Alternatives: Top questions answered

UBS House View Briefcases

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Should investors look at asset-based finance?

Key message

Asset-based finance has historically been dominated by institutional investors. Private investors may have been put off by perceived complexity and memories of the global financial crisis. But we think asset-based finance has a role to play in portfolios as a fresh source of income, potential diversifier, and a beneficiary of enhanced investor protections. Investors should consider the risks of this alternative strategy and its role as part of a financial plan.

House view

01 Asset-based finance has historically not been on private investors' radars.

- Private asset-based finance (ABF), an estimated USD 5tr market, involves making less liquid loans against the cash flows of various assets.
- ABF can be complex and illiquid, given the wide range of assets used as collateral and the bundling of assets in a process known as securitization.
- Some investors shunned ABF given the role of certain mortgage-backed securities during the global financial crisis.

02 But we think ABF has a role to play in long-term portfolios.

- ABF can offer appealing risk-adjusted returns, with average annualized fund performance ranging from 6% to more than 15% a year.
- These private loans often have more robust investor protections —like stricter covenants and more collateral—than other forms of fixed income.
- Private ABF can be a portfolio diversifier, with an average long-term return correlation of 0.48 to US investment-grade debt and 0.58 to private direct lending.

03 We advocate using active risk management to access this asset class.

- We think experienced managers are best placed to understand the opportunities and risks of different underlying assets (from car loans to music royalities).
- Investors should be aware of the risks of private ABF investing, which can include credit, illiquidity, and prepayment risks.

New this month

The International Chamber of Commerce Banking Commission's Trade Register report recently forecast an annual rise in trade and supply chain finance revenue of 3.8% until 2032, with increased digitalization potentially spurring more activity including securitization in this field.

One liner

We think asset-based finance offers fresh opportunities for income and diversification, subject to careful risk management.

Did you know?

- Private ABF has grown as stricter regulation limited banks' willingness and ability to lend to some borrowers.
- The primary driver of private ABF returns is income. Many managers pay out income streams of between 4% and 10% per year. Returns primarily come from the interest and principal payments on the underlying asset classes, such as loans, leases, receivables or royalties.
- While prime sectors continue to show strength in February 2024, delinquencies in non-prime areas have increased, particularly in the mortgage and auto loan sectors. However, we note that overall pricing and returns for this diverse sector should contain default risks for well-diversified investors.

Investment view

We like asset-based finance as a potential diversifier and source of alternative risk-adjusted returns. It should, however, be noted that managers' performance can differ widely due to differences in expertise, risk management strategies, asset selection, and diversification, underlining the importance of manager selection.

Can private equity overcome recent headwinds?

Key message

Private equity funds faced several challenges going into 2024. But headwinds from high interest rates, lower transaction activity, and a record USD 2.6tr in dry powder may fade. We see opportunities in top private equity funds, an allocation to which can improve the long-term risk-return outlook for portfolios subject to managing certain risks. Investors should consider the risks inherent to private markets before investing, including illiquidity, long lockup periods, leverage, and overconcentration.

House view

01 **Private equity funds face several key challenges going into 2024.**

- Elevated interest rates increase the cost of borrowing, an important component of private equity deal making.
- Weak transaction activity has made it harder to exit past deals, leaving the industry with a record USD 2.8tr in unsold investments, according to Bain & Co.
- Funds are sitting on a record USD 2.6tr in dry powder for deals, as of 15 December, according to S&P Global Market Intelligence.

02 **But these headwinds look likely to fade in 2024, with plenty of opportunities for strong returns.**

- The price of many acquisition targets has become more attractive due to recent headwinds. Opportunities have increased as companies seek to sell non-core operations.
- Rate cuts from the Fed, combined with a soft economic landing, should help restart dealmaking in 2024.
- While dry powder is at a record in dollar terms, relative to assets under management it is below the historical average. So, we don't see a glut of cash chasing too few deals.

03 **So, investors should continue to allocate selectively to top funds.**

- In the current environment, we favor funds with a strong record of boosting operational performance, along with funds exposed to strong secular trends.
- We have also seen sharper price declines in the valuations of middle-sized companies, creating greater opportunities. Investors should also consider adding exposure to secondaries.

New this month

EQT, the private equity group, could be set to relaunch plans for an initial public offering of dematology firm Galderma, with a valuation of around USD 20bn, according to a report by the Financial Times on 5 February. If confirmed, that would make it one of the largest European IPOs in recent years, kindling hopes that the offering market in the region could be reviving after a notable lull last year. EQT did not comment on the report.

One liner

We see a range of attractive opportunities in private equity, especially managers skilled at transforming companies and identifying the next generation of disruptors.

Did you know?

- A combination of slow global dealmaking and a weak public offering market meant that the number of private equity exit transactions last quarter was close to the lowest level in a decade, according to consultancy Bain & Co.
- Despite hitting record highs, current dry powder represents 27% of total assets under management, well below historical averages. Importantly, 50% of current dry powder was raised within the last two years and 70% within the last three. This suggests managers still have plenty of time to find opportunities.

Investment view

The headwinds for private equity can be overcome, in our view. We do not expect returns to be undermined by a glut of capital chasing too few deals. But investors should be selective. We see the greatest potential in funds with strong track records in operational upgrades, identifying high growth companies, and picking up secondaries at a discount. We think adding private equity to traditional portfolios can both improve investors' long-term risk-return outlooks, while diversifying sources of return.

Do hedge funds make portfolios more or less risky?

Key message

Hedge funds are seen as too risky by some. Investors must be able to bear certain risks not always experienced in stocks and bonds. But adding hedge funds to a portfolio can reduce risks to overall wealth. Hedge funds can help smooth portfolio returns, add diversification, and grant access to parts of the market that are often off limits to many investors. Certain hedge fund strategies are also well-placed to outperform in market downturns. We see the best current opportunities in macro, multi-strategy, and credit funds.

House view

01 **Hedge funds come with a range of potential pitfalls, which need to be understood and managed.**

- Hedge fund strategies that invest in illiquid assets, such as distressed debt, can limit investors' access to their money in a fund for 1–3 years.
- Hedge funds often don't share details of their strategy, making funds less transparent to investors.
- Complexity is an additional risk, with some strategies using more exotic instruments that individual investors may not understand.

02 **But savvy hedge fund investing can smooth returns and add new sources of return.**

- Some strategies, like macro funds, can make money even in falling markets, dampening swings in portoflios.
- Hedge funds can add sources of return beyond public bonds and stocks, while manager skill can help beat major indexes (or "generate alpha").
- Holding a collection of hedge fund approaches—including multi-strategy funds—can help investors avoid over-concentration and achieve diversification.

03 **So, we think the asset class can play a positive role in portfolios, both now and in the years to come.**

- With 2024 likely a year of elevated economic and political uncertainty, macro and multi-strategy funds are well-placed to exploit shifting market conditions.
- Elevated debt levels and interest rates above pre-pandemic levels create opportunities for credit funds that take advantage of mispricing between stronger and weaker borrowers.

New this month

The VIX index of implied US stock volatility stood at 13.4 as of 12 February, well below the average of close to 20 since its inception in 1990. This suggests investors are relatively sanguine about the potential for large market shifts in coming months.

One liner

We think hedge funds are powerful tools for managing risk and diversifying sources of return.

Did you know?

- The ease of selling a hedge fund (its liquidity) depends on how the manager invests. Funds working with more liquid securities (like Commodity Trading Advisors), may offer investors easier access to their funds than distressed debt funds or event-driven funds—which operate in less liquid instruments.
- Select hedge fund strategies can outperform in hostile market conditions. Between 2000 and 2002, the bursting of the "dot com bubble" led to a 47% fall for the MSCI All Country World Index. Equity market neutral funds lost just 0.4% and merger arbitrage 0.8% in the same period, based on Bloomberg and HFR data.
- A 20% addition of equity hedge fund substitutes to a 60/40 portfolio would have lowered portfolio swings with little change in returns between 2000 and 2022. This smoothing can result in swifter compounding of returns and higher wealth over long time horizons.

Investment view

Within hedge funds, we particularly like specialist credit hedge fund strategies. Discretionary macro funds and multi-strategy funds have proven resilient during crisis periods. Investors should understand the inherent risks of hedge funds, including illiquidity, lack of transparency, and use of leverage.

Will rate cuts revitalize private real assets?

Key message

Private real assets—investments in physical things like real estate and infrastructure—faced some challenges in 2023. Lower interest rates in 2024 may offer some relief to the sector. We like opportunities in areas linked to digitalization and decarbonization. Private real assets can improve the long-term risk-return outlook for portfolios, in our view, subject to managing certain risks.

House view

01 **Private real assets faced some challenges in 2023.**

- Higher borrowing costs hurt performance of some private real asset strategies last year, as many rely on debt to build and maintain assets.
- Global direct real estate investment stood at around USD 423bn for the year to end third quarter of 2023, according to JLL, a 50% year-on-year decrease and the lowest level of transaction activity in over a decade.
- The office sector faced particular problems with loan losses and lower demand for old assets.

02 **Lower interest rates this year may help private infrastructure and real estate.**

- Looser financial conditions and lower interest rates could provide better capital appreciation prospects in 2024.
- While we do expect global growth to moderate this year, we also see scope for select rental income growth in real assets.
- We favor a selective approach to private real assets, focused on quality assets with a good longer-term outlook.

03 **Digitalization and broader AI use favor exposure to data center assets.**

- The digital data universe is expected to grow more than sevenfold between 2020 and 2030, according to IDC, EMC, and Bloomberg Intelligence.
- Demand exceeds supply for hyperscale data centers—which house computer and infrastructure for cloud computing providers—with a 3% vacancy rate in 2022, according to ULI/pwc.
- We have a most preferred view on data center assets in the US, UK, mainland China, and Singapore in our global real estate strategy.

New this month

Markets are implying a roughly 50% chance that the Fed will start cutting rates at its March policy meeting, as of 29 January, according to CME's FedWatch Tool. That is down from 73% a month before.

One liner

We like select private real estate and infrastructure assets, especially those tied to long-term trends.

Did you know?

- The hyperscale market is the fastest-growing part of the global data center sector, with a 5-year compound annual growth rate of 22.6%, according to the Structure Research Global Colocation Report (February 2023).
- Emerging Asia needs to invest USD 1.7tr in infrastructure each year from 2016 to 2030 to remain competitive, according to the Asian Development Bank.

Investment view

We are selective on the real estate market, maintaining a focus on quality and resilience. Fundamentals in the industrial, logistics, and multifamily sectors are sound, in our view, supported by favorable trends such as e-commerce and demographics. Infrastructure can help investors grow their wealth, diversify portfolio returns, and better match long-term liabilities to assets. We see value in well-diversified private market vehicles. While infrastructure investments are typically long term and subject to illiquidity and longer breakeven periods than other private markets, they may also improve the long-term risk-return profile of a portfolio.

Should investors fear losses in private credit?

Key message

Some investors fear private credit will see a rise in defaults and losses in 2024, as prior rate hikes weigh on company cash flows. But we think the asset class can weather trickier times, thanks to private managers' ability to choose the most resilient creditors. We think near-term challenges warrant careful investing. Yet the long-term case for private credit as a diversifier and potential improver of a portfolio's risk-return characteristics remains intact, subject to awareness of the risks.

House view

01 Some investors fear higher defaults and losses in private credit in 2024.

- Lagged effects of interest rate rises have led investors to worry that private credit assets may experience more defaults or losses.
- Rising default rates in the US syndicated loans market have led some private credit managers to use payment-in-kind interest to mitigate losses.

02 But manager focus on the most resilient creditors can reduce risks for investors.

- Private credit managers tend to favor senior secured debt that is among the most insulated from company losses.
- New loans offer attractive yields. The median private credit transaction at end December originated at an all-in spread (additional yield over benchmark interest rates) of 600bps and a yield-to-maturity of 11.7% on an unlevered basis, based on JPMorgan data.
- Many managers are focused on lending to sectors that are less sensitive to growth, generate more cash flow, and need less capital investment—cybersoftware is just one example.

03 So, we think long-term opportunities in private credit outweigh near-term challenges.

- We continue to see a place for private credit and direct lending strategies as a strategic source of income in well-diversified portfolios.
- Investors should consider the risks inherent to private markets before investing, including illiquidity, long lockup periods, leverage, and overconcentration.

New this month

Recently released data from LCD showed 2023 was a busy year for private direct lenders supporting take-private deals in Europe. Public-to-private transactions accounted for 41% of European syndicated leveraged loan buyout volume last year, the second-highest annual percentage share ever.

One liner

The best private credit managers have navigated higher defaults and losses before—and still deliver interesting long-term returns for investors.

Did you know?

- Newly originated private loan data show financial sponsors are using less debt than in 2021, while putting in more equity relative to debt in leveraged buyout transactions than at any time since 1997.
- Many private loans are provided to deals sponsored by private equity houses. The latter offer operational expertise (like global provisioning to lower portfolio companies' costs of buying materials), additional due diligence, and considerable equity to reduce debtors' risks and provide a cushion in shakier economic conditions.

Investment view

We believe existing private credit investors in well-diversified funds, run by experienced managers, should be suitably compensated in terms of yields, investor protection, and stricter terms on new loans to offset potential losses elsewhere. We continue to see a place for private credit and direct lending strategies as a strategic source of income, diversifier of returns, and potential improver of a well-diversified portfolio's long-term risk-return characteristics, subject to awareness and management of the risks.

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Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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