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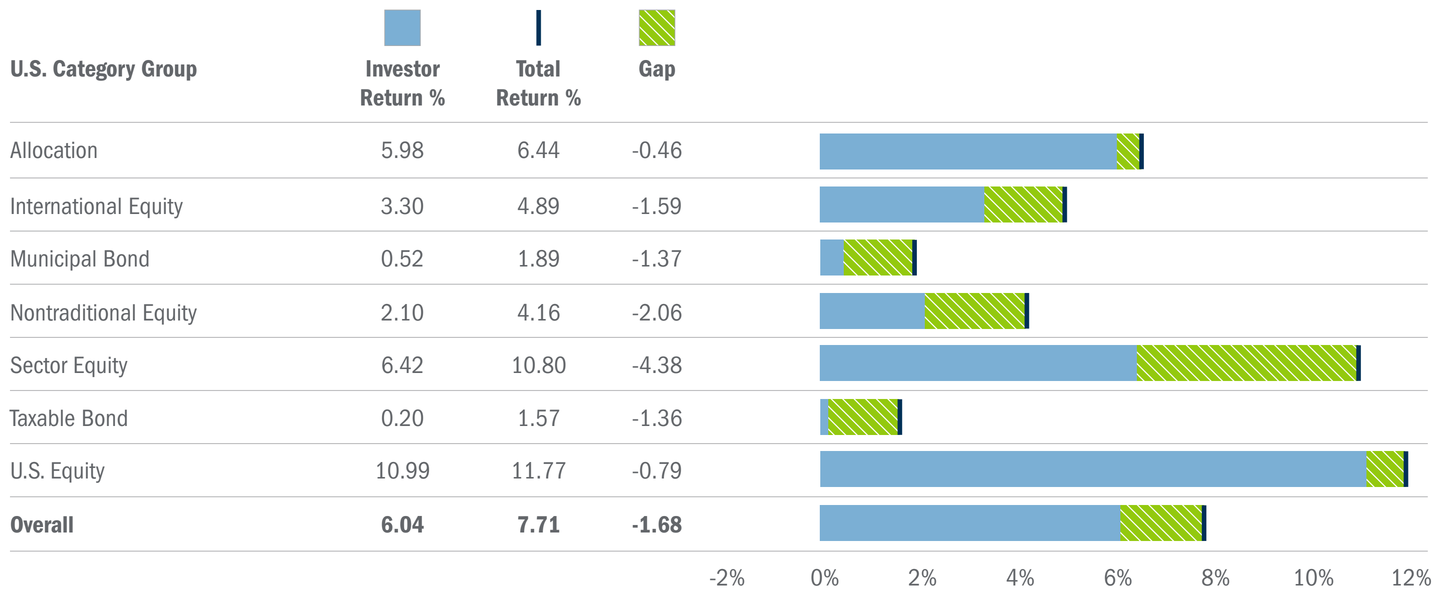
Do Semi–liquid Alternative Investments Belong in Your Portfolio?

BLUEROCK VANTAGE POINT

Many of us would like to consider ourselves typical investors that enjoy market returns. The reality is that many times emotions can take over, and we succumb to the urge to beat market returns. The results aren't usually good as this chart from Morningstar shows, given that actual investor returns are lower over the long term than the very same funds that they invest in. On average, investors underperform their own invested funds by about 1.7% per year, with even larger underperformance in certain investment categories.

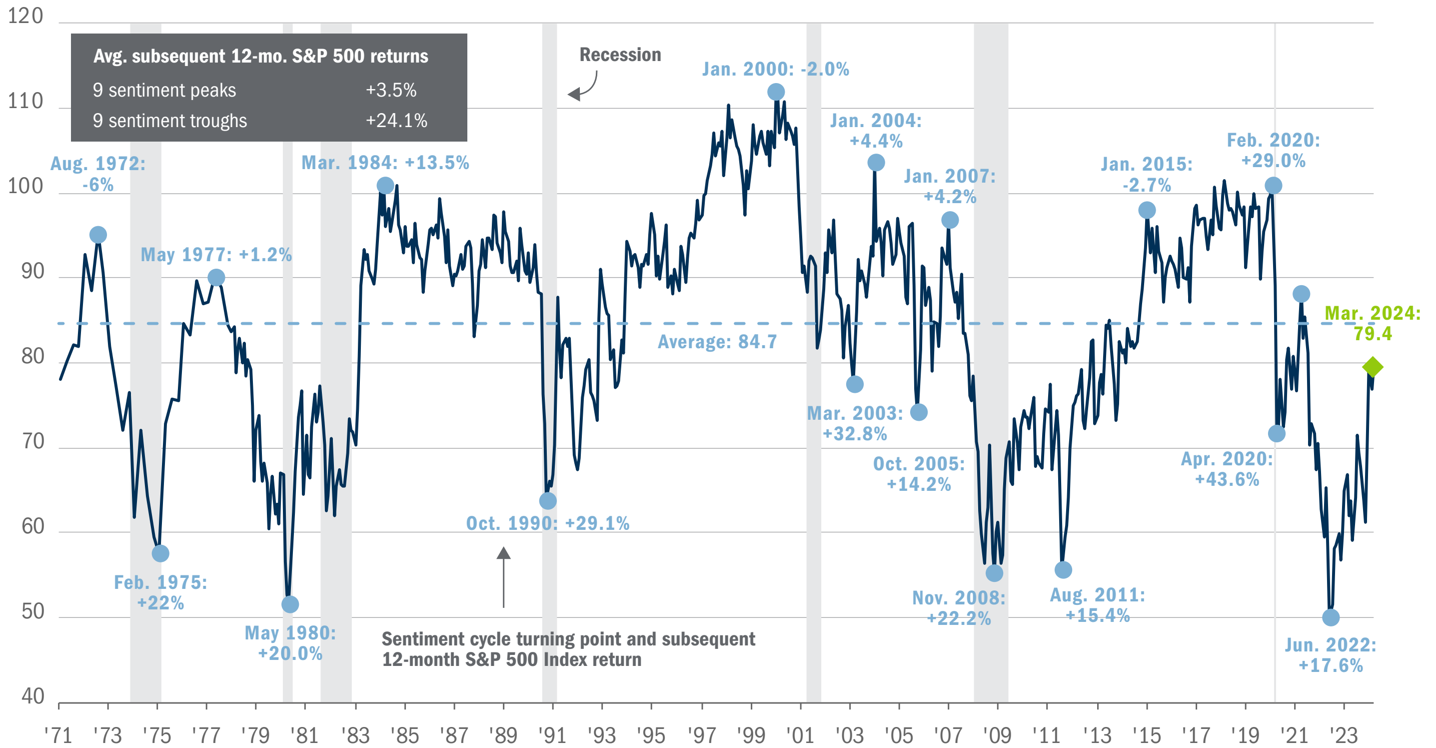
THE GAP BY U.S. CATEGORY GROUP (10-YEAR ANNUAL RETURNS)

The average dollar underperformed the average fund by about 1.7% per year



U.S. Category Group	Investor Return %	Total Return %	Gap
Allocation	5.98	6.44	-0.46
International Equity	3.30	4.89	-1.59
Municipal Bond	0.52	1.89	-1.37
Nontraditional Equity	2.10	4.16	-2.06
Sector Equity	6.42	10.80	-4.38
Taxable Bond	0.20	1.57	-1.36
U.S. Equity	10.99	11.77	-0.79
Overall	**6.04**	**7.71**	**-1.68**

But surely, the market as a whole must have some wisdom on economic conditions and valuations guiding their allocations? Not really. Take a look at historical consumer confidence levels and forward S&P 500 market returns. Overall sentiment seems pretty bad at forecasting market returns (with sentiment low point forward returns overall handily outperforming sentiment high point forward returns) which probably explains why average investors don't time markets very well.

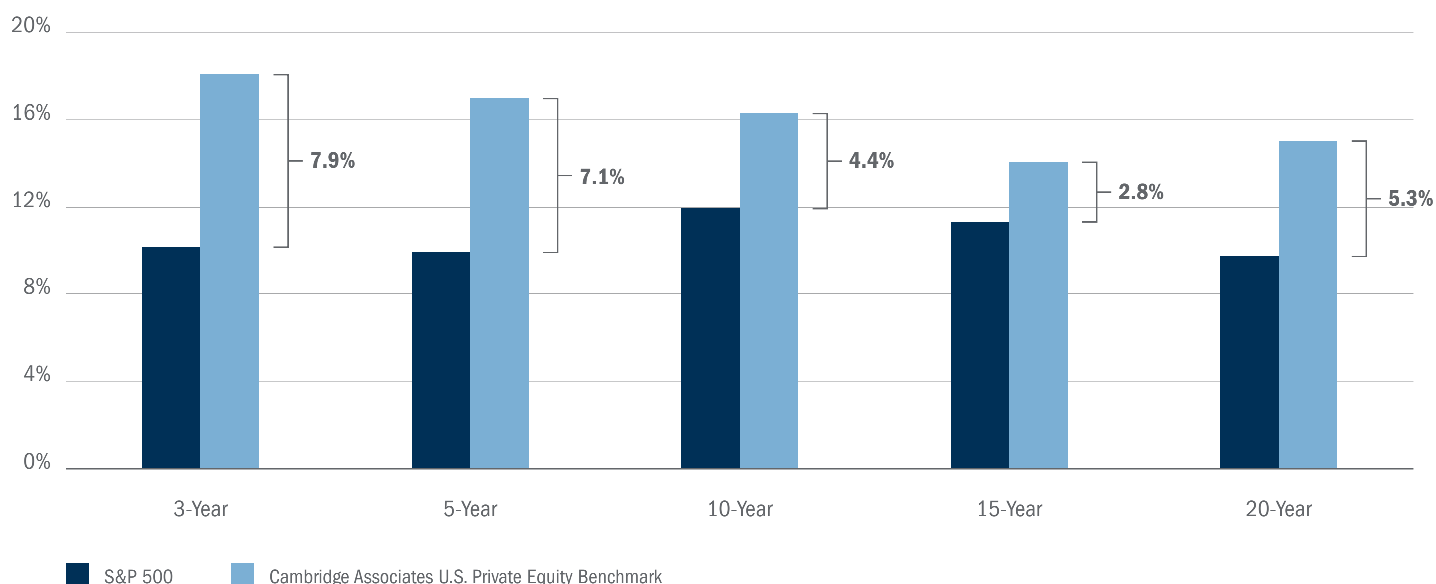


Source: JP Morgan Guide to the Markets, 3.31.2024

Of course, intraday liquidity allows and fosters this sort of market timing, but one question we should ask ourselves as investors is how much liquidity we truly need and how liquid do all our investments need to be? Could we achieve better results with less liquidity?

Years ago, institutional investors, like the Yale Endowment, heavily reallocated to alternatives like private equity, private real estate, and private credit. With a long-term outlook and a focus on overlooked asset classes (due to lack of daily liquidity), the Endowment outperformed its peers for many years. Many other pensions and endowments followed, and the average alternatives allocation of these groups increased to approximately 40% (Institutional Investor, 2019). As the investment management industry brought such alternatives to individual investors, there has been solid adoption, but still plenty of reluctance and misunderstanding.

Liquidity can be a double-edged sword and the lack of daily liquidity scares away enough people to create what has been known as the illiquidity premium, which is the concept that less liquid investments may outperform over long periods of time. Furthermore, investments can sometimes be managed more productively without a need for short-term results. Consider data from Cambridge Associates comparing S&P 500 performance to private equity over multiple periods as evidence of the illiquidity premium.



More individual investors have adopted semi-liquid alternatives in their portfolios, but retail investment in alternatives still only averages 2% of overall investment portfolios. Traditional managers as well as RIAs, independent broker-dealers, and wirehouses have taken note. Consider this imperative from Morgan Stanley's head of alternatives.

Morgan Stanley's global investment committee recommends that alts like private equity, credit and real estate should make up anywhere from 10% to 25% of portfolios. "And today at Morgan Stanley, it's much below that mark," she said. "So we think that there's a really rich opportunity here to increase our client penetration levels and to really grow that business because we certainly view it as a differentiator for us."

Long-term investment planning and prudent portfolio allocations in a variety of investments that span the liquidity spectrum can help in meeting investors' overall liquidity needs. Additionally, less liquidity can help resist the temptation to market time and ultimately create a smarter, more successful portfolio.

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