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Strategic: Diversify with alternatives

Diversify with alternatives

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Why? (1) Hedge funds have demonstrated the ability to limit losses during downturns while maintaining exposure to potential market gains; (2) Private infrastructure is generally less correlated with traditional asset classes, with return correlation ranging from -0.2 to +0.6 according to Cambridge Associates; (3) Middle-market buyout targets in the US may be a fertile ground for value creation, potentially benefitting from the next phase of Trump administration policies.

Hedge funds

With elevated geopolitical tensions, economic risks, and stretched valuations, adding hedge funds as alternative diversifiers may make sense. Their ability to go long and short, adjust exposures dynamically, and target specific dislocations—rather than purely chase market directionality or beta—positions them well for current conditions, in our view. If policy shocks and uncertainty persist, hedge funds should continue to benefit from a rich environment for active management and alpha generation. Strategies such as global macro, low-net equity long/short, and multi-strategy funds can further enhance resilience and improve risk-adjusted returns.

Private credit

While we watch closely for how US tariffs impact the operating environment for private lenders, particularly in import/export-sensitive sectors, we believe more domestic and less-growth-sensitive sectors of the private credit markets should be more shielded, in our view. We anticipate borrower credit risk and spreads to moderately increase from here.

Risk metrics may deteriorate, especially in the weaker segments of the market. Entering 2025, direct lending benefited from low defaults, below average leverage levels, and moderate non-accrual rates. We do not anticipate a surge in risk as our view that US GDP will slow in the second half of 2025 is consistent with positive growth, not recession. Yet, we acknowledge that lower-middle market firms and companies with limited pricing power, weak balance sheets, or those operating in tariff-sensitive sectors could experience a deterioration in their financials.

Overall lending activity is likely to slow as broad market uncertainty starts affecting deal volumes and banks' appetite to lend. This should reinforce the role of direct lenders as a funding source in periods of scarce capital. Alternative lenders may capture a bigger share of overall lending volumes moving forward.

Direct lending is short duration, generally senior, and less sensitive to market volatility given its non-listed nature. In more volatile times, lenders have several strategies at their disposal to support borrowers and manage risk effectively. But the current environment is likely to exacerbate the dispersion of outcomes across borrowers and lenders.

We prefer managers with a focus on sponsor-backed, upper-middle-market and large-cap deals in sectors more isolated from cyclical pressure. We also see European direct lending as attractive for cash flow, geographic, and currency diversification.

Private equity

While uncertainty and broader economic risks may pressure private company fundamentals, many private equity assets are domestically focused and less exposed to trade-dependent sectors, providing some resilience. Valuations are less concerning, as entry multiples have stayed relatively stable despite the sharp rally in public markets. Lower interest rates and the prospect of the Trump administration lessening the regulatory burden later this year also support the asset class, in particular the appeal of US middle-market buyout opportunities. This year, European and US middle-market median valuations (EV/EBITDA) have fallen to around 10x and now trade below the overall market, according to April 2025 Pitchbook data. We favor managers with a strong track record in value creation, especially in complex transactions such as carveouts and divestitures, and see continued appeal in secondaries, which may offer renewed discounts as investors seek liquidity.

Real assets

We focus on diversified exposure to assets with strong fundamentals and inflation-linked or GDP-resilient cash flows. In real estate, valuations have adjusted downward since late 2022, but demand for high-quality, stable assets should persist, supported by easing funding costs and limited new supply.

We favor higher-quality core and core-plus strategies (whose primary returns come from rental incomes) in logistics, data centers, and living sectors. In infrastructure, high barriers to entry, resilient cash flows, and structural scarcity—driven by trends like deglobalization and decarbonization—make core and core-plus segments attractive.

We also identify private markets tools to offer access to real assets underpinning CIO's Transformational Innovation Opportunities, examples being assets linked to the energy transition and digitalization. Their investments, often illiquid, can range from assets in renewables, storage facilities, electric grid infrastructure, and digital assets. These vehicles tend to target stable, inflation-linked cash flows and value creation through active management. Private infrastructure investments have historically demonstrated resilience, with annualized returns of 7.6% in 2024 and 10.6% over the five years to end 2024, based on Cambridge Associates data.

However, investing in private markets comes with unique risks, including but not limited to illiquidity, lock-in periods for capital, and the need for careful due diligence of unlisted assets.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

Appendix

Risk information
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