How alternatives fit into a portfolio

November 2020

Marketing material for professional investors and advisers only

Schroders

How alternatives fit into a portfolio

The need for higher returns and increased diversification has fuelled significant growth in the alternatives market over the past decade. Assets under management have grown from $6.5 trillion in 2011 to $10.3 trillion in 2019, spread broadly across the waterfront of the alternatives universe. Increasingly, we are seeing asset owners adopt an outcome-focused approach to looking at alternatives, cutting through the asset class labels. The demand for greater flexibility in the delivery of these outcomes has led to a number of new types of structures and mandates.

Andrew Dreaneen, Schroders' Head of Alternatives, and Ped Phrompechrut, Solutions Manager, look at what this means for asset owners. They discuss what's changed and what can be expected in the period to come. They also offer some practical thoughts on making better use of alternatives in the decade ahead.

Andrew Dreaneen
Head of Alternatives

Ped Phrompechrut
Solutions Manager

Let's start with the obvious question people are asking on this topic – why should we still consider alternatives given how well equities and bonds have been performing?

Andrew: Clients often say they want genuine diversification in their portfolios, which is where alternatives come in.

However, we recognise that embracing alternatives poses a number of challenges for investors. From deciding how much of their portfolio should be allocated to alternatives, to choosing the right strategy mix, or sourcing and underwriting the best managers and constructing a portfolio that will deliver, more often than not, on risk and return expectations. In addition to the perceived complexity and hassle factor of allocating to alternatives, as you point out, traditional market betas in the form of equities and bonds have performed extremely well for the past decade. It is therefore natural for one to think it is ok to miss out on alternatives. But often our period of analysis is much shorter than our 'actual' and required holding period. While equities and bonds can be uncorrelated over the long term, they are often highly correlated in a market shock environment, which is arguably when you need diversification the most.

Alternatives are now a $10 trillion+ market. Ignoring it is like ignoring European equities or US corporate debt. To have a robust and diversified portfolio, we believe it is important to consider alternatives as part of the strategic asset allocation and portfolio construction toolkit. Our view is that it is also important to build diversification across alternatives too and not just rely on one or two alternative investment strategies.

Recent central banks' communications mean negative nominal yields in the US and UK markets are more of a possibility than pre-Covid-19 periods. In that realm, the use of bonds for diversification becomes prohibitively expensive for many types of asset owners. Particularly so if bonds' correlation with equities is still expected to spike during times of stress. Investors have to look elsewhere for portfolio protection and volatility dampeners. We see many available options in alternatives.

If alternatives provide diversification benefits and contribute to a better risk-adjusted return, can you provide some investment examples?

Andrew: There are multiple reasons for adopting alternatives and we broadly classify these into three categories: enhancing growth/income, adding diversification and providing protection against an unexpected rise in inflation. Depending on a client's portfolio make-up and risk return objectives, they may lean more heavily towards one or two of these. We believe all are important considerations over the medium to longer term and this is where alternatives play a key role.

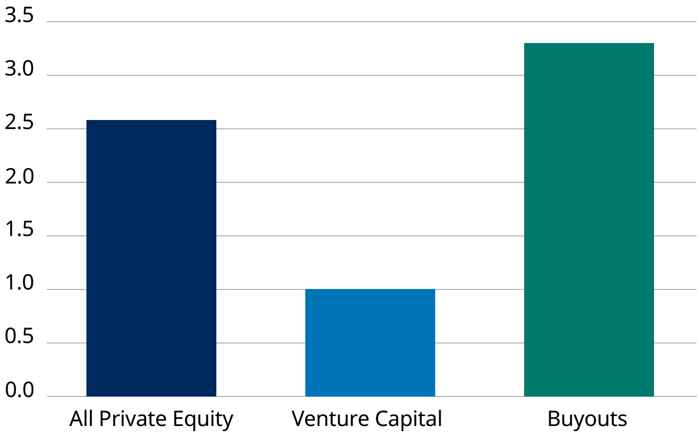
Growth

Ped: Taking equity risk and investing with control is one way of characterising what we mean by growth-focused alternatives. Private equity, for example, is a key ingredient in a growth portfolio. When looking at the return outperformance, the evidence net of fees has always been clear. The chart opposite shows this based on public asset comparators. Even in the most recent cycle of strong equity market returns, private equity came out significantly ahead with 258bps, net of fees, versus the S&P 500 Total Return Index as of 30 June 2020[1]. It's also no secret that public equity valuations are driven by a smaller sub-set of companies and that the capacity for further multiple expansion (the S&P 500 was at 32x earnings as at end of Q2 2020) is capped by how far rates can fall into negative territory. Opportunistic investments across real estate and special situations credit have also proven their abilities to generate mid-teen IRRs, offering other avenues to growth-focused investments beyond the traditional buyouts, growth and venture capital worlds of private equity.

Andrew: Historically, many hedge funds delivered equity-like returns with less volatility, which is a very attractive proposition. While many hedge funds continue to exhibit less volatility than equity markets, very few have performed as well as equity markets in recent times. This being said, many hedge funds can still play an important role as a building block within a growth-oriented alternatives portfolio. Not only are these strategies helpful from a liquidity standpoint, if implemented well, you can also get a nice asymmetric risk return profile. For example, 80% of the upside to equity markets with say only 50% of the downside, over a cycle, which can be a very powerful way to grow wealth through time.

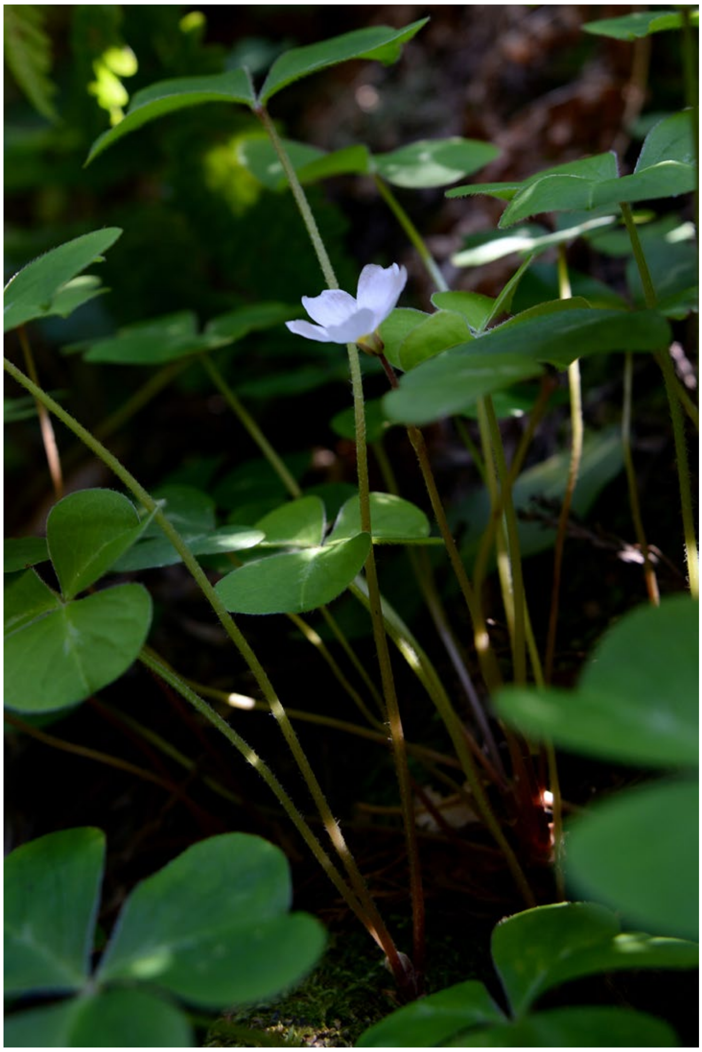
1 Direct Alpha methodology, Burgiss Private Equity, Venture Capital, and Buyouts, 2000–2015 vintage year funds, pooled results. Top quartile results beat public markets by significantly higher margins: 762bps, 648bps, 909bps, across the respective assets.

Private Equity outperformance vs. S&P 500



As at 30 June 2020.

Past Performance is not a guide to future performance and may not be repeated.



Income

Ped: Even before Covid-19, central banks were struggling with rates and quantitative tightening measures. Given where we are today as Covid-19 continues to weigh heavily on economic activity, it is difficult to imagine central bank policies becoming hawkish in the medium term. At the same time, the probability is rising of negative policy rates being introduced in the US and UK. Meanwhile, fiscal stimulus continues to ease the impact of the economic slowdown caused by the pandemic.

Many dividend-paying companies are currently preserving capital. This is either to ensure they can absorb a further unexpected liquidity impact, comply with terms of governmental financing, or ensure they keep in line with regulatory guidance and restrictions. This means cutting or scrapping dividends. There is no precedent for the current crisis, but estimates of the eventual cut in dividends for the UK market, as a whole, in 2020 have so far ranged from around 25% to as high as 50%[2].

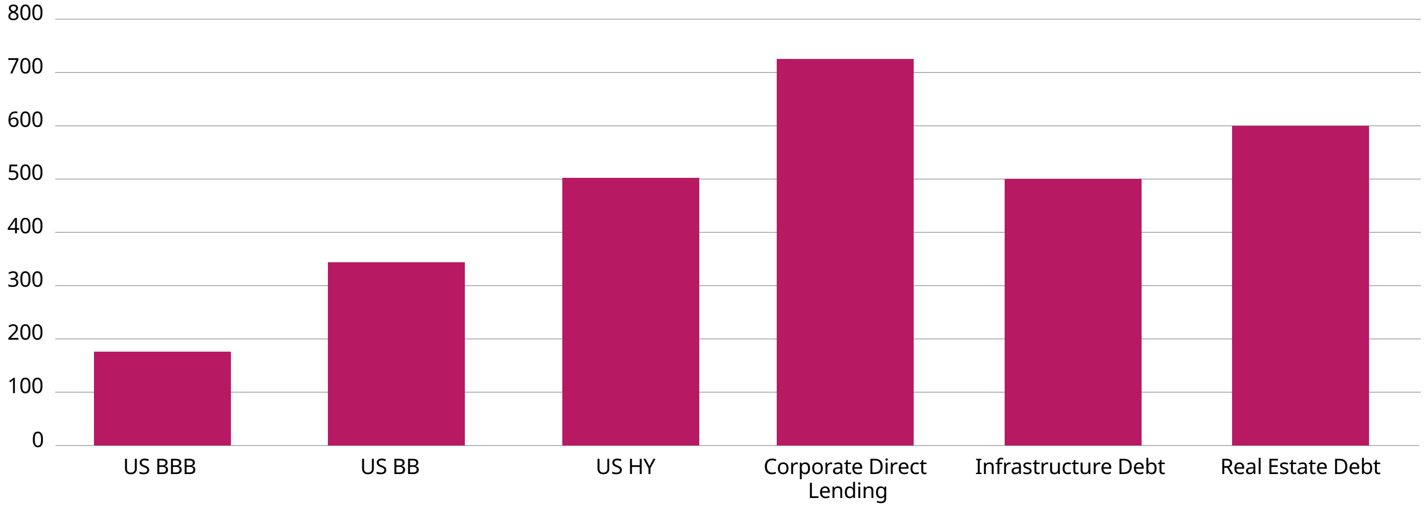
All of this results in lowering nominal income for investors and hence why we see greater participation in various direct lending markets, namely corporate, infrastructure, and real estate. Below we show the spread pick-up that's available for investors in these asset classes. Importantly, many sectors have historically been exposed to a lower risk of loss than equivalent-rated corporate bonds, owing to the security of collateral and/or greater protection in loan documentations. This has one of two drivers (or both in some cases)[3]:

1. Lower average default rates

2. Higher average recovery rates

2 Schroders insights article: Rory Bateman – Dividend cuts – what can investors expect
3 Schroders insights article: Duncan Lamont – Adding return and lowering risk with private debt

Observed spreads – comparing some areas of liquid vs illiquid credit



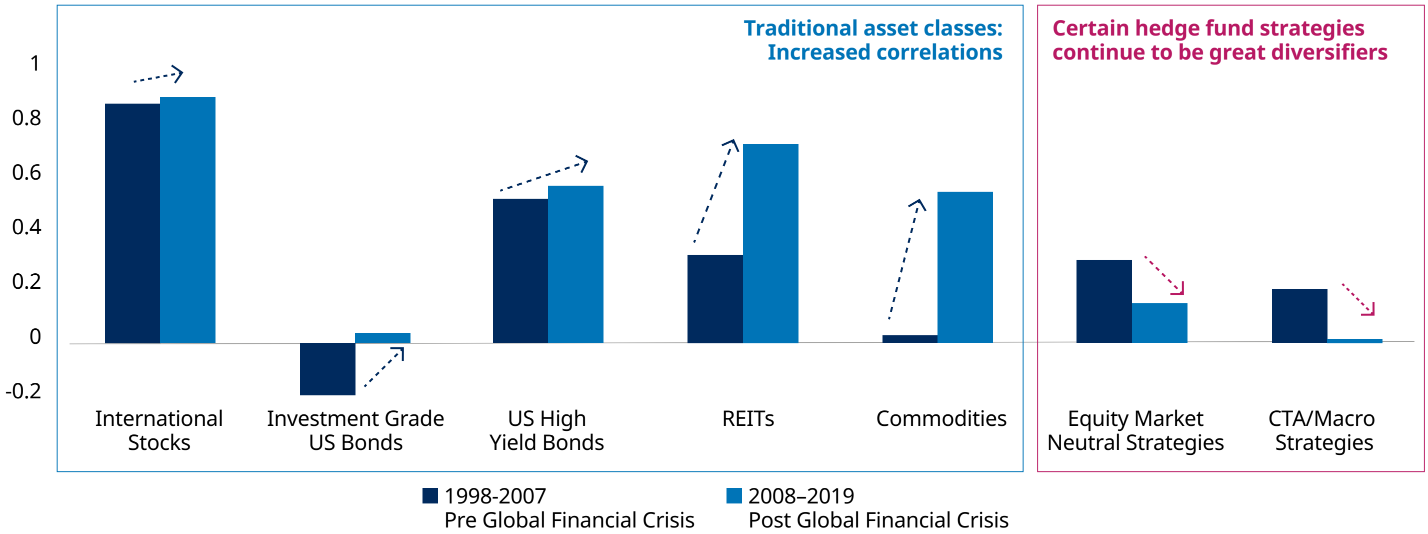
Source: Refinitiv data for liquid credit markets and Schroders estimates for illiquid credit markets. As of August 2020.

Diversification

Andrew: When looking for uncorrelated strategies, hedge funds feature high on the list of useful building blocks. The chart below compares the correlation of various risk assets to the S&P500 in the 10 years prior to the global financial crisis (GFC) and post GFC, what we can see is that the correlations among most of the traditional risky asset building blocks have increased considerably since the GFC. This means one cannot rely solely on traditional investment strategies for diversification. By way of example, if we take two hedge fund strategies such as equity market neutral and CTA/Macro, both have continued to exhibit strong diversification benefits both prior to and post GFC.

Why hedge funds now? True diversification may be harder to come by

Correlation of asset classes and hedge fund strategies with the S&P 500



Source: Morningstar Direct, Bloomberg as at 31 March 2019. Proxies as follows; For International Stocks MSCI ACWI ex-US; for Investment Grade US Bonds: Barclays US Agg Bond TR; for US High Yield Bonds: Credit Suisse HY; for REITS: Wilshire US REIT TR; for Commodities: S&P GSCI TR. Equity Market Neutral Strategies: HFRX EH: Equity Market Neutral Index. CTA/Macro Strategies: HFRX Macro/CTA Index.

Inflation protection

Andrew: Dealing with unexpected inflation shocks is very much a strategy of downside protection. Investors might want to put this type of strategy in place in certain periods rather than having it as a core portion of the portfolio on a persistent basis. And the reason for this is quite intuitive – it may never happen but you have a view on the probability of it happening and how severe it may be. This is informed by views on structural economic issues, monetary policies, or a significant supply shock for certain global goods.

For clients who hold the view that the probability of an inflation shock happening is sufficiently high and that it will be severe enough to demand protection, there are select options across alternatives: the main ones being commodities and real assets. The findings from Northern Trust and Morningstar below provide a directionally useful statistic – the inflation beta of select asset classes – compared to TIPS and a 60/40 portfolio.

Inflation betas over the period 1997–2018[4]:	
US TIPS	0.64
Commodities	5.14
Natural Resources	4.33
Private Real Estate	1.62
60/40 stock/bond portfolio	0.19

4 Northern Trust Research, Morningstar.

In practice, is there a benefit to using multiple strategies? Are there examples of clients investing across the spectrum?

Ped: So far we've discussed the different roles that alternatives can play in portfolios and mentioned a few strategies as examples along the way. In the below, we take a more holistic look at the universe of available strategies and mapped them across the objectives of growth, income, diversification, or inflation-protection and segmenting those that are liquid vs. illiquid. This framework provides an intuitive way of answering what strategies to use and by extension, should clients use more than one given a certain objective. In our view, there are two benefits to using multiple strategies. The first is it expands opportunity set from which to generate alpha. Take diversification objective as an example, investing across both real estate and infrastructure strategies mean having assets such as data centres, social housing, regulated utilities, and renewable energy all within the opportunity set rather than being limited to a sub-set of these attractive areas. The second is that the nature and magnitude of a downturn is highly unpredictable and assets that were expected to be stable and resilient to traditional recessionary shocks can be unexpectedly penalised (e.g., transportation assets). Using multiple strategies reduces the impact of such unexpected shocks as the overall portfolio is less likely to be concentrated in certain sector or geography. These benefits are not dissimilar to what investors expect out of investing across multiple strategies in their traditional portfolio and rather it is the complexity in doing so in alternatives that may be a barrier for clients rather than the soundness of the principle.

Andrew: What is also interesting about adopting a framework for allocating to alternatives is clients can blend different alternative strategies to create a specific liquidity profile. Many institutional investors have reduced

A framework for allocating towards alternatives. No single answer – need to consider the specific needs of each investor (liquidity, target risk, return, time horizon etc.)

Client				
Solutions				
	Growth	Income	Diversification	Inflation Protection
Liquid	Core Multi-asset Quantitative Directional Directional L/S Equity Directional L/S Credit Sector Specialists Event Driven Multi-strategy Activist	Multi-strategy Credit Securitised, ABS, MBS	Multi-asset CTA Macro Strategies Relative Value Equity Market Neutral L/S Equity L/S Credit Multi-strategy ILS Listed Real Estate and Infrastructure	TIPS Commodities
Illiquid	Buyouts Venture Capital Growth Equity Turnaround/Distressed Mezzanine Opportunistic Real Estate Opportunistic Infrastructure	Corporate Direct Lending Infrastructure Debt Real Estate Debt Secure Income Assets (e.g., Long Leases, Income Strips) Royalties ILS	Core / Core+ Real Estate, Infrastructure Natural Resources ILS	Natural Resources Core Real Estate

For illustrative purposes only and not a recommendation to buy or sell any financial instrument or adopt any investment strategy.

their portfolio allocation to public securities due to lower expected returns and have increased their allocation to private equity and private credit, where returns have historically been higher. What they are effectively doing is giving up liquidity for a higher expected return, or in other words, seeking an illiquidity premium. Whilst most institutional investors have a lot of flexibility as it pertains to illiquid investments, many individual investors, and the intermediaries who serve them, are still focused on liquid investments/ daily dealing products. This creates a conundrum as they are missing out on a significant part of the alternative investment opportunity set. As a result, we are seeing some innovative products come to market which blend public and private investments (referred to as hybrid products) or liquid and illiquid alternative strategies, thereby creating semi-liquid alternatives. Schroders is very well placed from a sourcing, manufacturing and engineering perspective to help clients create an alternative solution that best matches their specific requirements and we have multiple case studies we are happy to share.

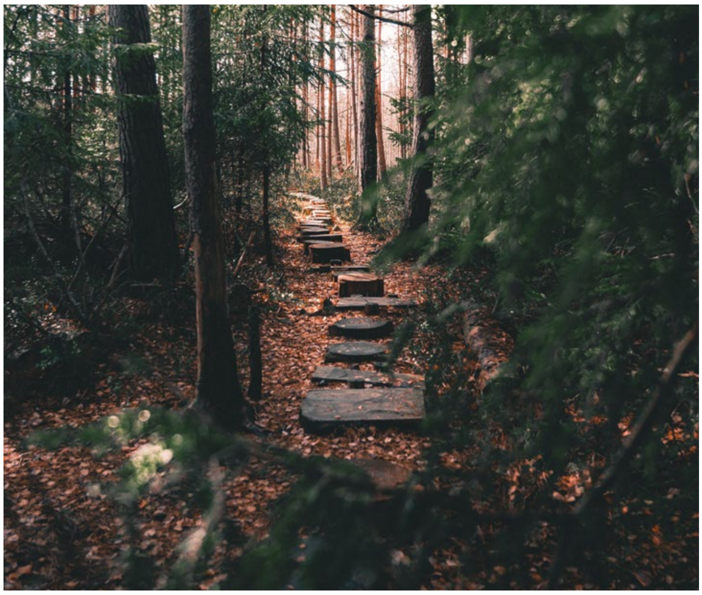


Figure: Using the full universe of alternatives allows investors to address their respective illiquidity budgets

Portfolio Allocation		Higher Illiquidity Budget 60–80% closed-end structures	Lower Illiquidity Budget 20–40% closed-end structures
Alternatives	Income	Multi-Strat Credit	Multi-Strat Credit
		Private Debt	Private Debt
	Diversifiers and Inflation protection	ILS / Relative Value HF	ILS / Relative Value HF
Credit		Core Infrastructure	Commodities
		Core RE	Listed Real Estate
Equities	Growth	Directional HF / Event-driven HF	Directional HF / Event-driven HF
		Private Equity	Private Equity

For illustrative purposes only and not a recommendation to buy or sell any financial instrument or adopt any investment strategy.

Within alternatives, some investors are taking the view that it may not be worth the complexity or illiquidity. What are your thoughts?

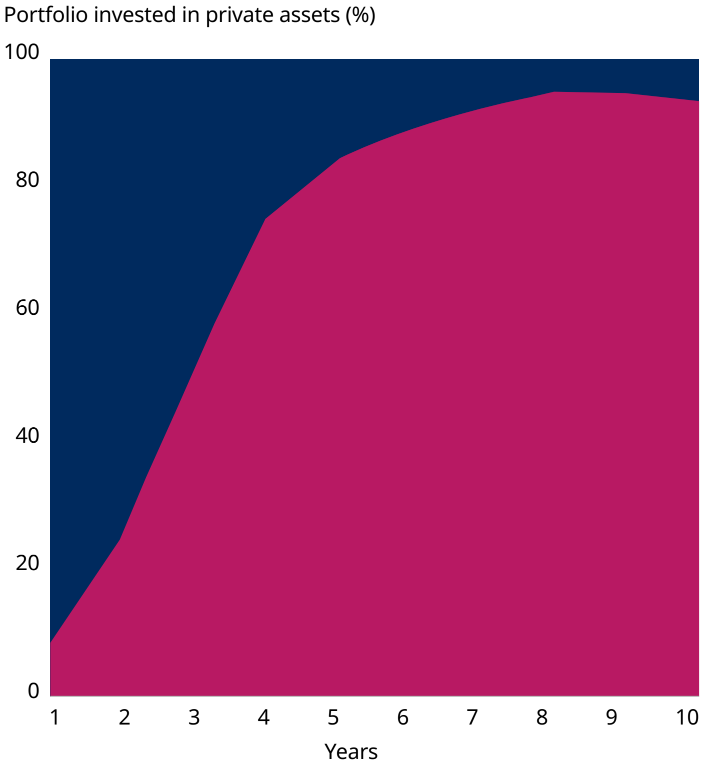
Andrew: Intermediaries often find hedge fund strategies – for example – too complicated to understand and explain to their end clients. Also, many consultants cite fees as being too expensive, especially for the average manager in light of the returns being delivered. Intuitively, we would all like to include some of the very best hedge fund managers in our portfolios, but some clients feel that allocating to hedge funds introduces a new set of risks. While it may reduce your market risk, it increases things like operational risks and manager selection risks. These are all very valid concerns, but we believe they are all manageable. Industry developments mean investors do not need to have all of the pre-requisite expertise and capabilities in-house, in order to benefit from the additional returns and diversification that are on offer. Investors can work with partners like Schroders to help identify the right alternative solutions.

Ped: Extending that into the realm of illiquid assets, the headline lock-up period of 10–12 years for many closed-end vehicles can elicit sticker shock. However, we have to remember that such vehicles will often have a 4–6 year investment period and will have distributed a significant amount of capital back to investors by years 6–7 in the form of income, returns, and capital repayments. This means investors are actually 'locking up' capital for a substantially shorter period of time than the actual term of these vehicles and while there will be exposure running into and above 10 years, such 'tail-end exposure' will be a small proportion of the amount the investor committed to the vehicles.

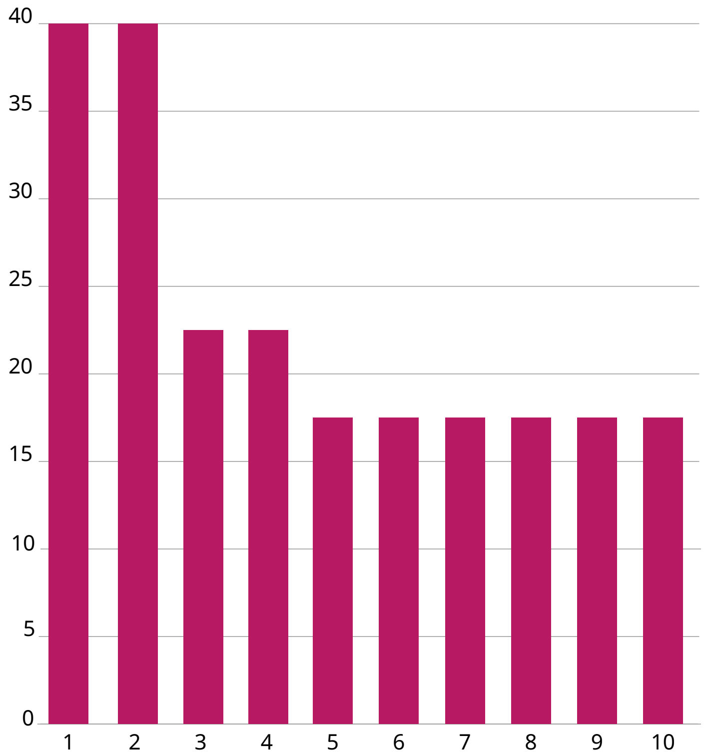
The other side of the coin is that these distributions create an additional complexity for investors as new commitments have to be made to maintain the desired level of exposure as money is returned and the need to manage on-going capital calls arising from those new commitments. The industry has made substantial progress in addressing these complexities and the associated administrative burdens. One example is to provide an 'evergreen' portfolio based on a robust commitment strategy and pair that with a tailored 'liquid carpark'. This allows for exposure to be ramped up and maintained based on a desired target allocation percentage while delivering the convenience of a single subscription and capital call. The below is an illustration of how such a portfolio could be built over time based on a combination of private equity, private debt, and a low-risk liquid carpark.[5]

5 Schroders calculations based on deterministic portfolio modelling using historical cash flow profiles of private asset fund investments from Burgiss database. Amount of commitment per year subject to actual rate of return achieved by the program while amount invested initially into the liquid carpark can either be set to optimize total return or minimize shortfall risk (e.g., over-commitment ratio).

Evergreen Private Asset Program
Allocation development of private assets and liquid carpark

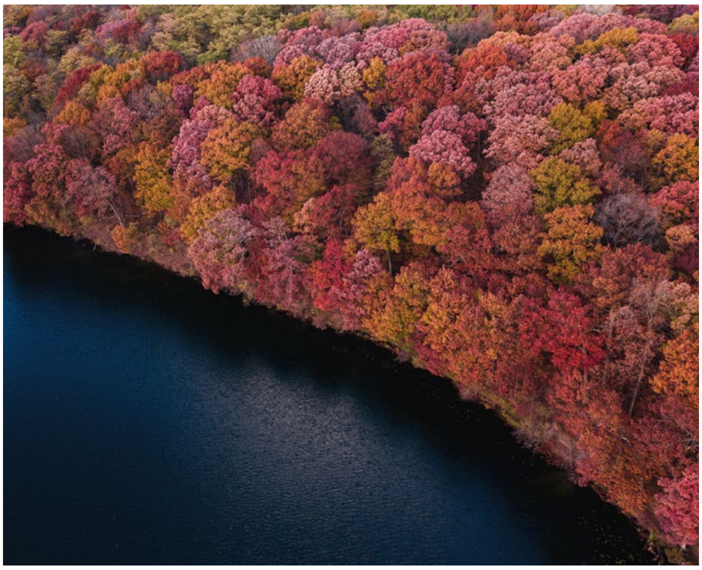


Underlying Private Asset Commitments as % of desired private asset allocation



The terminologies surrounding alternatives can be confusing – Liquid Alts, Private Assets, Close-end, etc. – can you just shape up the landscape for me? What strategies are covered, in what structures for different investors to consume?

Andrew: Over the last decade there has been considerable change within the hedge fund industry. One significant change has been hedge funds entering the mainstream via regulated mutual fund structures, referred to as liquid alternatives. The same democratisation is now taking place within private assets, with semi-liquid structures being created to widen the potential investor base. On the whole we believe this kind of innovation is beneficial, because it enables private investors to also benefit from alternative investment strategies that were previously reserved for institutional investors.



	Liquid	Semi-Liquid	Close-ended
Assets	Hedge funds Commodities Listed private assets vehicles	ILS Real Estate Infrastructure Private Equity and Private Debt (on a limited universe)	Real Estate Infrastructure Private Debt Private Equity Natural Resources
Example vehicles	Traditional Vehicles Investment Trusts	Luxembourg SICAV Limited Partnerships	Limited Partnerships
Key Attractions	Ease of access Ease of on-going exposure management, rebalancing Fits neatly into traditional reporting framework	Broad universe of managers and styles in liquid alternatives	Broad universe of managers and styles in private assets Smoothed volatility benefits buy-and-hold investors[6]
Key Drawbacks	Fewer choice of strategies and managers For listed private assets, volatility owing to NAV discount and premium; higher correlation to broader equities	Internal liquidity management and cash drag arising from reserves Differences in valuation policies and gating mechanisms can significantly reduce liquidity when it's most needed	Long lock-up periods Differences in legal and tax documentations owing to the use of limited partnerships Requires different lens for exposure management, ongoing reporting

6 From an accounting and regulatory standpoints. From an economic risk perspective, we advise the use of de-smoothed volatility for asset allocation considerations.
For illustrative purposes only and not a recommendation to buy or sell any financial instrument or adopt any investment strategy.

And so in terms of looking forward to the investing landscape post Covid-19, are there particular areas investors are paying special attention to?

Andrew: We have seen investors looking more closely at commodities as well as disruptive technologies.

Commodities: Many investors have been frustrated by commodities in recent years and few believe commodity returns can materially improve, let alone outperform equities or bonds. Allocations are resultantly very low. Yet, the macro backdrop is turning decisively positive for commodities. The reaction of authorities to the Covid-19 crisis has accelerated a potential shift from the era of Quantitative Easing (QE) to an era of Modern Monetary Theory (MMT), which would see the continued co-ordination of unprecedented monetary and fiscal stimulus. This epoch-change in macro policy could drive a shift from financial asset inflation to real asset inflation.

After a long period of poor returns and insufficient supply side investment, commodities could offer outstanding absolute and relative value. Commodities also stand to benefit from structural pressures on the US dollar and a shift to a more volatile multi-polar world.

Disruptive technologies: Since the onset of Covid-19, the world has witnessed an acceleration of trends within the technology sector. This has created an ideal backdrop for equity long-short managers, in particular tech sector specialists. The way many of us live our lives has materially changed. Looking toward the future, as we adapt to a world post Covid-19, this will give rise to many themes: a greater shift toward a cashless society; more online shopping to avoid crowded shopping malls; increased cyber security as people work from home and a need for more online and software driven learning. With shifts to e-commerce, cloud computing, direct-to-consumer video consumption, video game engagement and remote work access, all of this change is producing big winners and big losers creating a great backdrop for technology long-short investing.

Ped: To add to Andrew's comment, we believe this is an opportune time to re-shape portfolios to better fit the investment environment of the next decade. This is increasingly leading investors to pose a different question from "what alternative should I add with a 5% allocation size" to "how can alternatives help me get to the total portfolio return of x% while keeping similar total risk levels"?

With that, investors are open-minded to the underlying strategies and in many circumstances are becoming more interested in the practicalities of using multiple strategies. This leads onto sourcing of specialist opportunities, keeping a manageable number of relationships, and ensuring the exposures all tie up coherently with the long-term portfolio return and risk targets and through the process of designing and allocation and then customising and combining alternative exposures to best fit objectives and constraints. For example:

- An income solution that brings together senior direct lending, whole-loans and mezzanine real assets debt, and special situations credit that can be allocated to by both large and small investors.
- A combination growth and income solution that invests across mature private equity secondaries and junior infrastructure debt to enable a fast ramp-up portfolio with the potential for double-digit total return and attractive annual cash distributions (through income, capital gains, and principal).

Given the universe outlined, there's a truly vast array of combination potential that can be created to match desired outcomes.

Thank you both for your time, any final comments you would like to share?

Andrew: Many alternatives aren't really that alternative any more. They are becoming more mainstream and make up a sufficiently large part of the market to warrant strategic, ongoing allocation from all investors. We believe the portfolio benefits of including alternatives can be immense over the longer term. However, we also recognise some key challenges for investors, such as size and access, governance, administration, legal and tax, exposure and risk management. So it is important to consider all of the options including liquid, semi-liquid and illiquid structures. Schroders is well positioned to help in that we have investment strategy experts who can work with clients to assess what alternative strategies may make sense. Schroders manages over $65bn in alternatives, but we also have more than 50 manager research professionals to source external managers where we believe they will better contribute to overall portfolio outcomes.

Important information:

- Marketing material for Professional Investors and their advisors only. It is not to be provided to Retail Clients.
- Investment involves risk.
- Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy.
- The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations.
- Reliance should not be placed on any views or information in the material when taking individual investment and/or strategic decisions.
- Past Performance is not a guide to future performance and may not be repeated.
- The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of investments to fall as well as rise.
- Schroders has expressed its own views and opinions in this document and these may change.
- Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy.
- Insofar as liability under relevant laws cannot be excluded, no Schroders entity accepts any liability for any error or omission in this material or for any resulting loss or damage (whether direct, indirect, consequential or otherwise).
- This document may contain "forward-looking" information, such as forecasts or projections. Please note that any such information is not a guarantee of any future performance and there is no assurance that any forecast or projection will be realised.
- This material has not been reviewed by any regulator.
- Not all strategies are available in all jurisdictions.
- Schroders may record and monitor telephone calls for security, training and compliance purposes.

For readers/viewers in Argentina: Schroder Investment Management S.A., Ing. Enrique Butty 220, Piso 12, C1001AFB - Buenos Aires, Argentina. Registered/Company Number 15. Registered as Distributor of Investment Funds with the CNV (Comisión Nacional de Valores). Nota para los lectores en Argentina: Schroder Investment Management S.A., Ing. Enrique Butty 220, Piso 12, C1001AFB - Buenos Aires, Argentina. Inscripto en el Registro de Agentes de Colocación y Distribución de PIC de FCI de la Comisión Nacional de Valores con el número 15.

For readers/viewers in Brazil: Schroder Investment Management Brasil Ltda., Rua Joaquim Floriano, 100 – cj. 142 Itaim Bibi, São Paulo, 04534-000 Brasil. Registered/Company Number 92.886.662/0001-29. Authorised as an asset manager by the Securities and Exchange Commission of Brazil/Comissão de Valores Mobiliários ("CVM") according to the Declaratory Act number 6816.

For readers/viewers in Canada: Schroder Investment Management North America Inc., 7 Bryant Park, New York, NY 10018-3706. NRD Number 12130. Registered as a Portfolio Manager with the Ontario Securities Commission, Alberta Securities Commission, the British Columbia Securities Commission, the Manitoba Securities Commission, the Nova Scotia Securities Commission, the Saskatchewan Securities Commission and the (Quebec) Autorité des marchés financiers.

For readers/viewers in Switzerland: Issued by Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zürich, Postfach 1820, CH-8021 Zürich, Switzerland. Enterprise identification number (UID) CHE-101.447.114. Authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA)

For readers/viewers in the European Union/European Economic Area: Schroders will be a data controller in respect of your personal data. For information on how Schroders might process your personal data, please view our Privacy Policy available at www.schroders.com/en/privacy-policy or on request should you not have access to this webpage. Issued by Schroder Investment Management (Europe) S.A., 5, rue Höhenhof, L-1736 Senningerberg, Luxembourg. Registered No. B 37.799

For readers/viewers in the People's Republic of China: Issued by Schroder Investment Management (Shanghai) Co., Ltd. Unit 33T52A, 33F Shanghai World Financial Center, 100 Century Avenue, Pudong New Area, Shanghai, China, AMAC registration NO. P1066560. Regulated by Asset Management Association of China ("AMAC") This material has not been reviewed by the AMAC

EST. 1804

If you would like further information, please contact your usual Schroders representative

schroders.com

@schroders