Strategic: Diversify with alternatives

Diversify with alternatives

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- **Why?** 1) Demand for hedge funds is robust, with industry assets reaching a record USD 5.6 tr (HFR estimates) at the end of the second quarter after the largest quarterly increase on record; 2) Private infrastructure can diversify long-term income sources, with inflation-linked cash flows potentially appealing if oil supply disruptions persist. 3) Private equity offers the potential to capture long-term growth and direct exposure to key themes such as tech, health care, or energy. Investors must be prepared to tolerate unique risks when investing in alternatives such as illiquidity, high fees, and limited transparency.


A diversified allocation to alternatives can broaden return drivers and strengthen resilience when traditional equity and bond diversification is less effective. Source: Sinitta Leunen_Unsplash

Hedge funds

The current environment of resilient AI investment, broadening earnings growth, and gradually moderating inflation should support growth and risk assets, while policy uncertainty, geopolitics and elevated long—term yields leave room for volatility. For hedge funds, this backdrop creates a favorable mix of return generation and diversification opportunities. Elevated dispersion and rapid market rotations support active alpha generation, while less reliable traditional diversification (given higher government bond yields) and a broader set of structural themes strengthen the portfolio case for hedge funds.

We like low net and market neutral equity hedge managers, supported by high dispersion and low correlations. Equity market neutral strategies have returned 5.0% this year through August, a relatively steady performance profile despite sharp shifts in equity market leadership. The backdrop for alpha generation remains favorable. Elevated equity dispersion and unusually low correlations continue to support stock selection, while broadening market participation beyond the largest AI beneficiaries is increasing differentiation across companies, sectors, and regions.

We also rate merger arbitrage, fixed income relative value, and discretionary macro strategies as Attractive.

In merger arbitrage, second-quarter performance benefited from deal completions, regulatory progress, and spread compression.
Global M&A activity reached USD 3.1 trillion in the first half of the year, up 48 % year over year (Dealogic), supported by strategic acquisitions, AI—driven business transformation, and ongoing industry consolidation. Health care remains particularly active as companies seek to replenish product pipelines, while energy and power infrastructure are benefiting from rising electricity demand and AI - related capacity expansion. Financing markets remain open, and the US regulatory environment has become more pragmatic. We favor seasoned managers with the expertise to navigate hostile and unsolicited bids and regulatory complexity.

In fixed income relative value, heavy sovereign issuance, shifting investor demand, and periodic derisking should continue to generate opportunities across curves, asset swaps, and sovereign markets. We favor diversified managers able to rotate across regions, maturities, and instruments. The strategy can also complement traditional long-dated debt positions.

Discretionary macro managers remain up 8.8% year to date, with August marking a strong rebound. Performance has been supported by equity and AI-related themes, carry strategies, and selective rates positions. More recently, returns have been mixed as developed market rates repriced and concentrated equity exposures came under pressure, although EM carry and select commodity trades provided valuable offsets. However, sticky inflation, fiscal expansion, evolving central bank reaction functions, continued AI-related investment, and recurring geopolitical flare-ups are sustaining a broad and attractive macro opportunity set.

Private infrastructure

We believe infrastructure assets are well positioned to deliver resilient, inflation-linked returns through market cycles. Many infrastructure assets face limited competition and high barriers to entry, so owners can pass through cost increases to users. Infrastructure investments can help hedge against inflation because revenue streams are often tied to CPI, particularly for core strategies operating in regulated or contracted assets. Their income streams may therefore be more robust than other yielding assets to both economic volatility and inflation. Such qualities appear increasingly valuable in the current environment.

Infrastructure's returns have looked appealing relative to other parts of a well-diversified portfolio. Private infrastructure has delivered annualized returns of around 11% over the past decade, according to data from Cambridge Associates. But infrastructure also behaves differently to other assets, potentially helping steady portfolios. Recent years have seen the asset class's already low correlations with traditional stocks and bonds fall further. Infrastructure returns' correlation with a standard 60/40 portfolio has dropped to around 20% recently.

In the current climate, the investment backdrop for infrastructure is solid. Investor appetite is strong: net inflows into open-ended funds rose 30% year over year, dry powder declined, and infrastructure valuations remain close to their long-term averages. Performance moderated at the start of 2026, with the asset class returning 1.2% in the first quarter, potentially reflecting weaker sentiment in March amid heightened geopolitical concerns. Nevertheless, strong conviction in long-term secular themes, combined with solid year-to-date returns from listed infrastructure equities, supports continued optimism.

We believe investors who focus on diversified, core/core-plus assets in non-cyclical sectors—prioritizing predictable, inflation-linked cash flows—are best positioned to capture attractive, risk-adjusted returns, while supporting the essential modernization of the global economy.

Core and core-plus infrastructure strategies focus on already mature assets with stable income, potentially more matched to income-focused or balanced investors who want to generate the bulk of returns through yield. When observing historical performance of lower risk, core infrastructure strategies, more than 50% of total returns were derived from income. Investors overallocated to other private assets that pay income (private credit and real estate) could consider these types of assets.

Private equity

Global private equity experienced a temporary setback in the first half, but the broader recovery remains intact, supported by improving exits, distributions, net cash flows, and resilient company fundamentals.

Deal activity continues to pick up despite recent macro and geopolitical volatility, with momentum broadening beyond megacaps into the middle market and supported by continued interest in HALO (hard assets with low obsolescence risk), energy, and business products and services. Fundamentals are also resilient, with the median buyout company delivering 8% EBITDA growth in the first quarter, although dispersion across sectors and individual companies is meaningful.

Private equity's discount to public equities remains near all-time highs—reinforcing the relative valuation appeal of private equity. And while performance still lags public equity, improving exit trends, broader buyer participation, and the ongoing normalization of cash flows support a reacceleration.

We continue to see attractive opportunities in quality and resilient-growth areas such as health care, energy, infrastructure, and industrial businesses exposed to power demand and grid modernization. We advocate diversification beyond technology and software to capture the broader AI value chain.

Secondaries remain attractive, with first-half volumes up 15% y/y, supported by liquidity needs, portfolio rebalancing, disciplined pricing, and a broadening opportunity across strategies, continuation vehicles, and co-investment sales.

We generally maintain our bias for the US market, but also find Europe and select Asian markets attractive from a diversification perspective, supported by improving fundraising, recovering exits, and corporate governance reform.

Select direct lending

Direct lending has entered a more demanding phase. Returns reached 3.0% in 1H26 (vs 4.5% in 1H25) with the outlook still constrained by tighter spreads, and rising defaults.

CIO continues to see merit in diversified allocations to direct lending, sized to investors' individual risk and liquidity preferences. However, CIO downgraded the asset class to Neutral in the third quarter of 2025, reflecting the growing gap between the strongest and weakest borrowers and our expectation that lower central bank rates, tight loan spreads, and competition from the syndicated loan market would lead to more moderate returns.

Since early 2026, investors have had further considerations including the potential disruption of AI on direct-lending-backed software businesses, and a broadening group of evergreen funds limiting redemptions.

We now anticipate returns of 5-6% in 2026. In our view, strategically underallocated investors may still benefit from direct lending's long-term income and diversification, but manager selection is increasingly decisive. We favor top - tier platforms, less-cyclical sectors, upper-middle-market and large-cap borrowers, conservative leverage, seniority, collateral, and strong covenant protection.

Heavily allocated investors to the asset class may consider diversification into other alternative strategies, taking into account differing return, income, and risk characteristics.

Investors subject to redemption restrictions in evergreen structures should:

- Review liquidity terms, redemption mechanics, and governance provisions.
- Pay particular attention to manager quality—including liquidity management, communication, and alignment—particularly in stress scenarios.
- Diversify across fund structures and liquidity profiles to help mitigate concentration risk.
- Ensure their own liquidity needs are compatible with their chosen vehicle's design and be prepared for periods of restricted access to capital.

Private real estate

Private real estate continues to recover, with year-over-year returns improving from 4.9% in the last quarter of 2025 to 7.3-7.4% in the first and second quarters of this year. The rebound has been supported by stronger operating fundamentals, stable financing costs, and a gradual recovery in transaction activity.

That said, headline performance overlooks meaningful dispersion across regions and strategies, underscoring the importance of disciplined asset selection. The US has outperformed other regions over the past two years, while evergreen core and core-plus funds have generated stronger returns than closed - end opportunistic and value-add strategies.

We remain broadly constructive on private real estate, although narrower cap-rate spreads relative to Treasuries reinforce the need for selectivity. We continue to favor core and core-plus exposure, which offers greater income visibility, more resilient cash flows, and stronger loss limitation in a volatile interest rate environment, while limiting development and execution risk.

Diversified private markets vehicles

Similar to public markets, we think allocation to private assets should be diversified across sectors, strategies, geographies, managers, and vintages. We view this approach as the best way to mitigate overconcentration to any specific theme, reduce localized disruption or currency risk, and enhance access to specialized expertise and other levers of value creation.

Building robust portfolios however requires time, consistency and institutional access to maximize chances of success. For first time investors, we see merit in considering diversified private market fund of funds.

Appendix

Non-traditional asset classes are alternative investments that include hedge funds, private equity, private credit, 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.

- **Private Credit:** There are risks specifically associated with investing in private credit. This could include losses stemming from defaults on loans, which in significant adverse circumstances could result in a substantial 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.

Global asset class preferences definitions
The asset class preferences provide high-level guidance to make investment decisions. The preferences reflect the collective judgement of the members of the House View meeting, primarily based on assessments of expected total returns on liquid and commonly known indices, House View scenarios, and analyst convictions over the next 12 months.
Absolute view
Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.
Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.
Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities.
Note: For equities, we have a five-tier rating system with two additional preferences. When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."
Most Attractive: We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.
Least Attractive: We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.
Relative preferences
For the multi asset view, we also include relative preferences to help investors compare between items.
Preferred: We view this item more favorably than others within its asset class.*
Neutral: We see this item similarly to others within its asset class.*
Least preferred: We view this item less favorably than others within its asset class.*
*In the case of cross-asset, compared to other asset classes.
Note: The tactical asset allocation (TAA) positioning of our different investment strategies may differ from these views due to factors including portfolio construction, concentration, and borrowing constraints.

Appendix

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