Financial Advisors & Alternatives: Selecting Options Amid Growing Demand

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Overview:

- Financial advisors face an expanding array of alternative products designed to meet growing investor demands.
- If advisors don't address growing client demand they stand to lose a competitive edge.
- Many advisors may struggle to evaluate and incorporate these products effectively into client portfolios, as they might not fully understand the offerings.
- Understanding key criteria for product selection is essential, as not all sector-specific products are created equal.
- Certain sectors and strategies are easier to explain to clients and implement within portfolios.
- Advisors should leverage new offerings from leading private asset managers, tailoring implementations to align with each client's risk profile.

Advisor's Dilemma: Navigating the Growing World of Alternatives

Recently, I engaged in a discussion with a financial advisor whose clientele primarily include mass affluent and High Net Worth (HNW) individuals, with some Ultra High Net Worth (UHNW) clients as well — all of whom are accredited investors. The advisor indicated that many of their clients have been asking about alternative investments and there was concern about losing business if they didn't address the growing demand. The advisor asked my thoughts on integrating private alternatives into their model portfolios. As many in the advisory field understand, model portfolios are essential tools for managing client assets and scaling business growth, with different models tailored to various risk tolerances.

However, the advisor recognized that continuously conducting manager due diligence, particularly in the complex landscape of alternative investments, can be challenging. I found it refreshing that this advisor was aware of their limits, understanding that their true value lies not in masquerading as a portfolio manager but in making informed, prudent decisions for their clients.

Understanding the Advisor's Investment Philosophy

Before diving into specifics, I asked the advisor about their investment philosophy, current approach, and expectations from alternative investments. Their approach was centered around:

1. **Diversification**: Belief in maintaining a diversified portfolio and consistently staying in the market.
2. **Passive, Data-Driven Strategy**: Utilizing a passive investment approach on the public side, often leveraging factor investing for alpha generation.
3. **Seeking Alternatives for Yield and Diversification**: The advisor wanted alternatives that could provide yield-producing returns with low correlation to public markets, ultimately reducing portfolio volatility. Importantly, they sought investments with some degree of liquidity and minimal administrative burdens, such as capital calls or distribution complexities.

Assessing the Options:

Understanding the advisor had realistic expectations was a relief — they were not seeking excessive alpha or high teen returns from their alternatives exposure. For context, the advisor's proposed portfolio model used capital market inputs of a nominal 6.5% total annualized 30-year return for U.S. equities and an 8.5% return for alternatives.

My initial goal was to offer broad advice on incorporating private alternatives into the advisor's model portfolios, with a focus on strategies that could be easily tailored across client portfolios. Given the advisor's preference for simplicity and derisking, it was clear that illiquid, closed-end blind pool vehicles were off the table. These vehicles, often complex and requiring significant due diligence, would not align with the advisor's needs or client expectations.

Advisor-Level Diligence Criteria for Selecting Alternative Investments

Given the advisor's constraints and the need for a cautious approach, I outlined several key criteria to consider when selecting alternative investments:

Manager Criteria:

- Platform Stability: Has the manager been through a full market cycle?
- Reputation: Is the manager a true market leader or merely following trends? Are they thought leaders?
- Institutional Nature: Does the firm have institutional investors? Will the advisor's clients benefit from institutional-quality operations and reporting?
- Resilience: Can the manager and their reputation withstand significant shocks, such as a major asset write-off or negative headlines?

Investment Strategy Criteria:

- Simplicity: Is the strategy easy to explain and understand?
- Track Record: Does the manager have a track record in the strategy that aligns with the risk profile being offered?

- Return Drivers: Are returns driven by value-add operational execution to increase asset value rather than financial engineering?
- Sustainability: Is the strategy sustainable, not just a fad? Does it focus on inherently valuable assets?
- Yield Focus: Does the strategy offer a significant yield component?
- Portfolio Composition: What does the existing portfolio look like?

Investment Vehicle Criteria:

- Liquidity: Is the vehicle open to continually accepting new capital? How often can shares be redeemed?
- Investment Capacity: Does the vehicle have dry powder? Will it rely on new capital for investments or liquidity needs?
- Volatility Management: Does the vehicle offer limited liquidity and periodic valuations to reduce public market correlations?
- Cost: Are fees competitive with similar vehicles?
- Valuation Transparency: Are valuation processes clear and updated regularly?
- Operational Support: Does your administrative network support the product's reporting?
- Manager Support: Does the manager provide adequate support services and educational materials?
- Sustainability: At what AUM does the vehicle achieve long-term viability without reliance on fee waivers and still achieve its targeted returns?

Asset Class Selection:

Based on the current market and available vehicle options for accredited investors, I recommended exposure to private real estate and private equity, as these offer the most straightforward strategies for clients while providing the semi-liquid offerings that maintain the benefits of illiquid investments.

Real Estate via Core Plus

Core Plus real estate provides exposure to primary sectors like multifamily, industrial, retail, office, and alternative sectors such as data centers and student housing. The majority of these assets are stabilized, producing cash-on-cash yield from rent, with potential value growth from increasing net operating income through operational and physical improvements. With full recognition market timing is not a repeatable investment strategy, it doesn't hurt that given recent market adjustments, now could be an opportune time for entry.

Private Equity via Private Credit

For clients with higher risk tolerance, private equity presents a vast opportunity set given private companies with greater than $100mm of revenue outnumber public companies nearly 6:1[1]. However, due to the advisor's constraints, closed-end private equity fund investments may not be ideal. Instead, private credit, which provides companies the loans and credit needed to operate and fund growth, offers a compelling alternative, providing current yield and potential equity upside in more advisor-friendly vehicles. When selecting private credit vehicles, I recommended focusing on managers with strong origination capabilities and a significant track record in the space.

Proposed Solution:

To align with the advisor's goals, I recommended a strategy that utilizes private real estate and private credit to achieve diversification, yield, and risk management across client portfolios. These asset classes provide straightforward, semi-liquid investment options that cater to accredited investors' needs. Notably, there are perpetual vehicles that can be continuously invested in, offering opportunities for Dividend Reinvestment Plans (DRIP) to compound returns over time.

Private Real Estate: Non-Traded REITs

For private real estate, many Non-Traded REITs (NTRs) focus on Core Plus strategies and would be ideal. These investments offer access to income-generating real estate with potential value appreciation through active management. NTRs can provide periodic liquidity, balancing the illiquidity premium with liquidity needs. Additionally, for tax-sensitive investors, NTRs can offer multiple share classes for retirement accounts as well as additional potential tax benefits.

Core Plus real estate includes stabilized properties across various sectors, generating steady cash flows with opportunities for value growth. Selecting one to three NTRs with complementary sector and regional exposures ensures a diversified real estate allocation. Fund-of-funds options can also be considered for diversification, though they are likely to reduce returns due to additional fees.

Private Credit: Interval Funds or Non-Traded BDCs

For private credit, interval funds and non-traded Business Development Companies (BDCs) are recommended. These vehicles offer exposure to diverse private credit opportunities, generating attractive current income. Interval funds, with quarterly liquidity, suit clients needing flexibility across different account types due to multiple share class offerings. While non-traded BDCs may offer higher yields as they are required to pay out 90% of their taxable income, similar to REITs, they may not offer multiple share classes.

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[1] JPMorgan Asset Management: Private Equity: Accessing alpha opportunities outside public markets, 2024.07.01.

When selecting private credit vehicles, it's crucial to select established managers with strong origination capabilities. This ensures high-quality loan sourcing, reducing default risk and more consistent investment performance. I advised caution with managers involved in club deals, as these can introduce additional risks.

Implementation Strategy

It was suggested the advisor should implement a tiered strategy based on client risk tolerance. For clients seeking stability, a focus on Core Plus real estate through NTRs is ideal. For those with higher risk tolerance, a blend of private credit and real estate offers additional diversification and yield.

The advisor understood regular reviews of selected vehicles and managers are essential to ensure they continue to meet client needs and align with market conditions. Additionally, while not without some administrative burden, periodic rebalancing will help maintain the desired risk-return profile across portfolios.

The Bottom Line:

The democratization of alternatives has opened the door for accredited investors to access private markets once reserved for institutional investors. Advisors need to get up to speed on the nuances of alternatives quickly if they want to maintain their business edge. Just as on the public side of the portfolio, manager selection and the underlying vehicle structure are critical to achieving successful outcomes. For advisors new to alternative investments, today's landscape offers more options than ever before. Advisors must recognize the nuances between different products and capitalize on this shift, as clients increasingly seek to integrate alternatives into their portfolios to enhance diversification, yield, and overall portfolio stability.