Diversifying into alternatives can help improve risk-adjusted returns for portfolios when stocks and bonds sell off together. (UBS)

What can alternatives do for your portfolio?

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Alternative investments can help investors diversify their portfolios. They may offer better risk-adjusted returns than traditional asset classes and mitigate some losses when stocks and bonds fall together.

CIO sees particular opportunities in specialist credit hedge funds, macro hedge funds, secondaries in private equity, and in private debt. Investors should be aware of the unique drawbacks involved in investing in alternatives, like illiquidity.

Alternatives may offer better risk-adjusted returns than traditional assets.

- Adding 20% alternatives to a balanced portfolio has the potential to increase expected annual returns by about 50bps per annum over the long term, based on our capital market assumptions.

Alternatives can rally when stocks and bonds fall together.

- Last year's simultaneous annual losses for stocks and bonds was rare, happening just three times since 1926.
- Adding alternatives may help in a repeat scenario. Diversified alternatives' indexes (including commodities) delivered performance between –6% and +17% last year.
- We expect alternatives, depending on the strategy, to generate between 6% and 11% per year over a full business cycle (based on our capital market assumptions).

Private market investments may help generate income and grow long-term wealth amid uncertainty.

- In hedge funds, we like specialist credit managers that exploit differences between strong and weak companies, as well as discretionary macro hedge funds.
- We like secondaries in private equity, with discounts of around 16% of NAV offering value.

- Private debt offers high income of around 12% on new loans, according to JPMorgan, and may enjoy better investor protections than high yield.

Did you know?

- Credit long/short funds have historically outperformed traditional credit roughly two-thirds of the time after a market sell-off, according to HFRI RV: Fixed Income Corporate Index and Bloomberg US Corporate IG Index data since 1993.
- New private loans offer very attractive yields, in our view. At current levels, private loans are yielding a coupon of close to 12% per year on an unlevered basis. This is about 200bps more yield than US syndicated loans and 300bps more than US high yield.

Investment view

We particularly like specialist credit hedge fund strategies and secondaries in private equity. Higher interest rates can also support return potential for alternative asset managers, including in private debt. Discretionary macro funds, which we also like, have proven resilient during crisis periods. Investors should understand inherent risks of private assets, including illiquidity, longer lockup periods, and use of leverage.

Main contributors - Matthew Carter, Alison Parums, Jon Gordon, Karim Cherif

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