For investors willing and able to bear the unique risks of investing in alternative assets, CIO thinks exposure to the asset class in a well-diversified portfolio can help navigate a shifting backdrop. (UBS)

How alternatives can help navigate a choppy end to the year

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Our fourth-quarter outlook suggested the final months of 2024 would be driven by rates, the US election, and volatility. Early October trading has borne this out.

A stronger-than-anticipated ADP report for US private payrolls in September (143,000 jobs growth versus consensus' 125,000 forecast) bucked a five-month slowing trend. US Treasury yields have rebounded by 12 basis points to 3.85% since dropping earlier in the week, on Israel's first ground offensive in Lebanon since 2006 and Iran's missile launches on Israel, which led to a bid for perceived safe-haven assets. The S&P 500 Index fell just 0.2% on 3 October, while the VIX Index of US implied equity volatility rose to 20.4 to record a 30% jump in five days. This implies choppy US stock conditions ahead. And we expect more pronounced market swings as the US election enters its final stages (and especially as roughly 80% of S&P 500 companies report third-quarter earnings by 5 November).

But for investors willing and able to bear the unique risks of investing in alternative assets, we think exposure to the asset class in a well-diversified portfolio can help navigate a shifting backdrop:

Private equity and infrastructure can help investors diversify exposure to public equity markets. Private equity offers access to companies that are often not available in public markets. We expect private equity to deliver around 11% annual returns (after fees) over a full business cycle, according to our capital market assumptions, around 2.5 percentage points higher than our expectation for publicly listed equities.

Infrastructure assets may benefit from the global rate-cutting cycle, thanks to a reduced cost of capital and higher present values of future cash flows. We also believe the asset class can offer diversification benefits, with correlations ranging from -0.2 to +0.6 with other asset classes, based on our analysis of Cambridge Associates and Bloomberg data.

Private credit can offer an attractive alternative source of portfolio income. Private credit remains a potentially attractive addition to long-term portfolios, especially senior upper-middle-market and sponsor-backed loans that have been relatively resilient to rising defaults. The overall asset class currently offers yields of around 11%, based on JP Morgan data. Lower interest rates should reduce the floating return component in private loans and should reduce credit losses as financing costs fall. We expect high-single-digit to low-double-digit returns for 2024 and 2025 and also believe private debt will still offer higher yields than listed fixed income peers. Also, private credit has historically exhibited lower volatility than conventional credit and typically benefits from strong covenants and diversified borrower bases.

Hedge funds with low correlations to traditional assets can help reduce overall portfolio volatility. Hedge funds that employ strategies like equity market-neutral (EMN), global macro, and multi-strategy platforms are designed to take advantage of market inefficiencies, price dislocations, and macroeconomic shifts. These types of strategies may be less sensitive to general market movements, potentially delivering steadier returns regardless of market direction.

CIO analysis shows that adding around 10% of equity market-neutral hedge funds to a global 60% equity/40% bond portfolio can deliver comparable expected annual returns but would lower expected annual volatility by roughly one to three percentage points, based on Bloomberg data since 1990.

So, we believe investors looking to insulate portfolios against greater turbulence may benefit from considering or reviewing their alternatives allocation or constructing a plan to build an allocation for the first time. Investors should be mindful of the risks of investing in alternatives, including illiquidity, leverage, long lockup periods, and transparency.

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