60/40ish

Speaker Key:

DP David Pett

KM Kevin McCreadie

JB Jane Buchan

BD Bill DeRoche

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00:00:00	DP	Alternative investments are expected to play a key role in shaping portfolio returns over the next decade, but their success will largely depend on how they are integrated with existing stock and bond holdings. On this episode of Inside Perspectives, Kevin McCreadie, AGF CEO and chief investment officer, discusses some of the nuances of allocating to alts with Jane Buchan, CEO of Martlet Asset Management, and Bill DeRoche, the head of AGFiQ Alternative Strategies.
00:00:34		I'm your host, David Pett. Let's get into it. Thanks everybody for being here. Bill, welcome back. And Jane, thank you for being here, your first time on the Inside Perspectives podcast. So, welcome. I want to start with a survey stat based on a Harris Poll from this time last year. It shows that 59% of respondents are interested in investing in alternatives, and that 44% want to do so primarily for diversification benefits.
00:01:03		Now, there's lots of surveys out there, but this tells me we've reached a stage where there is now widespread buy-in among investors towards alternatives. But here's a question for you. Once you've bought into the idea that alternatives can help improve portfolio outcomes, how do you decide

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		what and how many types of different alts are necessary and/or desired? Kevin, I'll start with you on that question.
00:01:27	KM	I think the question is really, what are you trying to achieve? And you loop that back into the how many. So, if you're only worried about one thing, let's say it was inflation, then maybe just think about real estate, or you think about real assets, something that's going to give you protection in the future. But then I think about where we are in this, the back half of this decade particularly, where we are going to worry about inflation. We're also going to have to worry about income. Think about where rates are today around the world. Historic lows, and they probably won't remain there. And then you also throw in the fact that equity markets are probably not going to give you what they just did in terms of return.
00:01:57		And you'll probably have a lot more volatility. So, you have to put in that equation. How do I think about hedging some of that risk? And then lastly is the return component to this, too. So, if you have now four things or four pieces on the table that you are trying to solve for, the answer is you need a lot. It's not one fund, one thing, one asset class within that large word alternatives that will get you to your answer, given the fact that we're starting with a number of problems to solve.
00:02:22	DP	And then Jane, maybe just to follow up on that. Is it your experience when dealing with clients that they are looking for more than one solution from that alts bucket, whether it's reducing portfolio volatility, or diversification, or searching out higher risk-adjusted returns? Or is it more of a, I'm looking for one single solution?
	JB	What I see is people tend to use several different alternatives. I think it's a mistake to group all alternatives together. The thing they have in common is that they're not traditional stock and bond investing.
00:02:52		But beyond that, they're very, very different. As Kevin mentioned, for example, if you're worried about inflation,

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		some of them will do well. If you're worried about [unclear] exposure to smaller companies, where you're directly involved in their non-private, private credit and private equity. If you're worried about smoothing out your return stream, a lot of people will use hedge funds. So, they have very different functions. And so, we tend to see a blend of alternatives.
00:03:19	DP	And then Bill, just a thought on that in terms of your perspective? When you're out there talking to clients, what are you seeing on that front?
	BD	I think it's very similar to what Jane and Kevin alluded to, in that depending on what the client is looking to achieve, there's such a wide range here. It's important to listen. I think the big thing is that there are so many different risks associated with these strategies that it's important to understand what actually is going to drive the returns.
00:03:47		And based on those client objectives, we hit on some of the big ones, such as inflation or income needs, then you're going to look for those risk attributes that fit the solution best.
	KM	The other thing. We start with these problems that we're trying to solve for. Each one of the underlying funds, even within the same category of an alternative, is going to give you something very different. And I think this is where you have to start to bring into the lens, how do they work together in a portfolio sense? How do they correlate?
00:04:14		Because you may not get what you think you are positioning for if you don't start to look at how they work together within a portfolio context. So, looking at them in isolation also doesn't help you.
	DP	It sounds like what you're saying is that not only do you have to worry about the correlation of the alt to your traditional 60/40 stock and bond allocation, but you got to look within that bucket, too.

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	KM	That's exactly right, David. I think what happens is too many people slice this and they don't look at how some of the pieces will work either in tandem… You're not getting what you really want, which is that non-correlated aspect to getting your returns.
00:04:49		And so, I think there's a risk management overlay that comes in here from investors. That's going to be very important, especially when you're trying to solve this many problems. But the classic ones I think about. If you think you're getting an inflation hedge by buying real estate only, and then you think about the fact when rates go up, what does that do to cap rates of real estate at the same time? So, there could be offsetting impacts. So, if you're not focused on how much you dial into each one of those sub-pieces and what the underlying fund itself may be doing, you could end up with something that you didn't think your outcome that you were trying to achieve.
00:05:19	JB	But I also think one of the things you have to be careful about is understanding why you're doing it and what your time horizon is. So, as Kevin rightly points out, over the short term, real estate can be very uncorrelated, particularly as rates move around, because of the cap rate problem, but maybe over two to three years the correlation improves. The same thing can be seen with private equity, where when you have short, stark, deep drops like 2008 and last year, you see very little mark to market.
00:05:52		But if you were to have a three-year bear market, you would definitely see mark-to-market returns with private equity. So, I think the time horizon is also important. I see a lot of issues where people don't think about it, and they think, in the short term, it's going to be very uncorrelated.
	BD	And just adding to that time horizon issue that Jane just brought up. We've mentioned that risk associated with these strategies tend to be much more stable. So, you can get a fairly good idea what an allocation might be, given your overall portfolio.

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00:06:24		But then you have to think a little bit about, tactically, what is the market telling me? And if we just look at, say, that 60/40 portfolio for an example, we know that equities right now are at multiples in the 90th or higher percentile. So, there has to be concern going forward that those expected returns associated with your equity portfolio are going to be diminished. And then when we look at fixed income, we also have the concern that yields are as low as they are.
00:06:54		You really can't forecast price appreciation there. So, both asset classes are looking at diminished returns. You add on top of that real yields are extremely low, which is typically what provides the hedging for the equity market. You may not be able to see that same level of hedge that you would typically get from your fixed income allocation. So, now you have to really think in terms of, tactically, over the shorter term, how do I basically replace that in my overall portfolio?
00:07:27	KM	I think that's an important point. We have a term in the industry we call risk parity, where we can own more equities but borrow money to put into bonds to offset that. So, if your equity market goes down, your bonds go up, and you kind of hedge yourself out. When you start out with rates this low, and if there is a prospect of higher inflation than we've been used to for decades here, that may not work in the future. So, I think the traditional ways that you can hedge are probably off size a little bit given where we're starting from on the real yield side.
00:07:53	DP	And given what we've talked about so far, I want to get into allocations, and if there's any sort of rule of thumb in terms of how much you should be putting into a specific alt, and then your alt bucket more generally. But I did want to talk about the due diligence that is involved in choosing an alt. From my perspective, it seems like this might be a little bit more involved than what some investors might be used to, that are in a 60/40 of stocks and bonds. Is that a fair comment? And perhaps the follow up to that is, what does the due diligence involve in some of these cases?

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00:08:24	JB	Yes. So, the due diligence is more extensive. And I think the easy way, at least the way I like to think about it, is that it's very well defined, relatively well defined, when you go, for example, into a small-cap growth fund, what you're going to see. But in alternatives, the words can have a variety of meanings, and many of these strategies are, at least on the micro level, more responsive to developments in the market, and so they can change quite a lot.
00:08:54		So, I think you have to look a little bit more behind the curtain. Having done due diligence literally on thousands of managers over my career, I break it down into the three Ps. People. Who are the people? You want to make certain that the people have a good, strong background, have done this before. You don't want them to learn on your capital. Process. What is their process? What are they taking advantage of? How do they think about it? And more importantly, how are they going to react to changing market environments?
00:09:24		And then finally, performance. But you need to equally weight it amongst those three areas, in my experience.
	KM	I think Jane is right. I think it comes down to those three Ps. And I'd throw a couple of other things in there, too. Not only did the instrument or the fund perform as you thought it would. It should perform in the market environment that it is. So, if you had something that is outperforming when it shouldn't, it may look on the headline that that's positive performance, when in fact it should've done something else, that is equally an issue.
00:09:54		So, I expand on the performance piece. Not only what it did in the past, but is it doing what you thought it should do in the environment that we're in? Because these are all going to look very different through different periods and different market regimes. So, I'd add that P to it as well. And I also think the operational side of the due diligence function is going to become more important, especially around some of the volatility that we expect to see in some of these

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		markets. So, I'd say, different than maybe two decades, operational due diligence plays a big role in this. Compliance is going to play a big role in that due diligence, in addition to just the people that you're investing with.
00:10:26	BD	And I'd just add that due diligence looks very different depending on what strategy you're looking at. If you're looking for a strategy that's going to reduce volatility, something that typically has a negative correlation to equities, the due diligence on something like that, say a gold fund or a real estate fund that's in the public markets, is going to be very different than the due diligence you're going to do on a private equity or private credit fund, where you need to look at who the people are a lot more.
00:10:56		What experience do they have dealing with private credit? And things along those lines. So, depending on that strategy, that due diligence effort will look very different.
	DP	Given your experience over the years, as the alternative space has developed and evolved, is there a sense or do you get the feeling that… You go from institutional right down to retail to a certain extent on this. But that the knowledge level has increased dramatically over the last few years in terms of the questions that need to be asked?
00:11:24		Or is there still some uncertainty in terms of they want to get involved with this, but they're not quite sure what they need to do or what's important on that front?
	JB	From my viewpoint, the knowledge level has increased dramatically, but also you see new opportunities. For example, the private credit market, which is very important today, and you see a lot of interesting opportunities because many banks have decided that they don't really want to be in the lending business. They don't like it, coming out of 2008.
00:11:54		So, there's a really good opportunity, but there's very little track record or experience prior to 2008. So, while the level is coming up in terms of knowledge, there are always new

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		opportunities that are coming along because of the market environment.
	KM	The upper end of the market, the classical, institutional investor, the largest pension plans, they have large in-house resources dedicated to this effort. Many of the larger retail platforms, so think of your major banks and their wealth management subsidiaries, they too have now beefed up in terms of their ability and capabilities there.
00:12:28		I think it's the small end of the market, the retail client, that sees it, hears it, but may not still understand it. But it's starting to become more mainstream, and I think that that's where there's probably an educational work set. But no question the level has been raised pretty dramatically over the last couple of decades, for sure.
	DP	Okay, let's spend a little bit of time on allocation. So, we've hinted at obviously the reasons and how you might go about choosing the right alternative for your portfolio. But how much are we talking here in terms of working within that 60/40 portfolio? Are we looking at 5% allocations, 10% allocations, 20% allocations? Any thoughts on that?
00:13:04	JB	Coming from the large institutional perspective, which is where most of my experience is, when I think about the whole panoply of alternatives, include things like infrastructure and real estate, it's very unusual to find somebody with less than 10%. And then some of the very sophisticated, large endowment, particularly some of the large university endowments in New England, may go up to 50%. But I'd say your large institutional investor, on average, is probably about 25% to 30% in alternatives.
00:13:35	KM	Jane mentioned the endowment model. And it became popular with David Swensen, the late David Swensen, at Yale. It was sometimes thought of as the Yale model. And they really did a deep dive risk management around the liquidity that they needed in the portfolio. They held very few bonds. And their thinking was that was a way to manage [inaudible] cash flows. But they really focused on the

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		liquidity. When they could think about capital calls on different fund settings. When would they model out when they would get capital back. And so, [unclear] that equation of how much.
00:14:05		They had a lot. As Jane said, upwards at times 50%, was really around how much liquidity they thought they had to provide from that portfolio. So, liquidity starts to enter into it because each of these vehicles will have different timeframes, gates, and lives. So, if you think about a private credit fund, it's four to seven years. You think about an infrastructure fund, it could be ten to 12 [inaudible]. So, all of that goes into this mix as well. We start to think about how much goes into that bucket, that large bucket of alternatives.
00:14:32	DP	And to that point. And maybe, Bill, you can answer this question. But to that point, I think a lot probably goes into, if I'm just starting out with this, to use the phrase baby steps, does it make sense to just choose one and go in lightly with maybe a less than 5% allocation? Get your feet wet and then develop the portfolio from there.
	BD	I was just going to touch on that. Many of the folks that I find myself talking to recently are new to the game. They're not large institutions.
00:15:01		If anything, some of the things I've noticed is that they're probably overallocated to equities. Their equity portfolio has run up dramatically, which is mostly good news for them. They're very concerned about allocating to fixed income for all the reasons that we just discussed. So, they're looking for other areas to allocate away from equity. So, those are the conversations we tend to have. And I agree with you that the baby step approach definitely makes some sense in terms of just listening to what they want.
00:15:30		For some of them, it's going to be hedging some of that left-tail risk associated with equities. I think it's still fresh in their mind in terms of what happened, say, back in February or March 2020. So, that's always something that they're looking

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		to do. And for others, it's just diversifying return stream away, whether it's adding some infrastructure or some real estate to the overall portfolio. But again, I think it's just getting them to make that first allocation away, because for many of them it will be the first time they've actually done that.
00:16:02	DP	And then, Kevin, maybe just a quick question. Because Bill raises an interesting point, and I have heard this. One of the challenges, if that's the right word, is that if you want to add alternatives, what bucket do you take it from? Do you take it from the equity bucket? Or do you take it from the fixed income bucket? Or do you take a little bit from both? Is there any thought on that front as to how you alleviate that concern for investors?
00:16:27	KM	Now, I'll answer it with my degree in economics, which is it depends. So, if you're thinking about your fixed income bucket, and I look at that as if I want to go into private credit, and in my fixed income, my public market fixed income, if I'm using corporate debt instruments, high-yield debt [inaudible] I may not want to duplicate that. So, that would be a natural for me as an alternative away from fixed income. A lot of these strategies will have equity [inaudible].
00:16:54		Certainly, as you go into private equity, if it's a real estate venture, there are things in the public side of the equity market that look like that. So, many of these will absolutely come from the equity side.
	DP	And one of the things that I wonder about is if you're adding a particular private credit to the alt bucket, instinctively, that might suggest to me that you should be taking away from perhaps your public credit exposure. Does it work like that? Is that too simplistic to look at it that way?
00:17:19	JB	Yes, it is too simplistic to look at it that way because there's a huge difference. Your public credit portfolio, you can sell those, and there's a pretty good market for it. When you're in a private credit, you've made a loan. Private credits are loans to businesses, and that business doesn't have to repay you until the loan says it has to repay you. Trying to sell that

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		can be very difficult and you can take a pretty large haircut.
00:17:45		So, one of the things that I like to do when I think about, seen in a lot of investment communities, when I think about alternatives, my favourite question to ask the manager is, where does your strategy struggle? Tell me when and where your strategy struggles. First rule of thumb, if they can't answer that question, run away, because that's not a good question. Nothing works perfectly all the time. And the second thing is to figure out where it struggles. And then I would take it from the bucket that struggles at the same time.
00:18:15		So, that's what I would do. It very much depends on what you could do. So, for example, private credit, I can think of people that lend very high up in the capital structure to just mum-and-pop businesses. Businesses where they want a loan of $20 million, and a bank really doesn't want to go through all the effort to underwrite that, that looks like a very different profile than doing a private credit deal in natural resources, where you're very low in the capital structure. It almost looks more like an equity.
00:18:43		And both those managers will use the word private credit, but that's why you need to ask the manager where it doesn't work. I like to do defensive asset allocation, which means I take it from a similar bucket on the downside.
	DP	I will ask one last question of all of you. This comes down to that point that Kevin's made, that we're going to get more access towards these down the chain, towards retail investors. But that access is going to be [unclear] the term that people use, and a lot of that is publicly listed.
00:19:10		So, if I'm looking at infrastructure as a retail investor who has probably their access is through listed infrastructure as opposed to private infrastructure, is there a danger of looking at how institutional investors are invested in

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		infrastructure and not recognising that they're two different things?
	KM	I think that there is going to be some broader use of all of these classes of alternatives. You'll see structure start to emerge that are going to be more evergreen. So, things like private credit will lend themselves to that more easily.
00:19:38		You will see some of those evergreen structures, mean that they're open on a regular basis for inflows and outflows, start to emerge in probably other asset classes that have traditionally been longer tail, like infrastructure. The thing about infrastructure. Publicly traded infrastructure will look very different than private infrastructure. You don't have the same mix of sub-assets in them. There are very few publicly traded, if any, airports today, whereas the private space has many. Not many publicly traded port systems that you can buy or access.
00:20:07		You can do it maybe through a [inaudible] company that is an asset manager that specialises, but those again are very few. So, I do think you have to be careful. You're going to get different things, even though the word may sound the same. The same goes for real estate. [Inaudible] that's publicly traded will look different, very different potentially, from a very specific private real estate fund, which will have a different mandate [?].
	JB	Also, some of that gets washed out, I'm thinking about the public versus private in real estate, some of that gets washed out over time horizons.
00:20:36		And so, it's important to look at a long time horizon and realise that if you use some of the public alternatives, you need to not overreact over a short-term mark to market and look at the longer-term trend.
	KM	I fully agree. And I think that's part of the education phase. That emerging class of investors who want to invest in these instruments are going to have to really get themselves up that curve because I think you're absolutely right.

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00:21:00	DP	So, just to put a finer point on that. The idea here is that as you get into the public side of things, the short-term volatility, there's going to be a little bit more than what perhaps would be expected on the private side. And it's a lot to do with the… With respect to rates, it would be the equity risk that's attached to that. So, you have to be very cognisant of that, I think, going forward, right?
	KM	Theoretically, if you walked down the street and every building had a flashing price tag on it, that was based on what people thought things were worth, in private real estate, to Jane's point, because it would be instantly priced, it wouldn't look very different than maybe the public markets because we don't value it that way.
00:21:33		It does look different in the shortest terms. But over the long term, it won't. Probably just add that I think that we're going to see this convergence of people wanting more in this large category called alternatives, and we're all going to need more of it because of the environment that we're about to go in. As I mentioned, with low rates being probably with us for some time. With inflation probably being higher than where we have probably been used to for the last certainly ten years plus. And you throw into that at the same time, as I've said, the ability to dampen some of the volatility that will occur as we start to normalise those first two, rates and inflation.
00:22:05		So, I think this decade is going to be an important place for investors to get that education. Probably get some of these vehicles into greater proportion in their portfolio than they've been used to.
	DP	Okay, let's end it with that. Thanks again to Bill and Jane for joining us. Kevin, until next time. For a full transcript of today's episode, visit agf.com/podcast. Don't forget to subscribe to hear more from us at Apple Podcasts, Spotify, Google Play Music, Stitcher, Podcast Addict, and Pocket Casts.

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