# UPGRADING THE 60/40 PORTFOLIO WITH **ALTERNATIVES**

Recent headlines would have investors believe that the 60/40 portfolio, a mainstay of successful retirement plans for decades, is dead.

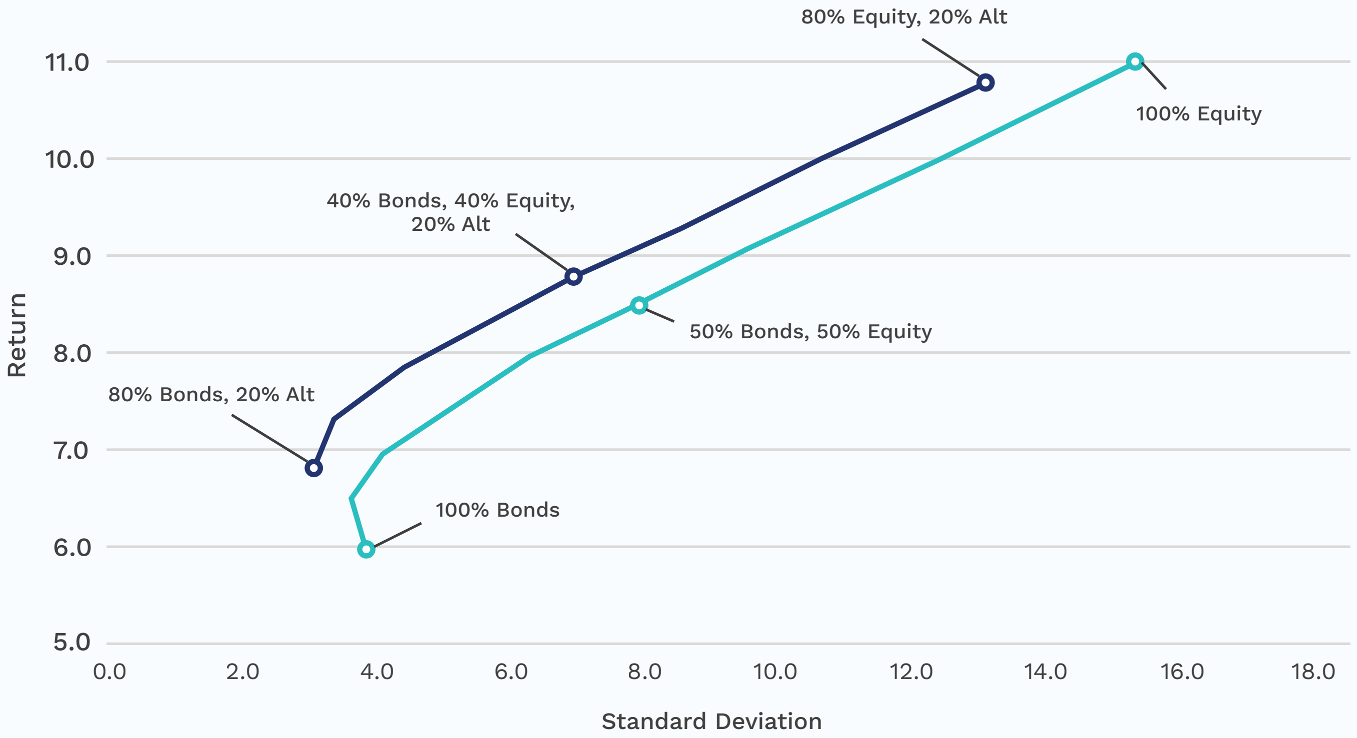
Rising rates have resulted in historically negative bond returns. And despite the increases, yields are still very low, making the income element of an asset allocation difficult to manage. The absence of total return on the bond side has many investors looking for the exits. But before we all organize a paddle out or a second line, there is another approach.

Institutions began rethinking their asset allocations decades ago. With their access to research, sophisticated management and scale, they began to incorporate alternatives into their investment process with the goal of maintaining a given level of risk but creating the potential for maximum return. The research often centered on building a portfolio that still followed the principles of modern portfolio theory, as exemplified by the efficient frontier.

# AN EXPANDED EFFICIENT FRONTIER

The goal of the efficient frontier is to construct a portfolio of multiple asset classes that will maximize returns for a given level of risk. The performance of any one asset class isn't as important as how the entire portfolio performs together. When alternatives are added to the portfolio, they move the entire curve up on the return spectrum, while maintaining the risk profile.

## Efficient Frontier



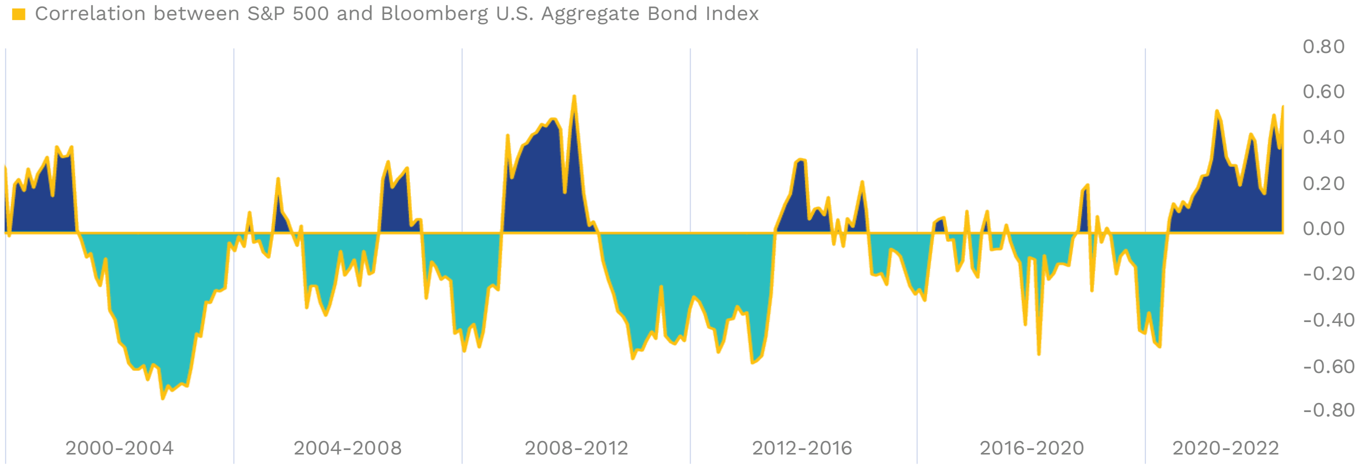

*Source: Bloomberg 1990-2019*

The basis for the asset allocation exemplified by the efficient frontier is the principle of diversification, famously called "the only free lunch in investing" by Nobel Prize laureate Harry Markowitz. And the core of diversification is building a portfolio with uncorrelated assets.

The relationship between equities and bonds over the last twenty years has largely been one of negative correlation, meaning that they move in opposite directions to each other. This has created a natural hedge on each position such that when one is down the other is up.

It isn't a given, though. Before 2000, stocks and bonds were positively correlated. And recently, they've been partying like it's 1999.

## U.S. Stocks, Bonds 90-Day Correlation Highest Since 1999




*Source: Bloomberg*

A recent paper examined macroeconomic conditions during periods when stocks and bonds were exhibiting negative correlations and found that there were some macroeconomic conditions in common. Low and stable risk-free interest rates and inflation are both present during negative correlations.[1]

While obviously not conclusive, the current environment of rising rates and higher inflation, or even just interest rate variability as rates bounce around and inflation spikes, may be contributing to the switch to positive correlation.

Besides return potential, alternative assets are generally thought to be effective diversifiers because they are less correlated to other assets, negative or positive. A portfolio employing alternatives may have the ability to expand the efficient frontier because of the diversification element provided by the less correlated returns of the alternative assets.

# THE DATA ON ALTS IS IN

The Alternative Investment Management Association reports that the average public/private pension fund allocates approximately 19% to alternatives. On the individual wealth side, the Capgemini World Wealth Report cites an allocation of approximately 10-15% over the past several years.

The definition of alternatives or "alts" has expanded over the last decade, and now includes things like fine art and even collectibles. However, for long-term investing purposes, alternative investment categories usually comprise private equity, hedge funds, real estate, infrastructure and natural resources (also called real assets), and private credit.

The chart below categorizes popular alternatives by their use in an investment portfolio and whether they are liquid or illiquid.

| | Liquid | Illiquid |
|---|---|---|
| Volatility Management | Long | Real Assets |
| | Market | |
| | Managed | |
| Capital Growth | Concentrated Equity | Private Equity |
| | Micro Cap | Venture Capital |
| | Merger Arbitrage | |
| Income | Long/short Credit | Private Real Estate |
| | Real Estate | Private Debt |

# ALTS AREN'T NEW – BUT INCOME ALTS MAY BE

Investors who incorporate alts in their portfolios are for the most part seeking diversification and the opportunity to enhance return, according to a recent survey.[2] However, a new reason is emerging – income. Thirty-six percent of wealth advisors who responded to the survey reported that they use alternatives primarily for income.

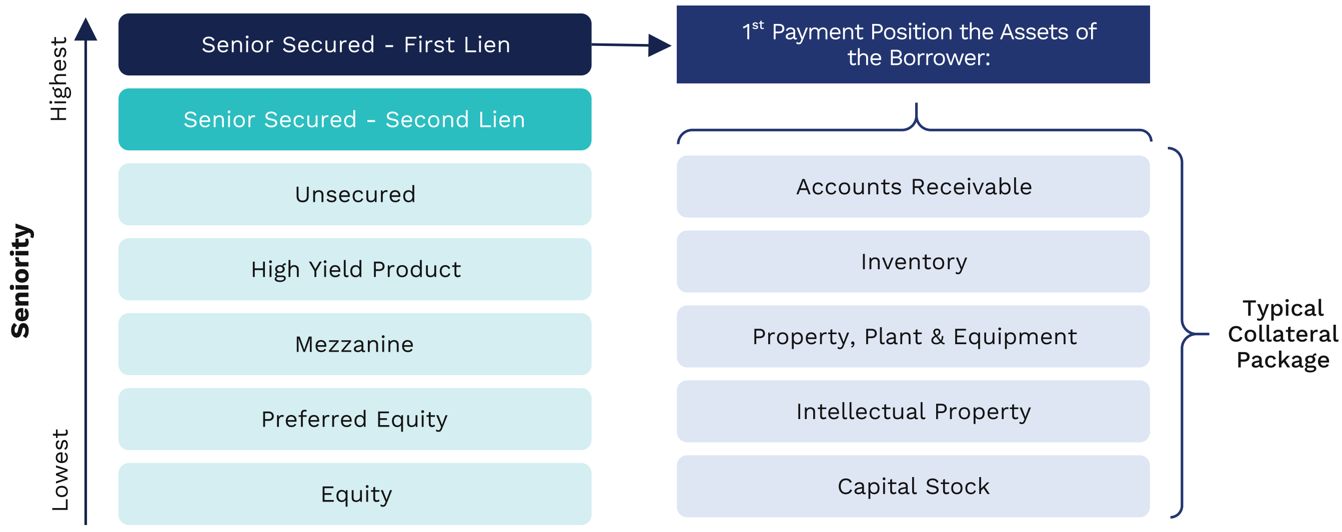
What is causing this sea-change in alternatives usage? There's both a "push" and a "pull" element. The push for investors is that with yields at historic lows, they've been forced to move beyond a traditional fixed-income allocation to meet income needs. The pull is that the credit spectrum has expanded and income options that offer enhanced yield with acceptable levels of risk are now available.

# INCOME-FOCUSED ALTERNATIVES – THE PRIVATE ADVANTAGE

Investors are increasingly looking outside the traditional fixed-income world into private credit, also called private debt. The asset class comprises loans made to companies by non-bank lenders. The companies are usually described as the "middle market," with revenues between $10mm and $1billion. Because of their size, these companies often cannot access the capital markets.

The non-bank lenders are generally institutional asset managers or specialty finance funds such as BDCs, who have proven expertise in originating these types of loans. They research the market, the companies and the financial prospects of the sector, they perform extensive due diligence and are experts in structuring the loans. These loans often have floating rates, so they can mitigate interest rate risk, and are typically senior in the capital structure of the company.

## The Capital Structure



## THE GROWTH OF PRIVATE CREDIT

Private debt has already achieved significant scale as an asset class. Total assets near the end of 2021 were $1.21 trillion, according to a recent survey by Preqin. The survey looked at future growth prospects, too, and found that assets are projected to increase 17.4% annually, to $2.69 trillion at the end of 2026.[3]

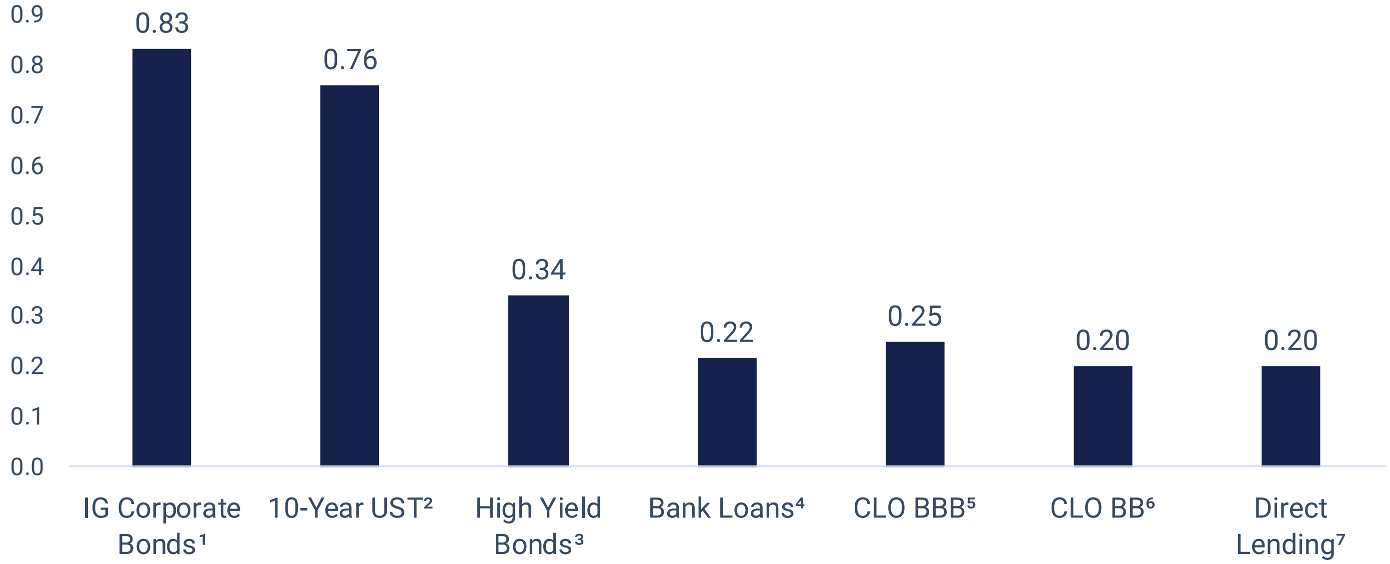
### Projected Increase In Private Credit Assets


What's driving the growth? According to a recent survey by The Lead Left, quoted in Institutional Investor, 95% of institutional investor respondents expect to maintain or increase their allocations to private debt in the next 12 months.[4]

## DIVERSIFYING ON THE INCOME SIDE

With traditional fixed income struggling and remaining positively correlated to the equity markets, the potential for portfolio volatility has increased. A look at how different income asset classes correlate to the Bloomberg Global Aggregate Bond Index provides some insight.

## Correlation to Bloomberg Global Aggregate Bond Index




*Note: As of March 31, 2022. (1) ICE BofA US Corporate Index (2) ICE BofA Current 10-Year U.S. Treasury Index (3) ICE BofA U.S. High Yield Index (4) Credit Suisse Leveraged Loan Index (5) JPM CLOIE BBB Post-Global Financial Crisis. (6) JPM CLOIE BB Post-Global Financial Crisis. (7) Cliffwater Direct Lending Index*

# A NEW LANDSCAPE

Individual investors are incorporating alternatives into their portfolios on the income side, as traditional fixed income investments remain under pressure. But even beyond enhanced yield, there's a recognition that the asset class has other features that can help to create a modern, diversified portfolio.

1. Hamlin, Jessica. Stocks and Bonds Have Moved in Opposite Directions for Decades. Here's What Could Change That. Institutional Investor. May 6, 2021.
2. PPB Capital Partners. Wealth Advisor Survey 2020. February 4, 2021.
3. 2022 Preqin Global Private Debt Report. January 12, 2022.
4. Zhang, Hannah. Private Credit Boomed Amid Low Yields — And Now It's Set to Flourish. Institutional Investor. May 11, 2022.