Alternatives for income

A new way to think about core alternatives: 5%, 7%, 9%

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IN BRIEF

- Income, an essential part of a diversified investment portfolio as a source of liquidity and stability, has traditionally been achieved through an allocation to core fixed income. However, one-third of fixed income securities yield less than 0%, leaving many investors underserved in their need for income today.
- A potential solution is core alternatives, which we define as those offering stable income flows forecastable over long time periods with a low margin of error. They include some private credit, well-leased developed market real estate and infrastructure, some real estate mezzanine loans and long-term leases on backbone transportation assets.
- Investors can think of core alternatives as grouped into three tiers by yield potential: 5%, 7% and 9% and as assets with three characteristics we call "SMS"—meaning scalable, mispriced and scarce.
- Unlike other high yielding fixed income sectors, core alternatives have a relatively low correlation to equities—improving overall diversification and making them attractive late in the cycle, albeit at a cost of less liquidity.

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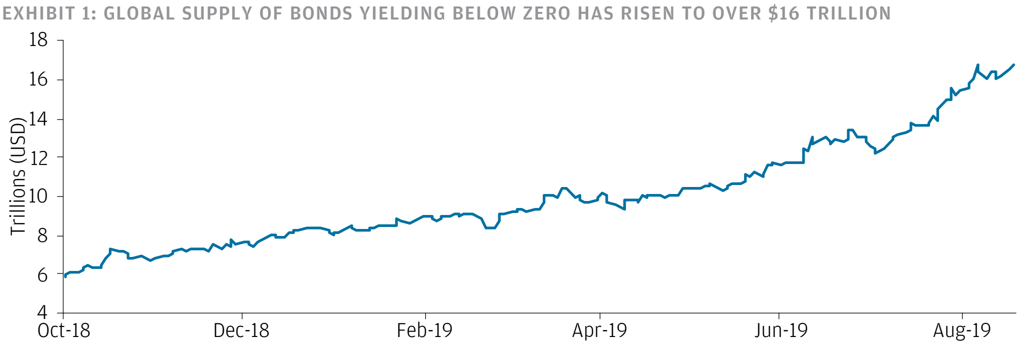
CORE ALTERNATIVES: THE VALUE PROPOSITION

Core fixed income has typically served the role of dampening equity beta while providing a moderate level of income in a portfolio. Income generation, traditionally from bonds, has been essential to well-diversified portfolios—as a source of liquidity and to stabilize return volatility. However, in today's low interest rate environment, when more than one-third of government bond yields are in negative territory,[1] core fixed income yields are often inadequate to meet investors' objectives (**EXHIBIT 1**).

The backdrop: Investors need to replace income in an era of 0% bond yields

EXHIBIT 1: GLOBAL SUPPLY OF BONDS YIELDING BELOW ZERO HAS RISEN TO OVER $16 TRILLION



Source: Bloomberg; data as of August 31, 2019.

[1] At the time of publication, more than $16 trillion of global debt was trading below 0%, according to Bloomberg.

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Investors in search of yield could add risk within fixed income sectors by allocating to high yield and emerging market (EM) debt, but the additional yield would come at the cost of higher correlation to equities late in the cycle.

Enter private market alternatives. Even as interest rates have fallen in developed markets, the relative spreads over sovereign debt of a wide range of core alternatives have remained attractive. Alternatives, particularly the core alternatives we discuss here, offer investors flexibility in meeting their objectives by generating income from sources that are uncorrelated with equities, complementing existing allocations.

DEFINING CORE ALTERNATIVES

We consider core alternatives to be alternative investments that offer a stable source of income at a meaningful premium to core bonds, with yields ranging from 5% to 9%-plus, and at the same time reduce equity beta, improving overall diversification, albeit at a cost of less liquidity. We categorize in **EXHIBIT 2** some of the main alternative asset classes according to their risk profile, role in a portfolio and structure, and compare them with fixed income and equities. Core alternatives, which make up our "core foundation," are the focus of this paper.

There are clear differences among the asset classes that fall under our definition of core alternatives, notably in what they are (a real estate property vs. a port, example), their purpose within a portfolio and the drivers of their returns. These variations are important as sources of additional diversification, allowing the assets to complement one another when core alternatives are added to a portfolio.

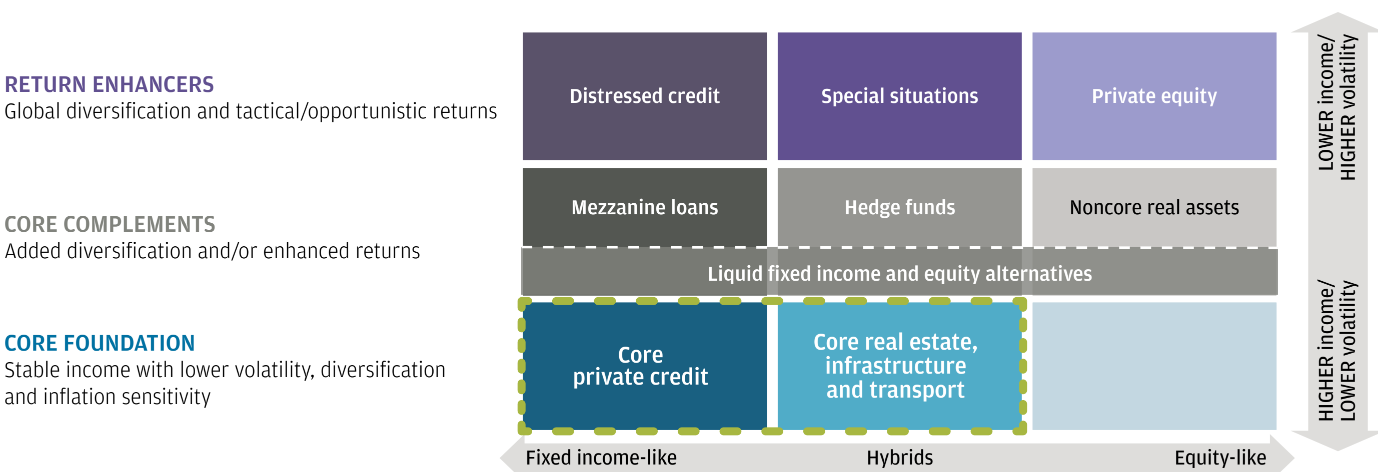
Core alternatives are unified by certain traits. Their cash flows are forecastable for long periods of time with a low margin of error. They include well-leased developed market (DM) properties; regulated utilities; other DM infrastructure with transparent, predictable cash flows; and large backbone transportation assets (maritime vessels, aircraft, railcars, etc.) in long-term contracts with high credit quality counterparties. Private loans are core if they are senior-secured with sufficient lender protections and are made to high credit quality counterparties.

THREE TIERS OF INCOME LEVELS: 5%, 7%, 9%

Just as each opportunity will vary, so will income potential. These variations are largely driven by asset class-specific characteristics. We have grouped core alternatives into three tiers by income potential—5%, 7% and 9% (**EXHIBIT 3**).

A range of alternative asset classes can provide investors with flexibility in meeting their objectives

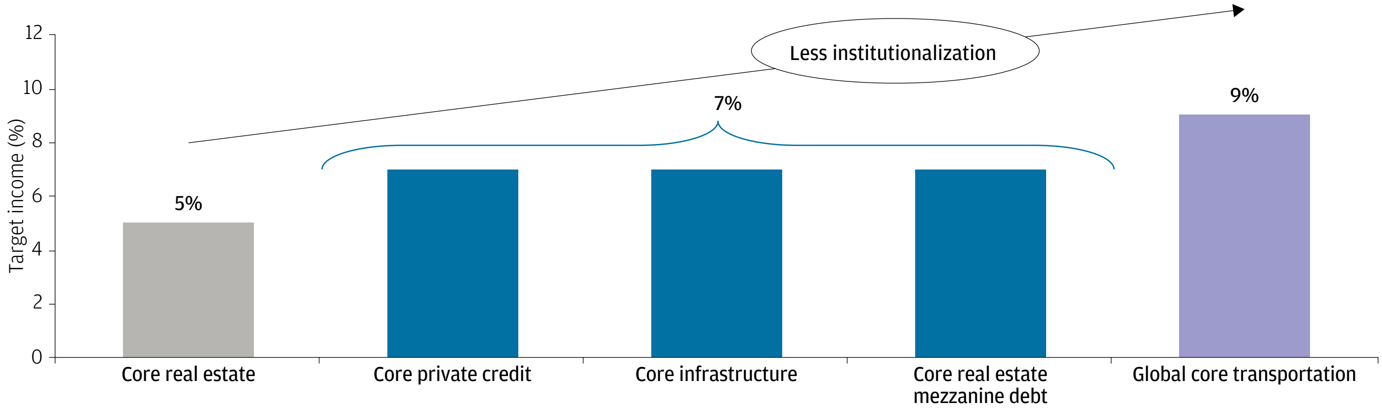
EXHIBIT 2: ALTERNATIVE ASSET CLASSES BY RISK PROFILE AND USE IN PORTFOLIO



Source: J.P. Morgan Asset Management—Global Alternatives. For illustrative purposes only.

5%, 7% or 9%? Core alternative asset classes' characteristics drive their income potential, which is likely to be compressed as institutional capital flows in

EXHIBIT 3: CORE ALTERNATIVES BY ASSET CATEGORY AND TARGET INCOME LEVEL



Core real estate: Greater capital inflows have resulted in more moderate income potential, though still a premium over public markets.

Core private credit: Within private credit, which encompasses a range of sectors and risk profiles, we find opportunities in niche segments, such as small to midsize corporate lending or nonqualified residential mortgage origination, offering potentially attractive yields while meeting our definition of core.

Core infrastructure: Infrastructure, a growing institutional asset class, offers attractive yields, particularly in the middle market (avoiding "trophy" assets that attract more bidders).

Core real estate mezzanine debt: The core real estate mezz lending opportunity arose as more restrictive leverage limits on banks and life insurance company lenders opened a gap in the capital structure between equity and senior debt that experienced real estate operators may fill.

Global core transportation: A dearth of capital since banks reduced their lending to the sector post-global financial crisis, coupled with specialized operating expertise, creates the potential for higher income through long-term leases on large backbone assets.

Source: J.P. Morgan Asset Management—Global Alternatives; data as of August 31, 2019. For illustrative purposes only. The targets in the chart are simplified figures subject to market conditions and other specific factors. These should not be taken as representative of any J.P. Morgan fund targets.

The target returns are for illustrative purposes only and are subject to significant limitations. An investor should not expect to achieve actual returns similar to the target returns shown above. Because of the inherent limitations of the target returns, potential investors should not rely on them when making a decision on whether or not to invest in the strategy. Please see the full Target Return disclosure at the conclusion of the presentation.

We note that we have seen income potential decline as certain categories of alternative assets have attracted larger capital flows and institutional capital has become more prevalent. Although there will be other factors at play, institutional investors' growing acceptance will very likely, over time, continue to cause some degree of income compression while simultaneously making markets more liquid.

PORTFOLIO INCOME WITHOUT MEANINGFULLY LIFTING EQUITY BETA

Allocating to high quality duration will always be an important component of a portfolio, particularly late in the cycle during risk-off periods. Investors in search of attractive yield within the confines of public markets will find that they need to include higher risk, higher volatility categories, such as high yield bonds or emerging market debt, which come at the cost of higher correlation with equities and greater volatility (**EXHIBIT 4**). In a late-cycle environment, diversifying equity exposure is especially important. Core alternatives provide a source of uncorrelated income without meaningfully increasing a portfolio's equity beta.

EVEN WITH LOW INTEREST RATES, SPREADS REMAIN ATTRACTIVE FOR THOSE WITH EXPERTISE

What these alternative asset classes have in common is that they're all what we refer to as "SMS"—by which we mean that they are scalable, mispriced and scarce. They are scalable because these are multi-trillion dollar markets offering an adequate volume of investment opportunities. They are mispriced, with larger spreads over public fixed income relative to historical levels. Even as developed market interest rates have fallen, core alternatives' spreads have remained attractive, highlighting the stability of their income premium through the market cycle. Core alternatives are scarce because they are challenging to source and/or execute. Even with a large universe of investments in total volume, the private nature of each one creates barriers to entry for those with insufficient networks to source transactions or who lack the expertise to perform due diligence and execute on the opportunities.

Low beta, high income from alternatives: Core real estate, real assets and credit

EXHIBIT 4A: MAJOR GLOBAL ASSET CLASSES

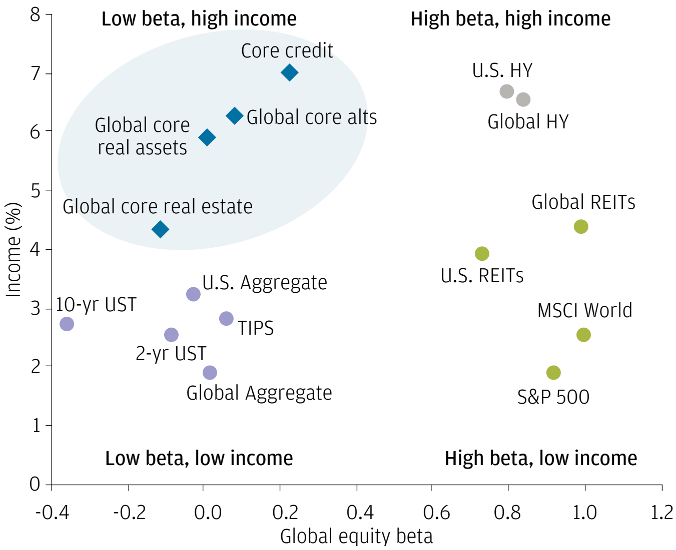
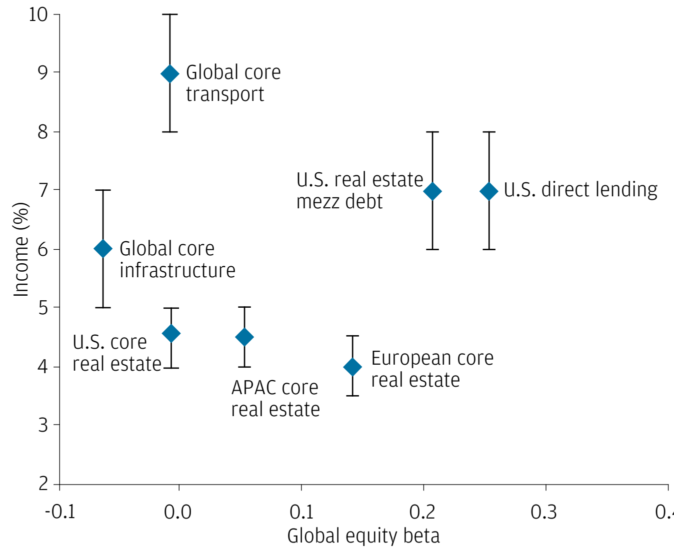


EXHIBIT 4B: MAJOR CORE ALTERNATIVE ASSET CLASSES



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: Barclays US Corporate High Yield Index; Global HY: Barclays Global High Yield Index; U.S. Aggregate: Barclays US Aggregate Bond Index; Global Aggregate: Barclays Global Aggregate Index; U.S. REITs: FTSE NAREIT All-Equity REITs; Global REITs: FTSE EPRA NAREIT Global Real Estate Index series. 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 Asia-Pacific 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 denote range-bound income metrics representative of a portfolio composed of the illustrated well-diversified core asset classes. Yields and income are used interchangeably. Betas for all asset classes are based on 11 years of annual returns.

INVESTMENT IMPLICATIONS

Given that core alternatives derive the majority of their returns—from 60% to 90%—from income, they can be especially useful to investors looking for a steady stream of cash flows. Core alternatives can also be attractive for investors not looking for distributable income. Because they generate returns driven predominantly by long-term contracted cash flows that are reinvested and thus compound over time, the result is a more consistent long-term outcome than strategies based more on appreciation. Finally, income-driven returns are less subject to timing risk, which can adversely hurt noncore strategies.

All these attributes, we believe, make core alternatives—whether at the 5%, 7% or 9% level—attractive components in portfolios at a time of low global bond yields, late in the cycle and, indeed, across economic cycles.

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NEXT STEPS

For more information, contact your J.P. Morgan representative.

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