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Diversify now? Making the case for alternative assets

Aon's Jeffrey Malluck, senior investment consultant, explores how investors can diversify their portfolio through investment in alternative assets

What is driving interest in alternative assets among institutions?

Equity and credit markets have performed well over the past 10 years. However, the current macro-political environment poses a number of risks to investors. The expectation is that equity and credit markets are likely to experience increased volatility with the potential for further short-lived sell-offs before a larger downturn. Diversification can lower portfolio volatility and enhance return. Allocating to alternative assets, which are typically less correlated to traditional markets, can help achieve this.

A key problem is that with high equity valuations, particularly in the US market, it does not take much to disappoint expectations. This was apparent in Q4 2018 as global equity markets fell significantly on the back of US/China trade concerns, higher interest rate expectations, slower global economic momentum and global political uncertainty. Global equity markets, as measured by the MSCI World Index, had their first negative calendar year performance since 2011.

Now in 2019, continued market sensitivity to news-flow and data releases suggests that further surges in market volatility would not be surprising. In recent years, equities have been well-supported as a result of low bond yields, so market sensitivity to an upward break in bond yields remains a risk.
Credit spreads (the higher yield from corporate bonds over government bonds) have also fallen to tight levels as a result of the favourable corporate and economic backdrop, quantitative easing and a move to ultra-low policy interest rates. Investors can diversify and help lower the risk of adverse market conditions to their portfolio through investing in assets or strategies with returns which are uncorrelated with traditional assets.

Which assets are proving popular?

Institutional investors are increasingly showing appetite to commit to less liquid alternatives. Illiquid assets can provide an attractive level of return which is driven primarily from income. These strategies can be used as part of a de-risking journey or as a source of generating additional return. Examples include:

Global property

An allocation to global real estate enhances the stability of income in a real estate portfolio and can provide a cushion against country-specific risks. This risk is aptly illustrated by the lower return expectations of UK real estate during Brexit uncertainty. Lower risk strategies focussed on the core/core-plus end of the market could be expected to deliver returns of 6% to 8% p.a. Higher risk value add strategies would typically target returns in the mid to low teens.

UK pension schemes have diversified their equity and fixed income allocations globally but have tended to retain a home bias when it comes to their property allocation. We view favourably allocations to global real estate.

Bank capital relief

Enables a bank to use capital markets to lay off some of its risk by buying credit protection on a portfolio of loans. This helps banks to achieve their regulatory capital requirements by essentially 'insuring' a portion of the risk associated with that portfolio, thereby reducing the amount of regulatory capital they are required to hold on their balance sheet. This type of transaction allows the bank to reduce its credit risk without having to sell assets or reduce its lending activity. A bank is therefore often willing to pay a significant premium since the impact on its return on equity can be substantial. Target returns for these strategies are typically 8% to 11%.

Direct lending

A form of corporate lending typically made to small and medium-sized enterprises (SMEs). Loans are typically secured on company assets and investor returns primarily comprise a margin above cash and arrangement fees. Target returns for these strategies are typically 6% to 10%.

Property debt

A loan secured against a property and its underlying income stream. The interest on the loan is paid out of the rent from tenants. If the property company cannot pay the interest on the loan, the underlying properties may be sold to repay the loan. The loans often attract arrangement fees. Some are structured so that the lender benefits if the underlying properties rise in value, which is particularly attractive when there is the potential for redevelopments/refurbishments. Returns can range from mid-low single digits to low-double digits, depending on the security.

Global infrastructure

The fundamental systems and assets needed for the operation of an economy. The capital provided for these projects was historically publicly funded but since the 2008 financial crisis, government debt has ballooned to levels where there is insufficient public funding for all infrastructure projects. Private investors can access a large opportunity set within the infrastructure universe that includes a wide range of assets and strategies. For institutional investors, infrastructure has a number of desirable characteristics including cash-flow generation (some of which can have inflation linkage), low correlation to traditional asset classes and attractive risk-return characteristics. Returns are typically 10% to 15%.

What should investors look for when selecting an alternatives investment manager?

Due to the specialisation of these alternative strategies, manager selection is critical when making an allocation. We have a preference for managers that have raised previous funds as it allows investors to analyse historical performance. In addition, we prefer managers with an experienced and well-resourced team, strong sourcing and workout capabilities and where managers are aligned with investors.
Investors have a range of ways to implement these strategies. From multi-manager approaches, which could be a fund of funds, or by developing their own portfolio; to multi-asset single funds or a single-idea approach.

With much uncertainty heading into 2019, the year ahead could be quite a bumpy ride for investors.
To mitigate and manage this risk we would encourage investors to continue to diversify and look further afield than the traditional asset classes.

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