A SAM Primer on the What, How, and Why of ALTERNATIVE INVESTING

SAM

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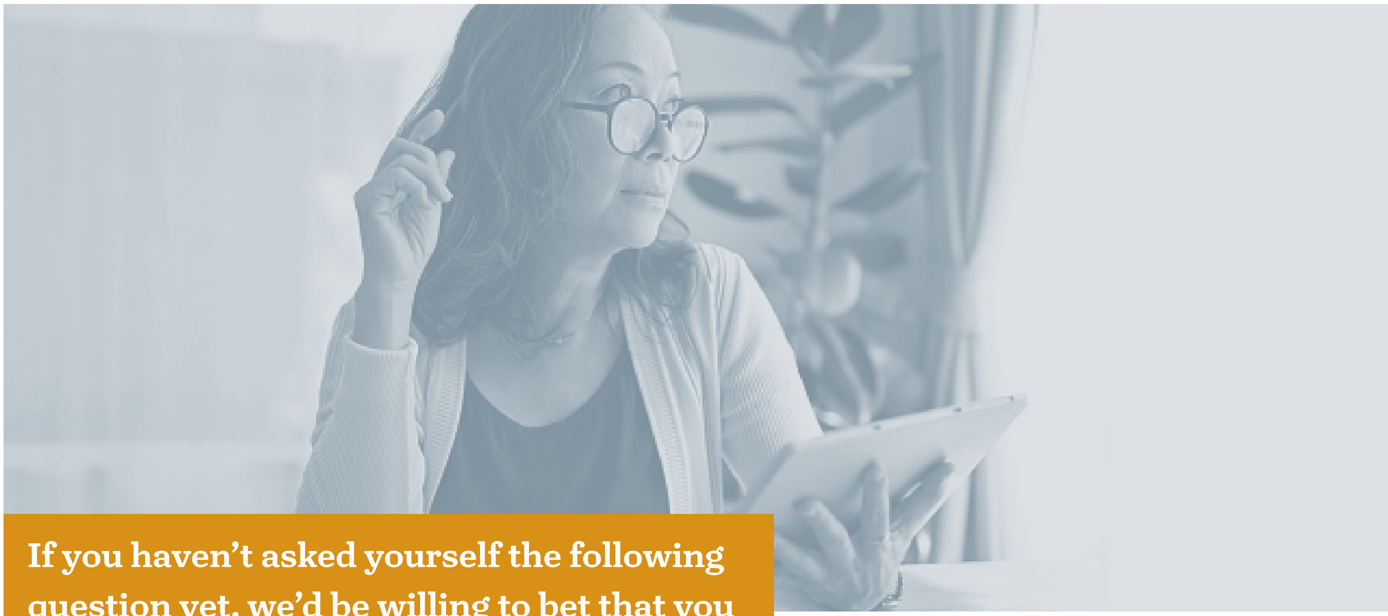

If you haven't asked yourself the following question yet, we'd be willing to bet that you will soon:

Should I Be Invested in Alternative Investments?

After all, alternative investments are one of the fastest growing asset classes around, particularly among individual investors. That's right, alternative investments such as private equity and hedge funds are no longer a secretive "members only" club, suitable only for endowments and other institutional investors. Instead, they are now catching on like wildfire with a broader group of individual investors and families. And this growth is in no small part due to the massive marketing push that alternative investment providers have thrust upon these individuals and, perhaps to an even greater extent, their advisors and brokers.

So, *should* you be invested in alternative investments? The answer – as you might expect – is that it depends... both on you, personally, and on the alternative investment you're considering. For just as each investor varies greatly in terms of his or her investment goals and financial situation, so too do the many types of alternative investments differ.

Still, you probably know enough about some of the potential benefits of alternative investments to be intrigued. Such investments can offer higher returns, enhanced diversification benefits, and access to otherwise off-limits asset classes and markets. But you may have also heard about the potential drawbacks of alternative investments. These typically include higher fees, little-to-no short-term liquidity, and investment mandates that can sometimes be more risky than traditional stocks and bonds.

So before you invest a dollar into any kind of alternative investment, you need to be properly informed. This guide won't get you all the way there given the unique nature of each investment offering. But we think this "What, How, and Why of Alternative Investing" primer provides a great start. (And once you've read it, reach out to SAM here to learn even more.)

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What Exactly Are Alternative Investments?

Just like with publicly traded stocks or bonds, alternative investments (also known as "alternatives" or "alts," as they're often called by institutional investors and Wall Street insiders) come in many different flavors. Below we provide a brief description of each of the main categories of alternatives and will discuss them in more detail later. But broadly speaking, *the easiest way to think of "alternative investments" is that it's a bundled grouping of many different investment assets that are NOT publicly traded stocks and bonds.*

These include:

Private Equity ("PE")

One of the largest and most established forms of alternatives is private equity. As the name suggests, PE involves investing in the equity of privately-held firms. While there are many different forms of private equity, the common goal for nearly all PE investment managers is to proactively work with private companies to add significant value to their businesses over several years. Here are some of the largest and most common styles of private equity:

- **Buyouts or Leveraged Buyouts ("LBOs")**
  This form of PE involves buying and taking control of an entire business so that the PE firm can manage all functions of a company to most efficiently effect change in the business. Oftentimes, the PE manager will utilize significant levels of debt to buy the business and increase returns, which is why these types of investments tend to be called *leveraged* buyouts.

- **Venture Capital ("VC")**
  Venture capital investing involves providing capital to early-stage private companies, including true startup ventures. Venture capital investors tend to back management teams they believe will harness secular trends in innovation or address a large, unmet need in the economy and create a rapidly growing and, ultimately, highly valuable company. Failure rates of VC-backed companies tend to be much higher than other forms of PE, but successful companies often create tremendous value for investors.

- **Growth Equity**
  This is a bit of a catchall grouping of PE investments that are not take-control buyouts or early-stage VC investments. But the goal of growth equity investors is still the same: to work with private companies to improve growth opportunities and optimize operational and financial efficiencies to create value and fuel growth over the longer term.

Private Credit

Private credit is an umbrella term for many different kinds of loans and fixed income instruments that are neither publicly traded bonds nor loans originated by traditional banks. Private credit lenders provide capital to companies (private or public) in a direct and privately-negotiated and -structured offering. Private credit funds invest across the debt capital structure, from convertibles and mezzanine debt to specialty financing and senior lending. And while there are exceptions, one major benefit to most private credit instruments is that they tend to structure interest payments on a "floating rate" basis, meaning that private credit investors are more insulated from changes in prevailing market lending rates than fixed rate public debt investors.

Hedge Funds

Like PE or private credit, hedge fund investment strategies also come in all shapes and sizes. Some are focused on large, "top-down" macroeconomic investment factors such as changes in interest rates or global currency values. Others are focused on more "bottom-up" investing, often trying to find relative value in one asset as compared with another. An example of this is a "long-short" hedge fund that will, for instance, invest in (or go long) companies in a particular sector that it believes will be winners and then bet against (or sell short) companies in the same sector that it believes will be losers, trying to make money on both sides.

Finally, there are also hedge funds that combine many distinct and unique strategies together, offering a "multi-strategy" approach that in theory should provide a diversified and differentiated return profile. While the differences between hedge funds are many, two themes tend to unite this asset class. First, investors in hedge funds generally use these instruments to improve the risk-adjusted return profile of their overall portfolio. Oftentimes this means they want to protect or "hedge" their investments from a certain type of risk factor (which is how the asset class got its name). Second, hedge funds tend to utilize very unique or sophisticated strategies that are hard to replicate elsewhere.

Private Real Estate

Private real estate within alternatives generally refers to investments in privately-held property or real estate assets. This spans a wide spectrum, from owning and renting out a house or small strip mall, to buying farmland or timberlands, and all the way up to investing with real estate developers that build large commercial offices and apartment building complexes. Two additional things to note: First, while many private property investments are structured as real estate investment trusts (or "REITs"), these are distinct and different from publicly-traded REITs. Second, while most investors think of private real estate investments as solely equity investments, there are alternative investments within real estate that are credit-oriented, including construction or bridge financing, mezzanine lending, and distressed real estate investing.

Precious Metals

Perhaps the most familiar alternative investment among individual investors is an allocation to precious metals. The most common investments in this category are gold and silver, but many investors also invest in others such as platinum, palladium, and even precious gemstones like diamonds. We'd also note that other hard assets such as scarce commodities and rare earth materials are becoming more popular among alternative investors.

Crypto Assets

Crypto assets such as Bitcoin and Ethereum represent a newer form of alternative investments. While individual investors can invest in these on their own, many alternative investment funds are looking to provide opportunities to invest in cryptos that purport to have added benefits such as access to early stage investing (i.e. VC investing in crypto startups) or broader diversification. As you likely have seen, volatility in this asset class has been extremely high, and we at SAM do not currently think an allocation to cryptos is suitable for many investors.

Niche Alternatives

Additionally, there are myriad other types of investing and collecting that can be considered alts. Primarily this refers to many collectible assets that tend to appreciate in value given increasing demand relative to scarce supply. Examples include art, fine wines, sports memorabilia, and vintage cars.

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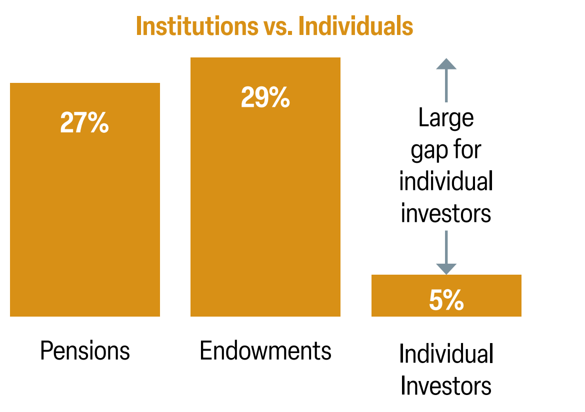
Potential Benefits

For decades, institutional investors such as pension funds and university endowments have been increasing their allocations to alternative investments. As a result, such institutions now have a much larger percentage of their total capital in alternatives as compared to individual investors.

Given how sophisticated these institutional investors tend to be as capital allocators, it seems reasonable to conclude that there must be some good reasons as to why they're flocking to alternatives. And in this case, we agree with that conclusion.

Benefits of alternative investments include:

Average Allocation to Alternatives

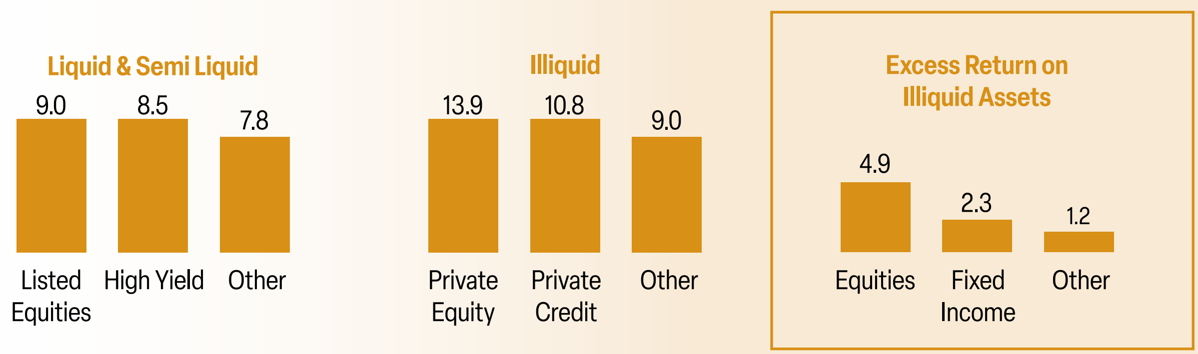


Source: *Global Pension Assets Study 2016, Wills Towers Watson, National Association of College and University Business Officers 2016 Study (Equal-weighted Average), Money Management Institute, "Distribution of Alternative Investments through Wirehouses", 2016*

Higher Returns

The most commonly cited benefit of adding alternative investments to your portfolio is that they generate higher overall returns than publicly traded investments. In many cases, this is true. In fact, in a study done by Cambridge Associates on returns from 1988 through 2017, both private equity and private credits assets outperformed their publicly-traded counterparts by more than 2 percentage points per year over the period.

Average Arithmetic Returns (%)



*Past performance is no guarantee of future results. Liquid = Hedge Funds and Commodity Futures, Swaps, Notes. Illiquid Other = Real Estate and Infrastructure. data for 4Q88-4Q17 except Infrastructure as 4Q98 is the first quarter with data for 10 or more funds, and HFRI Fund Weighed Composite as data starts in 1Q90. 4Q88 is the first quarter with data for 10 or more Private Credit funds.
Source: Bloomberg, Cambridge Associates, KKR Global Macro & Asset Allocation Analysis

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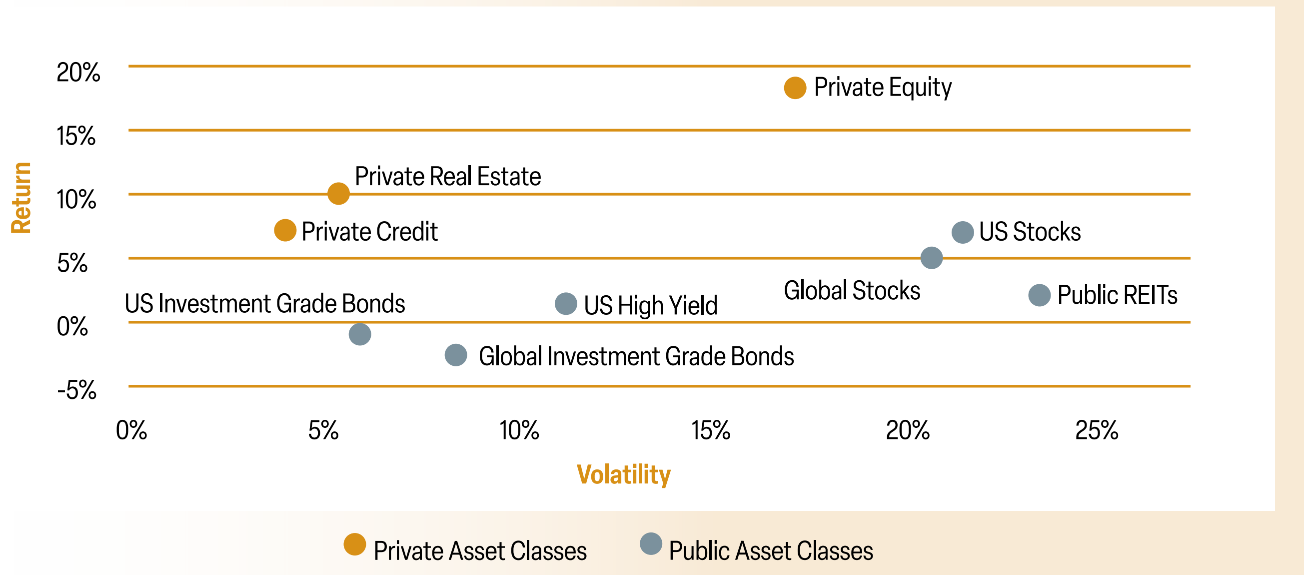
Stepping back, these higher potential returns for investing in private assets make sense given that investors are giving up the ability to freely trade in and out of assets the way you can in public markets. After all, if two assets produced the same level of returns and were otherwise equal other than one was liquid and the other illiquid, nearly all investors would choose the liquid option. This dynamic is called an “illiquidity premium” that alts and private assets generally must provide in order to compete with liquid investment options.

Better Risk-Adjusted Returns

Increasingly, what investors in alternatives are looking for is not necessarily higher absolute returns, but rather returns that are greater *relative* to the risk they’re taking. To measure risk, many investors look at the average annual volatility of an assets’ returns over time, and then compare that with average annual returns. Investment grade corporate bonds, for example, tend to have lower returns than US stocks. But they also tend to have much lower volatility in their return profiles.

The same is true for alternative investments, and actually the volatility tends to be much lower for private investments. As such, allocators to alternatives reason they can reduce the volatility – or risk of loss of capital – in their overall portfolio by increasing their allocation to private investments.

Risk Returns of Select Asset Classes

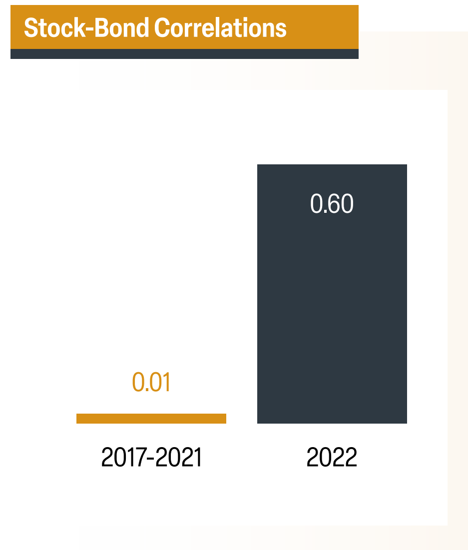


Source: Morningstar Direct for the 5-year period ending 9/30/2022

Greater Diversification

In general, publicly traded stocks and bonds have been regarded as the core building blocks of a diversified portfolio, often split 60% and 40%, respectively. This mix is intended to capture the growth upside of stocks and the yield and price stability of fixed income. Yet as you know, the average 60/40 portfolio had one of its worst years in recent history in 2022, with stocks and bonds highly correlated to the downside.

Alternative investments, on the other hand, have historically demonstrated considerable value to an overall portfolio by diversifying risks and mitigating volatility under different types of market stress. Private real estate, for example, has historically shown itself to be an effective hedge against inflation. Unlike traditional fixed income, which generates fixed cash flows, income from real estate can rise over time as rents rise. The same can be true of most private credit investments which tend to have floating rates of interest that rise when inflation and prevailing interest rates rise.



Source: Morningstar, as of 12/31/2022. Stock-bond correlation represents the average trailing 12-month correlations over the indicated periods. Stocks are represented by the S&P 500 Index. Bonds are represented by Bloomberg US Aggregate Bond index

Private equity can also provide diversification not typically available through most publicly listed securities. PE managers add value to their portfolio companies over several years and need not be as concerned about short-term gyrations in market sentiment or price. This long-term focus can enable PE managers and their companies to take advantage of secular trends and burgeoning sectors or themes that may be deemed too difficult or early-stage for public markets. But adding these longer duration investments may provide additional diversification and lower volatility compared to owning just public investments alone.

Access to Exclusive Investment Opportunities

Access to highly sought-after companies and investment managers is another significant benefit of investing in private equity or credit. For instance, anyone with a brokerage account can buy shares of Apple (AAPL) today. But prior to Apple's IPO, Apple management essentially had full discretion over who could become a shareholder. They could give employees shares if they wanted to reward them, or they could sell shares to a PE firm if they needed capital. But a third party couldn't simply *decide* to invest.

The same is true today, and often the most exciting private firms receive far more dollars' worth of interest from investors than they would want to raise to fund their business. This is why the biggest and best up-and-coming privately-held firms are exceedingly difficult to access regardless of who you are. Many PE firms spend years jockeying for position in advance of any potential fundraising opportunities, all in the hope that when the company is looking to fundraise they'll give some of the allocation to their fund. So for most investors, the only way to access these world-class companies is through alternative investment managers.

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Potential Drawbacks

As with most things in life, there's no "free lunch" when investing in alternatives. So before investing in alts, it's important to understand the potential drawbacks and downside risks as well.

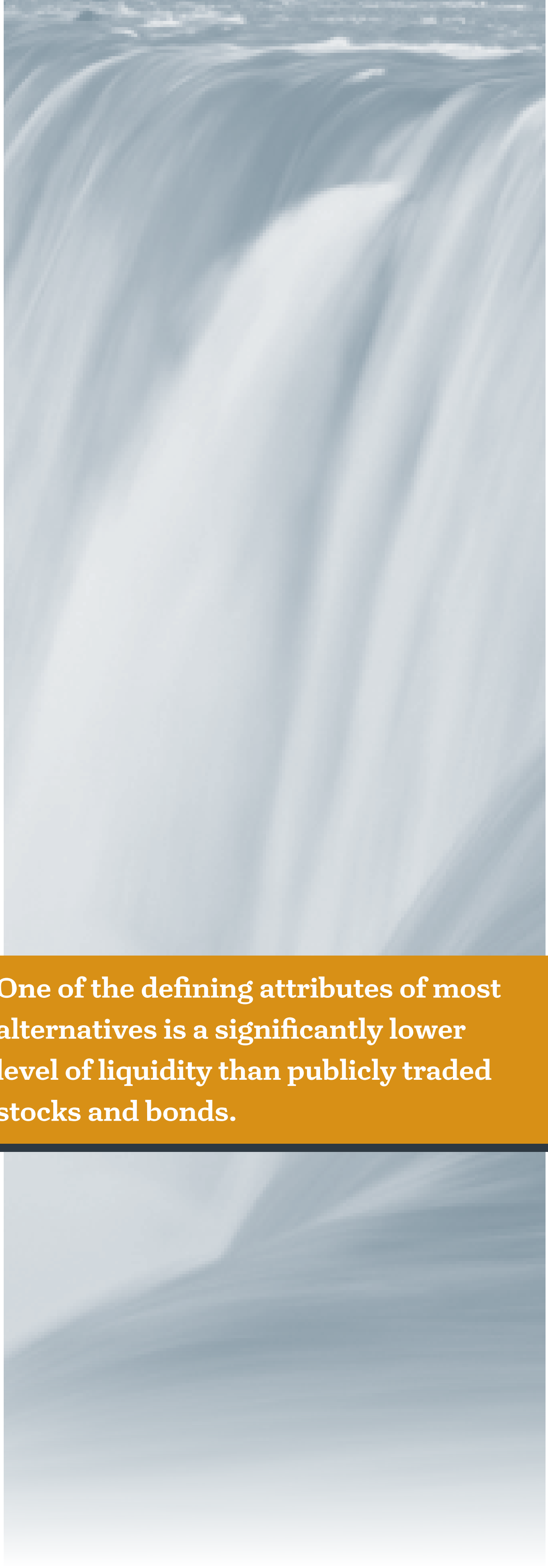
Liquidity (or Lack Thereof)

One of the defining attributes of most alternatives is a significantly lower level of liquidity than publicly traded stocks and bonds. And in many cases, this can mean no liquidity for investors for *years*, let alone months. In general, most firms raising capital to invest in alternatives require their investors to agree to a "lock-up period," or a set amount of time that the investors agree to not take their money out of the fund. This can range from a year all the way up to 10 years or more.

With that said, some alternatives do offer monthly, quarterly, or annual opportunities for partial liquidity, particularly those skewed more towards income generation than capital appreciation. For instance, a private credit manager may offer its investors the opportunity to redeem a portion of their investment each quarter, though typically capping the aggregate amount of redemptions at 5% or 10% of the fund's total assets.

Opacity

Another drawback of alternatives investing is known as "blind pool risk." This refers to the fact that when investing into a manager's fund as a limited partner ("LP"), you generally don't know what the manager is investing in, nor do you retain any control over your investment. The fund manager may explain the types of investments they're looking for or may even have some investments lined up before they raise capital, but in essence the LP is "blind" as to where their capital will end up.



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Less Regulated

Unlike publicly-traded companies, private companies aren't required to file financials that are easily accessible. While the general partner ("GP") may have access to all sorts of data on a private company they've invested in, generally the LP investors will not receive this privilege. Additionally, valuation of a private company is much murkier and much more subjective than with publicly-traded firms (as private companies don't see their stock traded day-to-day). This means LPs are virtually wholly reliant on the GP's subjective opinion of their asset values.

Higher Fees

Generally speaking, alternatives managers tend to charge higher fees to their investors than public market managers. The most well-known example of this is the traditional "2 and 20" fee structure. This refers to a 2% management fee on invested assets, plus a 20% "performance fee" share of fund profits. Some funds may be higher or lower on either piece of the "2 and 20," but the end result still tends to be a more onerous fee structure than a traditional wealth manager or registered investment advisor ("RIA").

Delayed Investment Deployment

For some types of alternatives, a final potential drawback is the pace at which the alternatives manager deploys capital. This is particularly true in private equity and private real estate funds with longer lockup periods. These funds are often called "drawdown" funds because while they request full commitment of capital on day one, the funds will be invested, or drawn down, over time, often years. This can leave some investors with large sums of committed but uninvested capital.

This dynamic can be fine for institutional investors with longer investment horizons and the tendency to be invested in many different alts (some of which may be in the capital deployment phase while others are in the capital return phase), but it's often a significant negative for individual investors.

Who *Can* Invest in Alternatives?

When it comes to the less institutionalized categories of alts, such as cryptos, gold, rare wines, and classic cars, just about anyone can invest, as you'd expect. However, when talking about those alts that were historically focused more on institutional investors, there are restrictions. Generally speaking, the intention of the restrictions and regulations is to protect less sophisticated and less informed investors from products that can have significant risks associated with them. So the government's restrictions fall into two categories: 1) you must be knowledgeable enough to invest in these products or 2) you must be wealthy enough that you should know what you're doing (or at least be able to better absorb a painful loss).

Specifically, these institutional grade alternative investments have three levels of accreditation:

Accredited Investor

Investors are considered accredited investors if they have an annual income of at least $200k (individual) or $300k (couple) for each of past two years and the expectation of earning at least as much in the current year. Or, they can meet that threshold by owning at least $1mm of investable assets. Finally, if they are in the investment business (and hold a FINRA Series 7, 65 or 82 license in good standing), that also works.

Qualified Client ("QC")

QC is the next most stringent threshold requiring a minimum of $2.2mm of investable assets, or at least $1.1mm invested with a specific advisor looking to make alts investments in his or her account. Investors can also be considered QCs if they are an officer or director of an investment fund manager or an employee who participates in the investment activities of the investment advisor.

Qualified Purchaser ("QP")

The qualified purchaser level of accreditation is the most stringent and one that is typically required to invest in the most sophisticated alts vehicles. As a QP, the government essentially considers you an institutional investor. To meet the QP threshold, an individual investor or a family-owned business must have a net worth of at least $5 million in investments excluding their primary residence. For a family-owned business, the company cannot have been formed for the sole purpose of purchasing a specific fund or other unregulated investment. There are some additional ways to qualify as a QP through trusts and other legal structures, but the main point is that to be considered a QP on your own, you really need to have a substantial net worth.

What if you don't meet the QP threshold? Are those institutional investments simply off limits? In some cases, yes, but there are ways to pool capital from multiple accredited investors to meet the QP threshold, provided that the structure is properly diversified and not solely created just to invest in one alternative investment. SAM is currently exploring ways to do this in a prudent manner and will provide more details if and when we conclude this is in the best interest of our clients.

If you'd like to be notified about future opportunities, contact us here.

Who *Should* Invest in Alternatives?

In our view, who *should* invest in alts is a more interesting question than who can, but that's partly because there's no one-size-fits-all answer. Here are a few types of investors that should consider an allocation to alternative investments (we're thinking specifically about the more institutional forms of alts here):

- **You have a long-term investment horizon for at least part of your capital.** Alts are generally illiquid and will require years, not months or even quarters to pay off. You need to be content with investing part of your capital for the long haul.
- **You have at least $1 million in net worth.** While we're not fans of all government regulation, in this case, we think they got it right. Investing in alts is a big commitment and you need to be of a certain level of means to be able to meet that commitment without taking on outsized personal risk.
- **You are looking for new ways to diversify your investment portfolio.** Alternative investments generally charge higher fees, so in our view, that's only justified when they provide access to assets and strategies that you can't otherwise get with publicly-traded assets or at lower fees.
- **You understand the risks up front and *still* want to invest in alternatives.** As we said, there are no free lunches. Alternative investments have some downsides. But once you are comfortable with those, the upside potential – including the ability to greatly improve your *risk-adjusted* returns – that alts provide is tremendous.

Who *should* invest in alts is a more interesting question than who can, but that's partly because there's no one-size-fits-all answer.

Other Factors to Consider

We've thrown a lot at you already and you are well on your way to becoming a more informed potential alternatives investor. But there a few more things we'd like you to consider...

How much should I invest?

That answer will of course vary for every person depending on your own unique financial situation. We highly recommend you consult with a financial advisor who is a fiduciary to help you answer that question. With that said, here are two guidelines. First, we do not think that you should allocate all of your investment capital to alternatives or even, in most cases, more than half your capital. Alts should be a supplement to what you do in the public markets, not a replacement. Liquidity is an incredibly valuable feature that you don't want to wholly give up. But with that said, we also think that alts investing should be a meaningful part of your investment portfolio if you are to go through the added complexity of doing it at all. As such, a rough guideline is that we're generally comfortable with a 10% to 40% allocation to alternative investments, with no one investment being more than 10% or 15%. But again, these are just rough guidelines.

How does the increase in interest rates impact alternatives?

Broadly speaking, we believe higher interest rates will have a significant impact on alternative investments. Whether it's a positive or negative impact depends on the type of alts we're talking about. In general, many forms of private equity investing and private real estate investing will likely do worse with higher rates. That's because these strategies have historically produced a significant portion of their returns for investors by being able to finance purchases with high levels of low-cost debt. In the current environment, higher loan-to-value levels of borrowing and cheaper debt rates just aren't available. So it stands to reason that this will impair future returns that relied upon them.

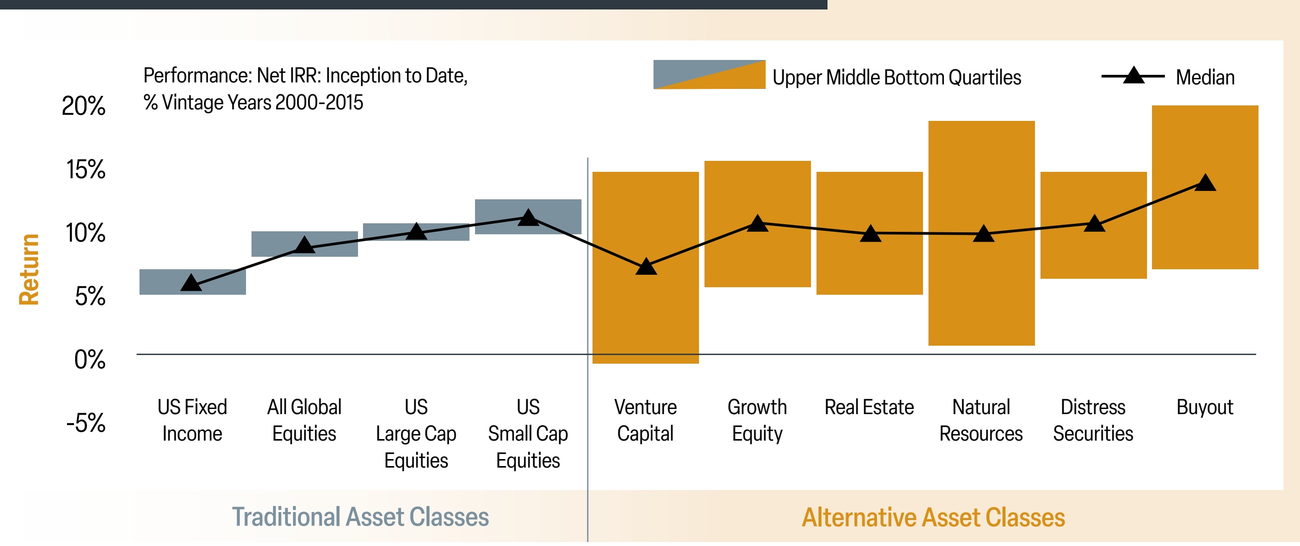
On the flip side, higher rates mean that now is a good time to be a *lender*. So, we do think the prospects for certain types of private credit are very favorable currently. Why, exactly? Well, here are four reasons. First, as we mentioned before, most private credit loans are floating rate, so the yields private debt lenders are able to realize are much higher now than in a low-rate environment. Second, when rates are rising, traditional lenders (e.g. banks and other financial institutions) tend to pull back on their lending volumes. So companies that otherwise might turn to a bank for capital are forced to seek funding from alternate sources. Third, bank lending pull-backs not only lead to private lenders seeing more opportunities to lend money but also generally provide them greater negotiating power. So they can either increase the credit-worthiness of their average borrower or improve their average terms and yields. (Reasons two and three are especially relevant today as traditional banks have tightened even more than normal following the Silicon Valley Bank collapse.)

And finally, when rates are high, valuation multiples in both the public and private markets tend to decline. As a result, many private companies will choose to push off fundraising as long as possible/ necessary to avoid onerous terms or decreased valuations from investors, increasing the pool of demand for lending even further. In other words, if I'm a CEO of a venture capital-backed company that raised money at a $100 million valuation two years ago (when VC valuations were much higher for startups), I'd much rather take on some debt to fund growth for a couple of years and hope that valuations improve than raise costly equity today at a valuation of say $30 million.

How much does manager selection matter?

This is probably the most important aspect of investing in alternatives that often gets overlooked. Selecting the right alternative investment manager matters… A LOT. In fact, selecting the right investment manager is often more important to private investments than it is to public investments. As you can see in the chart below, the difference between the top quartile (or top 25%) and the bottom quartiles (or bottom 25%) of investment managers in the private markets is much greater than the difference in the public markets.

Manager Selection Matters, Particularly in Alternative Asset Classes



Data as of 3Q2017. Data for alternative investments based on the avergae since-inception-IRR for vintage years 2000-2015 from Cambridge Associates. Data for traditional asset classes based on CAGR for the time periods 2000-3Q17, etc. through 2010-3Q16 from eVestment Alliance database to match the alternative asset class time frame. Source: Cambridge Associates, eVestment

That's why it pays to pick the right alts manager. Or better yet, partner with an allocator who can perform due diligence on investment managers and pick a diversified group of the best ones.

Conclusion

Alternative investments are a growing and exciting part of the investment landscape. And increasingly, they are becoming more available to individual investors. That is good news for investors who are seeking the potential for higher risk-adjusted returns and the benefits of diversifying their portfolios into investments that may otherwise be off limits... provided that those investors also understand the potential risks and limitations associated with such investments.

For those who do, allocating to asset classes such as private equity, hedge funds, private real estate, and private credit can reshape risks and returns of investment portfolios. Incorporating alternative investments can ultimately lead to more favorable long-term outcomes and get investors closer to successfully achieving their financial goals.

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Interested in Learning More?

A SAM colleague would be more than happy to walk you through how we help clients achieve their long term financial goals every day.

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As Chief Investment Officer, Austin is responsible for the development and management of investment strategies across all SAM portfolios. Prior to joining SAM, Austin was the Director of Research at Stansberry Research and the portfolio manager for the company's flagship portfolio products, Stansberry Portfolio Solutions.

Austin co-founded and ran North Oak Capital, a New York-based hedge fund that received a strategic investment from Julian Robertson and Tiger Management. He also held senior investment positions at SAC Capital Advisors and Soros Fund Management. Austin began his career at the Blackstone Group.

Austin has experience investing across asset classes, including public equities, derivatives, venture capital, private equity, real estate, and fixed-income securities.

He earned an MBA from Stanford Graduate School of Business, and a BS in Commerce from the University of Virginia. Austin lives in Maryland with his wife and three children.

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Prior to joining SAM, Jacob was an Analyst at Stansberry Research, primarily specializing in small and mid-cap growth opportunities and contributing to a range of products including Stansberry Venture Value and Stansberry's Investment Advisory. He was previously an Analyst with the Special Situations & Risk Arbitrage group at Berenberg Capital Markets. Jacob holds a BS in Management and a Master of Finance degree, both from the A.B. Freeman School of Business at Tulane University.

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