AN INTRODUCTION TO ALTERNATIVE INVESTMENTS

Uncertainty always reigns supreme for investors, although some periods reveal the potency of this truth more than others.

Alternative investments pursue strategies that diverge from conventional long-only opportunities in equities and fixed-income asset classes. The chief merit of diversification—improved risk-adjusted returns—is a product of combining strategies with a variety of correlations so that a portfolio's volatility is lower than the volatility of the individual strategies it employs. Periods of high uncertainty—when forecasting ability deteriorates and market-level volatility surges—can showcase the benefits of broad diversification.

We believe the distinct set of strategies offered by alternative investments can broaden diversification opportunities beyond those available via traditional investments, thereby improving upon the risk-reduction and return-enhancement opportunities that traditional asset classes can offer.

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Consider the Portfolio's Purpose

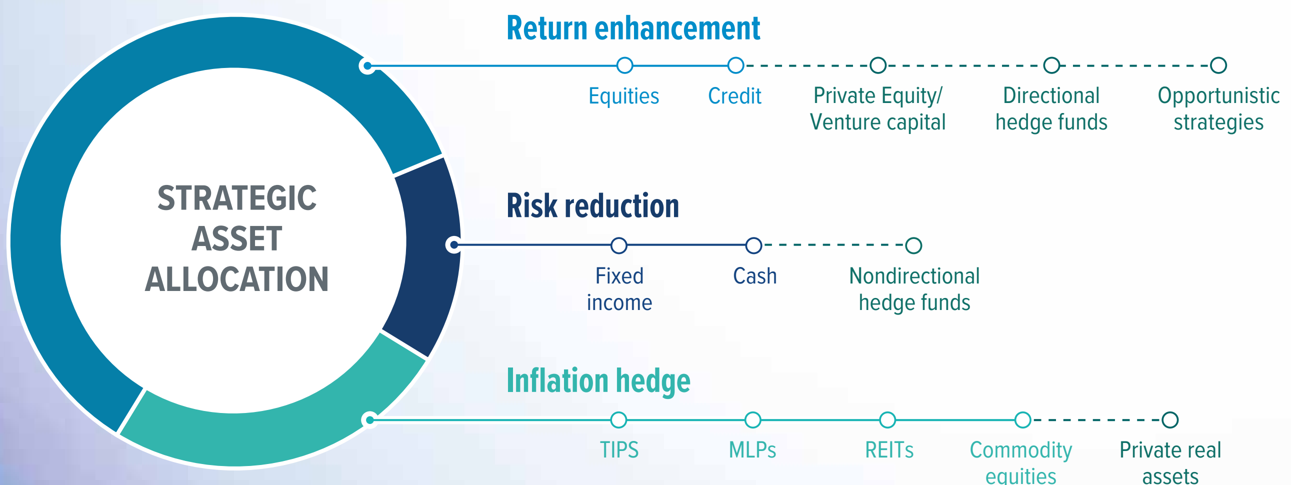
What exactly are alternative investments, and where do they fit in an investor's portfolio? Instead of thinking about alternatives as a catchall category, investors should contemplate the role of each strategy type within a broader portfolio, just as they would when investing in traditional asset classes. What objectives can alternative strategies help achieve?

This distinction is crucial to constructing goals-based investment portfolios for the long term. Broadly, each asset class or investment strategy will serve one of three purposes: return enhancement, inflation hedging or risk reduction.

- **Return Enhancement**: Investments expected to offer a high rate of return in exchange for higher volatility and poor performance in an economic downturn. Traditional asset-class examples include equities, high-yield bonds and emerging-markets debt.
- **Risk Reduction**: Investments expected to reduce overall portfolio volatility via lower standalone volatility, lower correlation with other asset classes, or outperformance relative to other investments in an economic downturn. Traditional examples include high-quality fixed income, cash and portfolio insurance strategies.
- **Inflation Hedging**: Investments that outperform other asset classes when inflation is unexpectedly high or when inflation is higher than the valuations of these asset classes might suggest. Traditional examples include commodities, Treasury Inflation-Protected Securities (TIPS), master limited partnerships (MLPs), real estate investment trusts (REITs) and inflation-sensitive equities.

We contend that each of these objectives can be supported by traditional and alternative strategies (**Exhibit 1**). There's a long tradition of cordoning alternative investments into a separate allocation, combining private asset, hedge fund and opportunistic strategies into one bucket despite their distinct characteristics. We believe integrating alternative strategies directly into goals-based allocations represents a more effective way to build portfolios.

Exhibit 1: Alternative investments have specific roles in a portfolio, just like traditional investments



Source: SEI, Investment Management Unit

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A Strategy-by-Strategy Walk Through Alternatives

Alternatives can be split into three broad categories—private assets, hedge funds and opportunistic strategies—with multiple subcategories.

- **Private assets:** Investments in private companies or assets such as real estate or natural resources. Examples of private asset strategies include:
  - ***Buyouts*** – The purchase of a mature company, typically with debt
  - ***Venture capital*** – An investment in a rapidly growing company, which is typically unprofitable and at an early stage in its life
  - ***Growth equity*** – An investment in a rapidly growing company later in its life cycle than a venture capital investment
  - ***Natural resources*** – An investment in an oil or gas field, which contains a fair amount of undeveloped or unproven reserves
  - ***Private real estate*** – An investment in a commercial real estate property, which is not fully occupied, needs improvements or is undeveloped
  - Private real assets
    - ***Core real estate*** – Investments in high-quality private commercial property such as office buildings, multifamily housing and warehouses. We employ quality limits for these types of assets, such as low vacancy rates, prime locations and low leverage levels.
    - ***Private natural resources*** – Investments in assets such as timber, minerals or higher-quality oil and gas fields
- **Hedge funds:** Strategies focused on investments in traditional securities, such as equities, fixed income and commodities, using nontraditional trading methodologies. Examples of hedge fund strategies include:
  - ***Directional*** – Strategies designed to achieve equity-like returns with moderate volatility and correlation to return-enhancing asset classes. This subset includes strategies in which managers take long and short positions in securities, such as equities and credit, but have significantly more long, rather than short, exposure.
  - ***Nondirectional*** – Strategies designed to produce a return over cash with limited volatility and correlation to traditional asset classes. This subset includes strategies in which managers have a relatively balanced weighting between long and short positions in equities, credit, fixed interest or commodities.
- **Opportunistic strategies:** As the name implies, these are strategies that do not fit into any of the aforementioned categories. Instead, they are developed based on idiosyncratic market events. Examples include credit investments, which became attractive after the 2008 financial crisis (such as collateralised loan obligations) or the debt of commodity-oriented companies after the sharp 2014 downturn in commodity prices.

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Aligning Alternative Strategies with Investor Goals

We believe we can deploy alternatives effectively by fitting each underlying strategy where it will best support a given goal and contribute to broader diversification.

Return Enhancement

- ***Private assets:*** We expect these strategies will, in aggregate, deliver approximately 2% to 3% in annualised excess returns over public equities with a similar level of volatility. Given these strategies inherently have equity and credit beta, they will have significant positive correlations with other return-enhancement strategies.
- ***Directional hedge funds***: These strategies can be expected to produce equity-like returns with less volatility. Like private assets, these strategies have equity and credit beta due to their long-bias exposures to equity and credit markets. As a result, they will have relatively high correlations with other return-enhancement strategies.
- ***Opportunistic strategies:*** These strategies are more heterogeneous than other alternative investment categories, rendering expectations more difficult to produce and unique to each given opportunity set. However, they typically arise from market dislocations that create a value-oriented buying opportunity in the associated asset class. Typically, these dislocations occur in less-liquid asset classes that have equity or credit beta. As a result, opportunistic strategies present an opportunity to generate return in excess of traditional return-enhancement strategies, but with fairly significant amounts of volatility and fairly high correlations to other return-enhancement strategies.

Risk Reduction

- ***Nondirectional hedge funds:*** These strategies have limited long-biased exposure to markets and, as a result, their performance characteristics should primarily comprise a manager's ability to generate alpha rather than market beta. Therefore, we expect them to produce approximately 2% to 3% annualised excess return over the risk-free rate, with fixed interest-like volatility and low correlations to other asset classes.

Inflation Hedging

- ***Private real assets:*** These strategies have characteristics that benefit from inflationary environments such as commodity beta. Likewise, a deflationary or low-inflation environment will likely cause them to lag the performance of return-enhancement strategies and possibly risk-reduction strategies as well.

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SEI's View

Combining traditional and alternative strategies satisfies the basic principles of efficient portfolio construction by expanding the variety of risky assets in a portfolio and, as a result, improving expected risk-adjusted returns.

When we build portfolios based on their objectives—blending asset classes and strategies to optimise for each underlying goal—we believe we can improve on the traditional asset-class bucket approach to portfolio construction.

Alternative investments encompass a diverse group of strategies with a range of liquidity constraints, fees and transparency limitations. Institutional investors will find that some strategies fit their objectives while others will not be appropriate. A thoughtful and individualised approach to learning about the role that each alternative strategy serves will prepare investors to understand how they fit into a broader portfolio and help set well-calibrated expectations for how each will perform under various market scenarios.

To learn more about SEI's investments and how we construct portfolios, please contact **institutionsuk@seic.com**

About SEI

We have 25 dedicated professionals who collaborate on our alternatives program. This team oversees approximately $8 billion in assets under management and works with several other teams within SEI, including our asset allocation and manager research professionals and legal and compliance teams, to integrate operational efficiency and industry best practices into our alternatives program.

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