

IN PURSUIT OF ALPHA, INCOME AND DIVERSIFICATION

Alternatives: From optional to essential

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IN BRIEF

- Alternatives are evolving from an optional to an essential portfolio component. We see expanding allocations to alternatives over the next decade by institutions and individuals of all types, each with distinct investment needs and constraints.
- Investors are increasingly turning to alternatives to meet their investment objectives - whether in pursuit of alpha, income or diversification.
- A comprehensive framework for allocating to alternatives will be critical as allocations rise and alternatives are recognized as vital to achieving investors' desired outcomes. We provide a framework that starts with investor objectives and builds solutions based on the roles that different alternatives can play within an overall portfolio.
- Alternative investing has distinct challenges. Illiquidity, dispersion of returns, limited transparency, tail risk and complex fee structures are, to varying degrees, intrinsic to alternatives and have limited their uptake by some investors.
- New solutions are being developed for smaller institutions and retail investors to access the potential benefits of alternatives. Increased flows may lessen investment hurdles but could also, over the long term, constrain alpha potential for some alternatives.
- Investors appear to have reached the conclusion that the long-term benefits of these nontraditional assets are likely to outweigh the challenges.

OVERVIEW

From optional to essential: That's how we see alternatives evolving over the next 10 to 15 years. This trend is already well underway, with significantly rising alternatives allocations among larger institutions as well as high and ultrahigh net worth individuals.

Three simple reasons explain our expectations:

- Our view that interest rates will stay “lower for longer”
- Shrinking opportunities for alpha, income and diversification
- Improving means of access to alternatives, combined with less restrictive regulations

The distinguishing characteristics of alternatives (See **WHAT MAKES ALTERNATIVES ALTERNATIVE?**) and the roles they can play within a portfolio help address the shortfalls of public financial assets today and may enhance the performance of traditional portfolio allocations:

- Lower interest rates over the past decade have sent investors on an avid search for income. Core alternative strategies in the real assets and alternative credit segments can provide stable sources of income.

- The ability of bonds to provide portfolio protection by rallying in a market downturn has been diminished. Hedge funds may provide new sources of diversification, and income-producing core alternatives can offer a measure of protection.
- Passive investing can provide market beta but cannot, by definition, provide alpha. Private equity, non-core real assets and hedge funds, on the other hand, are potential portfolio return enhancers.
- Should inflation risks tick up, which we see as a possibility over the medium term, the need for an inflation cushion could increase. Real assets can help.

Of course, investment objectives and experience with alternatives vary across and within investor segments; the inherent characteristics of alternatives (illiquidity, limited transparency, tail risk, fee structures) present greater challenges for some investors than for others; and the flow of capital into alternatives will likely shape the risks and rewards of these investments over time. In this piece, we look at:

- An objectives-based framework for allocating to alternatives that starts with investors' specific needs for alpha, income and diversification and allocates to different types of alternatives based on their roles within a portfolio, not their industry

WHAT MAKES ALTERNATIVES ALTERNATIVE?

“Alternatives” is an often-used catchall phrase for all nontraditional assets (private equity, alternative credit, real assets including real estate and infrastructure, etc.) and investment strategies – hedging, short selling, leverage and others.

But that doesn't mean alternatives are a hodgepodge of assets. They are all alternative sources of one or more outcomes that investors seek from traditional stocks and bonds – alpha, income and diversification – and can, with trade-offs, potentially help investors achieve these outcomes.

Alternatives also share characteristics that distinguish them from traditional stocks and bonds. They are, to different degrees, less liquid, have longer investment horizons and operate in more inefficient (private, less regulated) markets. They have less transparency, and information is not always equally available to all market participants. For all these reasons, alternative investments generally:

- Exhibit low correlations with traditional assets – which can make them good diversifiers* of traditional portfolios
- Deliver returns that are driven by income and/or alpha, making them potentially good stabilizers and/or return enhancers
- Have higher fees than traditional stocks and bonds

Finally, non-core** alternative managers' returns exhibit significantly higher dispersion than those of traditional managers. This stresses the importance of manager selection: Skillful managers are able to exploit market inefficiencies, bring about operational improvements and deliver enhanced returns.

* Diversification does not guarantee investment returns and does not eliminate the risk of loss. Diversification among investment options and asset classes may help to reduce overall volatility.

** Non-core refers to alternative categories outside of core alternative investments. While core alternative investments are designed to deliver stable income with lower volatility, non-core alternative investments tend to have added return and/or diversifier components. See EXHIBIT 2 for more information.

nomenclature. We believe aligning alternative asset selection with investor objectives within an overall portfolio context is critical – and a focus of most successful frameworks used by experienced alternative investors.

- Challenges and trade-offs that are specific to investing in alternatives and need to be considered when allocating to these assets.
- How different types of investors are utilizing alternatives today, how their access and use is likely to evolve going forward and the potential implications for alternative investing.

ALLOCATING TO ALTERNATIVES: AN OUTCOME-ORIENTED APPROACH

A large institution and an average household may have very different investment objectives and constraints, but they both face the same challenge: how to allocate capital to achieve their desired outcomes. We argue that the most effective approach to asset allocation is to let these desired outcomes, not traditional or alternative asset class labels, guide the decision-making process.

EXHIBIT 1 illustrates such an approach: It starts with investors’ objectives and allocates capital to assets and strategies – return enhancers (Alpha), yield enhancers/safe havens (Income) and diversifiers (Diversification) – to deliver the desired outcomes within an overall portfolio context.

We take a closer look at each of these functions, with examples of how traditional and/or alternative assets might be used to support them within a portfolio:

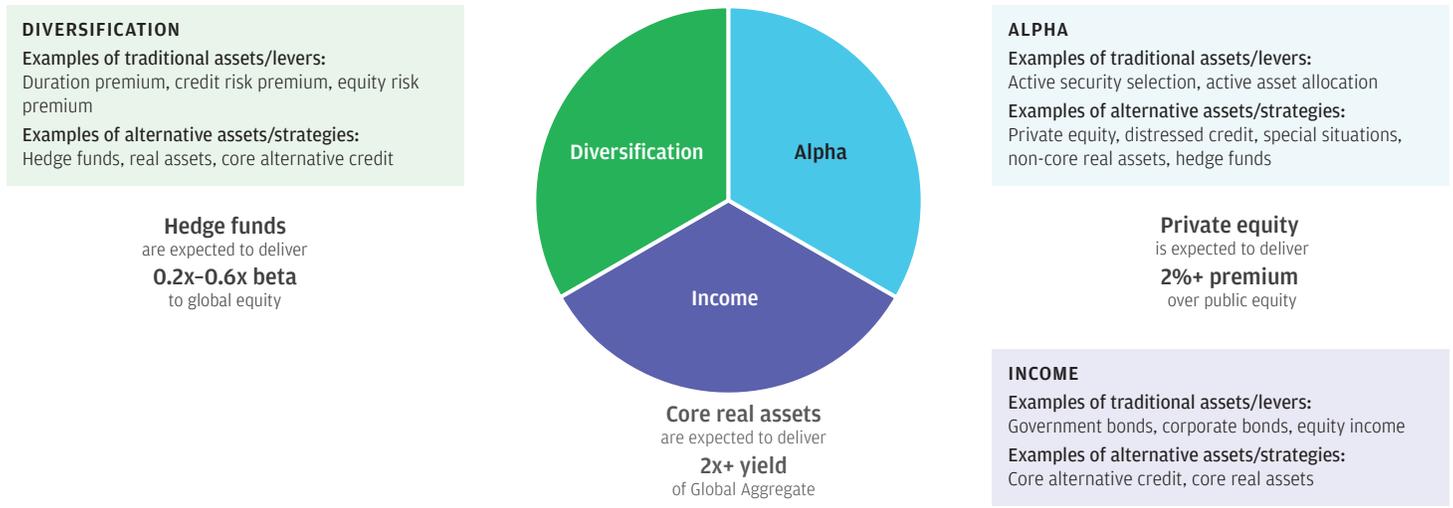
ALPHA is commonly defined as the return from skillful active management or value creation that lifts portfolio returns. Traditional active security selection and cycle-aware asset allocation, as well as private equity, opportunistic alternative credit (e.g., distressed credit and special situations) and non-core real assets, can be attractive alpha sources. Integrating environmental, social and governance (ESG) factors may enhance alpha generation across all these sources.

INCOME generation is a primary objective for many asset owners – for institutions that need to match liability cash flows or retirees who need to replace their earnings, for example. Within portfolios, income provides a source of liquidity and/or stability. High quality government and corporate bonds often fill this role. However, core alternative credit and real assets, including core real estate and infrastructure, can also provide a stable income stream in downturns. They may offer some appealing safe haven characteristics, with potentially higher yield, albeit at the cost of some liquidity.¹

¹ Thushka Maharaj et al., “Rethinking safe haven assets,” *2020 Long-Term Capital Market Assumptions*, J.P. Morgan Asset Management, November 2019.

Alternative and traditional assets share the same set of functions within a portfolio

EXHIBIT 1: ALPHA, INCOME AND DIVERSIFICATION



Source: J.P. Morgan Asset Management. Estimates are based on the 2021 Long-Term Capital Market Assumptions (LTCMAs); data as of September 30, 2020. Core real assets yield is calculated based on a weighted average starting NOI (after capex and depreciation) yield on a well-diversified portfolio of core real assets. Global Aggregate yield refers to the Bloomberg Barclays Global Aggregate current yield. Hedge fund beta range is calculated based on the range of hedge fund strategies covered by the LTCMAs.

Hypothetical performance results have many inherent limitations. No representation is being made that an asset class will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading.

DIVERSIFICATION is a critical risk management tool for asset owners. Holding assets (traditional and alternative) with low or uncorrelated sources of return can reduce volatility. Hedge fund betas are often used as effective risk diversifiers, although they do come with lockups, leverage and relatively large left-tail risks. Core real assets and core alternative credit can also diversify equity risk, as their return streams are driven by higher quality income and/or local economic factors.

As alternatives are increasingly viewed as essential, not as optional, in supporting these functions, we expect a further blurring of the boundaries between traditional and alternative assets. Fees, on the other hand, are likely to become more differentiated, with the gap widening between more passive index tracking or systematic strategies and more active, top-performing, alpha-seeking managers.

A simple framework for investing in alternatives

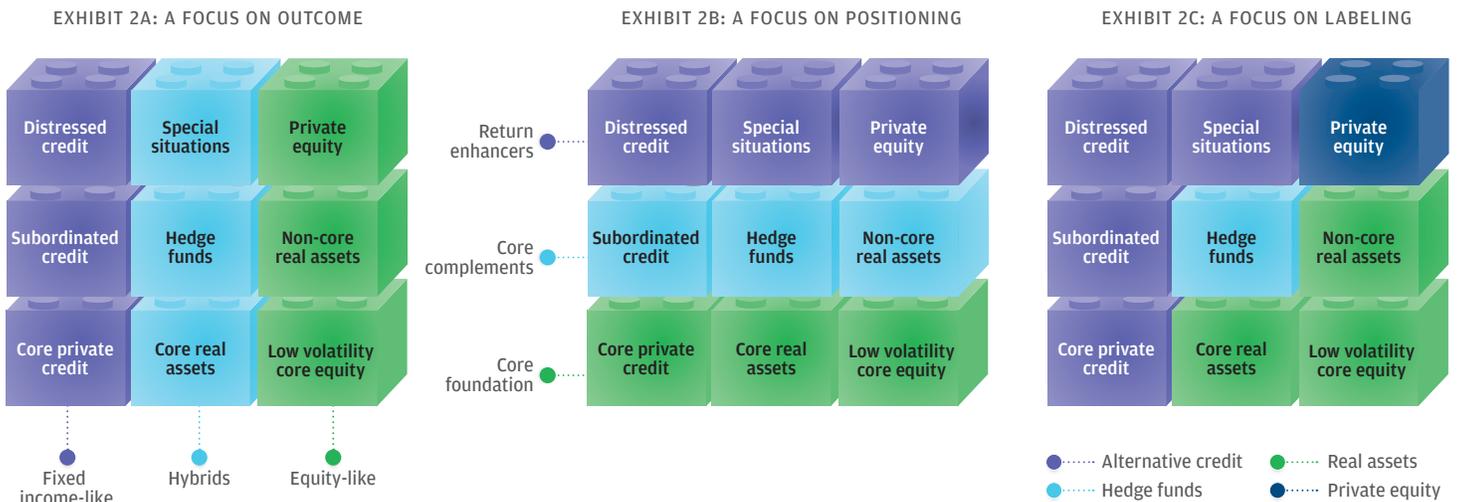
Investors taking an outcome-oriented approach can employ an alternatives investing framework to help sort alternative assets - not by their labels (alternative credit, private equity, hedge funds or real assets) but by the characteristics they share with traditional asset classes (fixed income-like, equity-like or both in the case of hybrids) and the attributes they provide to a portfolio (alpha, income and diversification).

EXHIBIT 2 illustrates a framework that categorizes the main alternative asset classes according to:

- **A FOCUS ON OUTCOME (EXHIBIT 2A):** Assets on the left are alternatives to or share characteristics with *fixed income*. In the middle are *hybrids*, with attributes of fixed income and equity. On the right are alternatives with *equity-like* attributes. From a portfolio management perspective, balancing exposures within these building blocks can be a source of alpha (i.e., tilting toward fixed income attributes in a risk-off environment and toward equity attributes in a risk-on environment) while maintaining a steady allocation to hybrid categories, which tend to be more all-weather.
- **A FOCUS ON POSITIONING (EXHIBIT 2B):** Starting at the bottom, the *core foundation* includes scalable categories that have stable cash flows as the primary driver of return and are also diversifying vs. traditional assets. In the middle row are the *core complements*, investments focusing on less transparent and relatively less scalable opportunities that provide diversification and/or enhanced returns benefiting from secular themes. The top row, *return enhancers*, can potentially produce outsize returns across a market cycle. Right-sizing the mix of these various components should reflect an investor’s specific objectives and constraints, as well as the economic environment.
- **A FOCUS ON LABELING (EXHIBIT 2C):** Color-coded groupings indicate how clusters of these building blocks are labeled in the industry today. We de-emphasize the label and encourage investors to consider the benefits and trade-offs of alternatives by focusing instead on their outcomes and roles within a portfolio.

An objectives-based alternatives framework emphasizes function over standard industry nomenclature

EXHIBIT 2: ALTERNATIVES ALLOCATION FRAMEWORK



Source: J.P. Morgan Asset Management - Alternatives Investment Strategy & Solutions. For illustrative purposes only. Hedge funds - hybrid core complements - are placed at the center of the framework, as they are flexible structures that can toggle between equity- and fixed income-like and hybrid functions. While low volatility core equity is denoted as part of real assets, it may represent a broader segment of liquid equity-like core alternatives.

Tailoring allocations to meet different risk-return objectives

The following hypothetical case study illustrates how investors with different risk-return objectives can improve their traditional multi-asset portfolio outcomes with an alternatives allocation that reflects their distinct risk-return profiles (EXHIBIT 3). The approach complements existing portfolio allocation approaches that we use in the broader portfolio construction process.

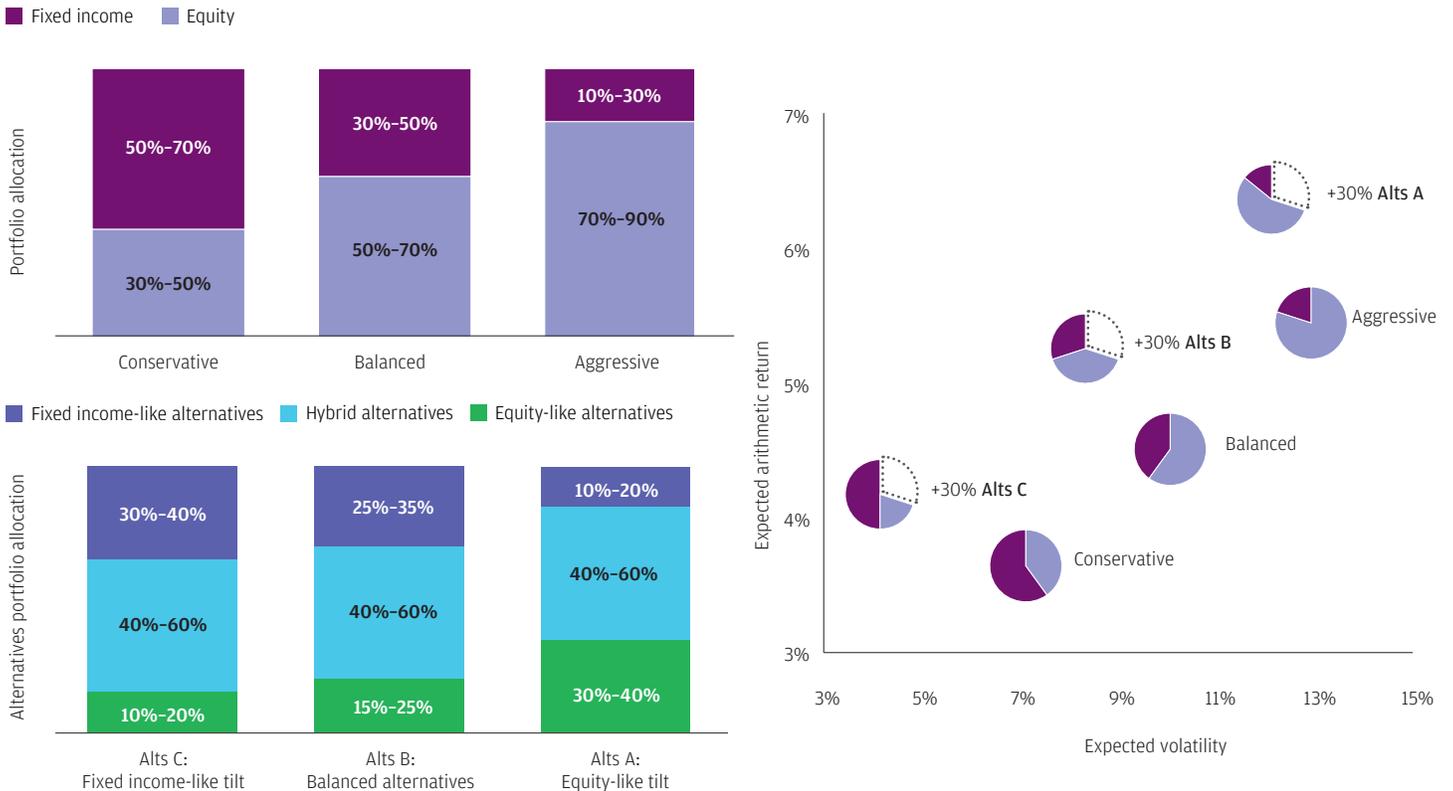
We start with three multi-asset portfolios with different equity/bond allocations: Conservative (40/60), Balanced (60/40) and Aggressive (80/20). Next, for each portfolio we reallocate 30% of capital from equities and bonds to a diversified, risk-return-appropriate alternatives set (Alts C, Alts B and Alts A, respectively) blending equity-like, fixed income-like and hybrid alternatives. In each case, incorporating an outcome-oriented alternatives allocation improves the overall expected portfolio risk and return.

ALTERNATIVES: MATERIAL OPPORTUNITIES/ INCREMENTAL RISKS

Hypothetical case study results like those captured in Exhibit 3 illustrate the potential advantages of alternative allocations, but they do not reflect the full set of risks and trade-offs inherent in alternative investing or capture those trade-offs for a specific investor. As highlighted in **WHAT MAKES ALTERNATIVES ALTERNATIVE?** and throughout our framework discussion, alternative investing comes with additional challenges not faced to the same degree in traditional investing, namely: illiquidity, manager return dispersion, tail risk and lack of transparency, along with generally higher fees. Allocating to alternatives proves the old adage “There’s no such thing as a free lunch.”

Objectives-based alternative allocations can help improve portfolio outcomes for a range of investors

EXHIBIT 3: ILLUSTRATIVE CASE STUDY - ADDING DIVERSIFIED ALTERNATIVE ALLOCATIONS BASED ON INVESTORS' RISK-RETURN OBJECTIVES



Source: J.P. Morgan Asset Management - Global Alternatives. Portfolio expected returns and volatilities are mapped via asset classes available in 2021 Long-Term Capital Market Assumptions, USD version; data as of September 30, 2020. Mapping detail is as follows: Equity - 100% AC World Equity; fixed income - 100% US Aggregate Bonds; equity-like alternatives - 100% private equity; fixed income-like alternatives - 100% direct lending; hybrid alternatives - 70%/30% real assets/hedge funds in Alts C, 80%/20% real assets/hedge funds in Alts B and 90%/10% real assets/hedge funds in Alts A. Core real assets portfolio is diversified across global core real estate, infrastructure and transport. Hedge fund portfolio is modeled as 100% diversified hedge funds. For broader definitions of equity-like alts, hybrid alts and fixed income-like alts, please refer to Exhibit 2. The 30% alternatives allocations are funded as follows: Conservative portfolio - 30%/0% equity/fixed income; balanced portfolio - 25%/5% equity/fixed income; aggressive portfolio - 20%/10% equity/fixed income.

Illiquidity and dispersion of returns

How different investors weigh the potential for capital gains against the need for steady cash flows speaks to their risk tolerance in the traditional sense. Evaluating the opportunities and uncertainties inherent in the operation of alternative strategies and non-long only management formats comes with added dimensions of risk: illiquidity and a wide dispersion of possible return outcomes.²

EXHIBIT 4 attempts to bring these considerations together to capture the essential trade-offs inherent in alternative investing.

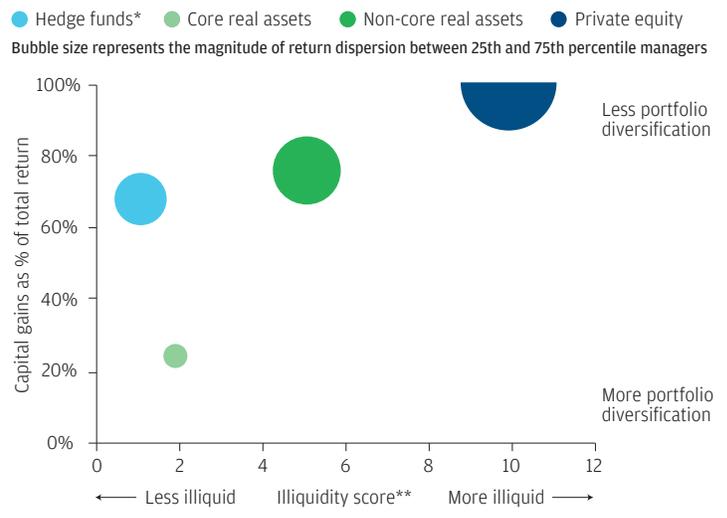
Consider the trade-offs for private equity – a highly illiquid investment that involves a long-term commitment to a strategy and, importantly, to an execution vehicle or manager, often through an entire economic or market cycle. The returns, largely in terms of capital gains, are potentially significant, likely to be highly correlated with public equity market returns (i.e., diversification is not the primary motivation for private equity investing) and can vary meaningfully across managers and vehicles. In a private equity partnership structure, illiquidity should be viewed as a positive attribute and a powerful tool for implementing operating enhancements that have the potential to drive alpha and deliver “fair” compensation for the loss of investment optionality. Historical return data confirm there has been a premium for illiquid asset investing, but this is not guaranteed. No mechanism within alternative investment strategies ensures a premium or higher return for the additional cost of illiquidity.

At the other end of the spectrum, core real assets have the potential to provide returns driven by stable cash flows. Returns are typically lower than those of private equity but come with greater liquidity and significantly lower dispersion of manager returns, and they can offer strong public equity diversification.

The added dimensions of illiquidity and wide dispersion of returns, in particular for capital appreciation-oriented categories, represent material increments to the assessment of risk and highlight the importance of due diligence in realizing anticipated outcomes. Investors need to ensure they get what they pay for.

Standard efficient frontiers do not capture two added dimensions of risk integral to alternative investing – illiquidity and manager risk

EXHIBIT 4: TRADE-OFFS IN ALTERNATIVE ASSET INVESTING



Source: Burgiss, Cambridge Associates, HFRI, NCREIF, Prequin, J.P. Morgan Asset Management; data as of Q2 2020 for hedge funds and core real assets; data as of Q1 2020 for non-core real assets and private equity.

* Hedge funds are represented by equity long-bias funds, trailing five years. Core real assets bubble is mapped using core real estate proxy. Non-core real assets bubble is mapped using non-core real estate proxy. Private equity returns are measured using 10-year internal rate of return.

** Illiquidity score is the estimated time to value realization: Hedge funds – one year; core real assets – two years; non-core real assets – five years; private equity – 10 years.

Other challenges in alternative investing

While illiquidity and dispersion of returns may dominate investors’ decision-making processes, other challenges – tail risk, a lack of transparency and more complex fee structures – should also be considered in a holistic assessment of alternative investing. While these factors may be limiting the role of alternatives in some investors’ portfolios, they could become less of a barrier.

Left-tail risk (simply put, the chance that an investment generates much lower than expected returns or greater than expected losses) is a valid concern. High profile cases like the failure of Long-Term Capital Management (LTCM) in 1998 are reminders of how devastating the resulting losses can be. Of course, it’s not difficult to find examples in the public markets of company collapses inflicting equally painful losses on investors. But with alternatives, other challenges can compound the aversion to left-tail risk: When transparency is lacking, investors cannot be sure they understand the potential downside. With illiquidity, they may not have the option to “cash out” in times of stress or to book profits. On the other hand, diversification across alternative building blocks and within alternative asset classes can help limit these portfolio risks.

² See “The evolution of market structure: Managing illiquidity risk across public and private markets,” 2019 Long-Term Capital Market Assumptions, J.P. Morgan Asset Management, for further discussion of the nature of illiquidity in both private and public assets, and how best to harvest illiquidity premia across the cycle.

Transparency, illiquidity and fees affect alternative investing today, but historically, public market segments faced similar hurdles, which declined over time. The rise of emerging market assets in the 1990s offered higher returns, but many public exchanges were in their infancy, liquidity was limited, and information-sharing was inefficient. However, over time, emerging markets became deeper and more liquid, transparency increased, and fees for international investors declined.

Could alternatives have a similar experience as they become essential portfolio components? The growing interest in alternatives has already resulted in increased capital-raising across real assets and private financial markets. Larger capital allocations could lead to lower fees; some alternatives (core real estate and hedge funds, in particular) are showing evidence of this already.

HOW DIFFERENT INVESTORS USE ALTERNATIVES: CURRENT SNAPSHOT AND ANTICIPATED TRENDS

As investors build out and restructure alternative allocations to meet their specific alpha, income and diversification objectives, a framework to help align expanding allocations with specific investment objectives is likely to become as essential as alternatives themselves.

We examine how various institutional and individual investor segments are using alternatives to address specific objectives today, anticipate where we are likely to see growth in allocations going forward and consider some potential implications for alternative investors as flows into these assets increase.

Institutional investors

EXHIBIT 5 compares and contrasts alternative allocations across endowments and foundations (E&Fs), sovereign wealth funds (SWFs), public pensions, corporate pensions and insurers, using a comprehensive dataset encompassing institutions of various sizes. When viewed at an aggregated segment level, results clearly show that differentiated investment objectives and constraints are shaping distinct alternative allocation patterns across investor types. While each institution has unique goals and constraints, these results support the rationale for an objectives-based framework and can offer a useful peer perspective as institutions expand and refine their own allocations.

ENDOWMENTS & FOUNDATIONS generally have aggressive return targets. Many allocate 10% to 50% of their portfolios to alternatives, with an emphasis on equity-like categories. Endowments, with a perpetual investment horizon, low spending rates and limited liabilities, have a greater tolerance for risk. Foundations are similar, with the added requirement of distributing a minimum percentage of their assets each year.

How are different types of institutions using alternatives to meet their objectives?

EXHIBIT 5: ALTERNATIVE ALLOCATIONS, KEY INVESTMENTS AND CONSTRAINTS BY INSTITUTIONAL INVESTOR TYPE

	Endowments & foundations	Sovereign wealth funds	Public pensions	Corporate pensions	Insurance
Typical alternatives allocation					
Range	10%-50%	0%-40%	10%-40%	0%-30%	0%-10%
Objectives					
Total portfolio focus	Asset only with spending considerations	Asset only with wealth preservation considerations	Asset only with liability considerations	Asset & liability	Asset & liability
Alternatives focus	Growth in real returns & diversified sources of alpha	Stable yield & growth	Growth, stability & cash flow management	Growth & stability	Income, diversification
Alternatives portfolio characteristics					
Risk orientation	Equity-like	Balanced	Balanced	Balanced	Fixed income-like
Return enhancement	High	Medium - high	Medium - high	Medium	Low - medium
Income	Low - medium	Medium	Medium - high	Medium - high	Medium - high
Equity diversification	Low	Low - medium	Low - medium	Medium - high	High
Downside protection	Low	Low - medium	Low - medium	Medium	Medium - high
Alternatives key constraints					
Liquidity	Low - medium	Low - medium	Low - medium	Medium	Low
Regulatory	Low	Low	Low	Low - medium	High

For illustrative purposes only. The information is based on a combination of actual data and a subjective view from J.P. Morgan Asset Management; data as of August 31, 2020.

SOVEREIGN WEALTH FUNDS AND PUBLIC PENSIONS are also major investors in alternatives, with more of a focus on assets than on liability considerations. SWFs have concentrated on real assets and private equity, where they can invest with scale, and typically have smaller allocations to hedge funds and alternative credit. Public pension plans, given their size and long-term investment horizon, typically allocate 10% to 40% to alternatives, using an increasingly wide array of strategies.

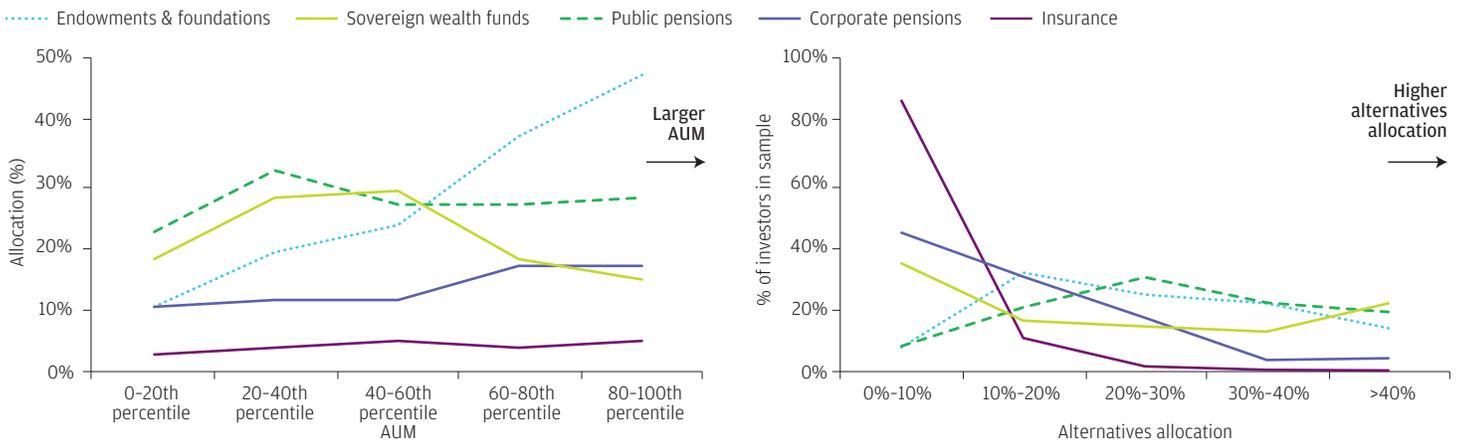
CORPORATE PENSION PLANS, as liability-aware investors, have become increasingly reliant on alternatives for income, stability and growth. Allocations to alternatives have increased, funded primarily from existing equity and fixed income allocations. Incremental allocations to real assets, private equity and private credit have been funded almost entirely from public equity reductions and new money flows. Looking ahead, fixed income-like core alternatives may play an increasing role in liability-hedging portfolios, given a continuing low rate environment.

INSURANCE COMPANIES, also liability-aware investors, need stable income return, low balance sheet volatility and capital efficiency. For these investors, alternatives have the potential to enhance return opportunities and improve diversification, especially in the current yield-constrained environment.

Looking ahead, we see expanding alternative allocations across institutions of all sizes and types. We do not see the fundamental investment needs of these segments changing significantly. What we do see is a greater reliance on alternatives, given our assumptions that interest rates will remain low and traditional markets alone will be less likely to meet investors’ objectives. Against this backdrop, we anticipate relatively strong growth among corporate pension plans and insurance companies – asset liability-aware investors for which liquidity and regulatory constraints, respectively, have historically kept alternative allocations below those of their asset-only peers. Small to midsize institutions, with generally smaller alternative allocations than their larger counterparts, are also likely to see some of the greatest increases (**EXHIBIT 6**). But not all institutions will have the resources to build and manage alternative allocations at scale. Growth among these smaller investors will depend on continuing industry innovation and the development of multi-alternative asset solutions and access vehicles to address the needs of this vast investor segment.

In general, larger institutional portfolios have greater allocations to alternatives

EXHIBIT 6: ALTERNATIVE ALLOCATIONS BY AUM AND PERCENTAGE OF INVESTORS



Source: Capital IQ, Center for Retirement Research at Boston College, National Association of College and University Business Officers (NACUBO), company 10-Ks, J.P. Morgan Asset Management; data as of August 31, 2020.

Alternatives allocation is defined as allocation to assets other than equity, fixed income and cash.

Sample statistics for institutional types:

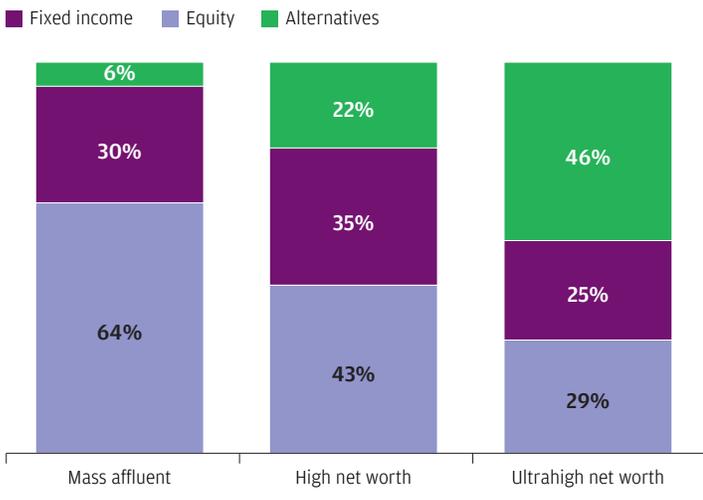
- Endowments & foundations data reflect over 750 global plans with USD 630 billion in assets. AUM percentiles: 0-20th percentile: <USD 50 million; 20-40th percentile: USD 50 million-USD 100 million; 40-60th percentile: USD 100 million-USD 250 million; 60-80th percentile: USD 250 million-USD 1 billion; 80-100th percentile: >USD 1 billion.
- Corporate pension data reflect over 180 U.S. plans with USD 1.5 trillion in assets. AUM percentiles: 0-20th percentile: <USD 2 billion; 20-40th percentile: USD 2 billion-USD 3 billion; 40-60th percentile: USD 3 billion-USD 5 billion; 60-80th percentile: USD 5 billion-USD 10 billion; 80-100th percentile: >USD 10 billion.
- Public pension data reflect over 130 U.S. plans with USD 3.5 trillion in assets. AUM percentiles: 0-20th percentile: <USD 2 billion; 20-40th percentile: USD 2 billion-USD 8 billion; 40-60th percentile: USD 8 billion-USD 15 billion; 60-80th percentile: USD 15 billion-USD 30 billion; 80-100th percentile: >USD 30 billion.
- Insurance data reflect over 300 U.S. plans with USD 5 trillion in assets. AUM percentiles: 0-20th percentile: <USD 1.5 billion; 20-40th percentile: USD 1.5 billion-USD 3 billion; 40-60th percentile: USD 3 billion-USD 6 billion; 60-80th percentile: USD 6 billion-USD 20 billion; 80-100th percentile: > USD 20 billion.
- Sovereign wealth fund data reflect over 50 global plans with USD 9.5 trillion in assets. AUM percentiles: 0-20th percentile: <USD 10 billion; 20-40th percentile: USD 10 billion-USD 50 billion; 40-60th percentile: USD 50 billion-USD 100 billion; 60-80th percentile: USD 100 billion-USD 300 billion; 80-100th percentile: > USD 300 billion.

Individual investors

Ultrahigh net worth individuals have one of the highest allocations to alternatives among investor segments, but for many individual investors alternatives are not yet a portfolio staple (**EXHIBIT 7**). However, with expected returns from public asset classes under pressure and less liquid investments becoming increasingly accessible, the retail investor may finally have an opportunity to share in some of the potential benefits of alternatives.

Many individual investors are still heavily reliant on traditional stocks and bonds vs. alternatives

EXHIBIT 7: WHERE INDIVIDUAL INVESTORS PUT THEIR MONEY



Source: *Institutional Investor*, KKR, J.P. Morgan Asset Management; data as of August 31, 2020.

Mass affluent is defined as an investor with USD 500,000-USD 1.5 million in investible assets. High net worth is defined as an investor with USD 10 million-USD 30 million in investible assets. Ultrahigh net worth is defined as an investor with USD 30 million or more in investible assets. High net worth and ultrahigh net worth data are as of 2017. Mass affluent data are as of 2018.

Ultrahigh net worth individuals, who have a relatively high tolerance for illiquidity and risk, hold over half of their total alternatives exposure in private equity, with the other half evenly split between real assets and hedge funds. Further down the wealth spectrum, investors tend to hold a greater share of their alternative assets in semiliquid investments like hedge funds, where fees, illiquidity and access may pose less of a constraint.

Alternatives are becoming more accessible to the average individual investor, as they are for small and midsize institutions. Obviously, the spectrum of strategies that are considered alternative is wide, ranging from equity long-short mutual funds to private capital vehicles with multi-year lockups, but asset managers are creative. Increasingly, semiliquid structures like interval funds³ and closed-end REITs are finding their way into the average investor's portfolio, while more creative solutions rely on lines of credit that can allow fund managers to handle redemptions without engaging in the forced liquidation of portfolio assets. In short, access and liquidity, two hurdles that have historically kept the average retail investor out of alternatives, are falling away for certain major alternatives categories.

We would expect that private equity, real assets and hedge funds will become increasingly prevalent in retail investor portfolios going forward, as they provide the alpha, income and diversification, respectively, that investors are looking for. Furthermore, with direct real estate finding its way into defined contribution retirement plan options, and the U.S. Department of Labor recently clearing a path for private equity to do the same,⁴ access looks set to become less of an issue going forward.

Broader access, increased flows - and new challenges

As alternatives are recognized as essential, accessibility for small to midsize institutions and retail investors improves and flows into the alternative investment universe swell, a new set of issues arises: Will alternative strategies and platforms be able to absorb these flows? And if they can, what are the likely implications for liquidity, transparency, fees - and alpha?

There is no obvious answer, and the transition from optional to essential will have different implications across alternative asset categories. On the positive side, increasing flows could mean deeper, more liquid markets and more pressure from investors for greater transparency. Mature and more core-like categories of alternatives (such as real assets) are generally more scalable than newer or non-core segments (such as differentiated or niche areas within alternative credit or hedge funds). Some of these less scalable core complements or return enhancers may not become mainstays of all investors' portfolios, as they are more susceptible to the crowding effect of large capital flows.

³ An interval fund is a type of closed-end fund with shares that do not trade on the secondary market. These funds periodically offer to buy back a percentage of outstanding shares at net asset value. They can provide retail investors with access to institutional grade alternative investments with relatively low minimums.

⁴ U.S. Department of Labor Information Letter 06-03-2020, Employee Benefits Security Administration, June 6, 2020.

A lesson learned from public markets is that the greater the scalability, the lower the potential for return and the lower the fees over time. However, when it comes to scalable alternatives this trend is likely to materialize only over the medium to long term, given conflicting forces. For example, within value-creation sectors like private equity, alpha generation gets harder when fundraising gets easier, but emerging market growth and technological innovation continue to provide opportunities to put funds to work. And for private core real assets, an acute investor demand for stable income sources is likely to drive increasing inflows; opportunities to earn the developed market public equity-like returns that core real assets can offer, with a preponderance of those returns from predictable income, are hard to come by in traditional fixed income markets. However, core real assets are omnipresent essential assets making up a multi-trillion dollar market, but they are still not an established component of many investor portfolios. Hence, return compression for these alternatives is likely to be a mid- to long-term phenomenon.

The bottom line is that all investors across the spectrum, from institutional to retail, will have to consider how increasing capital allocations will impact the characteristics of alternatives as we understand them today. Even with a larger opportunity set for investment than public markets have, alternatives may see enlarged flows lead to alpha and fee compression over time. However, with the premium over public markets for both income and capital appreciation currently greater than it has been for a number of years, the near-term potential for alternatives to deliver on alpha, income and diversification appears unchanged.

CONCLUDING REMARKS

Exercise. Smartphones. Online streaming services. Indoor plumbing. Once optional, now essential. For more than 50 years, institutional investors have enjoyed the option of adding alternative investments to their portfolios. Their ever-growing allocations, despite higher fees, liquidity constraints and manager performance dispersion, hinted that they were getting something in alternatives that wasn't readily available in the public markets. Whether in search of alpha, income or diversification, these investors now find themselves facing ever-fewer opportunities for these pursuits in the traditional asset classes. The optional has indeed become essential.

The rise of passive investing and stretched valuations in traditional markets, limited correlation benefits between fixed income and equities, and the likelihood of persistently low bond yields create an increasing urgency to add alternatives. Consequently, we expect rising alternative allocations over the next decade for investors of all stripes. Larger institutional investors will need to make way for small to midsize institutions and a fresh crop of retail investors as the alternative asset management industry invents new means for smaller-sized entities and more individuals to access the benefits of these asset classes - with positive potential repercussions in lower fees but perhaps negative ones in lower alpha.

The challenge for investors, then, is to ensure they are getting what they "pay" for when spending their precious fee, liquidity and risk budgets ... and not paying for what can be had elsewhere with less sacrifice. The operational intensity and complexity of many of these asset classes are substantially higher than for traditional investments, and tail risks are real. Manager skill, experience and track records, and the use of an alternatives asset allocation framework, are rarer commodities but also vital for success. In spite of the challenges, the alpha available from non-core real assets and private equity, the income from core real assets or alternative credit and the diversification from less macroeconomic-sensitive asset classes such as hedge funds have convinced investors resoundingly that the trade-offs inherent in alternative investing are worth it, particularly when the investment universe offers no alternative.

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LV-JPM52800 | 11/20 | US | 0903C02a829e6fa8