The new investment reality of more challenging markets requires long-term investors to cast a critical eye on their portfolios to ensure they are allocating their capital in the most risk- and fee-efficient ways. As the underlying drivers of risk-and-return are better understood, institutional investors recognize that alternatives play an increasingly important role in enhancing return potential, diversifying risk and providing downside protection. But as with other portfolio components, investors need to understand the distinct risk-and-return trade-offs that come with alternative investments, including liquidity and operational risks.
Moreover, in the same way that factor-based approaches are challenging traditional long-only active managers, long-short factor approaches are disrupting many hedge fund managers, requiring them to demonstrate their distinctive value-add. Still, a growing number of institutional investors recognize that alternatives have moved into the mainstream and will remain a critical building block in helping them achieve their long-term investment objectives.

**Fit For Purpose**

**Sizing the Appropriate Alternatives Portfolio**

Clearly the size and type of alternatives allocations will vary according to investment objectives: corporate DB plans close to full funding and wishing to defease their liabilities are likely to have less of an appetite for illiquid alternatives with extended lock-ups than, say, public pension plans or endowments and foundations with long-term, ongoing liabilities or spending plans. Also, we acknowledge that “alternatives” is a broad term for very differentiated asset classes and trading strategies that provide orthogonal exposures with complementary characteristics. When it comes to creating an alternatives portfolio, there is no one-size-fits-all approach.

Private equity, real estate, and hedge funds are the three largest alternative asset classes; PWC projects that together the three will comprise nearly 75 percent of overall alternative assets by 2020. Worldwide alternative assets under management reached a record of roughly $8 trillion as of year-end 2016, with private investments accounting for more than half of this total. Alternatives have enjoyed exponential growth in recent years, as investors have searched for incremental risk-and-return in a modest return environment. Figure 1 shows the targeted
allocations of more than 500 institutional investors surveyed by Prequin. While a notable, but diminishing portion of investors remain with minimal exposure, especially to private equity, we believe that the complexities related to manager sourcing, portfolio construction, and liquidity management will recede as barriers in this new investment reality. That said, liquidity management remains a crucial component of any alternatives allocation.

**GFC Lessons Learned**

**A Paradigm Shift in Liquidity**

One of the most dramatic lessons of the Global Financial Crisis (GFC) was a greater appreciation of liquidity risk during market shocks and the need to stress test portfolios for liquidity events. During the crisis we saw declining asset values along with private market alternatives that had capital commitments that spanned over a decade. The resulting denominator effect drove private market alternatives allocations much higher than the intended exposure, leaving portfolios less liquid and forcing some institutional investors to sell assets at distressed prices to fund portfolio liquidity needs.

Access to liquidity is not static. It is important to consider the liquidity of alternative investments and their underlying positions, specifically during periods of market duress. Allocations to the illiquid components of alternatives are and should be thought of as a long-term commitment of capital.

**Alternative Strategies**

**A Robust Opportunity Set**

By the latest count, public companies comprise just 0.1% of the more than 5.7 million total U.S. firms. Moreover, the number of listed US companies has declined by almost 50% over the last 20 years because of higher costs, greater regulatory burdens and other constraints. Private equity thus provides access to a vast opportunity set of less efficient markets. In our private equity investments, we expect to earn a return premium of 300 to 500 basis points over public markets. We expect that illiquidity premium to drift to the lower end of that range in the interim as public market returns move below trend and a surplus of market liquidity remains.

Real estate markets, meanwhile, remain relatively well supported by steady job growth, investors’ search for income, and low financing costs. Real assets like property may also provide investors with a measure of inflation protection and capital preservation. However, the distinctive attributes of individual properties and markets coupled with the risk of overpaying where prices...
have recovered since the global financial crisis highlight the need to work with managers who are well versed in local market conditions. Within public markets, hedge funds provide greater access to price dispersion and idiosyncratic trading. The rise of factor-based, long/short investing is poised to disrupt the traditional hedge fund industry. Factor-based hedge funds can capture a diversified range of systematic returns, while providing enhanced transparency, lower fees, and better liquidity than traditional hedge funds. Hedge fund managers that provide a differentiated, skill-based approach that cannot be easily systematized will continue to command a premium. Many hedge fund managers have struggled in recent years to deliver on their investment mandate. However, we believe that as we move into a more normalized monetary policy environment, higher return dispersions along with lower asset class correlations should provide a more supportive environment for hedge funds.

**Alternatives for Pension Plans**

Large pension plans are increasingly adopting a liability-driven approach that seeks to match the duration of their assets to the duration of their liabilities. As funded status increases, sponsors are switching their portfolios away from risk-seeking investments and towards risk-reducing ones. We believe it is important that the components of an alternatives portfolio span the liquidity risk spectrum to best address an investor’s risk-and-return objectives. For example, pension plans with a lower funded status and longer-term liabilities can use their long time horizon as an opportunity to capture the illiquidity premium with a meaningful allocation to private equity.

A lesson we learned from the GFC, which we apply to the pension plans we manage through our outsourced CIO business, is to assign a dollar target to illiquid investments; as plans de-risk, that dollar value is reduced. We then fund alternative allocations pro rata based on the component mix of risk-reducing and risk-seeking assets. This is an important shift from the traditional portfolio percentage approach and needs to be addressed when determining the appropriate size and mix of an alternatives portfolio.

Other institutional investors like endowments, foundations and sovereign institutions might have a much more diversified alternatives program across both liquid and illiquid investments with alternatives comprising 25% or more of their portfolios. For the three major alternatives categories, here are the issues we think investors should keep in mind:

**HEDGE FUNDS**
- Disruption caused by factor-based strategies is raising the bar on hedge fund managers to demonstrate their value-add, net of fees.
- Lower correlations should drive dispersion across securities, assets, and geographies
- Combining systematic and discretionary strategies for complementary exposures can produce a more capital-efficient hedge fund program

**REAL ESTATE**
- Important to diversify across the capital structure and geographic regions
- Provides long-term total returns and current income as investors search for yield in a low rate environment
- Offers lower duration than private equity

**PRIVATE EQUITY**
- Considerable “dry powder,” so it is important to consider valuations
- Important to be invested throughout the cycle, so diversify across sectors and vintages
- Work with strong management teams with experience across economic cycles
- Select managers that have access to a robust network to source deals
Alternatives Go Mainstream

We believe institutional investors will continue to need alternatives to augment public market returns and diversify away from public equity market risk. However, not all alternatives are created equal. Given the important role alternatives play in delivering non-correlated alpha and reducing portfolio risk, we think it is more important than ever to construct a durable, efficient, objectives-based alternatives portfolio.

Compensation for the illiquidity of private capital may ebb and flow. But for investors with long time horizons and known funding requirements, we believe exposure to the illiquidity premium, alpha opportunities and diversification benefits of private equity should be part of an alternatives portfolio.

Direct real estate investing is one of the oldest forms of alternative investments. Its characteristics of an attractive yield less tied to the direction of interest rates and purchasing power protection are as useful now as they have ever been.

HEDGE FUND DISRUPTION

The returns generated by many hedge funds are driven by well-established trading strategies that can be described as compensation for taking systematic exposure to alternative risk factors. These factors have attractive properties, including minimal market directionality and low correlation with traditional markets. Unlike long-only Smart Beta strategies, factor-based hedge funds express both long and short views in dynamic trading strategies. These factor-based strategies can complement discretionary hedge fund managers to provide investors with a hedge fund program that offers enhanced liquidity, greater transparency and overall lower fees.

Investors are increasingly allocating capital based on factors. According to a Citi survey of investors and intermediaries, primarily institutional, representing $935 billion of combined AUM, 81% of respondents are currently investing in, or looking to invest in, factor-based solutions, and 69% of respondents prefer to access factor-based strategies through a hedge fund vehicle. AUM in factor-based funds are projected to rise from $265 billion in 2014 to $1.2 trillion by the end of 2019 — making this the fastest growing product set in the asset management industry.

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Expected Factor-Based Investments in the Next 3 Years

- **86%** INCREASE
- **14%** MAINTAIN

Source: 2016 Citi Prime Finance Survey as of May 2016

State Street Global Advisors
Hedge funds will remain an important source of unconstrained access to public markets and downside risk protection. In our view, factor investing will disrupt a segment of the traditional hedge fund industry, while complementing discretionary hedge funds that provide true idiosyncratic alpha. The new paradigm for institutional investors will involve building more capital-efficient alternatives programs that are customized for their specific needs in a more transparent, fee-conscious and liquidity-aware format. 

“...We think it is more important than ever to construct a durable, efficient, objectives-based alternatives portfolio.”

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3 Joan Farre-Mensa, “Comparing the Cash Policies of Public and Private Firms,” SSRN, April 2014. NYSE and NASDAQ capitalizations were approximately $12 trillion and $5 trillion as of July 2012.  
4 Rayhunal Ibrahim, “The number of publicly traded US companies is down by 46% in the past two decades,” Yahoo News, August 8, 2016.  
5 2016 Citi Prime Finance Survey.  
6 Increasing Institutional Portfolio Complexity & the Resulting Shift from a Product to a Solutions Mindset, Citi Business Advisory, June 2015.
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* Assets under management were $2.6 trillion as of June 30, 2017. AUM reflects approx. $34 billion (as of June 30, 2017) with respect to which State Street Global Advisors Funds Distributors, LLC serves as marketing agent; State Street Global Advisors Funds Distributors, LLC and State Street Global Advisors are affiliated.

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