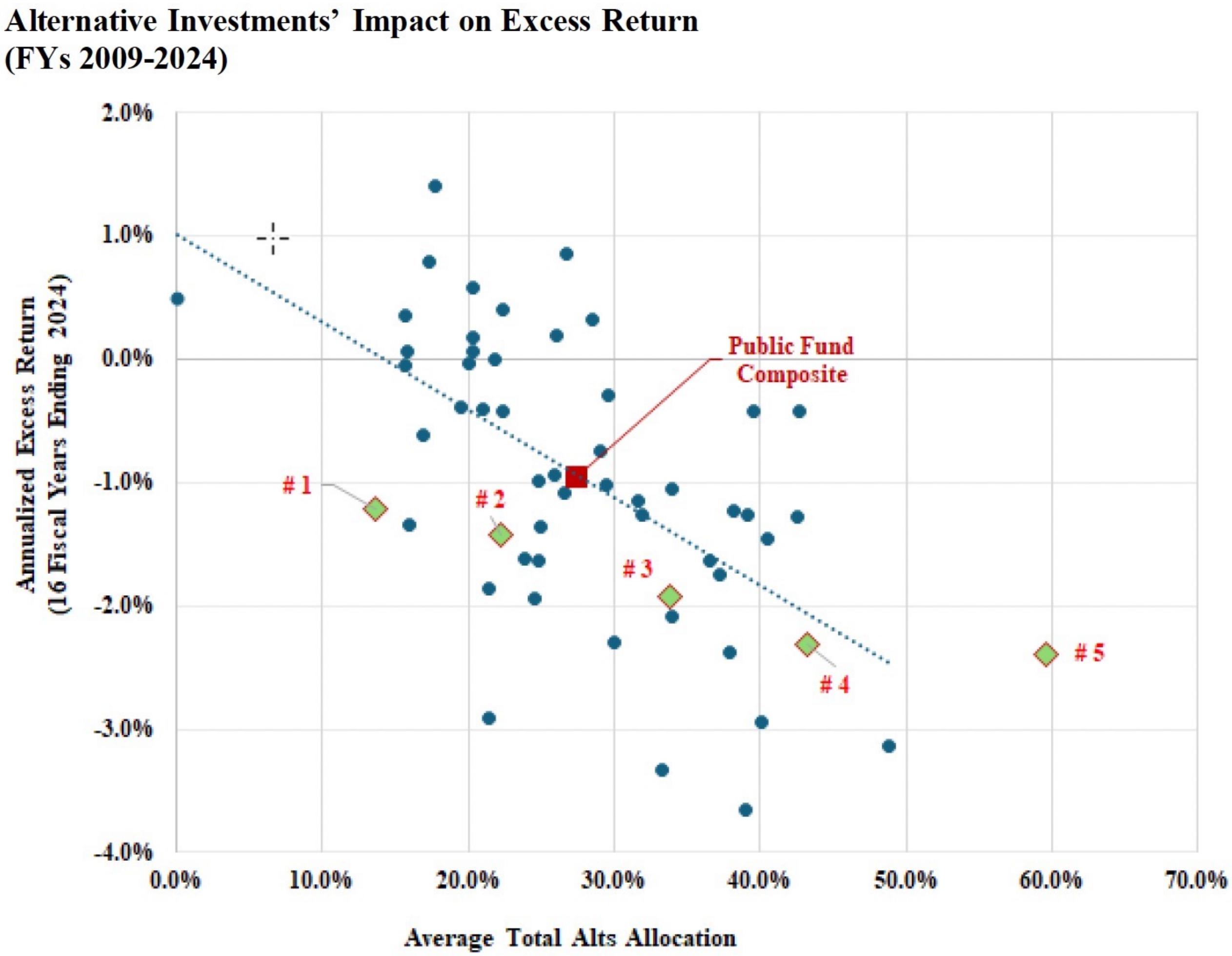
Source: Finominal

60/40 Portfolio Plus 20% Alternative Allocation: Max Drawdowns, 2003 to 2022



Source: Finominal

ALTERNATIVE INVESTING AND ALPHAS: THE ENNIS CRITIQUE



THE BOTTOM LINE!

- While alternative investing advocates will take issue with the Ennis findings, on empirical and statistical bases, **even long-term beneficiaries from alternative investing seem to have become more skeptical about its benefits over time**.
- In a 2018 paper, Fragkiskos, Ryan and Markov noted that among Ivy League endowments, **properly adjusting for risk causes any benefits** in terms of Sharpe ratios, from adding alternative investments to the mix, **to disappear**.
- In perhaps the most telling sign that the bloom is off the alternative investing rose, Yale's endowment announced its intent to sell of billions of dollars of private equity holdings in June 2025, after years of under performance on its holdings in that investment class.

1. (LOW) CORRELATIONS ARE UNDERSTATED OR MISLEADING

- Pricing lags; Unlike publicly traded equities and bonds, where there is an observable market price from current transactions, most private assets are not liquid and the pricing is based upon appraisals. In theory, these appraisers are supposed to mark-to-market, but in practice, the pricing that they attach to private assets lag market changes.
- Market crises: While correlations between investment classes are often based upon long periods, and across up and down markets, the truth is that investors care most about risk (and correlations) during crises, and many investment classes that exhibit low correlation during sideways or stable markets can have lose that feature and move in lock step with public markets during crisis.

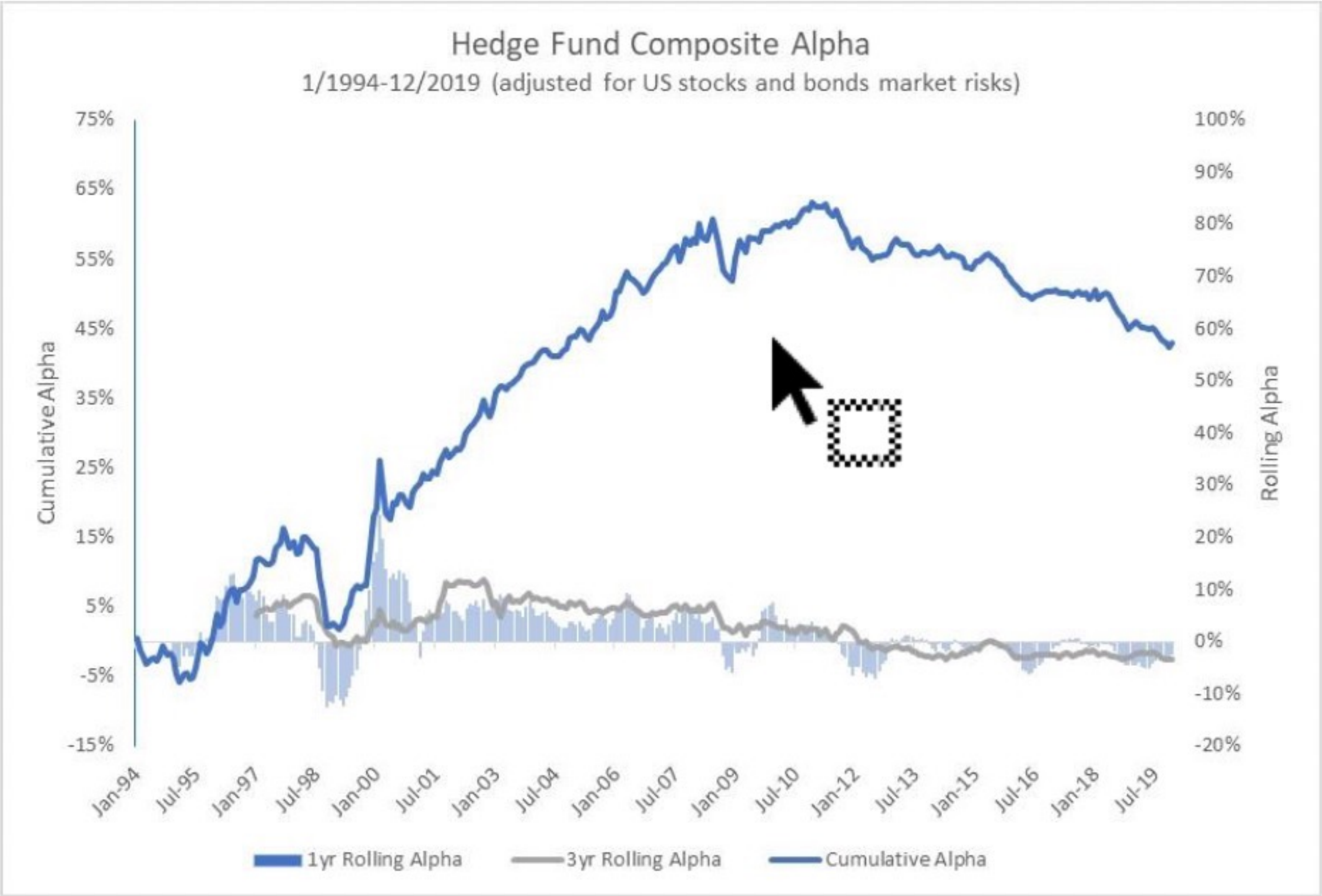
2. ILLIQUIDITY AND OPACITY

- Even the strongest advocates for alternative investments accept that **they are less liquid than public market investments** but argue that for investors with long time horizons and clearly defined cash flow needs that illiquidity should not be a deal breaker.
  - The problem with this argument is that much as investors like to believe that they control their time horizons and cash needs, they do not and **find their need for liquidity rising during acute market crises or panics**.
  - The other problem with illiquidity is that it **manifests in transactions costs**, manifesting both in terms of bid-ask spreads and in price impact that drains from returns.
- The other aspect of the private investment market that is mentioned but then glossed over is that they **tend to be opaque in terms of governance structure and reporting**. Again, that absence of transparency may be ignored in good times but could make bad times worse.

3. DISAPPEARING ALPHAS…

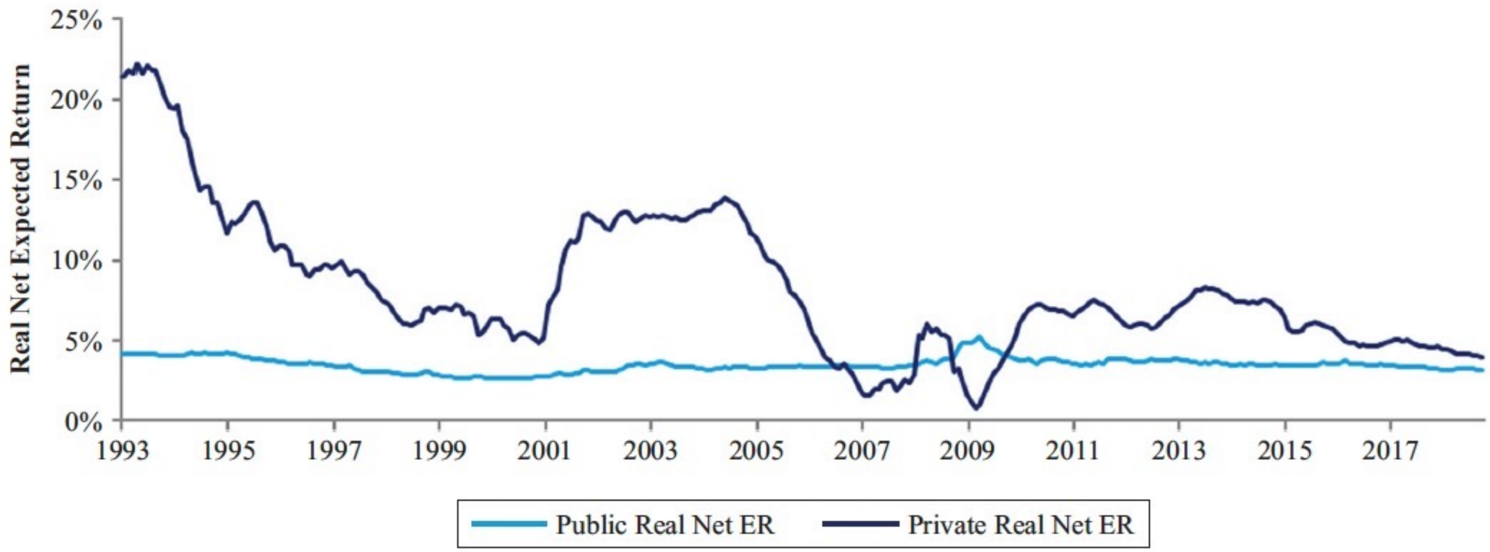
- When alternative investing first became accessible to institutional investors, the presumption was that **market-beating opportunities abounded in private markets, and that hedge fund, private equity and venture capital managers brought superior abilities** to the investment game.
- That may have been true then, but that perception has faded for many reasons.
  - First, as **the number of funds and money under management** in these investment vehicles has increased, the capacity to make easy money has also faded, and in my view, the average venture capital, private equity or hedge fund manager is now no better or worse than the average mutual fund manager.
  - Second, the **investment game has also become more difficult to win**, as the investment world has become flatter, with many of the advantages that fund managers used to extract excess returns dissipating over time.
  - Third, the entry of **passive investment vehicles like exchange traded funds (ETFS) that can spot and replicate active investors** who are beating the market has meant that excess returns, even if present, do not last for long.

A. HEDGE FUNDS



B. PRIVATE EQUITY

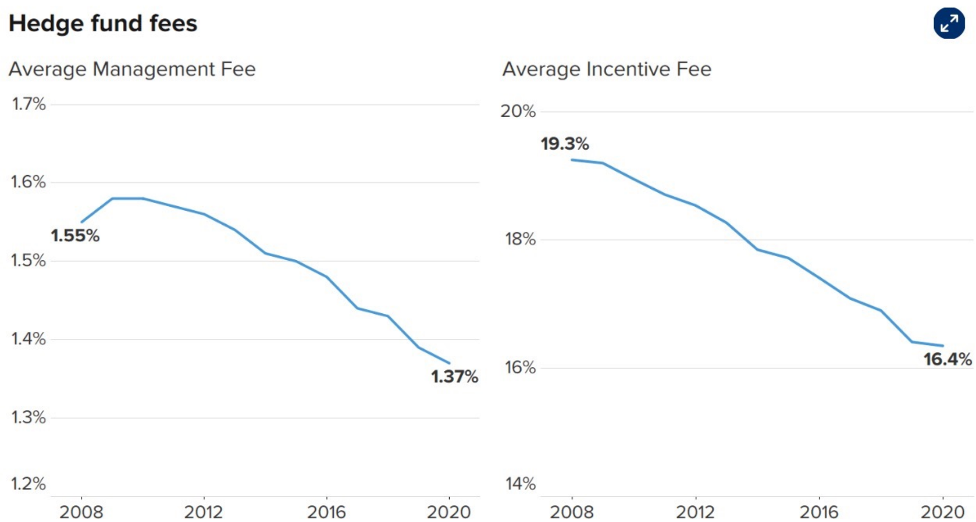
Net-of-Fee Expected Returns for Private Equity and Public Equity January 1, 1993–September 30, 2018



Sources: AQR, Pitchbook, Bain & Company (2018), Shiller, Consensus Economics, Bloomberg. For public equity real net ER, see Alternative Thinking Q1 2017 and footnote 36. Private equity real net ER described in the Appendix in further detail.
There is no guarantee, express or implied, that long-term return targets will be achieved. Realized returns may come in higher or lower than expected. For illustrative purposes only and not representative of any strategy that AQR currently manages.

4. THE COST EFFECT

- Most alternative investments have a management fee, set as a percent of assets under management, and a performance fee, where they get an additional fee, for outperforming a benchmark.
- The classic 2 & 20 fee entitles the hedge fund or PE investor to collect 2% of funds under management every year, and 20% of returns over the benchmark. Both have been trending down:



AN EPITAPH FOR ALTERNATIVE INVESTING? NOT NECESSARILY…

- **Be picky about alternatives**: Given that the alpha pitch has lost its heft, it is correlations that should guide investor choices on alternative investments. That will reduce the attractiveness of private equity and hedge funds, as investment vehicles, and increase the draw of some hedge funds, gold and many collectibles.
- **Avoid high-cost and exotic vehicles**: Investing is a tough enough game to win, without costs, and adding high-cost vehicles makes it even more difficult. On a related noted, alternative investments that are based upon strategies that are so complex that neither the seller nor buyer has an intuitive sense of what exactly they are trying to do should be avoided.
- **Be realistic about time horizon and liquidity needs**: On this front, individual investors need to be honest with themselves about how susceptible they are to panic attacks and peer-group pressure, and institutional investors have to recognize that their time horizon is determined by their clients, and not by their own preferences.
- **Be wary of correlation matrices and historical alphas**: If there is one takeaway from this post, I hope that it is that historical correlations, especially when you have non-traded investments at play, are untrustworthy and that alphas fade over time, and more so when the vehicles that delivered them are sold relentlessly.