The best offense is a good defense

Alternatives for uncorrelated income

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SUMMER IS USUALLY A QUIET PERIOD FOR MARKETS, BUT 2019 HAS BEEN AN EXCEPTION; THE FEDERAL RESERVE (FED) CUT RATES, TRADE TENSIONS WITH CHINA ESCALATED, GLOBAL MANUFACTURING ACTIVITY CONTINUED TO DETERIORATE AND THE 2-YEAR/10-YEAR U.S. TREASURY CURVE INVERTED.

Against this backdrop, equity markets were volatile, and the yield on 10-year Treasuries fell to its lowest level since 2016. The bond market continues to price in elevated recession risk, and foreign investors are embracing a risk-off posture by piling into dollar-denominated assets. The longevity of the expansion has officially been called into question.

This shift in sentiment has been driven by a number of factors. First and foremost is the issue of U.S./China trade. Lack of clarity around how this conflict will play out has led to a sharp decline in business sentiment and, subsequently, investment spending and manufacturing activity. Other countries are far more exposed to manufacturing than the U.S., but with 33% of manufacturing PMIs in contraction territory as of July, investors have become increasingly concerned that this weakness will begin to manifest itself in services and across labor markets. As long as the consumer remains healthy, the expansion should bend, rather than break. That said, softer consumer sentiment, a slowdown in employment growth and a bounce in layoffs relative to hiring suggest that risks to this view are rising.

At the same juncture, the Fed's recent rate cut has been poorly received by the markets. Chairman Powell was adamant in a recent press conference that the Fed is in the midst of a "mid-cycle adjustment," rather than embarking on a broader easing campaign. While Fed policy is likely too tight given the current state of trade negotiations, markets are looking for nearly four rate cuts by the end of next year. Absent broader weakness in economic data, this seems like a bit much, but as global monetary policy begins to ease more broadly, it seems reasonable to expect that investors will be faced with a low rate environment for the foreseeable future.

With this background, decisions around asset allocation have become increasingly complicated. The sharp decline in interest rates has led funded status to deteriorate, and with the short-term outlook for equities uncertain and the long-run outlook muted, materially adding to risk at this juncture seems inappropriate. Furthermore, interest rates could very well move higher before falling below current levels against a backdrop of recession, suggesting that any allocation to high-quality fixed income should be viewed as a hedge, with investors prepared to potentially lose money in the short term. As such, the appeal of uncorrelated income-producing assets has risen.

The generation of this uncorrelated income is most profound at the core of the private markets. We refer to private alternative asset classes as "core" if their cash flows are forecastable for long periods of time with a low margin of error. For example, core real assets include well-leased properties in major developed markets; regulated utilities and other infrastructure sectors with transparent, predictable cash flows in developed markets; and large backbone transportation assets (maritime vessels, aircrafts, rail cars, etc.) that feature long-term contracts with high credit quality counterparties. Within private credit, we consider loans to be core if they are senior-secured with sufficient lender protections and made to high credit quality borrowers.

The majority of private core alternative returns comes from stable income—to the tune of 60%–90%. Furthermore, because these tend to be higher-quality assets, they can help to dampen volatility. Moreover, due to the essential and often-times local uncorrelated nature of the return streams, core private assets exhibit a low correlation to broader markets and, to a great extent, each other. The non-correlation to equity markets is key, as in a low-rate, low-growth, late-cycle world, the majority of the total risk resides in market beta. Furthermore, with low-yielding core bonds, the potential to achieve high income with low beta is a powerful solution that can be utilized for both de-risking versus equities and enhancing income-driven return versus fixed income. The lack of correlation across core private alternatives is key, as it further dampens volatility and reduces downside risks associated with any one category. Therefore, from an asset allocation perspective, we believe that not only are core private alternatives better, but also that a broader, more diverse allocation that takes into account investor-specific liquidity considerations may be a prudent way forward.

Manager selection is of the utmost importance when deploying capital in these parts of the market, especially in high-dispersion, non-core private market segments such as private equity, non-core real assets/credit and hedge funds. However, dispersion is relatively lower at the core end of the private alternatives spectrum; this points to a greater emphasis on intra-core asset class portfolio construction that maximizes return and diversification, but at the same time minimizes volatility and downside risks.

EXHIBIT 1 breaks down major asset classes into four income-beta buckets: the bottom left is traditional safe assets, which offer protection in the form of low beta but at lower yields; the bottom right is major public equity categories that offer relatively moderate to low dividend yields, with liquidity and growth potential but with high market risk; the top right segment highlights high yield categories in fixed income that offer strong yields, though again at the cost of higher market risk; the top left includes the global core private market categories—private real estate, real

Low beta, high income from Alternatives: core real estate, real assets and credit

EXHIBIT 1A: MAJOR GLOBAL ASSET CLASSES

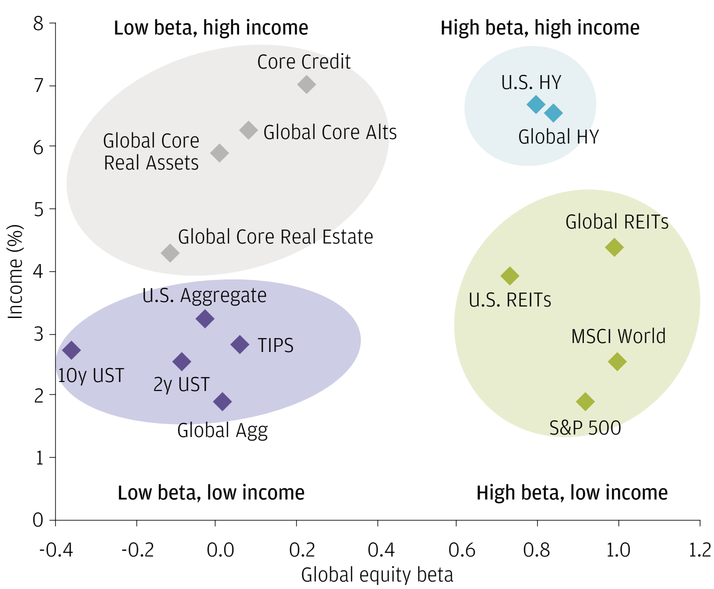
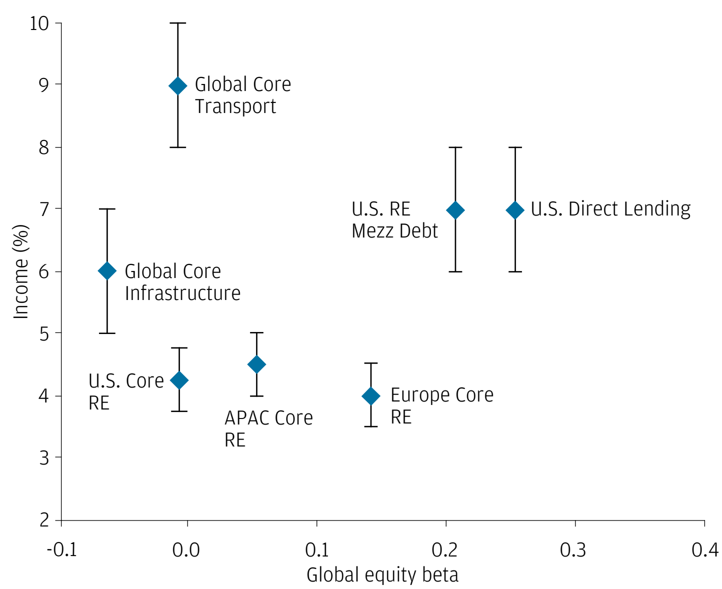


EXHIBIT 1B: MAJOR CORE ALTERNATIVES ASSET CLASSES



Source: Bloomberg, MSCI, S&P, ODCE, INREV, ANREV, Clarksons, FTSE, NAREIT, Cliffwater; data as of June 30, 2019. Sectors shown above are represented by Bloomberg indices. U.S. HY: Corporate High Yield; TIPS: Treasury Inflation-Protected Securities (TIPS); Global HY: Global High Yield Index, Global Agg: Global Aggregate, U.S. REITs: FTSE NAREIT All-Equity REITs, Global REITs: FTSE EPRA NAREIT Global REITs. Yield and return information based on bellwethers for Treasury securities. The global core allocations are for illustrative purposes only and assume a simplified weighting scheme—asset allocation in private core markets in general should consider investor-specific objectives and constraints. The allocation for global core real estate is based on an equal allocation to U.S. core real estate, Europe core real estate and APAC core real estate. The allocation for global core real assets consists of 50% global core real estate, 25% global core infrastructure and 25% global core transport. The core credit allocation consists of 50% middle market direct lending and 50% U.S. core real estate mezzanine debt. The global core alternatives allocation consists of an equal allocation to global core real estate, global core infrastructure/transport and core credit. Yields for each public market asset class are a 12-month average. Yields for each private market core asset class denotes range bound income metrics that are representative of a portfolio of the illustrated well-diversified core asset classes. Yields and income are user inter-changeably in the article. Betas for all asset classes are based on 11-years of annual returns for all sectors.

assets and credit—that offer the best of both, i.e., high income with low beta. The cost, of course, is lower liquidity relative to traditional, public assets; at the same time, however, these core real assets have much greater liquidity when compared to long-life lock-up, closed-end private structures.

We therefore encourage investors to take a fresh look at their asset allocation. At the current juncture, the best offense is a good defense; investors can implement this type of strategy by utilizing core alternatives, which offer a structurally mispriced income premium and can simultaneously help reduce market beta. This is a scarce combination in today's economic environment, but should be taken advantage of accordingly.

NEXT STEPS

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