ALLOCATING TO ALTERNATIVES

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Although private investments and hedge funds are both alternative investments, they have very different roles in a portfolio. Private investments can enhance portfolio returns,[1] whereas select hedge fund strategies can diversify portfolio risk.[2] Together, they can improve the risk-adjusted return of a portfolio — i.e., its efficiency ratio, defined as the portfolio's expected return divided by its risk (standard deviation). Private investments can increase the numerator of the efficiency ratio by boosting the portfolio's expected return. Select hedge fund strategies can reduce the denominator of the efficiency ratio by reducing the portfolio's risk through uncorrelated (diversifying) returns.

These benefits largely come from alpha (risk-adjusted excess return), so capturing them requires bearing some illiquidity and active risk. It is common for investors to seek alpha by hiring active managers in public equity, but there is no evidence of manager skill net of expenses in public equity.[3] In contrast, the opportunity set for alpha is far greater in alternative investments — particularly private investments. And capturing alpha from alternative investments benefits the portfolio's risk-adjusted return far more (and far more reliably) than capturing alpha from public equity. So spend your active risk budget — your appetite to hire active investment managers — on alternative investments. And consider low-cost, passive implementation for traditional stocks and bonds.

Asset allocation is the most important decision in portfolio construction. If assets serve the purpose of funding lifetime goals, then the optimal asset allocation solution must incorporate both assets and goals. The standard 60% stock/40% bond portfolio and its variants are increasingly being replaced by customized goal-aligned portfolios, composed of dynamic allocations to risk-control (goal-hedging) and risk-asset (return-seeking) sub-portfolios. As part of risk-asset sub-portfolios, alternative investments can improve the funding of partially hedged and unhedged goals. Private investments, through return enhancement, can decrease the present value needed to fund future goals. Select hedge fund strategies, through risk diversification, can decrease the dispersion (risk) in future goal-funding outcomes

1 See "Increase Portfolio Returns with Private Investments," Northern Trust Research Article (2021)

2 See "Diversify with Select Hedge Fund Strategies – Revisited," Northern Trust Research Article (2021)

3 See "Manager Performance and Persistence," Northern Trust Research Article (2022)

The market portfolio of capital assets is a good benchmark for asset allocation as it captures the collective decision-making of all asset allocators.[4] To determine the recommended mix of alternative investments within risk-asset sub-portfolios, we look to relative equilibrium market weights as a good starting point. From there, we find an "optimal" weight based on a combination of Northern Trust (pre-tax) capital market assumptions and an active risk budget as seen in Exhibit 1:

EXHIBIT 1: ALLOCATION TO ALTERNATIVE INVESTMENTS

Asset Category	Market Weight (%)	Optimal Weight (%)	Maximum Weight (%)
Private Investments	13	17	27
Hedge Funds	5	5	15

For suitable investors, the risk-asset model has flexibility to further increase alternative investment allocations within a risk-constrained maximum range. Higher allocations to alternatives generally start with private investments because of higher return potential and a larger opportunity set for alpha. But a portion of expected return enhancement is compensation for illiquidity, a primary risk to goal funding, so oversized allocations to private investments are more appropriate for investors with long-term goals, significant wealth transfers or large surplus assets. Successful goal funding also requires having sufficient cash on hand at the necessary time. Select hedge funds can provide diversifying sources of return to reduce volatility and make final payouts more certain for nearer term goals.

While hedge funds tend to be fairly liquid with relatively straightforward implementation, the funding of private investments through closed-end funds tends to present unique considerations. In addition to the typical diversification considerations within balanced portfolios (e.g., by asset class, geography, manager, etc.) private investment programs should also account for vintage year diversification as there can be a wide dispersion of returns from vintage to vintage (even when selecting top performers within a given vintage). Therefore investors should be mindful of not only selecting quality managers, which has proven to be critical in delivering good outcomes, but also deciding when to make commitments.

After capital is committed to a closed-end fund, the manager is typically required to deploy the fund's capital within an investment period of a few years and must ultimately exit the fund's investments by the end of a finite period (or term). But the manager is subject to unknown market conditions, into which they must invest and which they must ultimately exit, to realize returns. And market timing can be difficult. So instead of trying to market-time the best entry point for a single allocation, an investor may find it beneficial to implement and persistently adhere to a commitment pacing program — for example committing 25% of target each year, on average.

The ongoing nature of funding private investments naturally raises the question of how to best do so while most confidently capturing the enhanced return expectation. We illustrate two approaches in helping frame the decision of whether to fund commitments from risk-control (proxied by investment-grade fixed income) or risk-assets (proxied by global equity) based on Northern Trust capital market assumptions for a 12-year planning horizon (the typical term for a closed-end fund):

4 See "A Benchmark for Efficient Asset Allocation," Northern Trust Research Article (2017)

EXHIBIT 2 – EXPECTED RETURN BASED ON FUNDING SOURCE

Fund From	Annual Return	Year 0	Year 12	Realized Return
Risk Control	4.6%	$1,000,000	$2,013,357	6.0%
Risk Assets	6.5%	$1,000,000	$2,316,498	7.3%
Private Investments	9.0%	$1,000,000	$2,810,591	9.0%

Based on Northern Trust's return forecasts and a proprietary pacing model, funding commitments to private investments from risk-control is forecasted to return 6.0% (annualized) while funding from risk-assets is expected to generate a higher return of 7.3%. The highest expected return (9.0%) comes from an established private investment program that is able to "self-fund" commitments from existing funds' distributions.

However, future realized returns will likely differ from single point-estimates. To illustrate reasonable ranges in expected outcomes, we ran Monte Carlo simulations using Northern Trust capital market assumptions of return and risk (standard deviation) while making a simplifying assumption that risk-assets have zero correlation to risk-control while being perfectly correlated to private investments (as a less diversified subcategory of risk-assets):

EXHIBIT 3 – EXPECTED RANGE OF OUTCOMES BASED ON FUNDING SOURCE

			10TH PERCENTILE		90TH PERCENTILE	
Fund from:	Annual Return	Year 0	Year 12	Realized Return	Year 12	Realized Return
Risk Control	4.6%	$1,000,000	$1,785,781	5.0%	$2,260,154	7.0%
Risk Assets	6.5%	$1,000,000	$1,366,368	2.6%	$3,493,296	11.0%
Private Investments	9.0%	$1,000,000	$1,592,451	4.0%	$4,362,461	13.1%

Exhibit 3 shows the 10th and 90th percentile outcomes of a Monte Carlo simulation based on 3,000 trials. The 90th percentile outcomes are fully consistent with Exhibit 2 in that funding from risk-assets results in a higher return (11.0%) than risk-control (7.0%). The 10th percentile outcomes differ with funding from risk-control resulting in a higher return (5.0%) than risk-assets (2.6%), reflecting a wider range in potential outcomes given a higher level of assumed risk for risk-assets than risk-control.

Rational investors understand systematic risk and return are generally related. So in order to maximize the potential return enhancement of private investments, suitable investors must be willing to bear the risk of funding commitments with risk-assets until the private investments program is sufficiently mature to self-fund contributions.

While future commitments are hard-dollar obligations, the preferred funding source (risk-assets) is highly correlated, meaning the target exposure to private investments should generally move in the same direction as its funding source. Furthermore, the appraisal-based nature of private investments typically results in slower movement of asset re-pricing, which can provide additional time to recalibrate a commitment pacing program to private investments. And select hedge funds can provide diversifying sources of return to improve total portfolio efficiency while providing an additional liquidity source within risk-assets as necessary.

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